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7 November 2003

Peter Clark
Senior Project Manager
International Accounting Standards Board
30 Cannon Street, London EC4M 6XH, United Kingdom

Dear Mr Clark:

**ED5 Insurance Contracts**

The global organisation of Ernst & Young is pleased to comment on the Exposure Draft ED5, Insurance Contracts.

The lack of an IFRS on accounting for insurance contracts has been a significant impediment to the international comparability of IFRS financial statements and we therefore strongly support the development of an IFRS for insurance contracts. Whilst we understand the reasons behind the IASB's phased approach to the development of an insurance IFRS, we believe that ED5, while representing a pragmatic outcome for phase 1, will only provide a limited improvement in the comparability of financial statements. It is therefore imperative that the phase 2 standard is developed to be applicable for 2007 in line with the current IASB timetable.

In the Attachment to this letter, we respond to the specific questions raised by the Board in the Invitations to Comment. While broadly supportive of the objectives of ED5, in certain key areas we do not agree with the approach proposed in the Exposure Draft. We have summarised the key issues below.

- We believe the guidance in Appendix B on the definition of an insurance contract and, in particular, significant insurance risk is ambiguous and internally inconsistent. This may lead to differences in interpretation and hence reduce comparability. In our response to question 2, we have suggested improvements to the guidance in Appendix B to resolve this problem.

- We do not believe that embedded derivatives should be separated in phase 1.

- We do not believe that accounting standards should have expiry dates and therefore we do not consider it appropriate that ED5 should specify a time limit for exemption from IAS 8.

- While we agree with the disclosure principles set out in paragraphs 26 to 29, we are concerned that the disclosures suggested in the Implementation Guidance may become voluminous without improving comparability. We recommend that the Board consider whether it would be more appropriate to specify certain quantitative disclosures in the ED and provide more specific examples of the intended disclosures in the Implementation Guidance.

- We do not consider the disclosure of fair values of insurance liabilities (paragraph 30) in 2006 to be reasonable, given the current state of the phase 2 standard. Companies should not be asked to provide disclosures when the basis on which fair values are to be determined has yet to be confirmed.

- The loss recognition requirements will be much more onerous for companies whose local GAAP does not contain a loss recognition test than in most jurisdictions where such a test is already required. We suggest that where there is no loss recognition test, companies should be allowed to follow the same approach as used by companies where such a test is already required.

- We are concerned at the direction being taken by the Board towards fair value in phase 2. The principles that have been proposed for the phase 2 standard do not appear to be consistent with those already existing in IAS 39.

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We would be pleased to discuss our views with the IASB or board of staff at its convenience.
Please contact David Lindsell at 0207 951 4463.

Yours very truly,

Ernst & Young

## Question 1 – Scope

***(a) The Exposure Draft proposes that the IFRS would apply to insurance contracts (including reinsurance contracts) that an entity issues and to reinsurance contracts that it holds, except for specified contracts covered by other IFRSs. The IFRS would not apply to accounting by policyholders (paragraphs 2-4 of the draft IFRS and paragraphs BC40-BC51 of the Basis for Conclusions). The Exposure Draft proposes that the IFRS would not apply to other assets and liabilities of an entity that issues insurance contracts. In particular, it would not apply to:***

***(i) assets held to back insurance contracts (paragraphs BC9 and BC109-BC114). These assets are covered by existing IFRSs, for example, IAS 39 Financial Instruments: Recognition and Measurement and IAS 40 Investment Property.***

***(ii) financial instruments that are not insurance contracts but are issued by an entity that also issues insurance contracts (paragraphs BC115-BC117).***

***Is this scope appropriate? If not, what changes would you suggest, and why?***

We agree with the scope with one exception. Currently, IAS 39 exempts from its' scope all rights and obligations under insurance contracts. The draft IFRS proposes to amend IAS 39 to exempt insurance contracts covered by the IFRS. However, ED5 proposes that the standard on insurance contracts would not apply to policyholders. Therefore, it appears that policyholders need to apply IAS 39 when accounting for insurance contracts that they hold. We do not believe this was the intention of the Board; rather we understood that policyholders were to be allowed to continue to account for insurance contracts under their existing policies. This view is supported by paragraph BC 51 in the Basis for Conclusions. We therefore recommend that the draft IFRS be modified so that policyholders are not indirectly scoped into IAS 39.

While we agree that the IFRS should not specifically apply to assets held to back insurance contracts, this will lead to potential mismatches between assets and liabilities under phase 1, reflecting limitations in the approach to liability measurement in many GAAPs. Although it may be possible to reduce some mismatches by changing the accounting policy for liabilities to a more relevant and reliable policy as defined in paragraphs 14 and 15, it may be difficult to determine such a policy in practice and demonstrate that it is more relevant and reliable. Making such a change could also be argued to be contrary to the spirit of ED5, which is to make as few changes to liability valuations as possible until phase 2. We recommend that the Board provide additional guidance on this matter, indicating the types of changes that would be acceptable in phase 1.

***(b) The Exposure Draft proposes that weather derivatives should be brought within the scope of IAS 39 unless they meet the proposed definition of an insurance contract (paragraph C3 of Appendix C of the draft IFRS).***

***Would this be appropriate? If not, why not?***

The inclusion in the scope of IAS 39 of weather derivatives that do not meet the proposed definition of insurance contracts is appropriate.

## Question 2 – Definition of insurance contract

***The draft IFRS defines an insurance contract as a 'contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder or other beneficiary if a specified uncertain future event (the insured event) adversely affects the policyholder or other beneficiary' (Appendices A and B of the draft IFRS, paragraphs BC10-BC39 of the Basis for Conclusions and IG Example 1 in the draft Implementation Guidance).***

***Is this definition, with the related guidance in Appendix B of the draft IFRS and IG Example 1, appropriate? If not, what changes would you suggest, and why?***

Whilst we agree in principle with the definition that is included in Appendix A, *Defined terms,* and the related guidance in Appendix B, *Definition of an insurance contract*, the requirement for significant insurance risk will be difficult to apply without clearer guidance on how to determine when insurance risk is significant.

Paragraph B21 states, "Insurance risk is significant if, and only if, it is plausible that the insurance event will cause a significant adverse change in the present value of the insurer's net cash flows…." and then states that "the condition is met if the insured event is extremely unlikely". However, paragraph B22 states that insurance risk is not significant if the insured event would cause trivial changes in the present value of the insurer's cash flows in all plausible scenarios.

We believe the Board intended a plausible event to mean an event that has a reasonable possibility of occurrence. However, it is not clear how an extremely unlikely event would meet this condition. Including both 'plausible' and 'extremely unlikely' in paragraph B21 is confusing and will result in most, if not all, contracts being deemed insurance even if the exposure is incidental to the contract.

We believe that the Board's reference to extremely unlikely was an attempt to scope "true" insurance contracts that have a very low probability of an insured event actually occurring into the definition of insurance contracts. We would define a "true" insurance contract as a contract where one party (the policyholder) exchanges a fixed amount (the premium) in return for an amount (insurance coverage), based on an insured event. We consider that this view of "true" insurance is consistent with the unbundling example in the Implementation Guidance, because when an insurance contract has both deposit and insurance components, the unbundling example requires the insurer to separate the amount that supports the insurance component from the deposit component. The unbundling accounting effectively creates a fixed premium for the insurance component. The remaining cash flows of the contract are associated with the deposit component. The result of the unbundling accounting is to only use insurance accounting for the fixed premium insurance component. We therefore believe that the unbundling accounting is a mechanism to identify the "true" insurance component embedded in the contract and the definition of an insurance contract should make it clear that these contracts when not embedded in a larger contract meet the significant insurance risk criteria.

Accordingly, we recommend that the Board change the guidance in Appendix B to clarify how to determine if significant risk is present in an insurance contract. We suggest the following changes (changes in italics) to paragraphs B21 to B23 of the Implementation Guidance.

**Significant Insurance Risk**

B21 Insurance risk is significant if it is *reasonably possible* that an insured event will cause a *non-trivial* adverse change in the present value of the insurer's net cash flows arising from that contract (before considering possible reinsurance recoveries, because the insurer accounts for these separately). *An insurance contract can satisfy the condition that significant insurance risk is present when one party (the policyholder) exchanges a fixed amount (the premium) in return for reimbursement of defined losses (insurance coverage) based on an uncertain insured event."*

B22 Insurance risk is not significant if the *exposure to the insured event is trivial*. An insurer shall assess the significance of insurance risk contract by contract, rather than by reference to materiality to the financial statements. Thus, insurance risk may be significant even if there is a minimal probability of material losses for a whole book of contracts.

B23 It follows that if a contract pays a death benefit exceeding the amount payable on surrender or maturity, the contract is an insurance contract unless the additional death benefit is insignificant (i.e., trivial, judged by reference to the contract rather than to an entire book of contracts) *or if it applies only for a short portion of the term of the contract.* Similarly, an annuity contract that pays out regular sums for the rest of a policyholder's life is an insurance contract, unless the aggregate life-contingent payments are insignificant *or unless the payment depends on the election of an option when the realistic expectation is that the rate of election will be very low.*

## Question 3 – Embedded derivatives

***(a) IAS 39 Financial Instruments: Recognition and Measurement requires an entity to separate some embedded derivatives from their host contract, measure them at fair value and include changes in their fair value in profit or loss. This requirement would continue to apply to a derivative embedded in an insurance contract, unless the embedded derivative:***

***(i) meets the definition of an insurance contract within the scope of the draft IFRS; or***

***(ii) is an option to surrender an insurance contract for a fixed amount (or for an amount based on a fixed amount and an interest rate).***

***However, an insurer would still be required to separate, and measure at fair value:***

***(i) a put option or cash surrender option embedded in an insurance contract if the surrender value varies in response to the change in an equity or commodity price or index; and***

***(ii) an option to surrender a financial instrument that is not an insurance contract. (paragraphs 5 and 6 of the draft IFRS, paragraphs BC37 and BC118-BC123 of the Basis for Conclusions and IG Example 2 in the draft Implementation Guidance)***

***Are the proposed exemptions from the requirements in IAS 39 for some embedded derivatives appropriate? If not, what changes should be made, and why?***

While options and guarantees are common in insurance contracts, many of these options and guarantees do not meet the IAS 39 definition of derivatives and hence would not require a fair-value accounting treatment. We believe that the proposed requirement for separation of embedded derivatives is burdensome and places undue emphasis on only a few of the many options and guarantees in insurance contracts, others of which are likely to be of greater significance to cash flows. The requirement to perform a loss recognition test should require companies to recognise liabilities for options and guarantees where appropriate. This would mean that there would be no need to separate embedded derivatives, as all liabilities would be recognised.

Furthermore, the requirement to separate embedded derivatives from an insurance contract in phase 1 may only be a temporary accounting change if the Board adopts a fair value approach in phase 2 as currently proposed.

We therefore recommend that the requirement for separation of embedded derivatives be modified such that separation is not required.

If the Board decides to retain the requirement for separation of embedded derivatives, we recommend that the Board revise the guidance included in the Implementation Guidance ("IG") to eliminate reference to options that are not derivatives. Referring to the items in IG Example 2, we offer comments below to distinguish options from derivatives.

- *Option to take a life-contingent annuity at a guaranteed rate*

This is not an embedded derivative. The rates are fixed in the contract. This option to purchase an annuity at the fixed rates is more valuable when interest rates are low than when interest rates are high, but if offered separately (the test in IAS 39, paragraph 23) its price would not depend on a specified variable, or underlying, but rather on interest rates generally. To be a derivative, the price must depend on the value of a variable specified in the option contract.

- *Embedded guarantee of minimum interest rates in determining surrender or maturity values that is out of the money*

Whether this is a derivative depends on the nature of the entire contract. If the contract value is linked to equities, then the value of the guarantee of a minimum interest rate is an embedded derivative, as its value changes in response to the change in the price of the equities. If the contract is fixed, say the contract value is based on an accumulation of deposits at a variable rate that is totally at the discretion of the issuer, but it cannot be less than a certain rate, then the option to surrender is not an embedded derivative. Its value does not respond to changes in a specified variable.

- *Equity-linked return available on surrender or maturity*

In a typical variable equity-linked contract, the value of the contract is the value of the units, which are the contract's share of an investment portfolio. While the value derives from the investments, the purchase of units is tantamount to the purchase of the underlying investments, and hence the price of units is not small as compared to the price of the investments. The value of the option to surrender does not change in relation to the change in price of the underlying investments, and it should not be considered an embedded derivative.

***(b) Among the embedded derivatives excluded by this approach from the scope of IAS 39 are items that transfer significant insurance risk but that many regard as predominantly financial (such as the guaranteed life-contingent annuity options and guaranteed minimum death benefits described in paragraph BC123 of the Basis for Conclusions).***

***Is it appropriate to exempt these embedded derivatives from fair value measurement in phase I of this project? If not, why not? How would you define the embedded derivatives that should be subject to fair value measurement in phase I?***

We agree with the exemption of these embedded derivatives.

***(c) The draft IFRS proposes specific disclosures about the embedded derivatives described in question 3(b) (paragraph 29(e) of the draft IFRS and paragraphs IG54-IG58 of the draft Implementation Guidance).***

***Are these proposed disclosures adequate? If not, what changes would you suggest, and why?***

We agree with the disclosure requirements.

***(d) Should any other embedded derivatives be exempted from the requirements in IAS 39? If so, which ones and why?***

As we have stated, we believe that all embedded derivatives in insurance contracts should be exempted from the requirements in IAS 39 during phase 1.

## Question 4 – Temporary exclusion from criteria in IAS 8

***(a) Paragraphs 5 and 6 of [the May 2002 Exposure Draft of improvements to] IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors specify criteria for an entity to use in developing an accounting policy for an item if no IFRS applies specifically to that item. However, for accounting periods beginning before 1 January 2007, the proposals in the draft IFRS on insurance contracts would exempt an insurer from applying those criteria to most aspects of its existing accounting policies for:***

***(i) insurance contracts (including reinsurance contracts) that it issues; and***

***(ii) reinsurance contracts that it holds. (paragraph 9 of the draft IFRS and paragraphs BC52-BC58 of the Basis for Conclusions)***

***Is it appropriate to grant this exemption from the criteria in paragraphs 5 and 6 of [draft] IAS 8? If not, what changes would you suggest and why?***

We agree with the exemption from paragraphs 5 and 6 of [draft] IAS 8. However, we do not believe that accounting standards or parts thereof should have an expiry date. If the Board is unable to complete phase 2 in line with their proposed timetable, we believe their only practical option will be to extend the exemption date in ED5. That decision should be made at the appropriate time, rather than forced by the inclusion of such a "sunset clause" in ED5. Accordingly, we do not believe that it is necessary to state in ED5 that the exemption will only be available until 31 December 2006.

***(b) Despite the temporary exemption from the criteria in [draft] IAS 8, the proposals in paragraphs 10-13 of the draft IFRS would:***

***(i) eliminate catastrophe and equalisation provisions.***

***(ii) require a loss recognition test if no such test exists under an insurer's existing accounting policies.***

***(iii) require an insurer to keep insurance liabilities in its balance sheet without offsetting them against related reinsurance assets (paragraphs 10-13 of the draft IFRS and paragraphs BC58-BC75 of the Basis for Conclusions).***

***Are these proposals appropriate? If not, what changes would you propose, and why?***

We agree with (b)(i) and (iii).

We also agree with the requirement for a loss recognition test to be performed. Whilst we agree with the Board's concept that a loss recognition test should be performed as a mechanism to reduce the possibility of losses remaining unrecognised during phase 1, we do not agree that an entity whose existing GAAP accounting does not have a loss recognition test should be required to apply a fair-value based loss recognition test.

The guidance provided in paragraphs 11 and 12 of ED 5 appears to create two different thresholds for evaluating potential future losses when applying the loss recognition test. The first is if an existing accounting policy requires a loss recognition test and that test meets the minimum requirements of the proposed guidance. The second is when the existing accounting policy does not have a loss recognition test. For the latter the entity is required to use the guidance in IAS 37 to determine if a deficiency exists.

Because the guidance in IAS 37 is based on a fair-value estimate of the liability, any existing accounting policy that does not have a loss recognition test will default to a measurement model that can be labeled the higher of fair value or existing accounting policy. This requirement will lead to the recognition of a loss in the current period followed by a gain in future periods because a fair-value liability includes a risk margin. As the liabilities are settled over the expected life of the contracts, the risk margin will be unwound creating a gain as the exposure to risk is reduced. For most insurance loss recognition tests that are included in existing accounting policies, the additional liability that is recognised is an amount that would be necessary to avoid the recognition of a future loss over the remaining life of the underlying contracts without consideration of risk margins. Accordingly, it appears that ED 5 would impose a more stringent loss recognition test on entities whose existing accounting policies do not contain a loss recognition test. We do not believe it is appropriate to have two types of loss recognition tests and, therefore, entities following existing accounting policies without a loss recognition test should be allowed to follow the same loss recognition tests that other entities follow provided those tests meet the minimum requirements of the standard.

The guidance in paragraph 11 does not define "these minimum requirements," (for example, the items that should be included in the future cash flows). We believe that the minimum requirements that have to be met to continue to use the existing loss recognition test should be clearly identified. We recommend the Board should base those minimum requirements on the following:

- All expected future cash flows that will occur between the policyholder and the insurer;
- Anticipation of future investment income; and
- Future operating costs to administer the contract excluding those costs that are fixed in nature (e.g., overhead expenses)

Lastly, the completion of a comprehensive loss recognition test generally is a time consuming process. We are concerned that companies will not be able to perform such tests as required by ED5 at each reporting date. We therefore recommend that only an annual loss recognition test be required unless indicators are present that the liability for the insurance contracts under an existing accounting policy is insufficient to meet the obligations under those insurance contracts.

## Question 5 – Changes in accounting policies

***The draft IFRS:***

***(a) proposes requirements that an insurer must satisfy if it changes its accounting policies for insurance contracts (paragraphs 14-17 of the draft IFRS and paragraphs BC76-BC88 of the Basis for Conclusions).***

***(b) proposes that, when an insurer changes its accounting policies for insurance liabilities, it can reclassify some or all financial assets into the category of financial assets that are measured at fair value, with changes in fair value recognised in profit or loss (paragraph 35 of the draft IFRS).***

***Are these proposals appropriate? If not, what changes would you propose and why?***

We agree with the guidance for changes in accounting policies. We note that paragraph 16(b) states that entities should not change to an accounting policy that uses excessive prudence. However, the Board specifically has stated in paragraph BC 79 of the Basis for Conclusions that phase 1 does not define excessive prudence. To avoid confusion over what may be deemed excessive, we recommend that the guidance be that an entity should not change to an accounting policy that provides more prudence than the existing accounting policy, as long as the liability under the existing accounting policy is sufficient to reflect the obligations arising from the contracts.

## Question 6 – Unbundling

***The draft IFRS proposes that an insurer should unbundle (ie account separately for) deposit components of some insurance contracts, to avoid the omission of assets and liabilities from its balance sheet (paragraphs 7 and 8 of the draft IFRS, paragraphs BC30-BC37 of the Basis for Conclusions and paragraphs IG5 and IG6 of the proposed Implementation Guidance).***

***(a) Is unbundling appropriate and feasible in these cases? If not, what changes would you propose and why?***

***(b) Should unbundling be required in any other cases? If so, when and why?***

***(c) Is it clear when unbundling would be required? If not, what changes should be made to the description of the criteria?***

We agree that existing accounting models that do not require entities to recognise all assets and liabilities relating to insurance contracts should be required to recognise those assets and liabilities in phase 1.

However, we do not understand the guidance provided in the draft IFRS paragraph 7 and the example provided in the Implementation Guidance. Specifically, paragraph 7 gives the impression that the insurance and deposit components, while existing in the same insurance contract, are two independent components. This is clear from the last sentence in paragraph 7 that states “if the cash flows from the insurance component do not effect the cash flows from the deposit component, an insurer….” However, most insurance contracts that have deposit and insurance components contain provisions that will cause the deposit component to be impacted by the cash flows related to the insurance component. Paragraph 7 seems to imply that insurance contracts with profit sharing arrangements are not covered by the unbundling provision, as the deposit component is impacted by the insurance component. But the example provided in the Implementation Guidance (IG3) seems to indicate that a contract with a profit share should be unbundled. The guidance and the example appear contradictory and do not satisfactorily explain the reasons or the extent of the unbundling requirements.

We believe that the Board's intent was to follow an accounting model that is supported by the example and not the guidance provided in paragraph 7 of ED 5. Accordingly, we suggest that paragraph 7 be revised. Specifically, we believe that it is not relevant if the insurance component affects the deposit component. Instead, we believe that if the policyholder will receive a minimum fixed amount of future cash flows in the form of either a return of premium in the case when no loss event occurs or an insurance recovery (or payment to cover an insured event) when a loss event occurs, those future cash flows represent the deposit component and, hence, is a financing arrangement. Any amount paid by the policyholder that is not refundable to the policyholder if an insured event does not occur represents the premium for the insurance component.

Additionally, if a contract requires that the policyholder pay an additional premium when losses occur, that additional premium, regardless of when it is paid to the insurer, should be considered part of the deposit component, when paid or payable

## Question 7 – Reinsurance purchased

***The proposals in the draft IFRS would limit reporting anomalies when an insurer buys reinsurance (paragraphs 18 and 19 of the draft IFRS and paragraphs BC89-BC92 of the Basis for Conclusions).***

***Are these proposals appropriate? Should any changes be made to these proposals? If so, what changes and why?***

We agree with the proposal to eliminate the gain at inception of a reinsurance contract, subject to the comments in respect of question 6 above. However, we do not understand why the requirement to not allow a gain at inception does not fall under the guidance in paragraph 10.

We understand that the draft IFRS will allow entities to recognise, as income, a certain portion of the receipts from the reinsurer at the inception of the contract, to offset the portion of the acquisition cost expensed by the cedant. This guidance appears to focus on the cash flow that occurs from the reinsurer to the cedant. However, certain reinsurance contracts are priced on a net basis and the cedant only pays the reinsurer a net amount even though the economics could be that the reinsurance premium is one amount and there is implicit ceding commission to the cedant. The guidance in paragraph 18(c) does not adequately address this issue. We recommend that, if the Board intends to apply a rule that only actual cash received from the reinsurer can be recognised in income to the extent there were acquisition costs expensed, that the guidance in paragraph 18(c) be changed to reflect this. If however the Board did not intend for this to apply only to cash related receipts, paragraph 18(c) should be amended to "receipts or pricing credits from the reinsurer".

ED 5 paragraph 19 requires that a cedant apply IAS 36 to its rights under reinsurance contracts. Because ED 5 does not provide guidance on how to apply IAS 36 to those rights, there is uncertainty with regard to how cedants will apply this guidance. If the application of IAS 36 to the rights under reinsurance contracts results in those rights being measured at a discounted value when the liabilities that create those rights are valued at an undiscounted value, we do not agree with the application of

IAS 36 to those rights. We believe that the impairment of those rights should be based on the principle that impairment should be recognized when an entity determines that it will not receive all contractual cash flows. Accordingly we recommend that the Board provide additional guidance with regard to the impairment of these rights.

## Question 8 - Insurance contracts acquired in a business combination or portfolio transfer

***IAS 22 Business Combinations requires an entity to measure at fair value assets acquired and liabilities assumed in a business combination and ED 3 Business Combinations proposes to continue that long-standing requirement. The proposals in this draft IFRS would not exclude insurance liabilities and insurance assets (and related reinsurance) from that requirement. However, they would permit, but not require, an expanded presentation that splits the fair value of acquired insurance contracts into two components:***

***(a) a liability measured in accordance with the insurer's accounting policies for insurance contracts that it issues; and***

***(b) an intangible asset, representing the fair value of the contractual rights and obligations acquired, to the extent that the liability does not reflect that fair value. This intangible asset would be excluded from the scope of IAS 36 Impairment of Assets and IAS 38 Intangible Assets. Its subsequent measurement would need to be consistent with the measurement of the related insurance liability. However, IAS 36 and IAS 38 would apply to customer lists and customer relationships reflecting the expectation of renewals and repeat business that are not part of the contractual rights and obligations acquired.***

***The expanded presentation would also be available for a block of insurance contracts acquired in a portfolio transfer (paragraphs 20-23 of the draft IFRS and paragraphs BC93-BC101 of the Basis for Conclusions).***

***Are these proposals appropriate? If not, what changes would you suggest and why?***

We agree with the recommendation to allow for the recognition of an intangible asset.

## Question 9 – Discretionary participation features

***The proposals address limited aspects of discretionary participation features contained in insurance contracts or financial instruments (paragraphs 24 and 25 of the draft IFRS and paragraphs BC102-BC108 of the Basis for Conclusions). The Board intends to address these features in more depth in phase II of this project.***

***Are these proposals appropriate? If not, what changes would you suggest for phase I of this project and why?***

We agree with the proposed accounting for insurance contracts with discretionary participation features, although we note that the difference in equity and income that results from classifying the unallocated surplus as a liability when compared to classifying it as equity can be substantial and will significantly reduce the comparability of financial statements between companies with different accounting policies.

We agree that issuers of investment contracts with discretionary participation features should be allowed to continue using existing accounting policies. We note that accounting policies vary with respect to treating premiums as deposits or as revenue, and that these differences will continue in phase 1.

The draft standard requires that the liability for investment contracts with discretionary participation features be no less than the liability for the fixed element under IAS 39. This requirement may be difficult to apply. We recommend that this requirement be dropped if the unallocated surplus is classified as a liability, as the likelihood that the total liability is less than the amount under IAS 39 for the fixed elements is very low.

The proposals appear to require the disclosure of the fair value of investment contracts with discretionary participation features, under IAS 32. It is not clear whether this was the intention of the Board or whether this is a drafting issue. Given that the exemption from applying IAS 39 to such contracts arises from the lack of an agreed fair value model, it does not seem appropriate to require such disclosures. We recommend that the exemption be extended to include the IAS 32 fair value requirement.

## Question 10 – Disclosure of the fair value of insurance assets and liabilities

***The proposals would require an insurer to disclose the fair value of its insurance assets and insurance liabilities from 31 December 2006 (paragraphs 30 and 33 of the draft IFRS, paragraphs BC138-BC140 of the Basis for Conclusions and paragraphs IG60 and IG61 of the draft Implementation Guidance).***

***Is it appropriate to require this disclosure? If so, when should it be required for the first time? If not, what changes would you suggest and why?***

We disagree with the requirement to provide fair value disclosures from 31 December 2006.

Although such additional information may be useful to users of financial statements, the basis on which the fair values are determined has yet to be established (as confirmed in paragraph BC 140 of the Basis for Conclusions). Accordingly, we do not believe it is appropriate to include a disclosure requirement in any IFRS if the basis on which the disclosure will be made is not known when the standard is issued.

## Question 11 – Other disclosures

***(a) The Exposure Draft proposes requirements for disclosures about the amounts in the insurer's financial statements that arise from insurance contracts and the estimated amount, timing and uncertainty of future cash flows from insurance contracts (paragraphs 26-29 of the draft IFRS, paragraphs BC124-BC137 and BC141 of the Basis for Conclusions and paragraphs IG7-IG59 of the draft Implementation Guidance).***

***Should any of these proposals be amended or deleted? Should any further disclosures be required? Please give reasons for any changes you suggest.***

***To a large extent, the proposed disclosures are applications of existing requirements in IFRSs, or relatively straightforward analogies with existing IFRS requirements. If you propose changes to the disclosures proposed for insurance contracts, please explain what specific attributes of insurance contracts justify differences from similar disclosures that IFRSs already require for other items.***

We agree with the proposed disclosure requirements in the draft IFRS, except that we believe the extent of disclosure currently proposed may make it more difficult for users of the financial statement to discern the key information needed to help them make informed decisions. The Board should consider the benefits of more specific, including quantitative, disclosure requirements, which focus on key areas.

***(b) The proposed disclosures are framed as high level requirements, supplemented by Implementation Guidance that explains how an insurer might satisfy the high level requirements.***

***Is this approach appropriate? If not, what changes would you suggest, and why?***

We support the proposed disclosure requirements in the draft IFRS, with the following exceptions. The Implementation Guidance is key to understanding the requirements of the draft IFRS. However, the Implementation Guidance only accompanies and is not part of the draft IFRS. This might result in insurers focusing on the exact wording of the draft IFRS and ignoring or only applying parts of the Implementation Guidance. As a result, certain disclosures might not be included, which will affect the transparency or comparability of financial statements. Further to this, the Implementation Guidance does not have any legal status in the European Union. Therefore, we recommend moving certain components of the Implementation Guidance, e.g., disclosure requirements on terms and conditions of insurance contracts and the process to determine key assumptions, to the draft IFRS.

The Implementation Guidance explains how an insurer might satisfy the disclosure requirements. However, the Implementation Guidance often needs clarification as well, for example, the disclosure requirements regarding the effect of changes of assumptions used to measure insurance assets and liabilities. The draft IFRS does not provide sufficiently detailed guidance as to the level of disclosure required. We recommend further detailing in the Implementation Guidance and also adding examples clarifying the Board's intended disclosures.

***(c) As a transitional relief, an insurer would not need to disclose information about claims development that occurred earlier than five years before the end of the first financial year in which it applies the proposed IFRS (paragraphs 34, BC134 and BC135).***

***Should any changes be made to this transitional relief? If so, what changes and why?***

We do not agree with the requirement to include five years of claim development in a set of financial statements that cover a two-year period. Whilst the information may be of value to the users, it does not reflect the results of the activity for the period covered by the financial statements. However, we do believe that the disclosure that covers the development that occurred during the two-year period covered by the financial statements should be made in sufficient detail to enable the reader to understand the movement in the reserve estimate from year to year. That disclosure should require reference to the particular accident year causing the current year movement in claim liability. Therefore, a reader with sufficient disclosure information could determine the development of the prior year claim liability.

## Question 12 – Financial guarantees by the transferor of a non-financial asset or liability

***The Exposure Draft proposes that the transferor of a non-financial asset or liability should apply IAS 39 Financial Instruments: Recognition and Measurement to a financial guarantee that it gives to the transferee in connection with the transfer (paragraphs 4(e) of the draft IFRS, C5 of Appendix C of the draft IFRS and BC41-BC46 of the Basis for Conclusions). IAS 39 already***

***applies to a financial guarantee given in connection with the transfer of financial assets or liabilities.***

***Is it appropriate that IAS 39 should apply to a financial guarantee given in connection with the transfer of non-financial assets or liabilities? If not, what changes should be made and why?***

We agree that IAS 39 should apply to financial guarantees given in connection with the transfer of non-financial assets and liabilities.

## Question 13 – Other comments

***Do you have any other comments on the draft IFRS and draft Implementation Guidance?***

We are concerned with the direction that the Board seems to be taking to fair value as the concept is applied to investment contracts under IAS 39 (as expressed in the Basis for Conclusions paragraph 117) and as may be applied to insurance contracts in phase 2. The demand deposit floor is inconsistent with the definition of fair value in IAS 39, which states, "Fair value is the amount for which … a liability (could be) settled, between knowledgeable, willing parties in an arm's length transaction". We note that the holder of the liability is the company that issues the financial liability, not the consumer who holds the contract as an asset. While it is reasonable to assume that such a consumer would not accept less than the amount of the demand deposit to settle the liability, this is irrelevant to the IAS 39 definition of fair value because it does not represent an arm's length transaction (i.e., the amount that a third party would pay to assume the insurance liabilities and related future revenue streams related to those insurance liabilities).

Insurance and investment contract liabilities are typically assumed in an arm's length transaction when a group of such liabilities is transferred from one institution to another institution that is legally able to assume them. In such situations, there is no market evidence to suggest that the amount received must be no less than the aggregate value of the demand deposits. Rather the opposite is true. Actual market situations exist where the amount transferred is less than the aggregate demand deposit. This is because many consumers choose not to surrender their contracts, even when it may appear to be to their economic advantage to do so. Actual transactions are priced using such assumptions.

The situation could be compared to pricing a pass through mortgage-backed security. The value of such an asset is not capped at the amount that would be received if all the mortgages backing the security were pre-paid. The observed value may in fact be a greater amount, even though any individual mortgage holder will pay no more than the outstanding loan balance to settle the mortgage. The reason is that some mortgage holders choose not to prepay even when it may appear to be to their economic advantage to do so. We believe the Board should adopt a consistent approach to valuing assets and liabilities.

Further, we are concerned that the Board is considering amending IAS 39 on this point without due process. This is not a detail that happened to be overlooked in the original definition of fair value. As pointed out above, in the absence of a specific requirement that the fair value of a financial liability should not be less than the demand deposit value, the words of IAS 39 would lead one to the opposite conclusion. We ask that the Board not promulgate internally inconsistent and contradictory guidance, especially without due process.

We also have concerns with the ability of insurers to prepare fair value information in a timely manner once phase 2 is in place. We therefore recommend that the Board consider in developing the phase 2 standard the practical issues arising in preparing fair value information on a timely basis.

Field-testing the proposals before the standard is finalised may provide insights into practical implementation issues.