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Comments to Exposure Draft 5 Insurance Contracts

Dear Peter,

Swiss Re, as one of the world's leading reinsurers, supports the IASB in improving International Financial Reporting Standards (IFRS). Swiss Re Group's financial statements are published in accordance with Swiss GAAP (FER). Some of our subsidiaries, as well as a number of our clients use IFRS as their reporting standards.

Swiss Re, operating through more than 70 offices in over 30 countries, is exposed to accounting regulations issued by many different national standard setters and regulatory authorities. We strongly support the IASB's efforts in developing an international accounting standard that addresses the accounting for insurance contracts. We also welcome the Board's decision to minimise the amount and extent of changes to existing practices that may require reversal when the second phase of the project is completed.

Disclosure of the fair value of insurance liabilities

We are concerned about the feasibility of the fair value measurement concept for insurance contracts currently proposed for Phase II. We believe that further work must be done to determine if the fair value approach is superior to the alternative models for published accounts.

We share many of the concerns expressed by the insurance industry about the fair value approach to external reporting which are summarised below:

- The fair value model would introduce artificial short-term volatility, especially for those lines of business that generally have a long-term view and corresponding business models.

- The increased short-term volatility could increase the cost of capital for the entire insurance industry, and hence potentially impair its risk absorption role in the wider economy.
- The application of the fair value model would not necessarily improve the ability of users to analyse company performance. Consequently, we have not seen significant demand for the proposed accounting model from the insurance industry, its investors, customers, or regulators.

Although we support the principle of disclosing new information before measurement, we believe that it is not appropriate to introduce fair value disclosures before the issues above have been resolved. We believe that developing the information would require a significant investment both in people and systems, which could require significant adjustments at a later date.

Scope and the asset/liability mismatch

We agree that the future IFRS on insurance should apply to insurance contracts rather than the entities that issue insurance contracts. We support the proposal to include weather derivatives in the scope of IAS 39 if they do not meet the definition of an insurance contract under ED 5.

However, we are seriously concerned about the mismatch that will arise if financial assets held to back insurance contracts are measured at fair value under IAS 39, while insurance liabilities are measured on a different basis. Although this is unlikely to affect net income, it would introduce substantial volatility to shareholders' equity. We do not regard that volatility as a faithful representation of changes in financial position, nor do we think that the reasons provided in paragraph BC110 (a), (b) and (c) outweigh the effects of the mismatch on shareholders' equity.

For example, as of 31 December 2002, the fair value of Swiss Re's fixed-income securities available for sale represented over 350% of total shareholders' equity. Excluding the effect of deferred taxes, a 5% change in the fair value of the portfolio would change shareholders' equity by approximately 18%. Depending on the duration of the portfolio, this could result from a fairly small change in interest rates.

We believe that there are a number of possible alternative solutions that would prevent the inconsistent measurement of insurance liabilities and financial assets held to back insurance contracts during Phase I. These include the introduction of a separate asset category to back insurance liabilities measured at amortised cost.

The issue mirrors the mismatch that banks would face if they applied an inconsistent measurement of originated loans and the related funding.

Temporary exclusion from criteria in IAS 8

We support the approach of applying "local" GAAP during Phase I. We think this is an appropriate interim solution.

However, we are disappointed that despite granting a temporary exemption from the criteria of paragraphs 5 and 6 in IAS 8 (Accounting policies, changes in accounting estimates and errors), the Board proposes to eliminate equalisation and catastrophe provisions in Phase I.

Catastrophes and other infrequent events are part of a reinsurer's business and are reflected in the long-term nature of the reinsurance business. We are concerned that users of financial statements may misinterpret catastrophe provisions recognised in shareholders' equity as available for the payment of dividends. Given the widespread application of valuation models based on discounted future dividends, company valuations may be affected along with the resulting investment decisions.

Unlike many uncertain future events, catastrophes tend to occur regularly. For the law of large numbers to hold, catastrophe experience must be projected over a time period of sufficient length which normally exceeds significantly an insurance company's reporting period. It is prudent to consider as a liability a part of the total premium received for providing catastrophe cover in any given reporting period, and record that liability as a catastrophe provision.

Although we understand some of the concerns that lead to the prohibition of catastrophe provisions, we suggest that the Board require an appropriate disclosure in the notes to the financial statements instead of prohibiting the recognition of catastrophe provisions.

We note that the Board has allowed other practices to stand, such as the use of non-uniform accounting policies.

Reinsurance

We share the Board's concern about profit recognition upon inception of a reinsurance contract where the profit substantially relates to the failure to recognise the fair value of the underlying insurance liability. In our opinion, there are two alternatives to address this concern:

- Follow the reporting entity's existing accounting policies ("local GAAP") in Phase I and add a requirement to describe the accounting policy being applied.
- Combine the proposed guidance on initial recognition of reinsurance assets with US GAAP-based guidance on subsequent measurement.

Given the Board's decision not to address subsequent measurement of reinsurance assets, and because we believe this is an appropriate decision, we consider the first alternative to be the only feasible option.

We do not follow the proposed accounting for acquisition costs recovered from a reinsurer by a cedant as this would imply that the reinsurer was not receiving a corresponding premium for that period. Assuming that the deferral and matching principle applies to the premium, then we believe that it should also apply to acquisition costs.

Other disclosures

We are concerned about the amount and detail of the extra disclosure required by the ED and as clarified in the implementation guidance. We believe that there is a risk that the information will be difficult to understand when it is aggregated for a global company, including reinsurance companies which have large numbers of individual contracts. We have identified areas of specific concern below.

- Paragraph 27e requires disclosure about material changes in insurance liabilities, reinsurance assets and, if any, deferred acquisition costs. We are not convinced that analysing the changes in all these items will add value to the financial statements. We would prefer a more targeted approach similar to existing practice, focusing for example on the change in deferred acquisition costs and property and casualty reserves.

- The requirement in paragraph 29b may lead to the disclosure of the terms and conditions of individual insurance contracts. We believe that this is too detailed, especially in the reinsurance industry. The information provided would in effect duplicate the disclosure about concentrations of insurance risk.

- The disclosure about material concentrations of insurance risk (paragraph 29c) is also too voluminous and will certainly include information that is business sensitive in nature.

- We do not follow the logic for requiring separate disclosure about embedded derivatives which have not been measured at fair value (paragraph 29e). This means that they should have similar economic characteristics to their host contracts and should be covered by other disclosures.

- Paragraph IG7e requires extensive disclosure about actuarial methodology and models used to calculate various estimates that are very complex in nature. We are concerned that this detailed information will not add to the understanding of the financial statements. Provided that the inherent limitations of actuarial estimates are adequately explained in the reporting entity's accounting policy note, we recommend the elimination of this disclosure.

- The suggested format for a claims development table (IG Example 4) is based on an underwriting year. We understand that this is only an example and that companies may use either an underwriting year or an accident year basis in Phase I. This will ensure that companies that already prepare a claims development table do not have to change from one basis to another.

- According to BC134, it is unlikely that most life insurers would need to provide the claims development disclosure because an insurer need not disclose this information for claims that are typically settled within one year. However, life insurers that also write disability business would be affected because disability claims do not ordinarily settle within one year. In the interest of convergence with the US SEC loss development table rules, we suggest that the Board confines the claims development disclosure requirement to property and casualty business.

Unbundling

Our understanding of paragraph 7 is that unbundling is not required if the deposit component is recognised under the insurer's existing accounting policies. Based on this, we support the proposal.

Definition of insurance contract

We support the Board's principles-based approach to the definition of an insurance contract. Furthermore, we agree that credit insurance should fall within the scope of ED 5, if it requires, as a precondition for payment, the holder to be exposed to, and have incurred a loss on, the failure of the debtor to make payments on the guaranteed asset when due.

In our opinion, the example in 1.4 of IG1 requires clarification. We believe that a contract where beneficiaries receive nothing if the policyholder dies before a specified date cannot be considered a pure endowment contract. Indeed, we do not expect such contracts to occur frequently in practice.

Salvage and subrogation

We assume that the basis for conclusion does not mean that insurers should extend IAS 37 to salvage and subrogation in phase I. This would not be consistent with the objective of phase I, as salvage and subrogation are typcially part of existing reserving practices. We agree with the Board's conclusion that such issues are part of phase II.

Thank you for the opportunity to comment on the Board's proposals, and I am happy to discuss any of our comments with you.

Yours sincerely

Mark Swallow
Chief Accounting Officer
Swiss Reinsurance Company