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Ms Seema Jamil-O'Neill
Accounting Standards Board
Holborn Hall
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October 22, 2004

CL 87

Dear Ms Jamil-O'Neill

FRED 33 'Financial Instruments: Disclosures'

XL Capital Ltd (XL, we or our) would like to thank you for the opportunity to comment on FRED 33 'Financial Instruments: Disclosures'. We are pleased to have the opportunity to comment on proposals that will have a significant impact on the financial statements of all businesses writing insurance contracts.

We support the Accounting Standards Board plans to develop a convergence strategy based on the principles of IFRS that maintains the quality of UK financial reporting. However, we would prefer a convergence strategy that minimises the burden of change on UK companies. The strategy should be a 'true convergence' so as to facilitate comparability between entities adopting IFRS and those retaining UK GAAP.

We do not support the ASB's proposal in FRED 33 to adopt the same effective date and transitional arrangements for financial instrument disclosures as the IASB. To mandate such additional qualitative and quantitative disclosures, and new disclosures about entities management of their capital resources, on UK companies would be costly and burdensome to achieve. Instead, we strongly encourage the ASB not to converge in the short to medium term with the more complex standards such as IFRS 4, IAS 32 and 39. We recommend that these complex standards should only be converged with, following the completion of the Phase II insurance contracts project, when it is believed that a 'stable platform' will be reached for insurance contract accounting.

Our responses to the specific questions raised by the ASB are attached in Appendix A. We would be pleased to discuss any of these issues with you in detail if this would be helpful. You may contact me on 0207 933 7737.

Yours sincerely,

Jenny Ross, VP Accounting Research, Europe

cc: Jerry de St. Paer, EVP & Chief Financial Officer
Joseph C. Henry, SVP Finance
Derrick A. Irby, VP, Accounting Policy Officer

Appendix A

ASB (i) - The ASB does not propose any exemptions from the disclosure requirements in this Standard other than for entities applying the FRSSE. Do you agree?

We strongly disagree with this proposal. Instead, we propose that all UK companies be exempt from these disclosure requirements in the short to medium term. We strongly encourage the ASB not to converge in the short to medium term with the more complex standards such as IFRS 4, IAS 32 and 39. We recommend that these complex standards should only be converged with, following the completion of the Phase II insurance contracts project.

ASB (ii) - The ASB is proposing to retain the new capital disclosure requirements within this Standard as it believes that these represent an improvement in financial reporting. The effect of this would be that the capital disclosure requirements apply to all entities, including those that do not have any significant financial instruments. Do you agree with this proposal?

We strongly disagree with this proposal. Information about what constitutes capital, the level of an entity's capital and how it manages capital are important towards assessing the risk profile of an entity and its ability to withstand unexpected adverse events. However, we consider that capital targets set internally by management should not be required for disclosure. We are very concerned that the proposed disclosure requirements would require insurers to reveal proprietary information that either has the potential to be used by other insurers to gain a competitive advantage or could mislead users and thus have unintended adverse consequences to the company.

IASB (i)– Disclosures relating to the significance of financial instruments to financial position and performance

The draft IFRS incorporates disclosures at present contained in IAS 32 Financial Instruments: Disclosure and Presentation so that all disclosures about financial instruments are located in one Standard. It also proposes to add the following disclosure requirements:

(a) financial assets and financial liabilities by classification (see paragraphs 10 and BC13).
(b) information about any allowance account (see paragraphs 17 and BC14).
(c) income statement amounts by classification (see paragraphs 21(a), BC15 and BC16).
(d) fee income and expense (see paragraphs 21(d) and BC17).

Are these proposals appropriate? If not, why not? What alternative disclosures would you propose?

Given the different measurement bases in IAS 39 for each class of financial instruments, we support the proposal that all disclosures regarding financial instruments should be located in one Standard.

IASB (ii) - Disclosure of the fair value of collateral and other credit enhancements

For an entity's exposure to credit risk, the draft IFRS proposes to require disclosure of the fair value of collateral pledged as security and other credit enhancements unless impracticable (see paragraphs 39, 40, BC27 and BC28).
Is this proposal appropriate? If not, why not? What, if any, alternative disclosures would you propose to meet the stated objective?

We agree with the requirements to disclose the fair value of collateral pledged as security unless impracticable. However, we remain doubtful whether all entities will be able to provide the proposed disclosures for all activities, especially insurance companies, given that in some instances such fair value information is not readily available.

IASB (iii) – Disclosure of a sensitivity analysis

For an entity that has an exposure to market risk arising from financial instruments, the draft IFRS proposes to require disclosure of a sensitivity analysis (see paragraphs 43, 44 and BC36-BC39).
Is the proposed disclosure of a sensitivity analysis practicable for all entities?
If not, why not and what, if any, alternative disclosures of market risk would you propose to meet the stated objective of enabling users to evaluate the nature and extent of market risk?

We do not believe that it is appropriate to include the sensitivity analysis within the audited financial statements. Our concern is that these disclosures require significant levels of judgment and estimation, and that information could therefore be difficult to audit. We do not agree that the proposed sensitivity analysis disclosures are "relatively easy to understand and calculate" (BC 36 (b)). Furthermore, we are not clear what level of aggregation or detail would be considered adequate to meet the minimum disclosure requirements, and we are concerned that the necessary detail may result in voluminous disclosures. We consider that it is inappropriate to require this level of disclosure for all entities within a group. Furthermore, this volume of detailed information is less relevant for wholly or substantially owned subsidiaries, particularly where they have no listed securities and where this information is already part of the parent entity's consolidated financial statements. It may also prove impractical to produce this information at the intermediate levels where risks are managed by the business on a group basis.

IASB (iv) – Capital disclosures

The draft IFRS proposes disclosure of information that enables users of an entity's financial statements to evaluate the nature and extent of its capital. This includes a proposed requirement to disclose qualitative information about the entity's objectives, policies and processes for managing capital; quantitative data about what the entity regards as capital; whether during the period it complied with any capital targets set by management and any externally imposed capital requirements; and if it has not complied, the consequences of such non-compliance (see paragraphs 46-48 and BC45-BC54).
Is this proposal appropriate? If not, why not? Should it be limited to only externally imposed capital requirements? What, if any, alternative disclosures would you propose?

Refer to question ASB (ii) above. The answers are identical.

IASB (v) – Effective date and transition

The proposed effective date is for periods beginning on or after 1 January 2007 with earlier adoption encouraged (see paragraphs 49 and BC62-BC67). Entities adopting IFRSs and the draft IFRS for the first time before 1 January 2006 would be exempt from providing comparative disclosures for the draft IFRS in the first year of adoption (see Appendix B, paragraph B9).
Are the proposed effective date and transition requirements appropriate? If not, why not? What alternative would you propose?

We do not support the ASB's proposal to adopt the same effective date and transitional arrangements for financial instrument disclosures as the IASB. We do not agree that these proposals should be mandatory for all UK entities. Furthermore, the proposed disclosure requirements to apply to all non-IFRS UK entities (unless FRSSE applies) will impose an additional unnecessary burden on listed groups as they will be required to give this information anyway (albeit in aggregated form) in their consolidated accounts. A related issue arises from the fact that in a number of cases UK GAAP permits certain disclosure exemptions in recognition of the fact that group accounts are prepared. These exemptions should continue to apply where subsidiaries continue to follow UK GAAP but the group accounts are prepared under IFRS.

In addition, significant uncertainty still remains as to whether IAS 39 will be fully endorsed by the EU for adoption in Europe. If the entire standard is not endorsed, the effect of ASB convergence would be to require UK listed entities to follow it but with no such requirement for their Continental European counterparts. We believe that UK standards should move in step with Europe but not ahead of it. Apart from this, if IAS 39 is not endorsed, it may be subject to further change in the short term.

Although we understand the ASB's desire to convergence with IFRS we are concerned that the ASB has not fully considered the time and impact these system changes will have on financial statement preparers. Furthermore, it will be confusing to users as comparability to prior years and other insurers will be hindered due to changes in the presentation and disclosure of the financial statements.

With a proposed implementation date of 1 January 2007 insurers will be required to make significant system changes twice within two years (IFRS 4 in 2005 and FRED 33/ED 7 in 2007), and a third time as soon as the Phase II insurance standard is released. In order for insurers to limit the amount of changes they face within a short period of time, insurers may be forced to implement FRED 33/ED 7 early. Although the ASB may believe this to be an acceptable solution, it is not reasonable to expect insurers to include disclosures within their 2005 financial statements if the standard governing those disclosure requirements will not be finalized until 2005.

IASB (vi) – Location of disclosures of risks arising from financial instruments

The disclosure of risks arising from financial instruments proposed by the draft IFRS would be part of the financial statements prepared in accordance with International Financial Reporting Standards (see paragraph BC41). Some believe that disclosures about risks should not be part of financial statements prepared in accordance with IFRSs; rather they should be part of the information provided by management outside the financial statements.
Do you agree that the disclosures proposed by the draft IFRS should be part of the financial statements? If not, why not?

We are of the opinion that sensitivity analysis does not belong in the financial statements. Among other issues, it would be very difficult and expensive to audit. While we can understand that the ASB has no official capacity over information disclosed outside the financial statements, this should not be the basis to require inappropriate information within the financial statements.

IASB (vii) - Consequential amendments to IFRS 4 (paragraph B10 of Appendix B)

Paragraph B10 of Appendix B proposes amendments to the risk disclosures in IFRS 4 Insurance Contracts to make them consistent with the requirements proposed in the draft IFRS. The requirements in IFRS 4 were based on disclosure requirements in IAS 32 that would be amended by the draft IFRS. The Board's reasons for proposing these amendments are set out in paragraphs BC57-BC61.
Do you agree that the risk disclosures in IFRS 4 should be amended to make them consistent with the requirements proposed in the draft IFRS? If not, why not and what amendments would you make pending the outcome of phase II of the Board's Insurance project?

We do not agree that consequential amendments should be made to IFRS 4 before Phase II of the insurance project is completed. Disclosure revisions should be deliberated during the development of Phase II insurance standard. With a proposed implementation date of 1 January 2007 insurers will be required to make significant system changes twice within two years (IFRS 4 in 2005 and FRED 33/ED 7 in 2007), and assuming a third time, when the Phase II insurance standard is released. Such an approach will be incredibly costly and burdensome to insurers.

We strongly encourage the ASB not to converge in the short to medium term with the more complex standards such as IFRS 4, IAS 32 and 39. Instead, these complex standards should only be converged with, following the completion of the Phase II insurance contracts project.

IASB (viii) – Implementation Guidance

The draft Implementation Guidance accompanying the draft IFRS suggests possible ways to apply the risk disclosure requirements in paragraphs 32-45 (see paragraphs BC19, BC20 and BC42-BC44).
Is the Implementation Guidance sufficient? If not, what additional guidance would you propose?

We do not believe the Implementation Guidance is sufficient for financial institutions, without clarity regarding the manner in which sensitivity analyses should be calculated. For example, is "profit and loss" the profit and loss for the period being reported upon or forecasts of future period(s), which are not released into the public domain? Is the "reasonably possible change" a shock whereby risk variables are assumed to return to their previous level or do they continue on into the future (and become the company's best estimate)? The answers to these detailed questions, among others, can dramatically change the results of the sensitivity analyses, especially when considering the impacts of investment and intangible asset impairment and liability adequacy. We believe it would be irresponsible to leave such issues up to each company to decide. Until these issues are examined thoroughly, we recommend that FRED 33 should be delayed.

IASB (ix) – Differences from the Exposure Draft of Proposed Statement of Financial Accounting Standards Fair Value Measurements published by the US Financial Accounting Standards Board (FASB).

The FASB's Proposed Statement of Financial Accounting Standards Fair Value Measurements, which is open for public comment at the same time as this Exposure Draft, proposes guidance on how to measure fair value that would apply broadly to financial and non-financial assets and liabilities that are measured at fair value in accordance with other FASB pronouncements. That Exposure Draft proposes disclosure of information about the use of fair value in measuring assets and liabilities as follows:
(a) For assets and liabilities that are remeasured at fair value on a recurring (or ongoing) basis during the period (for example, trading securities)
(i) the fair value amounts at the end of the period, in total and as a percentage of total assets and liabilities,
(ii) how those fair value amounts were determined (whether based on quoted prices in active markets or on the results of other valuation techniques, indicating the extent to which market inputs were used), and
(iii) the effect of the remeasurements on earnings for the period (unrealized gains or losses) relating to those assets and liabilities still held at the reporting date.
(b) For assets and liabilities that are remeasured at fair value on a non-recurring (or periodic) basis during the period (for example, impaired assets), a description of
(i) the reason for remeasurements,
(ii) the fair value amounts,
(iii) how those fair value amounts were determined (whether based on quoted prices in active markets or on the results of other valuation techniques, indicating the extent to which market inputs were used), and
(iv) the effect of the remeasurements on earnings for the period relating to those assets and liabilities still held at the reporting date.
Disclosures similar to (a)(ii) above are proposed in paragraph 31 of the draft IFRS (and are currently required by paragraph 92 of IAS 32) and disclosures similar to (a)(iii) are proposed in paragraph 21(a).
Do you agree that the requirements in the draft IFRS provide adequate disclosure of fair value compared with those proposed in the FASB's Exposure Draft? If not, why not, and what changes to the draft IFRS would you propose?

We agree that the suggested disclosures included within the exposure draft provide adequate disclosure of fair value in accordance with the proposed guidance of the FASB.

IASB (x) – Other comments

Do you have any other comments on the draft IFRS, Implementation Guidance and Illustrative Examples?

We have no other comments.