

Sir David Tweedie
Chairman
International Accounting Standards Board

Sent by e-mail to Mr. Peter Clark, Senior Project Manager

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COMMENT LETTER ON ED 5 – INSURANCE CONTRACTS

Dear Sir David,

Thank you for the opportunity to comment on ED 5 Insurance Contracts.

Kredittilsynet is the authority supervising the Norwegian securities markets and all Norwegian financial institutions, including insurance companies and banks.

Kredittilsynet also prepares draft accounting regulations for insurance companies and banks on behalf of the Ministry of Finance.

Please find enclosed the comments from Kredittilsynet regarding the specific questions raised in ED 5 Insurance Contracts.

Moreover, please note that Kredittilsynet has participated in the writing of the Comment Letter from the International Association of Insurance Supervisors (IAIS), and by this has endorsed all comments put forward in the IAIS Comment Letter.

Best regards,

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Director General

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Introduction

Kreditilsynet supports the implementation of international financial reporting standards for insurance contracts which are relevant, reliable, comparable and understandable. We acknowledge the development of an International Financial Reporting Standard (IFRS) for insurance contracts by the IASB.

Norway, as a member of the European Economic Area (EEA), is committed to follow the EU accounting regulation, hereunder the IAS-regulation prevailing for the consolidated accounts of listed companies as from 2005. Following this, a Government appointed Accounting Commission has suggested to amend national accounting regulation, prevailing for separate accounts, compatible with IFRS/IAS.

However, already writing October 2003, a major concern to Kreditilsynet is the implementation of Phase I by 2005. Following the EU endorsement of Phase I, the EU Member States – as well as the EFTA-states with the EEA – will have to analyse the need for possible changes to financial reporting rules, supervisory requirements, company law (i.e. the issue of restricting dividends and distribution of profits to policyholders) and tax regulations. We acknowledge that these are issues to be raised within the EU in relation to the timeframe of the IAS-regulation and the endorsement procedure, but the IASB should be aware of these practical aspects regarding the implementation of an IFRS on insurance contracts.

Kreditilsynet would also like to highlight that ED 5 Insurance Contracts is only acceptable as a short term interim solution, i.e. as a “Phase I standard”. In our opinion, the present (draft) standard will not lead to comparable and consistent application as it permits the use of a variety of accounting policies which conflict with both the IASB Framework and the hierarchy (IAS 8).

It is important that Phase II provides a robust and sustainable standard for insurance contracts. Accordingly, Kreditilsynet encourages the Board to move towards Phase II without undue delay. In developing the Phase II standard, we urge the Board to consult broadly and field test proposals to make sure that the standard can be implemented safely with lasting benefits.

Please find below our specific comments to question 1–13 regarding the contents of ED 5.

Question 1

The scope defined for the IFRS on insurance contracts seems to be acceptable.

The focus on insurance contracts rather than on insurance entities is appropriate as it ensures that similar contracts will be accounted for in the same manner regardless of the legal structure of the entity issuing the contract. Likewise, IAS 39 and other relevant IASs should be applicable to insurance companies in the same manner as they are applicable to other entities.

Question 2

The definition of an insurance contract together with the guidance given is acceptable.

However, the content of the definition itself is not sufficient to give an indisputable interpretation. Kredittilsynet appreciates the supplementary appendix as well as the examples given in the Implementation Guidance. Given the rapid product development within insurance, we will emphasise the importance of a frequent review/update of the guidance. Accordingly, sufficient resources should be allocated to IFRIC in order to assist stakeholders in the critical implementation period as this would be essential to ensure a harmonised global implementation and interpretation of the standard.

In our opinion, the pure endowment contracts meet the definition of an insurance contract under ED 5 (the insured event being survival without sufficient financial resources). Accordingly, Kredittilsynet does not agree with the IASB's conclusions in the draft Implementation Guidance, example 1.4, and would appreciate if the example is revisited.

Question 3

Kredittilsynet agrees that any embedded derivatives, not closely linked to the host insurance contracts, should be separated and measured as financial instruments. We agree with the exemptions given regarding the option to surrender an insurance contract for a fixed amount (or amount based on a fixed amount and an interest rate).

Question 4

(a) Accounting policy and sunset clauses

Kredittilsynet recognises the need for a temporary exception from paragraph 5 and 6 of IAS 8 Accounting Policies until the IFRS for insurance contracts is completed (Phase II). It should be made clear that this exception will be valid throughout the whole Phase I, and that no specific dates ("sunset clauses") should be stated. We believe this is necessary in order to avoid confusion amongst stakeholders should Phase II be delayed.

(b) Catastrophe and equalisation provisions etc.

With respect to question 4(b) Kredittilsynet has no comments on proposals (ii) and (iii).

With respect to proposal (i) Kredittilsynet notices that equalisation provisions are not consistent with IASB's overall framework. However, as IASB is aware of, various kinds of equalisation provisions have been an integrated part of the prudential regulations in many jurisdictions. In this context, it should be noticed that the immediate abolition of equalisation provisions in Phase I may make it difficult to implement the necessary changes in the regulations regarding capital or solvency requirements (in order to keep the overall solvency or financial strength at the same level). Especially with regard to the EU/EEA IAS-regulation referred to in our introductory comments, this will not be possible, as the detailed work regarding the so called "Solvency II Project" (which will take into account the consequences of the new accounting standard) has not yet started. Accordingly, we foresee that an uncoordinated development and implementation of additional capital or solvency requirements may take place during Phase I. Even if this is first and foremost a supervisory issue, the IASB should be aware of these practical aspects of the implementation procedure.

Kredittilsynet understands that IASB will address the measurement of technical provisions in Phase II. However, in a Norwegian context, we have some concerns already in Phase I regarding the national regulations on technical provisions and especially those defined as fluctuation provisions. The fluctuation provisions, as defined by the national regulations, have obvious similarities with any "provisions for risk and uncertainty" (or "provisions for adverse deviation"), but at the same time they are classified as equalisation provisions in accordance with the EU Insurance Accounting Directive. Accordingly, the lack of any IASB guidance on how to stipulate the "provisions for risk and uncertainty" (as this will be a Phase II issue) may hamper the future development of the regulations on technical provisions in non-life insurance (including the rules on measurement methods regarding the provisions for outstanding claims).

Question 5

Proposal (a)

Kredittilsynet has no comments on the general principles stated in paragraph 14 of the draft IFRS.

It should, however, be noted that a consequence of the rules laid down by paragraph 16 may be that rather different accounting practices will be applied during Phase I – both with respect to insurance companies within a jurisdiction and between jurisdictions. A simple illustration of this point (involving two accounting practices) may be as follows:

- A non-life insurance company measuring its provisions for outstanding claims with excessive prudence will be allowed to continue this practice during Phase I.
- On the other hand, a company measuring its provisions for outstanding claims on a discounted basis in combination with fluctuation provisions stipulated according to transparent methods will not be allowed to continue this practice (unless the fluctuation provisions – due to changes in national legislation during Phase I – are (partially) trans-

formed into “admissible” provisions for risk and uncertainty). Cf. also our comment on question 4(b).

It is not obvious how the financial strength of the two companies should be assessed and compared during Phase I, as the differences between the companies would not be apparent from their financial reporting. Moreover, even if it is required that the companies during Phase I should disclose some information related to the prudence (i.e. safety margins etc.) applied in the calculation of their insurance liabilities, it may be questioned whether this disclosure will enhance the comparability of the companies’ accounts as there are no common benchmarks for quantifying the level of prudence. Accordingly, we expect a variety of disclosure practices to prevail until a full standard covering methods for measuring the technical provisions has been developed.

The rise of similar differences in accounting practices may take place regarding the proposed accounting for reinsurance, cf. our comments on question 7.

Proposal (b)

A clarification is needed as to whether this proposal is a general exempt from the revised IAS 39 paragraph 83 or whether it is an exempt in addition to the exemption from paragraphs 5 and 6 of IAS 8 and the timing in the clause?

Question 6

Sub-question (a)

Kredittilsynet finds the suggestion appropriate for Phase I, but we emphasise that if cash flows do interact, the compound transaction/position should not be unbundled.

Sub-questions (b) and (c)

As insurance contracts are, in general, designed, priced and managed as packages of benefits, unbundling required solely for accounting purposes should not be required at this stage.

Moreover, it is Kredittilsynet’s opinion that the question of unbundling should be carefully (re-)assessed before finalising Phase II. This will be necessary in order to ensure proper requirements on unbundling, including avoiding accounting rules leading to “artificial” unbundling of insurance contracts.

Question 7

Financial reinsurance and ART products/contracts

Other parties have raised concerns that all financial reinsurance contracts should be accounted for in a similar way irrespective of whether they are defined as insurance contracts or financial instruments. Kredittilsynet is, however, concerned that this focus will be at the sacrifice of a proper accounting of traditional ceded reinsurance. Please see our comments in

the following paragraphs, including examples illustrating the possible consequences of paragraph 18 with regards to traditional reinsurance.

For Phase I, the definitions of insurance and reinsurance together with the unbundling requirements may improve the relevance and comparability of accounting for many financial reinsurance contracts. We believe that this improvement should be sufficient for Phase I with regards to accounting of financial reinsurance.

Traditional reinsurance products/contracts

The focus on “the net amount paid at inception” in subparagraph 18(b) may lead to an incomplete or oversimplified approach to the cedant’s accounting for a traditional reinsurance coverage (i.e. the cedant’s rights under the reinsurance contract). This is especially the case when subparagraph 18(b) is read in connection with subparagraph 18(a).

The issue at stake may be illustrated by the reinsurance coverage related to a simple quota share reinsurance treaty. If the cedant measures its liabilities (e.g. the provisions for outstanding claims) on an undiscounted basis, while the reinsurer has stipulated the reinsurance premium on a discounted basis, the principle laid down by subparagraph 18(b) will lead to an artificial loss for the cedant at the outset (and a “bolstering” of earnings in subsequent periods).

Other cases reflecting potential problems related to the principle laid down by subparagraph 18(b) may arise due to the fact that reinsurance premiums often fluctuate rather widely as a consequence of the changes in the (overall) capacity of the reinsurance markets. In such cases the reinsurance premium will normally not be a reliable approximation for the cedant’s rights under the reinsurance contract.

In our opinion, it seems more relevant to state that the (direct) insurance companies should measure their rights under reinsurance contracts by applying an accounting practice that is consistent with the practice applied when measuring the direct insurance liabilities (on a gross basis).

Two further comments should be made:

- It is not obvious how subparagraph 18(a) should be interpreted in the light of paragraph 14 and subparagraphs 16(a) and 16(b).
- It should be clarified what kind of cases subparagraph 18(e) refers to.
For example, in cases where a non-life insurer measures his provisions for outstanding claims on a discounted basis, the (expected) future amounts paid in respect of incurred claims will normally exceed the discounted provisions. Accordingly, it is not reasonable to state that this fact is “evidence that the liability is understated”.

Other issues

Paragraph 19 of the draft standard states that IAS 36 should apply to the cedant’s rights under a reinsurance contract. We welcome a clarification as to the use of IAS 39 with regards to reinsurers’ share of paid claims.

Question 8

Kredittilsynet agrees that the proposals are appropriate as long as assets and liabilities are subject to different measurement methods.

If both assets and liabilities are measured at fair value, IAS 22 would apply.

Question 9

Kredittilsynet acknowledges the difficulties connected to the accounting of discretionary participating features and supports that the approach will be addressed in more depth in Phase II of the project.

There are references to “unallocated surplus” in ED 5, paragraph 24(b). Kredittilsynet welcomes a clarification of the semantics of the word “unallocated”. Does IASB refer to “unallocated between investors and policyholders”, or “unallocated to the individual policyholders”?

Question 10

According to Kredittilsynet’s understanding, the Board intends to issue a guidance before finalising Phase II, or to deliver a complete IFRS for insurance contracts by 31 December 2006.

A complete understanding of what will be expected to be disclosed is a condition for relevant and comparable disclosure. In order to ensure its reliability, Phase II or a complete guidance to fair value calculations, should be presented as early as possible. If no complete guidance on estimating fair value of the insurance contracts is presented before 31 December 2006, the full disclosure requirement should be postponed to avoid companies developing a diversity of assumptions and methods for the calculation of fair value close to the deadline for the published Phase II. In our opinion, a diversity of approaches regarding disclosure will neither serve the investors nor the supervisory authorities or the producers of financial reporting.

In the absence of quantitative disclosure of fair value, disclosure requirements in Phase I regarding the amount, timing and uncertainty of cash flows will give the users of financial statements some qualitative information on the nature and risks associated with insurance liabilities.

We acknowledge the analogy to IAS 32 and fair value disclosure on loans (BC 139). However, we have no knowledge of countries with experience of accounting according to IAS 32, and this particular standard has not yet been adopted by the EU Commission.

Question 11

In Phase I, entities should be required to disclose information that would allow the readers of the financial statements to assess the level of prudence applied in calculation insurance liabilities.

The information in the claims or run-off statistics is of marginal value on an aggregated level when comparing account reports etc. from different (non-life) insurance companies. In this particular case we presume that IAS 14 Segment reporting could be an appropriate way of showing the information on a more detailed level.

Question 12

Kredittilsynet has no comments to this question.

Question 13

Kredittilsynet encourages the re-opening of IAS 40 to include buildings used by the insurer (BC 114).