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Exposure Draft 7 - *ED7 Financial Instruments: Disclosures*

Old Mutual response

22 October 2004

1 ED7 Financial Instruments: Disclosures

Old Mutual welcomes the decision of the IASB to revise and enhance financial instrument disclosures and appreciates the opportunity to comment.

We agree with the IASB's proposal to include financial instrument disclosure requirements in one standard, rather than two separate standards (IAS30 and IAS32) as currently.

We have serious concerns over ED7's disclosure requirement for sensitivity analysis for market risks, particular in regard to insurance contracts (see our answer to Question 3).

We also have concerns over the capital disclosures which we believe will require disclosure of proprietary information that might provide advantage to our competitors, mislead investors and have unintended adverse consequences (see our answer to Question 4).

We participate in and have co-signed the comment letter of the CFO forum of leading European Insurers. Where appropriate we have reflected comments made in that letter in this letter.

1.1 *Question 1 – 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?

Answer

We strongly agree with the IASB's proposal to include financial instrument disclosure requirements in one standard, rather than two separate standards (IAS30 and IAS32) as currently. IAS30, being required of only one specific industry segment, was not consistent with the general IAS1 principle of consistency. IAS30 is difficult to apply to those diversified financial services groups, such as Old Mutual, which have significant banking operations as well as insurance and asset management operations.

We also agree with the proposed additional disclosures, as they are important in understanding the exposure of financial institutions to financial instruments. In particular:

a) We agree that carrying amounts by the IAS39 asset and liability classifications should be separately disclosed.

b) We agree that with the requirement to reconcile movements in any allowance account

c) We agree with the disclosure of net gains and losses by IAS39 asset and liability classifications.

d) We believe paragraph 21 (d) "fee income and expense (other than amounts included in determining the effective interest rate) arising on financial assets and financial liabilities, and from trust and other fiduciary activities that result in the holding or investing of assets on behalf of individuals, trusts, retirement benefit plans and other institutions" should be clarified as to whether IAS 18 deferred costs and deferred revenue amortisation arising on investment management contracts are included or not.

1.2 ***Question 2 - 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?

Answer

We agree with the exemption that when impracticable fair value disclosures of collateral should not be required. As BC28 states as an example it would be impracticable to fair value residential property provided as collateral by customers for mortgage loans.

Where the provision of fair value information is practicable and is combined with qualitative disclosure of an entity's policies for obtaining collateral pledged as security, we agree that these disclosures will be useful in providing information to the user about how an entity mitigates the losses it expects to incur in the event of default.

1.3 ***Question 3 - 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?

Answer

We have serious concerns over the level of sensitivity analysis envisaged by ED7, especially as extended by consequential amendment to insurance contracts. We certainly do not agree with the statement in BC36(b) that the proposed sensitivity analysis disclosures are "relatively easy to understand and calculate".

ED7 is more prescriptive than IAS32 as it makes sensitivity analyses wider in scope than just interest rate risk and it makes sensitivity analyses a requirement which is troubling for a number of reasons.

Firstly, sensitivity analyses can easily be misleading to the users of financial statements as they have a great deal of limitations, i.e., such calculations would likely ignore decisions and actions that management would take in response to changes in risk variables. In addition, there are a number of areas that that require clarification. 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. Until these issues are examined thoroughly, we recommend that the final standard does not require sensitivity analyses.

Secondly, we are very concerned that you are proposing to extend ED7 quantitative market risk disclosures to insurance contracts. Predicting the impacts on insurance contracts from changes in risk variables is a complex topic. While risk is managed internally, capital and risk management are based on very different recognition and measurement principles than those applied in the financial statements. Requiring the publication of the sensitivity analyses of ED7 net income and equity contradicts the IASB approach of allowing each company to disclose risk information that is consistent with how risk is managed internally.

1.4 ***Question 4 - 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?

Answer
As an insurance company, we are concerned that the proposed disclosure requirements would require insurers to reveal proprietary information that either has the potential to be used by our competitors to gain a competitive advantage or could be misread by readers and thus have unintended adverse consequences to the company. In order to give readers adequate insight and a meaningful overview of our capital management, we believe that under the ED7 proposals, we would have to disclose information regarding our

underwriting assessment criteria for insurance risks as well as guidance from rating agencies or regulators that we are attempting to adhere to. Such insights are not necessarily intended for public consumption, and have the potential to be taken out of context.

1.5 ***Question 5 - 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?

Answer

Although we believe the effective date is reasonable considerable uncertainty has been created with regards to timing of implementation of the provisions of ED7 before its effective date. Accordingly, we recommend providing additional transitional rules, e.g., the ability to early-adopt certain provisions and not others, that may help companies avoid the cost of collecting IFRS disclosure information that will be no longer be required in 2007 at the latest.

1.6 ***Question 6 - 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?

Answer

In light of the issues elsewhere in this letter, sensitivity analyses do not belong in the financial statements. Among other issues, it would be very difficult and expensive to audit. While we understand that the IASB has no official power over information included outside the financial statements, this should not be the basis to require inappropriate information within the financial statements. We recommend that the IASB discuss this matter with CESR.

1.7 ***Question 7 - 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?

Answer

In the light of comments made in our answer to Question 3 on sensitivity analysis, in our opinion, it is too early to include insurance contracts in the scope of ED7's sensitivity analysis requirements.

We note that insurers' risk capital models have not been subject to audit and the processes surrounding them have not been designed with audits in mind. The FSA in the UK has acknowledged this by asking for the risk capital reporting from UK insurers to be private between the FSA and the individual insurers for at least two years before results are publishable.

It is therefore our view that the changes proposed to IAS 32 should not be extended to insurance until;

- the phase 2 proposals are established and understood, and
- the work on Solvency 2 by the European Commission is finalised, at which time comparable information will be available.

1.8 ***Question 8 - 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?

Answer

In our opinion the guidance currently proposed to be included in ED7 Implementation Guidance is not sufficient. In particular more guidance is required on how the sensitivity analyses should be calculated. We draw your attention to our answer to Question 3 in which we refer to lack of clarity over the definitions of "profit and loss" (current reported period versus forecasts of future periods) and "reasonably possible change".

1.9 ***Question 9 - 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 (unrealised 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?

Answer

In our opinion the requirements in ED7 provide adequate disclosures of fair value.

1.10 ***Question 10 - Other comments***

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

Answer

None