Hill House
1 Little New Street
London EC4A 3TR
United Kingdom

Tel: National +44 20 7936 3000
Direct Telephone: +44 20 7007 0907
Direct Fax: +44 20 7007 0158
www.deloitte.com
www.iasplus.com

Deloitte Touche Tohmatsu

31 October 2003

Sir David Tweedie, Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir David,

Exposure Draft ED 5, Insurance Contracts

Deloitte Touche Tohmatsu is pleased to comment on the International Accounting Standards Board's (the Board's or IASB's) Exposure Draft—ED 5 *Insurance Contracts* (referred to as ED 5 or the draft standard). Our responses to the questions raised in the Exposure Draft are set out in the Appendix to this letter.

While we applaud the IASB for its efforts to address the accounting for insurance contracts, we question the approach taken in ED 5. That is, to develop an "interim standard" that exempts entities within the scope of the draft standard from complying with certain parts of the Framework and defers addressing recognition and measurement principles until a later date. We do not believe this approach should be precedent for future projects. In contrast, we would prefer that the IASB address these issues as part of a comprehensive project involving the development of proper recognition and measurement principles for insurance contracts.

We disagree with the insertion of a "sunset clause" in relation to this exemption. While we acknowledge the need to progress on a timely basis to the solution that will emerge from the phase II project, we are concerned that a short timetable has been imposed before there is any clarity as to whether phase II can be completed before the expiry of this deadline. We believe that the Board's efforts should focus on determining the long-term solution for accounting for insurance contracts at the earliest date achievable. In addition, without adequate guidance on how to determine the fair value of insurance contracts, we suggest the Board re-consider the usefulness of the fair value disclosures proposed. We believe that it is important for entities applying the final standard to be able to understand and implement such requirements as they likely will be a significant change for most entities.

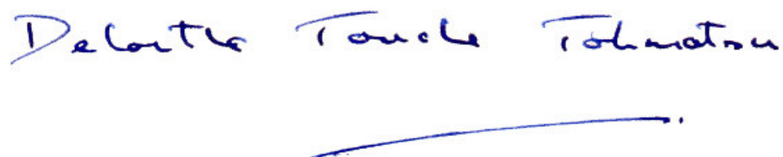
We understand the IASB's desire to finalise as many of its projects prior to the implementation of International Financial Reporting Standards (IFRS) in Europe. Consequently, we accept the need to provide some interim guidance on the accounting for

insurance contracts before a final standard on recognition and measurement principles is completed. However, we do not believe that such efforts should compromise either the integrity of the Board's due process or the applicability of the Framework.

Due to the compromise nature of the proposals included in the draft standard, our comments are limited to the practical aspects of such proposals rather than their conceptual merit. As a result, we have not responded to all of the questions posed in the draft standard.

If you have any questions concerning our comments, please contact Ken Wild in London at (020) 7007 0907.

Sincerely,



Appendix
Comments of Deloitte Touche Tohmatsu on
Insurance Contracts

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

(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?

We generally agree with the scope in the draft standard.

We suggest that paragraph 4(f) be clarified to state that the definitions of the final standard apply to determining what constitutes an insurance contract in the hands of a policyholder but that the remainder of the standard does not apply if the definition of an insurance contract is met. This by implication would require other relevant standards, in particular IAS 32 and 39, to be applied if the definition is not met.

We also recommend that the Basis for Conclusions clarify that "self-insured" employee benefits are not dealt with under the final standard but are within the scope of IAS 19 Employee Benefits. In addition, we suggest that the IASB clarify whether employee discounts on insurance contracts sold by the entity to its employees cause the entire insurance contract to be an employee benefit to which IAS 19 would apply or whether it is only the discount that constitutes the benefit, leaving the remainder of the contract to be dealt with under the final standard.

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?

We generally agree with the definition of an insurance contract as set out in the proposed standard and elaborated upon in the appendices, Basis for Conclusions and draft implementation guidance. Our specific comments on the definition are as follows:

- It is not clear as to what is meant by "significant insurance risk", in that the terms "plausible" and "extremely unlikely" appear contradictory. We note paragraph B21 of Appendix B of ED 5, which states:

  > Insurance risk is significant if, and only if, it is plausible that an insured event will cause a significant 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). This condition is met even if the insured event is extremely unlikely or if the present value of contingent cash flows is a small proportion of the expected (i.e., probability-weighted) present value of all the contractual cash flows.

  The term "plausible" in paragraph B21 may be interpreted to imply that it should be reasonably possible (i.e., something greater than a remote chance of occurring) that an insured event will occur. It appears that the IASB's intention was that the term "plausible" refers to the likelihood of loss, given that the event occurs, while the term "extremely unlikely" refers to the likelihood of the event occurring. We suggest the IASB provide clarification to make this distinction clear. In addition, we suggest that the Board explicitly note in paragraph B21 whether or not remote scenarios, including catastrophic type events, should be included.

- There appears to be an inconsistency between the wording in paragraphs B21, where it is phrased in terms of <u>net</u> cash flows, and B23, where it is phrased in terms of the difference between the payment on death and payment on surrender, which is a <u>gross</u> cash flow measure. The wording in paragraph B23 could be interpreted as when there is more than just a trivial change of the present value of the net cash flow there is a significant insurance risk. This would be a broader meaning of significant compared to B21.

- We note that IG Example 1.2 may be too widely drawn in that it would appear to include almost any contract that has a redemption penalty that is waived on death. This would affect many loans and mortgages otherwise accounted under IAS 39. We suggest that the example should be re-framed to refer to surrenders where the penalty is in excess of the recovery of outstanding acquisition costs.

- We disagree that pure endowments (IG Example 1.4) are best described as "investment contracts unless there is significant mortality risk". Such policies make no payment unless the policyholder survives to the maturity of the policy and they are priced on the assumption that a proportion of policyholders will fail to survive until maturity of the policy. If a larger than expected proportion does survive to maturity, then the insurance company would make a loss. Conversely, if a smaller proportion survives the company

would make a profit. In each case the risk is significant and it is an insurance risk rather than an investment risk.

We suggest the Board include additional examples on borderline cases to clarify the application of "significant insurance risk".

We note, and agree with, the discussion in the Basis for Conclusions that excludes gambling activities from the definition of an insurance contract. We do, however, note that where a bookmaker mitigates risk by taking a back-to-back contract with another bookmaker, it is likely that the contract will meet the definition of a reinsurance contract. Although we do not believe this to cause significant problems, we suggest the Board to clarify whether this was its intention in the final standard.

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?

(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?

(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?

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

We generally agree with the proposed exemptions from the requirements in IAS 39, but suggest including guidance on the following contracts in IG Example 2: Embedded Derivatives:

- Contracts containing non-guaranteed participating dividends or experience refund provisions (based on actual experience of the insurance enterprise with respect to the related block of contracts).

- Contracts that provide for pass-through to the contract holder of investment return on a group of assets.

- Insurance contracts containing cash surrender options that provide for the contract holder's allocation of contract account value among various variable investment options.

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?

(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 until they are discharged or cancelled, or expire, and to report insurance liabilities 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 would prefer that the IASB address the accounting for insurance contracts as part of a comprehensive project involving the development of proper recognition and measurement principles, thereby eliminating the need to provide a "temporary" exemption from the Framework. We believe the Framework is the document that provides the basis against which standards are prepared and allows constituents to determine the direction of future standards. Deviating from the Framework creates uncertainty as to the basis the Board is using to develop standards which we believe to be an undesirable outcome.

We disagree with the insertion of a sunset clause in relation to this exemption and believe that if the Board views the exemption from the Framework as necessary, this exemption should be included until it is no longer necessary. The inclusion of a time period may leave the Board with no choice but to extend the exemption if the phase II project has not been finalised by the time period envisaged. As a result, the Board may face undue time pressure in an area where we would prefer due consideration be given to the appropriate accounting for insurance contracts. We understand the IASB's desire to finalise many of its projects prior to the implementation of IFRS in Europe. However, we do not believe that such efforts should compromise either the integrity of the Board's due process or the applicability of the Framework.

We believe that the IASB should clarify in the final standard whether there can be future claims under current contracts qualifying for recognition as catastrophe provisions. Reading BC 61 which states that ED 5:"...prohibits the recognition of catastrophe and equalisation provisions relating to <u>future</u> claims on <u>future</u> contracts" would lead us to conclude that some catastrophe provisions are still allowed to be recognised for future claims under current contracts. This would lead to a situation whereby such catastrophe provisions are not totally eliminated but are merely reduced.

We agree with the restrictions set out in paragraph 10 of the draft standard. In principle, we agree that a "minimum" loss recognition test should be performed to reduce the possibility that losses remain unrecognised. However, we note that the guidance in paragraphs 11 and 12 of ED 5 appears to create two different thresholds for evaluating potential future losses. That is, in cases where an entity's existing accounting policy requires a loss recognition test and that test meets the minimum requirements in paragraph 11, the draft standard does not impose further requirements on the test. However, where an entity's existing accounting policy does not require a loss recognition test that meets the minimum requirements in paragraph 11, the entity is required to follow the guidance in IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, to determine if a deficiency exists.

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 test that other entities follow, provided those tests meet the minimum requirements in paragraph 11 of the draft standard.

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 recognise the need to narrow divergent practices in accounting for insurance contracts and support the Board's effort's to do so. We agree with the proposal to allow the reclassification of financial assets in the draft standard only when there is an improvement in the accounting for insurance liabilities. We suggest the final standard clarify that the financial assets included in this category cannot be removed from this category at a later stage.

We note that the draft standard provides the ability to change practices prior to the introduction of the final standard and believe the exemption should only apply to accounting practices that have been consistently used in accounting for insurance contracts over the past three years. If changes to accounting policies in this area have been made prior to the effective date of the final standard, then they should only be "grandfathered" if they were an improvement to the previous policies as judged by the criteria in paragraph 14 of the draft standard.

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?

The conditions that require unbundling are not clear under the guidance in ED 5. For example, what types of contracts are to be included in the definition of 'traditional" life

insurance contracts? We believe that the current description of traditional life insurance contracts under paragraph 8 of ED 5 may lead to inconsistency in determining to which contracts the unbundling guidance should be applied. We note paragraph IG6 of the Implementation Guidance, which states:

> The unbundling requirement is intended to capture examples of this kind in which a payment by one party leads to automatic repayments by the other party in a future period. Although arrangements of this kind are more common in reinsurance, the same principle applies in direct insurance. However, paragraph 8 of the draft IFRS confirms that the unbundling requirement is not intended to capture traditional surrender features in life insurance contracts.

The last sentence in paragraph 7 of ED 5 notes that if the cash flows from the insurance component do not affect the cash flows from the deposit component, an insurer shall effectively unbundle the contract into insurance and deposit components. We suggest that the Board clarify whether the unbundling guidance in paragraphs 7 and 8 of ED 5 applies to all property and casualty contracts or only those types of contracts described in paragraph IG6.

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?

Paragraph 19 of ED5 requires the application of IAS 36 *Impairment of Assets* to the rights under ceded reinsurance. We believe the Board should reconsider the implications of this paragraph given the unique nature of reinsurance.

As a result of subjecting the cedent's rights from reinsurance purchased to IAS 36, ceded reinsurance assets that are undiscounted are likely to be impaired. We note that since reinsurance assets are not traded in an active market, the value in use would generally apply in determining the recoverable amount. In addition, the discount rate used in computing the value in use under IAS 36 could be significantly different than the discount rate that would be applicable under a fair value approach, which is envisaged in the phase II project. As a result, paragraph 19 of the proposed IFRS could result in inconsistent treatment where reinsurance assets would have to be discounted under IAS 36, even if insurance liabilities are not discounted under local GAAP.

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 believe the understanding of the proposals would be enhanced if the final standard clarified that the allocation between the various components may be amended from time to time. In addition we suggest that it be clarified that the guidance on discretionary participation features also apply to cases involving an unallocated deficit.

We note that the disclosure of the accounting policies relating to such features is contained in the implementation guidance only. We believe that it would be more appropriate to make this explicit in the text of the final standard.

Question 10 – Disclosure of the fair value of insurance assets and insurance 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 do not believe that it is appropriate to require this disclosure without adequate guidance on how to compute fair value. We note that this requirement differs from that proposed in IAS 32 at the time, in that markets for financial instruments were far more developed and models for determining the fair value of non-traded financial instruments were at a more advanced stage. Given the unique nature of such assets and liabilities, we suggest that the Board provide some guidance on how to measure the fair value of such items. Such guidance may be along the lines of the fair value considerations as discussed in IAS 39 paragraphs 95-101. If the IASB determines that it is not feasible to provide such guidance in the final standard, then we believe that such disclosures should not be required.

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.

(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?

(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?

The disclosure requirements in paragraphs 26 are in the context of disclosing information that "identifies and explains", while the disclosures in paragraph 28 require disclosure of information that "enables users to understand". These terms imply different levels of information to de disclosed. We believe there should be consistent language used in characterising the level of disclosure required under these paragraphs. We believe the term "identifies and explains" more appropriately characterises the level of disclosure required as it does not imply that the financial statements are required to educate users.

The implementation guidance discusses how an insurer "might satisfy" the disclosure requirements in the draft standard. Paragraphs IG 7 - IG 59 include an extensive list of subjects and issues for consideration in developing disclosures, with the expectation that insurers will select the most meaningful information. We note that insurers writing diverse lines of business, complex products or operating in multiple jurisdictions are likely to have difficulties in completing these disclosures, including obtaining data from historical time periods where it was not previously required or estimates of future cash flows or sensitivity results of the type not normally provided. In addition, the guidance includes disclosures about risks, uncertainty and sensitivity to assumptions and other elements. We suggest the Board reconsider the appropriate level of disclosure that should be required, including the need to aggregate the disclosures.

We believe the proposed disclosures in paragraph 29(c)(iii) are excessive. We encourage the IASB to revisit whether the benefits of capturing such information are worth the costs. Alternatively, we suggest that the proposed claims development data either be included on a time frame similar to other disclosures in the financial statements, or replaced with a roll forward of claim reserves for each statement of operations that is included in the financial statements, detailing a breakdown of incurred and paid losses for current and prior accident years.