EFRAG
European Financial Reporting Advisory Group

31 October, 2003

Sir David Tweedie
Chairman IASB
30 Cannon Street
London EC4M 6XH
UK

Dear David,

Re: ED 5 *Insurance Contracts*

On behalf of the European Financial Reporting Advisory Group (EFRAG) I am writing to comment on ED 5 *Insurance Contracts* ("ED 5"). This letter is submitted in EFRAG's capacity of contributing to IASB's due process and does not necessarily indicate the conclusions that would be reached in its capacity of advising the European Commission on endorsement of the definitive IFRS on the issues.

If ED 5 were to be the final standard on accounting for insurance contracts we would have to regard it as inadequate in that it permits the use of a variety of accounting policies which conflict with both the Framework and the hierarchy (paragraphs 5 and 6 of the proposed amendments to IAS 8), which form the basis for International Financial Reporting Standards. It also permits the use of non-uniform accounting policies for the insurance liabilities of subsidiaries which are consolidated within one group. As a result there will be little consistency between accounting policies used by different companies and a lack of comparability.

Nevertheless we recognise the need for the proposed standard as a bridge towards the final standard ("phase II"). We acknowledge that it has not been possible to develop and implement that standard in time for the 2005 introduction date for the use of International Financial Reporting Standards by listed companies in Europe. As such phase I is intended to permit insurance companies to apply International Financial Reporting Standards without having to make significant systems changes twice.

It is important, however, that phase II should be introduced as soon as practicable so that phase I does not come to be regarded as a long term standard. In that respect we do not believe that a sunset clause (paragraph 9, which provides temporary exemption from application of the hierarchy set out in paragraphs 5 and 6 of the proposed improvements to IAS 8 *Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies,* expiring in 2007) is the right instrument to achieve that.

The key principle of ED 5 is that companies will be able to continue to use existing practices by and large but where accounting policies are changed they must move towards policies most likely to be used in phase II rather than away from them. We believe this represents a practical approach and we therefore support it.

We acknowledge that the mismatch caused by different measurement bases for assets and liabilities in the interim phase is a major issue for the insurance industry. It will result in great volatility in equity because unrealised gains and losses on assets (categorised as available-for-sale) will be recognised in equity but no corresponding adjustment will be made for gains and losses on the liabilities which are matched by the assets. Insurers continuously manage their investments portfolio of bonds to meet their liabilities when due. Gains and losses on a long term bond portfolio will be temporary if the bonds are held to maturity. Unfortunately insurers cannot account for such bonds at cost (as held-to-maturity-assets) without triggering the penalties of the tainting rules of IAS 39 should they have to realise those assets early in the event of unexpected changes in lapse rates and mortality patterns. We therefore suggest a relaxation of the tainting rules of the held-to-maturity category for fixed interest rate instruments under clearly defined criteria for insurance business only and for the short term during which phase I will apply. (See also our comments in response to Question 13 – *Other comments*).

Although we accept that the intention of phase I is that it should be seen as an interim standard and a bridge towards phase II, we are concerned that phase I will require insurance entities to change only some of their accounting practices applied under national GAAP and to keep other parts at the same time. We fear that by requiring piecemeal changes to existing practices without more detailed consideration of the entire accounting for insurance business – which will be done for phase II - there is a risk that the resulting financial information is less meaningful. This is particularly the case when reinsurance is dealt with separately from insurance.

We also acknowledge that requiring the disclosure of fair value of insurance assets and insurance liabilities from 31 December 2006 presents a dilemma. We believe the requirement is inappropriate until IASB has decided how fair value is determined. We expand further on this in our response to Question 10 – *Disclosure of the fair value of insurance assets and liabilities.*

Appendix 1 sets out our answers to the questions raised in ED 5 *Insurance Contracts*.

If you would like further clarification of the points raised in this letter Paul Rutteman or myself would be happy to discuss these further with you.

Yours sincerely

Johan van Helleman
EFRAG, Chairman

EXPOSURE DRAFT 5 - INSURANCE CONTRACTS

<u>Question 1 – Scope</u>

(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?

<u>EFRAG response:</u>

(a) ED 5 addresses insurance contracts rather than entities. We support this decision on the grounds that it specifies the basis of accounting for similar contracts, regardless of the legal structure of the entity issuing the contract.

Clause (a) (i) of Question 1 refers to the requirement that assets held to back insurance contracts must be accounted for using existing IFRS, for example IAS 39 *Financial Instruments: Recognition and Measurement* and IAS 40 *Investment Property*. In practice, financial assets will usually fall into the category "available-for-sale" and therefore be accounted for at fair value with gains and losses taken to equity. This will lead to a mismatch between the measurement basis of assets (normally fair value) and insurance liabilities (usually some form of amortised cost according to current local GAAP). We believe this approach should be revisited and we comment further in our response to Question 13 – *Other comments*.

Clause (a) (ii) of Question 1 relates to the scoping out of investment contracts from ED 5, because they should be accounted for under IAS 39. We agree with this but believe it important that there should be consistency of accounting treatment of long-term financial contracts between the IFRS for insurance contracts and IAS 39 in general.

(b) We believe it is appropriate that weather derivatives are brought within the scope of IAS 39 unless they meet the proposed definition of an insurance contract.

<u>Question 2 – Definition of an Insurance Contract</u>

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?

<u>EFRAG response:</u>

We believe that the definition of an insurance contract set out in ED 5 when read in conjunction with the related guidance in Appendix B is acceptable.
However, the definition of "significant insurance risk" appears inconsistent between paragraphs B21, where it is phrased in terms of net 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 gross cash flow measure. We are concerned that it will be difficult to determine if a contract includes "significant insurance risk" or not, and that as a result comparability of financial information may be reduced. The wording of Appendix B, 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 recommend the Board to include additional examples on borderline cases to clarify the interpretation of "significant insurance risk".

We have some detailed comments connected with the definition of insurance contracts:

(i) We are concerned that the case where the death benefit exceeds the surrender amount (IG Example 1.2) is too widely drawn in that it will catch 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 would 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.

(ii) 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 proportion than expected were to survive to maturity, then the insurance company would make a loss. Conversely, if a smaller proportion were to survive the company would make a profit. In each case the risk is significant and it is an insurance risk rather than an investment risk.

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?

EFRAG response:

(a) and (b)

In principle we support the view that all embedded derivatives should be reflected at fair value and note that this is the overall intention under the phase II proposals. These proposals should be developed consistently with changes in IAS 39 to ensure all derivatives are reflected at fair value. However we acknowledge that, as a result of such proposals, companies may face significant implementation problems. Consequently we support the Board's view to apply the current principles under IAS 39 whereby embedded derivatives that meet the definition of insurance contracts need not be separated.

We believe that the implementation guidance developed by the Board is sufficiently clear to apply to derivatives embedded in insurance contracts.

However, we note that the analysis in the implementation guidance is based on the assumption that the host contract is a debt-like instrument by nature (see IAS 39 IGC Question 23-12). The reason for the assumption is that the instrument has a stated maturity and does therefore not meet the definition of an equity instrument (IAS 39 paragraph 8). This could lead, for example, to the analysis that a unit-linked or particularly an index-linked contract represents a debt-like host plus an embedded future. This is a counter-intuitive result and is at odds with the manner in which unit-linked, or variable plans are accounted for and managed in every territory internationally. In consequence, the result may lead to significant implementation issues with the need for extensive explanations. We suggest that further consideration is given to the nature of the host contract and, in particular, whether the direct linkage of the liabilities to equity-type performance may be better portrayed as an equity-like instrument.

If all insurance contracts are to be treated as debt like instruments, then this can lead to circumstances where significant minimum interest rate guarantees are not separated. As noted above, we are generally in favour of such guarantees being recognised. However, we conclude that the non-separation of such guarantees is acceptable as an interim measure in order to ensure consistency with IAS 39 until the treatment of embedded derivatives in IAS 39 is itself revisited.

(c) In line with our views above on the recognition of derivatives, we believe that the Board's proposals for the disclosure requirements for such options are adequate.

(d) No other embedded derivative has been identified as requiring exemption.

<u>Question 4 – Temporary exclusion from criteria in IAS 8</u>

(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?

EFRAG response:

(a) We regard the exemption as appropriate given the current state of the Board's development of phase II of the project on insurance contracts.

In general we do not believe the sunset clause is appropriate because we can foresee potential problems in the event that phase II is delayed. It could be that entities would have to fall back to other accounting regimes or could cherry pick different principles of different GAAPs thereby creating their "own GAAP". This would certainly be a lack of consistency of choice in the absence of a standard. However, we recognise the need for a high quality comprehensive standard on insurance contracts at the earliest practical time.

(b) In general we believe that the proposals in (i), (ii) and (iii) are appropriate.

We believe that the requirement not to recognise catastrophe provisions or equalisation provisions under future insurance contracts may be interpreted as a permission to recognise them under current insurance contracts (which would also cover renewals of existing contracts) and to carry them forward for an unlimited time. We recommend a change of wording to avoid any misinterpretation.

With regard to proposal (b) (ii), we would welcome further clarification regarding the implementation of a loss recognition test. We support the need for loss recognition in phase I but believe that the "current estimate of future loss" needs to be clarified further. In particular, the requirement in Paragraph 11 of ED 5 may be interpreted to apply to the aggregate of the entire portfolio of insurance contracts. If this is the case, then it would be helpful if the text made this clear.

Additionally, most if not all GAAPs used in European jurisdictions require loss recognition tests but these tests are done in accordance with local GAAP rather than IAS 37. In consequence, some individual contracts may show losses under IAS 37 that are not evident under the local GAAP, even though, looked at systematically, the two approaches would lead to comparable strength of provisions. We would not expect further loss recognition tests to be required under IAS 37 in these circumstances as this would be causing unnecessary work for the short period during which phase I is effective.

We believe that additional guidance should be provided on how to apply IAS 37. For example, we would expect that such tests would include all options and guarantees within the insurance contracts but it would be helpful if this were stated explicitly.

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?

EFRAG response:

We believe that the proposals in (a) and (b) are appropriate. However, we note that the effect of some of the proposals can be interpreted as preventing companies from moving to US GAAP and we wonder whether this was intended, because it could penalise European companies in the long-term if the phase I standard is in place for more than a short period.

We do not agree that entities should be able to use non-uniform accounting policies for the insurance liabilities and related deferred acquisition cost assets of subsidiaries (as described in paragraph 16 (e)), because it reduces the relevance and reliability of financial statements (as the IASB argues in BC88). However, taking into account the limited objective of ED 5 of granting temporary exemption from certain international accounting practices in order to avoid system changes that might no longer be needed in phase II of the project, we accept this for an interim period. We acknowledge that it is not possible to switch to an accounting policy of using non-uniform accounting policies if an entity already uses uniform accounting policies for insurance contracts across its subsidiaries.

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?

EFRAG response:

(a) We regard the current proposal in paragraph 7 of ED 5 as an improvement compared to previous draft proposals as it recognises that unbundling is required only when the bundled nature of the plan obscures the proper accounting for the obligations.
However, EFRAG does not favour the unbundling of insurance contracts in principle, except in cases where the structure of the contract is clearly artificial. This is because insurance contracts are, in general, designed, priced and managed as packages of benefits and, in consequence, any unbundling required solely for accounting purposes would necessarily be artificial.

Where the structure of a contract does obscure the accounting for the deposit element and unbundling of the insurance and investment components may be required, we believe the criterion should be that “the cash flows of the insurance component and the investment component do not interact” rather than the current one-sided proposal to test if “the cash flows from the insurance component do not affect the cash flows from the deposit component”. This change would lead to a more balanced approach and leave bundled a number of traditional products, where the one-sided test might apply unnecessarily.

(b) We do not believe that unbundling should be required in any other cases and we agree that surrender values should not be unbundled from traditional life contracts.

(c) Subject to the comments made under (a), we believe it is clear when unbundling is required during phase I.

Question 7 – Reinsurance

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?

EFRAG response:

We do not believe that these proposals are appropriate in the sense that the proposed treatment of certain aspects of the reinsurance of insurance contracts under phase I does not consider in detail the entire accounting for reinsurance, which will only be done for phase II.

For example, under many existing GAAPs for insurance, the insurer's liability for direct insurance contracts is based on the conservative assessment of future conditions. This approach leads to losses being reported at outset. If a reinsurance treaty subsequently takes a proportion of that liability and the cedant accounts for that treaty on a consistent basis, then the loss at outset is partially reversed on the same proportionate basis.

The current proposals in paragraph 18 of ED 5 will lead to the loss at outset on direct business being recognised but not the subsequent partial reversal if the business is reinsured. This will lead to the creation of artificial losses at outset and the bolstering of earnings in subsequent periods for reinsured contracts.

Further, the proposed spreading of profits for reinsurance contracts over future periods represents a significant additional systems requirement for phase I that would not be used subsequently in phase II.

Paragraph 19 of ED 5 requires application of IAS 36 *Impairment of Assets* to rights under a reinsurance contract and therefore the technical reinsurance asset or liability to be valued at the lower of carrying value and recoverable amount (the higher of net selling price and value in use). This would impose a requirement to fair value (at discounted value) the asset or liability. Thus, the reinsurance obligation has to be valued at "fair value" although the Board has not yet decided upon measurement principles for insurance liabilities. Therefore, we suggest that the Board clarifies that it is not the intention to require a fair value measurement at this stage.

We therefore recommend that in general the treatment of all aspects of reinsurance accounting should be addressed in phase II and not in phase I. This would allow reinsurance accounting to be made consistent with the approach adopted for direct business in phase II thereby avoiding the creation of anomalous results and the need to modify financial systems solely for phase I.

We would, however, like to maintain the requirement that certain financial reinsurance contracts with a lack of risk transfer to reinsurers are treated as financial rather than insurance transactions although we recognise that a proper application of the proposed definition would already provide for that.

<u>Question 8 – Insurance contracts acquired in a business combination</u>

IAS 22 *Business Combinations* requires an entity to measure at fair value assets acquired and liabilities assumed in a business combination and ED 3 *Business Combinations* proposes to continue that long-standing requirement. The proposals in this draft IFRS would not exclude insurance liabilities and insurance assets (and related reinsurance) from that requirement. However, they would permit, but not require, an expanded presentation that splits the fair value of acquired insurance contracts into two components:

(a) a liability measured in accordance with the insurer's accounting policies for insurance contracts that it issues; and

(b) an intangible asset, representing the fair value of the contractual rights and obligations acquired, to the extent that the liability does not reflect that fair value. This intangible asset would be excluded from the scope of IAS 36 *Impairment of Assets* and IAS 38 *Intangible Assets*. Its subsequent measurement would need to be consistent with the measurement of the related insurance liability. However, IAS 36 and IAS 38 would apply to customer lists and customer relationships reflecting the expectation of renewals and repeat business that are not part of the contractual rights and obligations acquired.

The expanded presentation would also be available for a block of insurance contracts acquired in a portfolio transfer (paragraphs 20-23 of the draft IFRS and paragraphs BC93-BC101 of the Basis for Conclusions).

Are these proposals appropriate? If not, what changes would you suggest and why?

<u>EFRAG response:</u>

We regard these proposals as appropriate.

On a point of clarification, paragraph 20 of ED 5 permits, but does not require, an expanded presentation, that splits the fair value of acquired insurance contracts into two components. BC93 identifies the second component as the present value of in force business. This is a particular example arising in the acquisition of a portfolio of life insurance contracts. However, similar issues arise in other types of insurance business acquisitions. For example, a company acquiring a portfolio of general insurance provisions/claims with an accounting policy that does not discount provisions/claims might recognise an intangible asset (being the difference between the value of the liability in accordance with the acquirer's accounting policy and the fair value of the liability). Confirmation that this intangible asset and potentially other such assets are permitted under the ED 5 would be useful.

We understand that phase I will not exempt insurance assets and liabilities from the requirement for an acquirer to measure assets and liabilities acquired in a business combination in accordance with ED 3 *Business Combinations*. We support this general approach. However, the illustrative example B.3 in ED 3 seems to give rise to an anomaly. Applying, by analogy, the illustrative example B.3 "Customer contracts and the related customer relationships" to insurance contracts, an open book of insurance contracts would be recognised as an intangible asset in a business combination.
However, under ED 3 paragraph 43, it is a precondition that such an asset meets the definition in IAS 38 *Intangible Assets*. Phase I will require the application of IAS 38, which requires control and therefore excludes customer relationships (paragraph 15 of the proposed amendments). For this reason we understand that the portfolio to be valued in the insurance project is limited to the closed book.
We would welcome clarification as to whether an open or closed book approach is seen as most appropriate.

<u>Question 9 – Discretionary participation features</u>

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?

<u>EFRAG response:</u>

We support the temporary exemption for contracts with discretionary participating features as an interim measure until phase II is implemented and we agree that an intermediate category, neither liability nor equity, should not be permitted for the unallocated surpluses associated with discretionary participating features in insurance contracts (paragraph 24 (b)).

However, we understand that these contracts are still within the scope of IAS 32 *Financial Instruments: Disclosure and Presentation* for disclosure purposes (see Appendix C1 of ED 5), which means that fair values of such contracts should be disclosed at least from December 2005 onwards. Since the main reason that these financial instruments with discretionary participation features are excluded from IAS 39 during phase I is the unsolved question of classification of the unallocated surplus as equity or liability and we acknowledge that this is one of the main objectives for phase II, we believe they should also be also exempted from IAS 32 disclosure requirements for phase I.

The mismatch – which we refer to in detail under Question 13 – *Other comments* - caused by the use of different measurement bases for assets and liabilities in profit participating contracts would not arise to that extent if the unallocated surplus (unrealised gains and profits) were to be regarded as constructive obligations regardless of the nature of the discretionary features and even though the allocation of unrealised profits or losses to shareholders or policyholders is still to be made. We believe that, where unrealised gains and losses resulting from carrying assets at fair value relate to participating contracts with discretionary features during phase I they may be regarded as constructive obligations rather than equity. We note that in some instances doubt may arise as to whether certain discretionary participation features constitute constructive obligations. We ask the Board to confirm in the final standard that such discretionary features may be regarded as constructive obligations if market practice makes the payment of the benefits reasonably certain. If this approach to participation rights can be regarded as an improvement it would then be regarded as a change in accounting policies permitted under phase I (paragraph 14 of ED 5).

Paragraph 25 of ED 5 requires the application of paragraph 24 to investment contracts that contain both a discretionary participation feature and a fixed element that requires non-discretionary payments. Paragraph 24 (d) requires the issuer of such a contract to continue its existing accounting policies for such contracts subject to the exceptions listed. This results in the continuation of an existing accounting policy of accounting for such contracts as premiums and appears to conflict with the principles applying to other investment contracts. We would appreciate clarification whether this basis of revenue recognition is intended.

Furthermore we ask the Board to confirm our understanding of ED 5 paragraph 24 (a) and (d) that it does not require IAS 39 deposit accounting to be extended to investment contracts with discretionary participation features and therefore reporting the fixed element separately from the discretionary participation feature.

<u>Question 10 – Disclosure of the fair value of insurance assets and insurance liabilities</u>

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?

<u>EFRAG response:</u>

Whilst we recognise the Board's proposal to require disclosure of fair value of insurance liabilities as an interim step towards phase II we believe it is unreasonable to require fair value of insurance liabilities to be disclosed when IASB itself has not determined how those fair values should be arrived at. There is at present a variety of views as to what is meant by fair value in this context (e.g. entry value or exit value) and practical difficulties in setting up models to determine these values (because there is no active market for insurance contracts). To leave the meaning open is to invite different interpretations leading to non-comparable and possibly unreliable information.
We understand the Board intended to resolve this point by completing the phase II standard before phase I comes into force. However this would mean that in the phase I standard IASB is asking for a mandate to interpret its own requirement before explaining what that interpretation may be. For that reason we believe the disclosure requirement should be introduced only when it is understood (by IASB and its constituents) what is called for and after IASB has exposed the detailed requirement for public comment.

We recommend instead that the Board should encourage the disclosure of (fair-) value-based information including information about the key assumptions and the methodology used to arrive at those values. We believe that many insurance companies already provide such information (e.g. embedded values) on a voluntary basis.

<u>Question 11 –Other disclosures</u>

(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?

EFRAG response:

(a) Overall we support the proposed disclosures in (a), (b) and (c) set out in paragraphs 26 to 29 of ED 5 provided such disclosures are balanced between qualitative and quantitative information.

However, we believe that certain requirements are broad and could be interpreted to be too burdensome for entities if the Implementation Guidance is not carefully considered together with the wording of the proposed IFRS. For example paragraph 29 (b) requires the disclosure of "those terms and conditions of insurance contracts that have a material effect on the amount, timing and uncertainty of future cash flows." In our view this is so widely drawn that it could be taken to require a mass of detailed information about different policy conditions and the potential effectiveness of exclusion clauses (as determined in a variety of court cases). The Implementation Guidance in IG38 and 39 suggests that what is required is more limited and general in nature and is required only for "each broad class of insurance liabilities and reinsurance assets held", It would be helpful if the wording of the standard were to be conformed with that currently in the guidance notes, especially since the Implementation Guidance does not form part of the standard.

There are some disclosures that we regard as sufficiently important to investors that the additional burden is justifiable. In particular, we support the requirement of information on positive or negative claim provision run-offs although we note that the actual information required may differ in detail from that required for US GAAP.

(b) We regard this approach as appropriate.

(c) We do not believe that any changes should be made to the transitional relief referred to in the question.

Question 12 – Financial Guarantees

The Exposure Draft proposes that the transferor of a non-financial asset or liability should apply IAS 39 *Financial Instruments: Recognition and Measurement* to a financial guarantee that it gives to the transferee in connection with the transfer (paragraphs 4(e) of the draft IFRS, C5 of Appendix C of the draft IFRS and BC41-BC46 of the Basis for Conclusions). IAS 39 already applies to a financial guarantee given in connection with the transfer of financial assets or liabilities.

Is it appropriate that IAS 39 should apply to a financial guarantee given in connection with the transfer of non-financial assets or liabilities? If not, what changes should be made and why?

EFRAG response:

We agree with the Board's proposal that provides a clear distinction between financial guarantees given by a transferor of non-financial assets or liabilities and a credit insurance written by a credit insurer. As a result, the genuine activities of credit insurance, which meet the definition of insurance, will be covered by the proposed IFRS on Insurance Contracts and therefore will be treated as other insurance contracts. Similarly, financial guarantees provided by industries other than the insurance industry, for example banks, would also be treated as insurance contracts, if they meet the definition.

Question 13 – Other comments

Do you have any other Comments on the Exposure Draft and Implementation Guidance?

1. Measurement basis for insurance assets and liabilities

The interaction between IAS 39, including the current proposed changes, and ED 5 creates a measurement mismatch for insurance contracts, which is acknowledged by the Board in BC110. This results from the recognition in phase I, that insurance liabilities will continue to be measured under existing accounting policies, which usually adopt some form of amortised cost approach, while the financial assets backing these insurance liabilities will, in most practical circumstances, need to be held on an available-for-sale basis, which results in the assets being held on the balance sheet at market value. This will result in volatility, often for artificial reasons, in equity. We describe the volatility as artificial because, even when the assets and liabilities are perfectly matched, movement in equity would occur solely due to the different measurement bases.
We know that some European countries (e.g. the UK and Ireland) already require insurance assets to be included at fair values (except for certain fixed interest rate instruments) while using a different (cost-based) measurement basis for the liabilities and therefore the proposals of phase I will not be a major change for companies in these countries. We believe that for many companies in continental Europe, however, fair value measurement of financial assets and some form of amortised cost measurement for corresponding liabilities resulting in volatility in equity is a problem.
The impact of the mismatch can be significant. By way of illustration, the impact on a well-matched book of annuities in payment of a 1% change in interest rates could be of the order of 7% to 10% of technical provisions. The impact of such a change on a well-matched block of traditional non-participating plans could be of the order of 3% to 5% of technical provisions.

To date the IASB has not felt able to accept any suggestions because there is no wish to extend the exceptions to the general principle that investments be marked to market. We believe that the mismatch issue is sufficiently important in phase I of the project that it should be further addressed by IASB, possibly in close cooperation with interested parties.

EFRAG is aware that a number of major European insurance companies already apply US GAAP and are required therefore to include their investments held to match insurance liabilities at fair value and so are experienced in coping with the volatility issue to the point that users of financial statements expect investments to increase or decrease in line with market conditions. However, users also recognise that insurance is a long-term business and their liabilities will fall due "on average" some time in the medium to long-term future. It is therefore normal to discount such liabilities to reflect present values. EFRAG therefore

discussed whether the mismatch problem could be avoided if, at the same time as moving to the use of fair values for investments, insurers discounted their insurance liabilities, also described as the unlocking of the interest rate. The advantage of such an approach is that it overcomes the mismatch problem to a large extent without requiring any changes to existing standards (e.g. IAS 39).
However, only a few companies currently discount their liabilities for the non-life business and most of the companies currently discounting their liabilities for the life business do not update interest rates used on a regular basis. Therefore, the implementation of such a proposal would present considerable practical difficulties. It would be a step towards fair valuation of insurance liabilities but may well not reflect the approach which the Board will finally decide to use for phase II. Since it is also not intended that phase I should require changes which may be reversed in phase II we do not suggest that this idea be further developed in phase I. Instead, we propose the following approach:

As regards the mismatch in the area of profit participating contracts and how it could be avoided in phase I we refer to our answer to Question 9 – *Discretionary participation features*. However, if our proposal to regard the unallocated surplus of participating contracts as constructive obligations were to be accepted by the Board, there would remain a large area of contracts – non-participating plans and all non-life contracts - for which a mismatch would still arise.

Having reviewed the available solutions to address the mismatch for the remaining contracts, we believe that the best solution is a relaxation of the tainting rules that constrain the held-to-maturity category of financial instruments in IAS 39. That relaxation would be based on clearly defined criteria for insurance undertakings only and limited to the short period during which phase I applies. Under this solution a certain number of fixed interest rate instruments held by insurance entities to match insurance liabilities (using well defined criteria to demonstrate the matching designation) could be designated at outset as held-to-maturity. This designation should be subject to specified criteria which force companies to make sure that specific assets (held to back insurance liabilities) are designated to specific liabilities. An unexpected sale of such designated financial assets before maturity date should not be the trigger for the tainting rules that constrain the held-to-maturity category if and only if the sale is a necessary reaction by the management to an unexpected and significant change in insurance risk (e.g. change in mortality or lapse rates). Any general practice of managing portfolios to optimise interest rate returns depending on current fluctuations of financial markets should not fall within the described exemption. This means that simple mis-estimations should not be hidden under this system.

Accordingly, we ask the Board to reconsider a solution that would allow the measurement of assets held to back insurance contracts to be measured at amortised cost under clearly specified criteria as described above and would be limited to phase I only.

2. Accounting for investment contracts with a demand feature

Paragraphs BC115 to BC117 discuss some aspects of the application of IAS 39 to long term investment contracts, noting in particular in BC116 the "long maturities, recurring premiums and high initial transaction costs" that are features of these plans and that are less common in other financial investments. However, the subsequent discussion of the fair value of these investment contracts, notably in BC117 (e), gives no recognition to these features and, instead, overrides the "expected surrender pattern" to impose a minimum liability (sometimes referred to as a demand deposit floor) equal to the amount available on demand to the individual policyholder.
Further, we see an inconsistency in the arguments used by the Board in BC117 (d), where it is stated that the fair value of a liability is based on the "expected (ie probability-weighted)

surrender patterns" whereas BC117 (e) says that the fair value of a financial liability with a demand feature "is not less than the amount payable on demand".
Although we can see a relation to the issue of core deposits of banks, we believe that investment contracts issued by insurance companies in contrast are not primarily sold to serve as demand deposits but rather as systematic long-term savings typically related to planning for retirement. Investment contracts are not savings accounts for the purpose of making interim withdrawals or for immediate access to cash. That makes them different from core deposits in banks and we ask the Board to revisit the "demand deposit floor" in the light of the portfolio approach of the insurance business and the going concern presumption.

3. Deferred acquisition costs

We believe that the treatment of deferred acquisition costs for insurance and investment contracts under phase I should be harmonised. Entities still do not differentiate between investment and insurance contracts in their accounting systems and a different treatment of acquisition costs would force them to implement major system changes only for phase I, which we believe is costly and burdensome.

For cost benefit reasons we do not believe that these changes should be made just for phase I. While recognising the impact on other financial institutions, we propose that IAS 39 be amended in the context of the amortised cost approach, to permit the deferral of internal and external acquisition costs for all contracts in line with other standards such as IAS 18 *Revenues*, which would be allowed for all industries. However, deferral should only apply where costs can be directly attributed to the sale of a contract. The costs would be amortised in line with revenue recognition.

4. Comparative Figures

Based on the current proposals of the Board and based on the transitional requirements – in particular for first-time adopters – we see some inconsistency in the requirements to apply IAS 32 and 39 to comparative figures, particularly in 2004:

(i) Our understanding is that the application of revised IAS 32 and 39 will not be required for comparative figures for the financial year 2004 since it can only be applied from 2005 on. The definition of insurance contracts will create a residual class of contracts (investment contracts) written by insurers that will be accounted for under IAS 39. Therefore investment contracts would be exempted in 2004 whereas all ED 5 requirements have to be applied to insurance contracts for comparative figures in 2004.

(ii) IFRS 1 *First-time Adoption of IFRSs* requires retrospective application of existing standards from the date of transition, which normally would be 1 January 2004. Since there will be no requirement to apply IAS 32 and 39 to investment contracts, an insurance entity would have to apply ED 5 recognition, measurement and disclosure requirements only for insurance contracts in 2004.

We ask the Board to clarify the above mentioned issues and make the requirements for comparative figures consistent between different standards (revised IAS 32 and 39, IFRS 1 and ED 5). In general we believe - where useful and reasonably possible – comparative figures should be provided and exemptions should be considered carefully.