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6 November 2003

Sir David Tweedie
Chair of the International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

***RE:*** *Exposure Draft ED 5 – Insurance Contracts*

Dear Sir David:

The Global Financial Reporting Advocacy Committee (GFRAC) of the Association for Investment Management and Research (AIMR)[1] is pleased to respond to the International Accounting Standards Board (IASB) *Exposure Draft ED 5 – Insurance Contracts.*

The GFRAC is a standing committee of AIMR charged with representing the views of investors to and maintaining a liaison with bodies that set financial accounting and reporting standards in a global context, particularly the IASB. The committee is also charged with responding to requests for comment from national standard setters and regulators on international financial reporting issues. The Committee comprises AIMR members from Asia, Europe, and North America with varying professional backgrounds and expertise in the investment industry.

A special subcommittee of the GFRAC, consisting of analysts who monitor and evaluate firms that issue insurance contracts, was formed to address proposed financial reporting standards for insurance contracts under Phase I and Phase II of the Board's project. The eleven-member subcommittee has global representation of AIMR members from Asia, Europe, and North America who have finance and actuarial backgrounds.

## General Comments

The GFRAC commends the IASB and its staff on their efforts to develop an international financial reporting standard (IFRS) for insurance contracts based on fair value principles. This accounting treatment is consistent with our current position that *all* financial instruments should be measured, recognized, and reported at their fair value. We believe a fair value approach greatly improves the transparency of vital financial information, and thus, enables users of financial statements to predict more reliably the amounts, timing, and uncertainty of an enterprise's future cash flows. In that regard,

[1]With headquarters in Charlottesville, VA and regional offices in Hong Kong and London, the Association for Investment Management and Research® is a non-profit professional association of more than 67,200 financial analysts, portfolio managers, and other investment professionals in 116 countries of which 54,940 are holders of the Chartered Financial Analyst® (CFA®) designation. AIMR's membership also includes 127 Member Societies and Chapters in 46 countries.

it offers a much greater degree of relevance than historical cost or other measurements based on methods that do not incorporate sensitivity to financial risk exposures, such as interest rate risk and credit risk. (Please refer to the results from 2003 AIMR Corporate Disclosure Survey presented under ***Preference for Fair Value Accounting.***)

Moreover, the IASB's insurance project seeks to fill the gap in current international financial reporting, which lacks an accounting standard to address insurance contracts. Consequently, a wide-range of approaches is used to measure, recognize, and report information regarding insurance contracts. Having one high-quality standard for insurance contracts, that is applied globally, would greatly improve the overall quality of information. Users of this information would have consistent and comparable data and disclosures about insurance contracts, thus, enabling them to make well-informed investment decisions.

***Phase I Approach to Disclosures***

Although we would prefer a more immediate solution to the current plethora of insurance accounting and reporting, we also understand and support the Board's current two-phase approach to the project. Given the current timeframe of the European Commission to implement international accounting standards (IAS) by January 2005, there is not sufficient time to develop, as well as fully implement, a comprehensive standard for insurance contracts. Therefore, we concur with the Board's decision to focus on some key principles regarding the accounting and reporting of insurance contracts in Phase I as a transition to a comprehensive solution in the near future under Phase II.

As users of financial information, we have a strong interest in the proposed disclosure requirements under Phase I. The Board has decided to design such requirements as a set of three high level principles:

(1) Explanation of reported amounts
(2) Amount, timing and uncertainty of cash flows
(3) Fair value of insurance liabilities and insurance assets

Under the current proposed standard, the first two principles have several items listed that the insurer shall disclose to comply with these principles. The third principle has none. We realize that fair value measurement and recognition has yet to be determined for insurance contracts and will be addressed in Phase II of the project.

However, we believe that the third principle should also have specified items that shall be disclosed, such as an explanation of the method used to determine fair value, including the key assumptions. These items would be similar to those required for amounts provided in the financial statements under the first principle. For example, elements of paragraph IG8 in the *Draft Implementation Guidance* should be included as part of the final standard under paragraph 30 rather than as guidance:

> *An insurer* ***discloses the methodology used to determine the fair values*** *disclosed to comply with paragraph 30 of the [draft] IFRS. If the financial statements disclose*

> ***supplementary information, for example embedded value information, that is not prepared on the basis used for other measurements in the financial statements, an insurer discloses the methodology used to determine this information****. Disclosures about embedded value methodology would include disclosure of whether, and how, embedded values are affected by estimated returns from assets and by locked-in capital and how those effects are estimated.* [Emphasis added.]

Additionally, we have concerns about the proposed disclosure requirements designed under a "principles" approach rather than "prescribed" approach. We do not believe that the proposed approach will provide consistent and comparable data and information about insurance contracts without requiring some standardized disclosures. Such disclosures would include reconciliation between the beginning and ending balances for major categories of insurance liabilities and insurance assets. These reconciliations would distinguish between cash flow items and actuarial assumptions (or measurement adjustments), quantifying the effects from such items as -

**Cash Flow Items**

- Insurance premiums
- Policy benefits and claims
- Policy dividends, experience rebates, or participating payments etc.
- Policy surrenders and lapses
- Policy loans
- Reinsurance ceded and assumed

**Actuarial Assumptions (or Measurement Adjustments)**

- Insurance assumptions for mortality, morbidity and loss rates
- Policy surrender and lapse rates
- Incurred but not reported insurance claims
- Interest rate risks

***Preference for Fair Value Accounting***

For many years, users of financial statements have sought relevant and timely information about financial instruments and off-balance sheet items and activities. We believe that recognizing fair value measurements in the financial statements, along with comprehensive disclosures of sensitivity analyses of assumptions underlying the reported fair values, will provide the necessary information to evaluate properly an enterprise's exposures to financial risks, as well as rewards.

This preference for fair value accounting was affirmed in a recent survey conducted by AIMR[2]. The 2003 survey polled AIMR's current membership, which represents a global diversity of investment

[2] AIMR retained Fleishman-Hillard Knowledge Solutions to survey membership to identify the key perceptions of information sources and types of factors that are most important when analyzing companies. In June 2003, AIMR conducted two Web-based

professionals who are users of financial reports and disclosures. The following two questions were asked regarding the importance of information sources and the markets in which respondents monitor and evaluate companies:

(1) ***Question 6:*** *Considering the companies you usually follow, use the five-point rating scale (5 = extremely important to 1 = not important) to rate each of the following information sources for its importance to your analysis.*[3]

(a) *Information about off-balance sheet assets or liabilities*
(b) *Information about risk (e.g., business, financial, and market risk factors) or information about the sensitivity of key assumptions*
(c) *Explanation of accounting estimates and reserves*
(d) *Fair value of assets and liabilities on the balance sheet*
(e) *Historical cost amounts of assets and liabilities on the balance sheet*

(2) ***Question 14:*** *In which of the following geographic regions is the domestic market for the companies that you follow? (Select all that apply)*

The following table presents a cross-section of the responses given for the above questions.

***(n=722: Mean Rating for the Importance of Certain Information Sources Used in Analysis)***

| ***Responses by Geographic Markets*** | ***Information about off-balance sheet assets or liabilities*** | ***Information about risk and sensitivity of key assumptions*** | ***Explanation of accounting estimates and reserves*** | ***Fair value of assets and liabilities on the balance sheet*** | ***Historical cost amounts of assets and liabilities on the balance sheet*** |
|---|---|---|---|---|---|
| **TOTAL** | **4.5** | **4.1** | **4.0** | **4.0** | **3.5** |
| Global | 4.5 | 4.2 | 4.1 | 4.1 | 3.6 |
| USA | 4.5 | 4.0 | 4.1 | 3.9 | 3.5 |
| Canada | 4.6 | 4.2 | 4.1 | 4.0 | 3.5 |
| U.K. | 4.4 | 4.0 | 4.0 | 3.9 | 3.4 |
| Continental Europe | 4.5 | 4.1 | 3.9 | 3.9 | 3.3 |
| Hong Kong | 4.2 | 4.1 | 3.8 | 3.8 | 3.4 |
| Japan | 4.3 | 4.0 | 3.9 | 3.8 | 3.4 |
| Other region in Asia | 4.4 | 4.2 | 3.9 | 4.1 | 3.6 |
| Australia or New Zealand | 4.4 | 4.3 | 3.9 | 3.9 | 3.5 |

email surveys of its membership. The membership was divided into two groups, one for each survey: 772 respondents replied to the Corporate Disclosure Survey and 1050 respondents replied to the Corporate Communication Survey. Both surveys had the same questions from 1 to 5. In particular, *Question 5* sought opinions about the importance, quality, and change in quality over the past three years of certain financial statement information.

[3] ***Question 6*** of the survey listed 33 different sources of information for respondents to rate. The five items selected for the table are those most related to fair value measurements and reporting. The survey results for information about historical costs were provided as a comparison to the results for fair value amounts.

Interestingly, survey respondents considered certain nonfinancial information, such as corporate governance practices, to be more important than historical cost information.

However, this shift in accounting principles will not come without some additional effort by all capital market participants, including preparers, auditors, regulators, and users of this information. We realize that accounting and reporting based on fair value principles, in comparison with historical cost-based principles, require more extensive and detailed analysis of the methods and assumptions used to determine those fair values. Consequently, market participants will need to redesign the current financial reporting model and to educate themselves in its application.

Nonetheless, in the long-term, the gain in the quality and relevance of information will far exceed the costs. We believe that having the economic consequences disclosed, i.e., risks and rewards related to financial instruments (such as insurance contracts), justifies the movement to a fair value based model for financial reporting.

***Asset-Liability Management***

Many firms, including financial services companies, already apply many principles underlying a fair value model through the use of Asset-Liability Management (ALM) techniques. Since the early 1970's, ALM has been used as a discipline by management to understand the firm's financial risks and exposure to those risks. At first, the model analyzed risks in terms of cash flows and identified the expected gap between inflows and outflows of cash. However, this approach was rudimentary because it did not consider the duration and convexity of those cash flows and how they might be affected by changes in interest rates and credit risks. Consequently, ALM has since evolved to address those risk exposures, as well as a firm's exposure to other financial risks, e.g., currency exchange rate risk.

The continued deployment of ALM is having a profound impact on the current accounting model which focuses on historical-cost based measurements. It provides a more accurate and meaningful picture of the risk/reward trade-offs in a firm's business. For example, Jackson National Life Insurance Company (JNL)[4] provides an explanation of its asset-liability management capabilities and financial discipline in its 2002 annual report as follows:

> *In product development, our asset/liability management capabilities determine which products we can offer, how we structure those products, and the returns we require from those products. In product pricing, for the more risk we take, the more return we demand. When we offer guarantees or embedded options with products, we evaluate the risk and price accordingly. When developing our investment strategy, our product structure is a key component in defining our*

[4] JNL is a U.S. subsidiary of the UK-based international financial services group – Prudential plc. At January 2003, Prudential plc (NYSE: PUK) held $250 billion in funds under management and operates in the UK, continental Europe, Asia and the United States.

> *asset mix. The risk-adjusted return on that asset mix determines the allowable pricing for our products.*
>
> *JNL's liability portfolio consists primarily of products with annually resettable crediting rates. This gives us much less exposure to long-term interest rate risk than companies that are tied to longer durations in their liabilities. As our product line has evolved to include more complex products, such as variable annuities, equity-linked indexed annuities, institutional products, and market-value-adjusted fixed annuities, we have been steadily increasing our diversification of risk. By doing so, we have moved our overall product mix into a lower profile. We anticipate further movement in this direction as we continue to grow.*
>
> *JNL has guidelines in place to manage every type of risk we accept, whether interest rate risk, spread risk, credit risk, or liquidity risk. We do not accept risk that we cannot properly evaluate, and we do not take risks for which we do not get adequately compensated….*

As noted above, insurance firms are currently managing their financial assets and financial liabilities using fair value techniques to determine which products to underwrite, which investment strategies to adopt and how best to manage overall risks. Moreover, those firms actively acquiring insurance firms or blocks of insurance business analyze and determine the fair value of those targets as part of their decision-making process. Likewise, current and prospective investors of those insurance firms want similar information for making their investment decisions.

As noted in *The Handbook of Asset/Liability Management* edited by Fabozzi and Konishi, 1996 - "The balance sheet as we know it today does little to describe the risk it represents. New risk-based accounting will need to be developed. The mark-to-market approach will gain popularity."

***Enterprise's Expected Future Cash Flows***

A balance sheet that incorporates fair value measurements reflects better the financial position of the enterprise at the date of the balance sheet, and therefore, the more appropriate starting point for developing the enterprise's expected future cash flows. In addition, fair value measurements, along with comprehensive disclosures of sensitivity analyses, make transparent the actual structure of the balance sheet. This enables users to assess more thoroughly the enterprise's exposure to risks, as well as its structural possibilities for future action in similar or changing circumstances. To achieve this end, the reliability of the figures remains important, but this should be considered as a constraint in the move to greater relevance rather than an impediment. In all these aspects, fair value offers a much greater degree of relevance than historic cost.

### *Volatility and Distortion of Financial Performance*

Fair value accounting reflects better economic reality by showing the volatility inherent in the values of financial instruments given changes in market conditions and operations of the enterprise. Historic cost-based accounting facilitates the smoothing of these effects, thus, obscuring this volatility and masking the actual economic impact of various positions held in financial instruments. Therefore, we argue that fair value accounting unmasks the *real* volatility; it does not create it.

Once all financial instruments are recognized at fair value, there should be less *reported* volatility, or distortion of results, if a firm is effectively managing its risks and exposures to those risks. Today, however, there is a distortion in the reported financial performance because of the current mixed-attribute accounting model where some financial assets are marked-to-market and others are not, and financial liabilities are measured using non-fair value techniques.

To remedy this distortion, some have argued that insurance firms should be allowed an exemption from applying IAS 39 for debt securities designated as available for sale (AFS). We have never thought that IAS 39 was a satisfactory way in which to account for financial instruments. We have always viewed it as an interim solution, just as we view Phase I of the insurance project as an interim solution. As noted above and in numerous other submissions to the IASB, the GFRAC supports full fair value for financial instruments and insurance contracts. However, we do **not** believe that the flaws in the current IAS 39 nor the failure of Phase I of the project to require fair value accounting for insurance contracts justifies exempting insurance firms from applying IAS 39.

There are several reasons for this. First, some companies are already applying IAS 39 or its U.S. GAAP equivalent. Exempting those that have not yet adopted it would result in diversity in practice. We believe that all companies should be applying the same accounting principles to financial instruments (in this case IAS 39) even if those principles are not yet perfect. We see no reason to exempt one class of company. In this way, at least financial assets will be consistently presented in the balance sheet from company to company. To achieve consistency in practice, if companies already using IAS 39 were required to go back to historic cost that would be a step backwards. It would also be disruptive and costly for those companies, especially since they would be required to switch back to a fair value methodology in a few years' time.

Second, we do not see how an exemption from IAS 39 could be crafted that would not open the door for confusion and abuse. If the exemption were for "insurance companies," how would companies with insurance subsidiaries apply the exemption in consolidated financial statements? Would some financial assets be accounted for under IAS 39 and others not? That does not seem to be a satisfactory answer and will only lead to confusion. The same problem would arise if financial assets supporting insurance contracts were exempt from IAS 39. In that case, there would be the additional problem that there would need to be "rules" put in place to avoid the appearance (or reality) of a company selectively choosing which financial assets supported the insurance liabilities.

We recognize that applying IAS 39 to insurance firms may not provide the "true" picture of the firm's financial position. However, not applying it would provide no picture at all. Not only would

companies be using diverse rules to account for insurance contracts, they would be using diverse rules to account for financial instruments as well. Given the disclosures that accompany IAS 39, users of financial statements will not misinterpret the results as feared. Experience with insurance companies following U.S. GAAP, and those already using IFRS, supports this contention. The result of applying IAS 39 may raise questions about the financial position of the enterprise, but management should be willing and able to address these in the notes to the financial statements.

***Sensitivity Analysis and Stress Testing of Assumptions***

At present, the principles of accounting require that material items should be disclosed. We believe sensitivity analysis is *the* essential element needed for estimating an enterprise's future expected cash flows, which are needed in calculating its valuation. Therefore, sensitivity analysis is an integral and essential component of fair value accounting and reporting. For example, many derivative instruments have "tails" that affect future cash flows. Unless those potential effects are transparent in disclosures and analyses, e.g., sensitivity analyses or stress tests, the balance sheet representation of fair values for financial instruments is incomplete and cannot be used properly to assess risk-return relationships and analyze management's performance.

Moreover, the importance of sensitivity analysis is evident in that a primary purpose of derivatives is to modify future cash flows either by minimizing the exposure to risks, or increasing risk exposure, and/or deriving benefits from these instruments. Also, an enterprise can readily adjust its positions in financial instruments to align its financing activities with operating activities and, thereby, improve its allocation of capital to accommodate changes in the business environment. All such activities, or their possible occurrence, should be transparent to the users of financial statements. For example, we believe that not reporting significant interest rate or foreign currency swap transactions would be as inappropriate as not consolidating a significant subsidiary.

## Summary of Comments on Specific Questions

(1) **Scope of ED –** The GFRAC concurs with the Board's decisions regarding the scope of the final IFRS for insurance contracts.

(2) **Disclosures –** As mentioned previously in the **General Comments**, we have concerns about the proposed disclosure requirements designed under a "principles" approach rather than "prescribed" approach. We do not believe that the proposed approach will provide consistent and comparable data and information about insurance contracts without requiring some standardized disclosures. Such disclosures would include reconciliation between the beginning and ending balances for major categories of insurance liabilities and insurance assets.

(3) **Definition of Insurance Contract -** The only concern we have with the current proposed definition is how "significant" insurance risk will be interpreted and applied. However, we believe this lack of distinction will become less of an issue once all financial contracts, including those that underwrite insurance risk, are measured and recognized at fair value using the same principles.

(4) **Embedded Derivatives -** We agree with the proposed exemptions and the requirement to bifurcate the put option linked to a change in an equity or commodity price index, and an option to surrender a financial instrument, which do not meet the definition of an insurance contract.

(5) **Changes in Accounting Policies -** We agree with the Board's decision to prohibit certain practices from being considered proper changes in accounting policies during the interim period or until a final IFRS for insurance contracts is effective.

(6) **Unbundling -** We strongly support the Board's decision to require separate display of deposit components of certain insurance contracts. Such disaggregated information allows users of financial statements to understand the risks and the effects on expected cash flows and financial performance of the firm.

(7) **Reinsurance Purchased -** We agree with the Board's proposed accounting treatment for ceded insurance risk

(8) **Insurance Contracts Acquired -** We disagree with the Board's decision to permit, rather than to require, a separate display of the insurance liabilities and insurance assets. Netted information obscures the gross liability of the firm and therefore, makes this fact less transparent to financial statement users. We believe that the Board **should require** that liabilities and assets should be shown separately.

(9) **Discretionary Participation Features -** With regard to reporting requirements, we disagree with the current optional display of the discretionary amount. The user of financial

statements needs to know what is fixed and what is discretionary in order to forecast properly the expected future cash flows of the firm

**(10) Financial Guarantees -** We concur with the Board's basis of conclusions and decision to include financial guarantees in connection with non-financial asset or liability transfers**.**

## Comments on Questions Asked in the ED

### *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.

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. 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.

***Is this scope appropriate? If not, what changes would you suggest, and why?***

**GFRAC response:** We concur with the Board's decision about the scope of the final IFRS. This is consistent with AIMR's position in the comment letter date 30 June 2000 which addressed the 1999 Insurance Issues Paper –

> *We agree with the Steering Committee's position, which favors (1) limiting the scope of the IASC Insurance Project to insurance related contracts only and, therefore, (2) excluding other financial instruments held by insurance companies. Currently, there are other accounting standards* (IAS 32, Financial Instruments: Disclosure and Presentation and IAS 39, Financial Instrument: Recognition and Measurement)*, which already specify accounting treatment for financial instruments.*

*(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.

***Would this be appropriate? If not, why not?***

**GFRAC response:** We agree with the proposed treatment of weather derivatives as explained in the *Basis of Conclusions* paragraphs BC38 - 39.

**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.

***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?***

**GFRAC Response:** The only concern we have with the current proposed definition is how "significant" insurance risk will be interpreted and applied. In other words, will firms consistently apply this definition? Currently, firms issue products that underwrite insurance risk bundled with elements of financial risks and other services, such as asset management, causing the distinction between the two risks to be less definite. However, we believe this lack of distinction will become less of an issue once all financial contracts, including those that underwrite insurance risk, are measured and recognized at fair value using the same principles.

**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.

***Are the proposed exemptions from the requirements in IAS 39 for some embedded derivatives appropriate? If not, what changes should be made, and why?***

**GFRAC Response:** We agree with the proposed exemptions and the requirement to bifurcate the put option linked to a change in an equity or commodity price index, and an option to surrender a financial instrument, which does not meet the definition of an insurance contract.

(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?***

**GFRAC Response:** We are concerned that instruments that transfer insurance risk may be excluded from Phase I. This exclusion, combined with the potentially problematic interpretation of the term "significant" could pose serious implementation problems for the standard.

(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?***

**GFRAC Response:** As mentioned previously in our General Comments section of the letter, we have concerns with the proposed discretion to disclose certain relevant information. With regard to derivatives measured at fair value, the following disclosures should be required rather than provided as examples of possible disclosures:

- Sensitivity analysis;
- Fair value of the embedded derivative; and
- Information about the exposure to risks – interest rate risks or market risks – that would have a material impact on the firm's financial performance.

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

**GFRAC response:** We are not aware of any others derivatives that should be exempt from IAS 39.

**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.

***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?***

**GFRAC Response:** We agree with the decision to allow a temporary exemption for insurance contracts and reinsurance contracts until a final IFRS for insurance contracts is completed and effective.

(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 equalization 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

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

**GFRAC Response:** Yes. We believe that is appropriate to exclude the above items from the temporary exemption from IAS 8. Items (i) and (iii), in particular, are consistent with previous positions held by AIMR which were expressed in the letter to the IASC date 30 June 2000.

**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.

(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 recognized in profit or loss.

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

**GFRAC Response:** We agree with the Board's decision to prohibit certain practices from being considered proper changes in accounting policies during the interim period, or until a final IFRS for insurance contracts is effective. Those policies would include:

(1) Measuring insurance liabilities on an undiscounted basis.
(2) Measuring insurance liabilities with excessive prudence.
(3) Reflecting future investment margins in the measurement of insurance liabilities, by either:
    a. Using a discount rate that reflects the estimated return on the insurer's assets; or
    b. Projecting the returns on those assets at an assumed rate of return, discounting the projected returns at a different rate and including the result in the measurement of the liability.
(4) Measuring contractual rights to future investment management fees at an amount that exceeds their fair value as implied by a comparison with current fees changed by other market participants for similar services. It is likely that the fair value at inception of those contractual rights will equal the origination costs paid, unless future investment management fees and related costs are out of line with those market comparables.
(5) Using non-uniform accounting policies for the insurance liabilities (and related deferred acquisition costs, if any) of subsidiaries.

**Question 6 – Unbundling**

The draft IFRS proposes that an insurer should unbundle (i.e. account separately for) deposit components of some insurance contracts, to avoid the omission of assets and liabilities from its balance sheet.

***(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?***

**GFRAC Response:** We strongly support the Board's decision to require separate display of deposit components of certain insurance contracts. Such disaggregated information allows users of financial statements to understand the risks and the effects on expected cash flows and financial performance of the firm. As to the feasibility of this requirement, we cannot address it directly. However, we would presume that firms that issue such bundled contracts would analyze the cash flows separately for each component to properly price the total contract.

**Question 7 – Reinsurance purchased**

The proposals in the draft IFRS would limit reporting anomalies when an insurer buys reinsurance.

***Are these proposals appropriate? Should any changes be made to these proposals? If so, what changes and why?***

**GFRAC Response:** We agree with the Board's proposed accounting treatment for ceded insurance risk. AIMR has long had a strong preference for presentations that are gross rather than net when ever possible. If there is an inflow and a related outflow but with different parties, even if the outcomes are dependent on the same event, they should be presented gross. This provides more transparency. This is consistent with our view expressed in our letter dated 30 June 2000 on a separate but similar issue as follows:

> *We disagree with the Steering Committee's tentative position stating that insurers should recognize potential recoveries as a reduction to its net liability to the policy holder. Netted information obscures this activity and, therefore, is less transparent to financial statement users.*

Additionally, we support the proposed accounting in paragraph 18 (c) regarding receipts from the reinsurer and that the cedant shall apply IAS 36, *Impairment of Assets*, to its rights under a reinsurance contract.

**Question 8 - Insurance contracts acquired in a business combination or portfolio transfer**

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.

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

**GFRAC Response:** We agree with the Board's decision **not** to exclude insurance liabilities and insurance assets from the requirement of IAS 22, *Business Combinations*, to measure at fair value assets acquired and liabilities assumed. This is a long standing practice in applying the purchase method in business combinations. As stated earlier in this letter, we believe that it is important that all entities should apply IFRS in the same manner to avoid confusion and to enhance comparability.

However, we disagree with the Board's decision to permit firms a choice in presentation. We believe that choices of display are just as detrimental to comparability and understanding as choices of principle. For that reason, we believe that insurance contracts assumed and insurance assets acquired in a business combination should be presented initially at the date of acquisition at their fair value in the balance sheet like all other assets acquired and liabilities assumed. However, because there is no agreed upon methodology in practice to value insurance contracts, and because of the difference between the liabilities measured in accordance with the insurer's accounting policies for insurance contracts it issues and the fair value of insurance contracts assumed in a business combination, we strongly recommend that the Board mandate footnote disclosure of the 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 it is not reflected in (a).

This will facilitate comparison of companies that are growing internally with companies growing by acquisition.

**Question 9 – Discretionary participation features**

The proposals address limited aspects of discretionary participation features contained in insurance contracts or financial instruments. 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?***

**GFRAC Response:** We concur with the Board's decision and reasons to deter the final treatment of such discretionary features to Phase II of the project. However, since the classification of the discretionary amount, as either a liability or equity item, will not be determined in Phase I, we

suggest that the Board be more explicit about changes in classifications between reporting periods. The reclassifications, i.e., moving the discretionary amount between a liability or equity item, would be treated as a change in accounting principle and IAS 8 would need to be applied.

With regard to reporting requirements, we disagree with the current optional display of the discretionary amount. The user of financial statements needs to know what is fixed and what is discretionary in order to forecast properly the expected future cash flows of the firm.

**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.

***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?***

**GFRAC Response:** We concur with the Board's decision to require firms to disclose the fair value of insurance assets and insurance liabilities. However, to make this information more meaningful and useful, we believe that this principle should also require specific items to be disclosed, such as an explanation of the method used to determine fair value, including the key assumptions. These items would be similar to those required for amounts provided in the financial statements under the first principle. For example, elements of paragraph IG8 in the *Draft Implementation Guidance* should be included as part of the final standard under paragraph 30 rather than as guidance:

> *An insurer* ***discloses the methodology used to determine the fair values*** *disclosed to comply with paragraph 30 of the [draft] IFRS. If the financial statements disclose* ***supplementary information, for example embedded value information, that is not prepared on the basis used for other measurements in the financial statements, an insurer discloses the methodology used to determine this information****. Disclosures about embedded value methodology would include disclosure of whether, and how, embedded values are affected by estimated returns from assets and by locked-in capital and how those effects are estimated.* [Emphasis added.]

**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.

***Should any of these proposals be amended or deleted? Should any further disclosures be required? Please give reasons for any changes you suggest.***

**GFRAC Response:** We strongly support disclosures about the estimates and expected timing and uncertainty of future cash flows regarding amounts reported in the insurer's financial statement. (Please refer to our **General Comments** section of the letter for more elaboration.)

(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?***

**GFRAC Response:** We have concerns about the proposed disclosure requirements designed under a "principles" approach rather than "prescribed" approach. We do not believe that the proposed approach will provide consistent and comparable data and information about insurance contracts without requiring some standardized disclosures. Such disclosures would include reconciliation between the beginning and ending balances for major categories of insurance liabilities and insurance assets. These reconciliations would distinguish between cash flow items and actuarial assumptions (or measurement adjustments), quantifying the effects from such items as -

**Cash Flow Items**

- Insurance premiums
- Policy benefits and claims
- Policy dividends, experience rebates, or participating payments etc.
- Policy surrenders and lapses
- Policy loans
- Reinsurance ceded and assumed

**Actuarial Assumptions (or Measurement Adjustments)**

- Insurance assumptions for mortality, morbidity and loss rates
- Policy surrender and lapse rates
- Incurred but not reported insurance claims
- Interest rate risks

(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.

***Should any changes be made to this transitional relief? If so, what changes and why?***

**GFRAC Response:** We strongly support the Board's decision to require disclosure that provides the claims development for at least a five year period for both general and life insurance contracts.

This information should be disclosed by major categories of insurance contracts that have similar characteristics with regard to risk. Such information enables the users to understand better the firm's insurance risks and exposures to those risks, as well as the trends in claims and loss experience. This view is consistent with the one expressed in AIMR's comment letter dated 30 June 2000 as follows:

> *We strongly support the disclosure of claims development for both life and general insurance activities, the format currently used in the U.S. by general insurers. Such a disclosure enables financial statement users to:*
> 
> *(1) assess potential risks facing the insurer;*
> *(2) determine whether past provisions have been optimistic or conservative and, thereby, evaluate the reasonableness of the provisions in the balance sheet; and*
> *(3) analyze trends in the recent performance without the distortions of the movements in prior years.*

**Question 12 – Financial guarantees by the transferor of a non-financial asset or liability**

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. 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?***

**GFRAC Response:** We concur with the Board's basis of conclusion and decision to include financial guarantees in connections with non-financial asset or liability transfers.

## Closing Remarks

The GFRAC strongly supports the Board's decision and efforts to develop a final IFRS for insurance contracts that is based on fair value principles. Thus, we urge the Board to complete Phase II of the project for an implementation of the final IFRS by 2006.

The GFRAC appreciates the opportunity to comment on the IASB's proposed IFRS for insurance contracts. If you have any questions or require further elaboration of our views, please do not hesitate to contact Patricia Walters at 1.434.951.5315 or patricia.walters@aimr.org.

Sincerely,

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