Organizacion Internacional
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OICU-IOSCO

October 31, 2003

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

Dear Sir David:

The International Organization of Securities Commissions (IOSCO) Standing Committee No. 1 on Multinational Disclosure and Accounting (Standing Committee No. 1) thanks you for the opportunity to provide our thoughts regarding ED 5, ***Insurance Contracts*** (ED 5).

IOSCO is committed to promoting the integrity of international markets through promotion of high quality accounting standards, including rigorous application and enforcement.[1] Members of Standing Committee No. 1 seek to further IOSCO's mission through thoughtful consideration of accounting and disclosure concerns and pursuit of improved transparency of global financial reporting. The comments we have provided herein reflect a general consensus among the members of Standing Committee No. 1 and are not intended to include all the comments that might be provided by individual members on behalf of their respective jurisdictions. In addition, the lack of a response to a specific question posed by the Board in its Invitation to Comment does not necessarily indicate a lack of consensus amongst the members of Standing Committee No. 1. Rather, Standing Committee No. 1 has chosen to limit our response to those questions that our members believe involve key issues and on which a consensus was reached.

We understand from statements made in ED 5 and other information issued regarding this project that the International Accounting Standards Board (the Board) undertook this project as a first step in developing an International Financial Reporting Standard (an IFRS) for all insurance contracts. Specifically, in light of the complexities involved in having a "clean slate" upon which the Board will develop a comprehensive basis of accounting for insurance contracts, it is our understanding that the Board has concluded that it would be impractical to attempt to develop a new Standard prior to the 2005 first time adoption of IFRSs by many reporting entities. Thus, in an effort to balance the need for a uniform accounting standard with the cost of implementing a "temporary" standard, the Board has decided that the focus of ED 5 should be in making improvements to the accounting and disclosure for insurance contracts in certain instances where the short-term benefits of such

[1] See IOSCO website, www.iosco.org

changes outweigh the short-term costs. ED 5's provisions also focus on preventing entities from newly adopting less favorable accounting and disclosure policies in the interim period leading up to issuance of a comprehensive standard. Our comments are being provided with this context in mind and would not necessarily be the same if the proposals in ED were intended to be a long-term solution.

General Comments

Standing Committee No. 1 supports the Board's decision to undertake a limited scope project that would result in limited improvements to accounting and disclosure practices for insurance contracts in advance of the Board's deliberations on a broader, principles-based standard for insurance contracts. Not withstanding our support for the Board's decision, we acknowledge the limitations inherent in a temporary standard and thus, we believe that users of financial reports will be much better served once a comprehensive IFRS for Insurance contracts is in effect. As such, we look forward to the Board's conclusion of phase II of the project in as expeditious a manner as possible.

With regards to the Board's decisions in phase I, Standing Committee No. 1:

- Supports the Board's decision to incorporate a "contract based" approach into ED 5 for the reasons enumerated by the Board in paragraph 9 of the basis for conclusions (the Basis). We agree with the observation that the lines between different types of financial services entities are becoming increasingly difficult to draw as the various industries move into new business areas and new products are developed.

- Supports the Board's conclusion in paragraph 139 of the Basis that disclosure of the fair value of insurance liabilities and insurance assets would provide relevant information for users. However, the relevance of the information supplied depends upon whether the amounts provided by such disclosures are reliably measured. Thus, as we will discuss in more detail in our response to question 10, prior to such disclosures being required we believe that the Board must give priority attention to developing further guidance as to how such fair values should be estimated, especially in circumstances where assets and liabilities (such as those related to insurance contracts) are not widely traded in markets. As you will see in our response to that question, we have suggested an alternative disclosure requirement that could be used until such time as the relevant fair value measurement guidance has been developed.

- Agrees with ED 5's proposed elimination of the reporting anomalies that currently arise in certain circumstances upon an insurer's purchase of reinsurance for the same reasons enumerated by the Board in paragraph 90 of the Basis.

There are also several areas of ED 5 for which we have comments that we would like to bring to the Board's attention. These are as follows:

While Standing Committee No. 1 believes that the contract-based approach to writing this IFRS is the right approach, we note that a contract (i.e. characteristics) based approach could scope into phase I or phase II of the insurance project many types of contracts that have not previously been thought of as insurance contracts. Therefore the scope of ED 5 has the potential to impact many more entities than its title might suggest. We believe the Board should consider whether sufficient attention has been paid to ED 5 outside of the insurance industry, and should reach out to representatives of non-insurance enterprises during the exposure period and prior to issuing a final standard to ensure appropriate consideration is given. The perspective of such enterprises may bring to light additional items requiring the Board's attention prior to the Board's issuance of a final standard.

We note that the two-phased approach to this project has necessitated that the Board seek to balance the need for uniform accounting and disclosure standards with the cost of implementing a "temporary" solution. We recognize that in order to achieve this goal, it is necessary for the Board to provide a temporary scope exception to the provisions of paragraphs 5 and 6 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* (for an insurer's insurance contracts issued and reinsurance contracts held) while simultaneously developing prohibitions against very specific practices. As a result, ED 5 represents a fairly significant departure from the IASB's goal of providing "principles-based" accounting standards. Thus, while we agree with the end product of ED 5 as an interim step, we hope that in phase II of the project the Board will return to its stated approach to standard writing.

With regards to equalization and catastrophe reserves, as securities regulators with a goal of providing investors with high quality financial reports for use in making investing decisions, we concur with the Board's decision in paragraph 10(a) to eliminate the practice of maintaining such reserves. However, we are troubled by the Board's decision in paragraph 16(b) to permit the continued use of existing accounting policies that result in the measurement of insurance liabilities with "excessive prudence" at the same time that the Board acknowledges that it is unable to define the term in phase I. If a term is to be used in an IFRS, we believe that it should be defined. Our concerns are more fully described in the response to question 4b. One additional point that we would like to make regarding "excessive prudence" pertains to the Board's decision to permit a measurement principle that is captioned as "excessive". We believe that allowing "excessive" reserves to be recorded contradicts the principle of neutrality that is a necessary characteristic of high-quality financial information. .

Our final point relates to ED 5's fair value provisions. These provisions arise both directly (i.e. the fair value disclosure requirements) and indirectly (i.e. the decision to include assets held to back insurance contracts in the scope of IAS 39) from the provisions of ED 5. Both of these provisions represent a fairly substantial change from existing IAS requirements. In light of the broad impact that these provisions could be expected to have, Standing Committee No. 1 is unanimous in encouraging that the Board, as part of its due process, ensure that all parties concerned, including both entities that are traditionally thought of as "insurers" and those that are not, are given full opportunity to discuss their concerns about ED5 prior to the Board's issuance of a final standard. Our response to Question 1 contains some additional thoughts regarding this topic.

This concludes our discussion of some broader themes that Standing Committee No. 1 would like to express with regards to ED 5. The remainder of this letter provides responses to several of the questions raised in the Board's invitation to comment.

Responses to certain questions raised in the invitation to comment

Below you will find responses to certain questions that were raised in the Board's invitation to comment.

Question 1– Scope

(a) The Exposure Draft proposes that the IFRS would apply to insurance contracts (including reinsurance contracts) that an entity issues and to reinsurance contracts that it holds, except for specified contracts covered by other IFRSs. The IFRS would not apply to accounting by policyholders (paragraphs 2-4 of the draft IFRS and paragraphs BC40-BC51 of the Basis for Conclusions).

The Exposure Draft proposes that the IFRS would not apply to other assets and liabilities of an entity that issues insurance contracts. In particular, it would not apply to:

i. Assets held to back insurance contracts (paragraphs BC9 and BC109-BC114). These assets are covered by existing IFRSs, for example, IAS 39 Financial Instruments: Recognition and Measurements and IAS 30 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?

Response

Standing Committee No. 1 generally agrees with the Board's decision to exclude from the scope of ED5 other (i.e. non-insurance contract) assets and liabilities of an entity that issues insurance contracts. With the continuing consolidation of traditional financial and insurance institutions into hybrid entities, we believe that it is in the best interest of users of financial statements to have non-insurance contracts that meet the definition of a financial instrument be accounted for in a uniform manner. However we do note that there have been widespread concerns expressed by the Board's constituents with regards to the lack of an IAS 39 financial asset category for "assets backing insurance contracts." These concerns arise from a belief that using a different measurement basis for insurance contracts and assets backing them will result in volatility that does not fully reflect the economic reality of an insurer's asset liability management. Many of those expressing such concerns believe that insurers would not be able to avail themselves of the "Held to Maturity" classification for a significant portion of their investments. The Board acknowledges this in paragraph 110 of the Basis and provides a brief example of how an entity might use the "Held to Maturity" classification in certain instances. In light of continuing concerns that are being raised on this issue, Standing Committee No. 1 recommends that the Board meet with representatives of groups affected by ED 5 (e.g. regulatory agencies, investors, members of industry, etc.) to discuss the matter further. We believe such meetings can be most effective if they include a mix of affected parties in any discussions. As part of these discussions, the Board may wish to consider whether it is possible to provide additional guidance that would help insurers identify instances in which "Held to Maturity" classification for financial assets would be appropriate and whether it would be possible for insurers to avail themselves of the provisions of IAS 39, paragraph 83(c) which would permit an entity to sell assets classified as held to maturity if the sale was due to "due to an isolated event that is beyond the enterprise's control and that is non-recurring and could not have been reasonably anticipated by the enterprise."

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?*

Response

We agree with the concept of excluding from the scope of IAS 39 embedded derivatives that transfer a significant amount of insurance risk. However, in order to ensure that this concept is interpreted consistently in practice, we believe that additional guidance may be needed with regards to the meaning of the term "significant" as that term is used in paragraph 123 of the Basis.

For example, paragraph 11 of Appendix B indicates that a link to a price index in a life-contingent annuity is an embedded derivative that "meets the definition of an insurance contract" thus obviating the need for the insurer to account for this feature as a derivative instrument pursuant to the provisions of IAS 39. When discussing similar features in paragraph 123 of the Basis, the Board indicates that the embedded feature meets the definition of an insurance contract "because the payout is contingent on an event that creates *significant insurance risk.*" It is not entirely clear to the members of Standing Committee No. 1 when the amount of insurance risk is sufficient to cause an embedded *financial* derivative, embodying financial risk, to avoid the scope of IAS 39. Specifically, one could interpret paragraph 123 of the Basis to mean any of the following:

i. The insurance risk inherent in the contingent event is, or could be, significant in relation to the financial risk contained in embedded feature.

ii. The insurance risk inherent in the contingent event is, or could be, significant in relation to other insurance risks absorbed by the insurer.

iii. The insurance risk inherent in the contingent event is, or could be, significant in relation to the insurer's overall operations.

Standing Committee No. 1 has not developed a preference for any specific interpretation; however, we would like to point out that each of these interpretations would only be workable to the extent that preparers and auditors of financial statements were able to overcome the valuation challenges discussed in paragraph 118(b) of the Basis. Additionally, in ED 5, as well as in the interpretations that we have provided above, the term "significant" is not defined or explained with a principle that would be useful in making such judgments.

Question 4– Temporary exclusions from criteria in IAS 8

(a) Paragraphs 5 and 6 of [the May 2002 Exposure Draft of improvements to] IAS8 Accounting Policies, Changes in Accounting Estimates and Error 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 contract 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?

Response

Standing Committee No. 1 supports the Board's decision to exempt an insurer from applying the criteria set forth in paragraphs 5 and 6 of IAS 8 to insurance contracts that it issues and reinsurance contracts that is holds. While the members of Standing Committee No. 1 appreciate the unusual nature of this exemption, and thus the Board's desire to minimize its life via a specific provision of this draft IFRS, we also share a common concern that the issues identified by the Board in paragraphs 53 and 54 of the basis (i.e. regarding the lack of consistency that may result from individual companies determining what is "acceptable" as well as the costs likely to be incurred by insurers to develop systems that would be required for an interim accounting model) will not disappear in the absence of a comprehensive insurance standard, if such a standard is not issued and effective for periods beginning on or after 1 January 2007. Thus, while we appreciate and support the Board's determination to complete phase II of the Insurance Project prior to December 31, 2006, we would suggest that the phrase "For accounting periods beginning before 1 January 2007…" in the second sentence of paragraph 9 of the draft IFRS be replaced by the phrase "For accounting periods before the new IFRS on insurance contracts (phase II) is implemented…" in order to avoid the having the issues identified in paragraphs 53 and 54 of the Basis arise (albeit temporarily) if the Board is unable to meet its December 31, 2006 goal due to unforeseen circumstance.

(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 (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?

Response

As we indicated in our general comments earlier in this letter, we concur with the Board's decision in paragraph 10(a) to eliminate the practice of maintaining equalization and catastrophe reserves. However, we are troubled by paragraph 10(a)'s potential interaction with the Board's decision to permit continued use of existing accounting policies that result in the measurement of insurance liabilities with "excessive prudence." Additionally, without a sufficient definition of the term excessive prudence, it may be difficult for auditors and regulators to even identify the improper adoption of an "excessive prudence" measurement policy by an entity that had not already had one. Thus, we believe that as currently worded, paragraph 16(b)'s provisions are largely inoperable.

At a minimum we would suggest that the Board consider including a definition of the term "excessive prudence" in the final IFRS. Additional guidance might also be provided by the use of an Illustrative Example in the Implementation Guidance describing some of the practices that may indicate the use of "excessive prudence" in measuring insurance liabilities. In addition, Standing Committee No. 1 believes that the Board should add to paragraph 27 of ED5 a requirement that all insurers include disclosures in the footnotes to their financial statements that would allow a reader of the financial statements to assess an insurer's policy and rationale applied to the measurement of insurance liabilities. Such a disclosure requirement would likely provide useful information to investors while allowing the Board ample time to resolve the definitional/measurement issues related to the term "excessive prudence."

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 (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)...

(c) Is it clear when unbundling would be required? If not, what changes should be made to the description of the criteria?

Response

We believe that the level of liability recognition necessary to overcome the unbundling requirement for traditional life insurance contracts containing surrender or maturity values is unclear. Specifically, paragraph 7 requires than an insurer unbundle contracts into their insurance and deposit components if an insurer's existing accounting policies do not result in the insurer recognizing obligations to repay amounts received under the contract or rights to recover amounts paid under the contract. It is unclear whether liabilities representing such obligations must be measured at an amount equal to the obligation itself, or whether the mere recognition of an obligation, regardless of the amount at which is it recognized on the balance sheet, is sufficient to overcome the unbundling requirement. Those supporting the first view (the measured amount of the liability must equal the obligation in order to avoid unbundling) point to paragraph 8 which indicates that insurers would not be required to unbundle traditional life insurance contracts containing surrender or maturity values (which could be regarded as deposit components) if the insurer's existing accounting policies cause it to recognize *all liabilities* under those contracts. Those supporting the second view (the measured amount of the liability need not equal the obligation in order to avoid unbundling) believe that the exception provided in paragraph 8 is merely an accommodation meant to avoid the large-scale systems changes that would be required to unbundle large portfolios of traditional life insurance contracts. To support their view, they point to paragraph 36 of the Basis, which states, "...failure to unbundle these contracts would affect *measurement of these liabilities*, but not lead to their *complete* omission from the insurer's balance sheet [emphasis added]." We believe that the Board should clarify its intent in the final standard.

One additional point that we would like to make regarding unbundling pertains to the definition of the term "deposit component". As we mentioned in the general comments section of this report, the scope of ED 5 will likely expand outside of the insurance industry. Thus, although we believe that most preparers in the insurance industry are generally familiar with the term deposit component, including a definition in Appendix A might facilitate a uniform understanding of this provision of ED 5 across all industries.

Question 7 – Reinsurance purchased

The proposals in the draft IFRS would limit reporting anomalies when an insurer buys reinsurance (paragraphs 18 and 19 of the draft IFRS and paragraphs BC89-BC92 of the Basis for Conclusions).

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

Response –

As indicated in the general comments above, we strongly support the Board's decisions to limit reporting anomalies that result when an insurer buys reinsurance.

Question 9 – Discretionary participation features

The proposals address limited aspects of discretionary participation features contained in insurance contracts or financial instruments (paragraphs 24 and 25 of the draft IFRS and paragraphs BC102-BC108 of the Basis for Conclusions). The Board intends to address these features in more depth in phase II of this project.

Are these proposals appropriate? If not, what changes would you suggest for phase I of this project and why?

Response –

We generally agree with the Board's proposal not to require that insurers make several changes to their existing accounting policies for discretionary participating features. Although the Board defines a discretionary participating feature in Appendix A of ED 5, and describes these features in paragraph 102 and 103 of the Basis, we believe that expanding the Implementation Guidance to include examples of discretionary participation features that encompass the various insurance products and features that have already been created for market, regulatory or statutory reasons in the jurisdictions represented by members of Standing Committee No. 1 would help achieve a more uniform application of ED 5's provisions.

Question 10 – Disclosure of the fair value of insurance assets and insurance liabilities

The proposals would require an insurer to disclose the fair value of its insurance assets and insurance liabilities from 31 December 2006 (paragraphs 30 and 33 of the draft IFRS, paragraphs BC138-BC140 of the Basis for Conclusions and paragraphs IG60 and IG61 of the draft Implementation Guidance).

Is it appropriate to require this disclosure? If so, when should it be required for the first time? If not, what changes would you suggest and why?

Response –

As mentioned in the general comments section of this letter, Standing Committee No. 1 agrees with the Board's conclusion that disclosure of the fair value of insurance liabilities and insurance assets would provide relevant information for users. However, in order to ensure that investors are receiving information that is generally consistent across insurers, we believe that it is important that the issues associated with measuring the fair value of insurance contracts prior to requiring disclosure of such information be resolved. We are not confident that such measurement issues will be resolved by December 31, 2006.

We recognize that part of the Board's reason for requiring fair value disclosures for periods ending on or after December 31, 2006 is to encourage insurers to begin work on fair value systems to avoid the need to provide a long transition period for phase II. An alternative developed by Standing Committee No. 1 would be to require, for periods beginning on or after December 31, 2006, disclosure of expected cash flows associated with insurance contracts for each of the next 5 years and aggregated cash flows associated with periods beyond year 5. Consistent with the requirements of paragraph 16(a) of the draft IFRS, an insurer would calculate the amounts disclosed in a manner (discounted or undiscounted) that correlates with the insurer's policy for measuring insurance liabilities. Insurers that are already disclosing the fair value of their insurance liabilities should be required to provide a list of assumptions that were applied to their disclosed expected cash flows in order to obtain such fair values.

Replacing the current fair value disclosure requirement with such an interim cash flow disclosure requirement could have the advantage of providing useful information to investors that could be consistently prepared, while simultaneously requiring that insurers begin developing systems to track the information that would be the backbone of future fair value disclosures. Fair value disclosures could then be required once sufficient measurement guidance is developed. With regard to speeding the development of fair value measurement guidance, we are aware that insurers in certain jurisdictions represented by the members of Standing Committee No. 1 are already *voluntarily* disclosing the fair value of insurance assets and liabilities. Thus, while we are hesitant to recommend that the Board require fair value disclosures based on a definition of fair value that has not been derived through due process, we encourage the Board to reach out to insurers that are already disclosing fair value in order to get a sense of best practices with regards to measurement that may already exist.

For the same reasons discussed in paragraphs 138 to 140 of the Basis, we are suggesting that our proposed disclosures only be required for periods on or after December 31, 2006. However, in order to prevent "systems changes" from becoming a standard presumption leading to future requests for extended delays of implementation dates, minimized restatement requirements, or reduced prior period disclosure requirements on future standards, we would suggest that the Board include a statement in the Basis further explaining the uniqueness of the Board's decision.

Question 13 – Additional comments regarding the scope of ED 5

Paragraph 2(a) of ED 5 indicates that the proposed standard would be applicable to "insurance contracts (including *reinsurance contracts*) that it issues and to reinsurance contracts that it holds." Throughout the document, the only subsequent use of the term reinsurance contract pertains to accounting for an insurer's purchase of reinsurance in order to cede risk to another enterprise. Thus, we have concluded that the Board's intent was that all of the accounting and disclosure provisions of ED 5 that pertain to insurance contracts also pertain to reinsurance contracts purchased. While we believe that most preparers of financial statements would reach a similar conclusion, preparers may find it helpful if the Board included the following statement at the end of paragraph 2(a) of the proposed IFRS: "(i.e. unless otherwise stated, when discussing insurance contracts that have been issued, the terms insurer or insurance contract are intended to be inclusive of reinsurers or reinsurance contracts)."

If you have any questions or need additional information on the recommendations and comments that we have provided, please do not hesitate to contact me at 1 202 942 4400.

Sincerely,

Scott Taub
Chair
IOSCO Standing Committee No. 1