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Response to Discussion Paper
UK GAAP Insurance Accounting

30 April 2012

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30 April 2012

Dear Seema

FRG Response to ASB Discussion Paper: Insurance Accounting - Mind the UK GAAP

This letter sets out the response of the UK Actuarial Profession's Financial Reporting Group (FRG) to the discussion paper "Insurance Accounting – Mind the UK GAAP" (Discussion Paper) published by the Accounting Standards Board (ASB) on 30 January 2012. The FRG is a cross practice working group established by the Institute and Faculty of Actuaries to consider the potential implication of changes to financial reporting standards affecting its members and to support its representatives on the International Actuarial Association Insurance Accounting Standards subcommittee. The FRG membership is made up of senior industry practitioners in the area of financial reporting, with a mixture of experience in life insurance, non-life insurance and pensions. The membership, mostly formed of UK actuaries, also includes two chartered accountants and one sell-side equity analyst. The views set out below reflect those of the members of the FRG and do not necessarily represent the views of the UK Actuarial Profession as a whole.

We thank the ASB for the opportunity to respond to the Discussion Paper. The future of UK GAAP for insurers is important for a number of reasons. First, the introduction of Solvency II will render the existing UK GAAP approach obsolete. Second, the effective date of Solvency II is likely to be earlier than the effective date of IFRS 4 Phase II, creating a potential void in UK GAAP. Finally, statutory account profits are already used as a basis for taxing UK general insurance companies and are expected to be used as a basis for taxing UK life insurance companies from 2013.

We have structured our letter below to specifically respond to the questions asked in the Discussion Paper. We note, however, that in our discussions we have considered the advantages and disadvantages of each of the four options proposed in the Discussion Paper. For completeness we have included our analysis of each of the options in the Appendix to this letter. We confirm that we are happy for the comments in this letter and its Appendix to be placed on public record.

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Response to questions posed in the ASB Discussion Paper

Long-term solution

The ASB Discussion Paper posed the following question:

"7.4 Do you agree that the long-term solution for accounting for insurance by reporting entities in the UK (listed and unlisted) is to incorporate IFRS 4 Phase II into UK GAAP, when issued by the IASB and adopted for use in the EU?"

We agree with the ASB Discussion Paper that the long-term solution is to incorporate the requirements of IFRS 4 Phase II into UK GAAP. This is based on our current expectation of the timing and contents of a new IASB insurance contracts standard and subject to our understanding as set out in the following paragraph.

IFRS 4 Phase II will likely contain a definition of "insurance contracts" and only be applicable to contracts falling within that definition. We presume that when referring to "IFRS 4 Phase II" the ASB means to implement all the necessary changes from IFRS to provide a financial reporting basis for contracts that can currently be accounted for as insurance contracts under UK GAAP. For example, contracts sold by insurance companies but classified as "investment contracts" under IFRS would be subject to future versions of IAS 18 and IAS 39 (e.g. IFRS 9) as proposed by the IASB and adopted by the European Union (EU). This would also affect the measurement of insurers' other assets and liabilities such as financial instruments.

Short-term solution

The ASB Discussion Paper posed the following questions:

"7.5 When providing comments on the short-term solutions please comment on:
(a) whether you agree that all aspects of the problem have been identified? If not, what is missing and how do you see it impacting the accounting for insurance contracts?
(b) what is your preferred solution (whether one of those set out in section 6 above or not) for insurance accounting in the UK during the gap period?
(c) what is your rationale for proposing that solution, including the balance of cost and benefits?
(d) what is the likely impact of any changes in accounting for insurance contracts under UK GAAP on the entity you have in mind. It would be helpful if your response clarifies the current position of the reporting entity you have in mind (listed, unlisted, reporting in accordance with IFRS/grandfathering/own accounting policies/UK GAAP/other)."

We have provided answers to each part of this question below.

7.5(a) whether you agree that all aspects of the problem have been identified? If not, what is missing and how do you see it impacting the accounting for insurance contracts?

The Discussion Paper has identified the technical considerations of the proposed options but we feel that problems can also arise from behavioural considerations arising from the optionality available to the reporting entities.

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Under the existing regime, UK insurance companies have the option to fully apply EU-adopted IFRS. This option has already been exercised by a number of EU-listed insurers in preparing the UK statutory accounts for their unlisted insurance subsidiaries (as noted in Discussion Paper point 2.1(b)). Insurers that have adopted EU-adopted IFRS have the option under IFRS 4 to change their insurance contracts accounting policies for the valuation of insurance contract liabilities without a full compliance with the IFRS Hierarchy set out in IAS 8, which requires a new policy to be more relevant and reliable than that previously adopted. Instead, IFRS 4 introduces a more benevolent regime for change in accounting policies for the valuation of insurance contract liabilities whereby the changed policy continues to benefit from the grandfathering provisions from the IFRS Hierarchy and it only needs to be more relevant and no less reliable or more reliable and no less relevant than the policy it replaces. Individual insurers may use this regime for an early adoption of selected aspects of IFRS 4 Phase II valuation basis or to enable reporters to incorporate elements of Solvency II valuation within their IFRS financial statements. As noted in the Discussion Paper, some changes that would be permitted under IFRS are currently not permitted under UK law such as discounting of general insurance liabilities with a term of less than four years.

The consequence of this optionality is that an even greater variety of reporting bases becomes possible for UK statutory accounting reporters which could lead to inconsistent valuation of liabilities ultimately impacting on the distributable profits and level of taxation. Given that the short term solution selected by the ASB may need to remain in place for a number of years, we recommend that consideration should be given to the potential under the four options for increased diversity in the selection of accounting policies including the extent to which insurers can choose to adopt IFRS.

7.5 (b) what is your preferred solution for insurance accounting in the UK during the gap period?

We strongly reject the use of either Option 3 – Solvency II or Option 4 – early adoption of IFRS 4 Phase II as we do not consider that it is appropriate for companies reporting under UK GAAP to have to apply more complex bases for valuing insurance contracts than is required of companies who report under IFRS and unlisted companies should not be expected to incur the additional cost of implementing such complex bases ahead of those using IFRS. In addition to this over-arching consideration, in the appendix to this letter we have identified a number of specific disadvantages of Options 3 and 4, which we feel render them less desirable than Options 1 and 2.

Currently the FRG members have mixed views with regard to Option 1 and Option 2. We believe that for many firms Option 1 – current IFRS 4 and Option 2 – current UK GAAP will amount to the same basis but it is the difference between these two bases that is important. As explained above, current IFRS 4 permits changes to the valuation basis provided these move the valuation basis closer to the requirements of IAS 8.

Some members of the FRG feel it is undesirable to allow those reporting under UK GAAP to be able to amend their accounting policies. As noted above, if Option 2 was selected and a UK GAAP reporting entity wanted to change their accounting policies, they would be required to do so under the principles stated in Financial Reporting Standard (FRS) 18 if all the conditions were met to retain the true and fair view of the insurer's financial statements. Alternatively an insurer could elect to adopt IFRS to benefit from the IFRS 4 framework that deliberately allows a more relaxed regime for changes in accounting policies than under

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IAS 8. In this scenario, the emphasis on the first time adoption of IFRS as the entity's new reporting framework would provide a more appropriate context for the change to the IFRS 4 regime and provide the same useful information to users of financial statements as under current UK GAAP.

Other members of the FRG would favour Option 1 over Option 2 based on the merits of having consistency in financial reporting requirements for listed and unlisted insurers and because companies not currently applying FRS 26 would need to make changes to apply the contract classification requirement of FRS 26 if Option 1 was selected. In other words, under Option 1 all insurers would classify investment type contracts sold by insurers as financial instruments unless they meet the definition of an insurance contract in IFRS 4.

7.5 (c) what is your rationale for proposing that solution, including the balance of cost and benefits?

The FRG considers that the short term solution to UK GAAP for insurers and reinsurers should require the minimum amount of change. We see little benefit for the ASB or for companies producing financial statements to incur significant additional costs in moving to a short term solution and then incurring further costs when the long term solution is implemented.

We also recommend that the short term solution for UK GAAP should be a basis which is well understood and for which there is an established understanding of both the preparation and auditing of the financial statements.

Whilst users of insurance companies' financial reports may highlight the limitations of current reporting bases, at least these bases are well understood. Introducing changes in the short term and again in the long term leads to greater inconsistency of reporting and consequently greater difficulty in assessing performance over time and comparing across companies.

Options 1 and 2 best meet the criteria set out above. Implementing Option 1 – current IFRS 4, would require some significant implementation for firms not currently applying FRS 26. We note, however, that these changes are expected to be consistent with and required by the recommended long term solution.

We believe that Option 3 and Option 4 would result in significant implementation costs both for reporting entities and for the ASB and we do not believe these costs are justified in relation to a short term solution.

7.5 (d) what is the likely impact of any changes in accounting for insurance contracts under UK GAAP on the entity you have in mind. It would be helpful if your response clarifies the current position of the reporting entity you have in mind (listed, unlisted, reporting in accordance with IFRS/grandfathering/own accounting policies/UK GAAP/other).

Within the FRG we have views on a range of different types of organisations and we discussed the relative positions of listed and unlisted companies, the extent of implementation of FRS 26 and the various accounting policies currently implemented for the valuation of insurance contracts. These deliberations have been reflected in our observations earlier in this letter and in the attached appendix.

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Financial Reporting Group of the Institute and Faculty of Actuaries

If you wish to discuss any aspects of our comments, the FRG would be pleased to help further. Please contact Peter Stirling, the Secretary of the Financial Reporting Group:

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Yours sincerely

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Appendix

In this Appendix we have summarised the advantages and disadvantages identified in respect of each of the four options identified in the ASB Discussion Paper. We also considered whether there are any other viable options for the ASB and we have not identified any to be considered.

Option 1: Incorporate the current version of IFRS 4 into UK GAAP

We understand this approach would lead to the grandfathering of pre-existing UK GAAP accounting policies and that reporters would be permitted to change those pre-existing accounting policies as permitted under current IFRS 4.

Advantages of Option 1

- Option 1 creates consistency of financial reporting requirements between listed and unlisted insurers.
- It also provides some flexibility to preparers to either grandfather existing accounting practices or make improvements for example to align certain aspects of an insurer's accounting policies to Solvency II or IFRS 4 Phase II, if that is desired. It would enable subsidiaries of IFRS reporting parent companies that have adopted IFRS 4 changes to their insurance liabilities accounting policies to adopt the same policies as used for the group consolidated accounts.
- Audit review processes are well established.

Disadvantages of Option 1

- Additional work for entities not currently reporting under FRS 26 in relation to contract classification. However these changes will have to be implemented under the proposed long term solution to move to IFRS 4 Phase II so Option 1 would only change the timing of making these changes.
- IFRS 4 permits reporting entities to change their valuation basis for insurance contracts to a basis that improves them when assessed against the IFRS hierarchy required under IAS 8 for the development of accounting policies under IFRS. This option can lead to inconsistency in valuation bases between reporting entities which decide different changes at different times. Those UK unlisted insurers who already adopt IFRS for their financial statements and UK listed insurers who are required to report under IFRS already benefit from this option.
- The Discussion Paper notes that Option 1 is not favoured by users. We believe that many external users of accounts would naturally focus on the consolidated published accounts of listed entities which are reported using IFRS not UK GAAP so we place less weight on this disadvantage.

Option 2: Embed the relevant rules of the FSA's Realistic Capital regime into UK GAAP

The FSA's Realistic Capital regime does not apply for general insurers and a number of life insurers. Based on our interpretation of the Discussion Paper, we understand Option 2 to be the intention to retain all the current UK GAAP requirement and where those requirements are currently set by a body other than the ASB and may not be maintained for the duration of the short term solution, the ASB will transpose those requirements into ASB accounting standards.

Advantages of Option 2

- Option 2 maintains the status quo in the short term and insurers reporting under UK GAAP would not be required to adopt the requirements of IFRS 4 Phase II ahead of current IFRS reporting entities.
- UK unlisted insurers would not be required to adopt IFRS for "investment contracts" in the short term, although they would be required to make this change as part of the proposed long-term solution.
- Audit review processes are well established around this basis.

Disadvantages of Option 2

- As noted in the Discussion Paper current UK GAAP is based on the regulations due to be replaced by Solvency II. Due process would be required to agree and implement any necessary changes to the document comprising UK GAAP for insurers.
- In particular, we believe there is extensive cross-referencing between the FSA requirements and the ABI SORP and it will be necessary to capture all the relevant rules, for example there are requirements for Non-directive Friendly Societies covered in IPRU-INS and brought into UK GAAP by the ABI SORP.

Option 3: Update FRS 27 and the ABI SORP for Solvency II requirements

We understand this to mean that the ASB would take the balance sheet measurement basis for insurance contracts technical provisions and reinsurance assets set out in the European Directive 2009/138/EC and the associated Implementation Measures, which are currently in draft and the ASB would develop the necessary standard for the presentation of the income statement and other disclosures.

Advantages of Option 3

- This approach would maintain greater consistency between regulatory and financial reporting bases and processes; however, this consistency will be limited to insurance contracts for firms that have not adopted FRS 26, as investment contracts issued by insurance companies are included as insurance contracts for the Solvency II balance sheet.

Disadvantages of Option 3

- The aim of Solvency II is not to produce a meaningful measure of accounting equity and profit; instead it is targeted at producing regulatory capital requirements for the protection of policyholders. There has been no deliberation on this method as a basis for performance reporting and we believe that its use for such a purpose would identify many weaknesses which are not relevant when considering regulatory capital requirements.
- Our understanding of this option is that a definition of accounting equity and profit would be based on the Solvency II measurement of assets and liabilities as the basis of "own funds". This would ignore the distributability of profits. This option would require the development of an income recognition approach as stated in the Discussion Paper.

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- We consider that the development of an approach for recognition of revenue and presentation of performance would require an onerous level of work for the ASB, which would not have any long term benefits given the proposed long term solution. We further note that the work of the IASB has encountered many challenges in the development of an approach that combines a current valuation basis with appropriate revenue and profit recognition suggesting this may not be a viable short term solution.
- There is still some uncertainty as to the timing of Solvency II and the Level 2 Implementing Measures are still in draft and may be subject to further changes.
- This option would create a non-level playing field for UK GAAP reporting entities compared to IFRS reporting entities. We consider it inappropriate to require unlisted insurance companies in the UK to apply a more complex valuation basis than listed insurance companies.
- For reporting entities that have not adopted FRS 26, this would apply both to contracts that meet the IFRS 4 definition of "insurance contracts" and to "investment contracts" sold by insurers. It is not clear what benefits there would be for investment contracts being accounted for under Solvency II when under the long term solution these will be accounted for under IAS 18 and IAS 39.
- Discounting is required in Solvency II but, as noted within the Discussion Paper, discounting of General Insurance claims liabilities with a term of less than four years is not permitted under UK / European law currently for financial reporting purposes.
- Choosing Option 3 would require firms to change their financial reporting bases twice given the difference between the short term and long term solutions as there is a very low likelihood that the contract recognition and valuation bases used in Solvency II and IFRS 4 Phase II will move into close alignment. Adoption of Solvency II then IFRS 4 Phase II within UK GAAP accounting seems unnecessarily burdensome and expensive both for the reporting entities and for the ASB.
- Audit review processes are not established.
- Given the disadvantages of Option 3 we believe that many more reporting entities may choose to switch to reporting under IFRS requirements.

Option 4: Incorporate 'IFRS 4 Phase II' draft proposals into UK GAAP

Option 4 would adapt the requirements of the IASB's most recent due-process document for IFRS4 Phase II, for example, a ballot draft or an Exposure Draft, if a final standard is not available in time for the short-term solution for UK GAAP.

Advantages of Option 4

- Potential for UK insurers to go through a change in their accounting only once if the version used is close to the final standard.

Disadvantages of Option 4

- The IASB has made good progress in developing a standard for insurance contracts but there are still a number of areas to be resolved including the recognition of revenue and the presentation of performance. It is likely that the draft standard available at the time the ASB wishes to implement its short term solution will be subject to further, perhaps significant changes, prior to the new IFRS being finalised.

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- This approach would lead to considerable implementation costs for the short term solution and may still result in additional costs when the long term solution is finally implemented.
- Option 4 would create a non-level playing field for UK GAAP reporting entities compared to IFRS reporting entities. Unlisted insurers would be required to adopt the requirements of IFRS 4 Phase II ahead of current IFRS reporters.
- Discounting will be required in IFRS 4 Phase II but discounting of General Insurance claims liabilities with a term of less than four years is not permitted under UK / European law currently for financial reporting.
- Audit review processes are not established.
- Given the disadvantages of Option 4 we believe that many more reporting entities may chose to switch to reporting under IFRS requirements.

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