The Actuarial Profession

making financial sense of the future

Response to Exposure Draft
IFRS

Insurance Contracts

November 2010

About the Actuarial Profession

The Institute and Faculty of Actuaries is the chartered professional body for actuaries in the United Kingdom. A rigorous examination system is supported by a programme of continuous professional development and a professional code of conduct supports high standards, reflecting the significant role of the Profession in society.

Actuaries' training is founded on mathematical and statistical techniques used in insurance, pension fund management and investment and then builds the management skills associated with the application of these techniques. The training includes the derivation and application of 'mortality tables' used to assess probabilities of death or survival. It also includes the financial mathematics of interest and risk associated with different investment vehicles – from simple deposits through to complex stock market derivatives.

Actuaries provide commercial, financial and prudential advice on the management of a business' assets and liabilities, especially where long term management and planning are critical to the success of any business venture. A majority of actuaries work for insurance companies or pension funds – either as their direct employees or in firms which undertake work on a consultancy basis – but they also advise individuals and offer comment on social and public interest issues. Members of the profession have a statutory role in the supervision of pension funds and life insurance companies as well as a statutory role to provide actuarial opinions for managing agents at Lloyd's.

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International Accounting Standards Board
1st Floor, 30 Cannon Street
London
EC4M 6XH

25 November 2010

Dear Sir/Madam

Exposure Draft: Insurance Contracts

Thank you for the opportunity to comment on this exposure draft *Insurance Contracts.* A detailed response to the exposure draft is being left to the International Actuarial Association. However, there are a number of issues with the exposure draft, predominantly those which affect UK insurers disproportionately, where we believe separate representation is appropriate.

We set out below comments on these issues and confirm that we are happy for them to be placed on the public record. We would emphasise that whilst we accept the exposure draft is a big improvement on IFRS 4, the comments do not reflect all our concerns with the proposals. In particular, we very much doubt their adoption will remove the need for life assurance companies to provide supplementary information to cater for the needs of investors.

Business with discretionary participating features

The intended treatment of assets within a participating fund which are surplus to the requirements of current policyholders needs clarification. In paragraph B61(j) there is a reference to liabilities being included in respect of future policyholders but this is contradicted in a number of places elsewhere.

We believe it is appropriate to split the surplus into its shareholder and policyholder components. The latter could be indentified as a separate item from the liability for in-force policyholders and perhaps labelled “members’ interest” in a mutual. In a 90/10 proprietary company, the shareholders interest would need to allow for what is commonly referred to as the “burn through” cost, representing the market-consistent mean value of any future shareholder support to the fund needed to make benefit payments.

Unit-linked business

We were pleased that the exposure draft addressed some accounting mismatches for this business. However, we were disappointed that one such mismatch was not dealt with, namely that associated with the requirement to cover a deposit floor (surrender value) in the policyholder liability combined with the need to establish a deferred tax charge on a full undiscounted basis. In the UK the allowance within a unit fund for capital gains tax may be less than the full undiscounted amount for reasons associated with treating policyholders fairly and this can lead to some wide, artificial swings in reported profit.

We appreciate the IASB’s desire not to change IAS 12 merely on account of an issue largely confined to UK unit-linked business. However, it would be helpful if, say, the Basis for Conclusions could record that the deposit floor for unit-linked business need not be the

Maclaurin House
18 Dublin Street
Edinburgh · EH1 3PP
T +44 (0)131 240 1300
F +44 (0)131 240 1313

Staple Inn Hall
High Holborn
London · WC1V 7QJ
T +44 (0)20 7632 2100
F +44 (0)20 7632 2111

Napier House
4 Worcester Street
Oxford · OX1 2AW
T +44 (0)1865 268 200
F +44 (0)1865 268 211

www.actuaries.org.uk

actual surrender value but rather could reflect the IAS 12 deferred tax liability where this adjustment removes an accounting mismatch.

Risk Margins

The proposal to require a risk margin calculated in accordance with a cost of capital approach (we expect the normal approach to be adopted by UK insurance companies) to be re-calibrated to a confidence level is impractical and of very little theoretical benefit. It would require stochastic modelling for many companies that otherwise would have no need for such a technique.

We also believe that a confidence level as proposed would itself give a misleading impression even if it could be calculated. This is because it ignores the fact that the use of market-consistent financial assumptions incorporates a margin above a mean “real world” outcome.

Contract boundaries and medical expense insurance

Medical expense insurance is a major line of business in the UK. It is generally written on an annually renewable basis but an individual is guaranteed renewal regardless of his or her claims experience. The premium on renewal is set having regard to the expected experience of the entire portfolio.

A strict interpretation of the rules on contract boundaries would require a major change in systems to value the impact of future (unknown) premiums for very little practical benefit. This is because the profits expected to arise on these future premiums would, under the proposals in the exposure draft, be balanced by an increased residual margin, the run-off of which is essentially arbitrary. Nothing seems to be gained by not treating this business as short duration – although a loss recognition test on a recurring premium approach would seem appropriate.

Transitional rules and general overhead expenses

In the UK, for historical reasons, a large number of life assurance companies are effectively closed to new business. Under the proposed transitional rules such companies will report no release of residual margins and the only expected offset to the emerging overhead expenses excluded from the fulfilment cash flows will be the release of the risk margins. It seems likely that losses will be reported in many cases with opening equity correspondingly overstated.

We believe that this situation highlights the undesirability of excluding general overhead expense, other than those reasonably allocated to new business production, from the fulfilment cash flows. We strongly recommend their inclusion for all companies, which would have the beneficial effect of reducing the size of the residual margins reported (with their arbitrary run off).

Whilst the above change will mitigate the problem of profit reporting for closed life companies we also believe that the transitional rules should require companies to establish residual margins for in-force business on a "best endeavours" basis. If general overheads are included in fulfilment cash flows it is likely that such margins could be restricted on the grounds of materiality to recently issued business which should make their calculation a practical proposition. Additional disclosure would be required to support this change

lease contact Pauline Simpson, Life Practice Manager on 01865 268237 or via pauline.simpson@actuaries.org.uk if anything is unclear or we can help.

Yours faithfully

Pauline Simpson
Practice Manager, Life