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Accounting Standards Board
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30 April 2012

Dear Sir

Insurance Accounting - Mind the UK GAAP

We are pleased to comment on the Accounting Standards Board's (the Board's) discussion paper "Insurance Accounting – Mind the UK GAAP" published by the Board on 30 January 2012.

Summary response

We agree with the discussion paper that the long-term solution for accounting for insurance contracts under UK GAAP is to adopt the requirements of IFRS 4 Insurance Contracts Phase II when this standard has completed its development under the IASB. Of the four short-term options identified in the discussion paper, our preferred option is Option 1, namely that the current version of IFRS 4 is incorporated into UK GAAP.

However, we also note that IFRS 4 has been prepared within the wider context of IFRS standards and the incorporation of IFRS 4 into UK GAAP will need to be carried out with care in order to avoid potential inconsistencies in the treatment of insurance contracts and financial instruments. We note, in particular, that the distinction between financial instruments and insurance contracts is in some cases a complex judgement. The IASB has worked hard to ensure that the views of the insurance community have been taken into account in determining the scope of their standards on insurance contracts and financial instruments. We therefore encourage the ASB to ensure that where insurers choose to apply FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland in its entirety, ie do not choose to account for financial instruments under either IAS 39 Financial Instruments: Recognition and Measurement or IFRS 9 Financial Instruments, that contracts would be classified in the same way as under EU-adopted IFRS.

To this end we note that under EU-adopted IFRS certain contracts containing a discretionary participation feature are outside of the scope of IAS 39 and IFRS 9. As presently drafted Section 11 of FRS 102 on basic financial instruments contains a scope exclusion for such contracts but Section 12 on other financial instruments does not contain this scope exclusion.

Similarly, the IASB have ensured that accounting mismatches are eliminated where at all possible by providing sufficient flexibility in the accounting for financial assets, often allowing these to be stated at fair value. In our view, similar flexibility should be accorded to insurers adopting FRS 102 in its entirety, such that accounting mismatches can be eliminated wherever possible. For those insurers choosing not to apply either IAS 39 or IFRS 9, as currently drafted FRS 102 would require all financial assets which met the conditions of being a basic financial instrument to be accounted for at amortised cost. In some circumstances, this would not enable insurers to eliminate these accounting mismatches in their financial statements.

Our detailed responses to each of your questions is set out in Appendix A. If you have any questions on our response, or wish us to amplify our comments, please contact Jake Green (jake.green@uk.gt.com or telephone 020 7728 2793) or Nigel Masters (nigel.masters@uk.gt.com or telephone 020 7865 2582).

Yours faithfully

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Appendix A

Response to questions posed in the discussion paper

Long-term solution

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 Board that the long-term solution is to incorporate the requirements of IFRS 4 Phase II into UK GAAP. However, we note that IASB Project on Insurance Contracts is not supported by users in all its aspects, notably in its transition requirements. Accordingly, the standard may not be fully adopted within the EU. Therefore, we support the adoption into UK GAAP of the version of the IFRS accounting standard that is adopted by the EU. This should ensure consistency between listed and unlisted insurers.

We also note that the successful introduction of IFRS 4 Phase II into UK GAAP will depend on the resolution of the overlaps and inconsistencies between that standard and the other accounting standards that would make up UK GAAP. For example, IFRS 4 Phase II will adopt a definition of "insurance contracts" that will address certain policies but will leave other contracts written by insurers to be recognised and measured under the proposed replacement to UK GAAP (FRS 102). The treatment of financial instruments under UK GAAP will need to be able to accommodate this.

Short-term solution

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?

The large number of areas of interaction between any Insurance Contracts standard and the remainder of UK GAAP, the range of assets held by UK insurers and the diversity of product designs adopted by UK insurers mean that it is likely that practical implementation problems will arise once the details of any standard are implemented. At the present time, we have not identified any problems beyond those noted in the discussion paper.

(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 the your rationale for proposing that solution, including the balance of cost and benefits?

Our preference of the four options set out in the Discussion Paper is Option 1. We explain below our reasons for this view:

Option 1

- The main strength of Option 1 is that it provides flexibility for preparers to either grandfather existing accounting practices or make improvements in line with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors (eg align certain aspects of the basis to Solvency II if that is desired). This has the obvious advantage of minimising the disruption and cost of implementing a standard which may only be in force for a few years.

- Option 1 allows insurers to move towards the preferred long term solution in a reasonably controlled progression. While Option 1 will require additional work for non-FRS 26

Financial Instruments: Recognition and Measurement companies, notably contract re-classification, this is a direction that they would have to take in any case under the long term solution.

- Whilst recognising that Option 1 does not require a single measurement or presentation approach, it does offer a degree of consistency of accounting policy between listed and unlisted insurers.

Option 2

- Option 2, embedding the relevant rules of the FSA's Realistic Capital regime into UK GAAP, would allow the majority of non-listed insurers to maintain their current measurement approach but would not by itself cater for the smallest non-listed insurers who are not required to follow the realistic capital regime. In our opinion, for these smallest entities the cost of implementing the realistic capital regime would be disproportionate, even if this were not an interim solution. This could be addressed by requiring the rules underlying the Modified Statutory Solvency Basis also to be included. However, this creates added complexity for preparers and the ASB.

- Option 2 would have the temporary advantage of not requiring UK non-listed insurers that have not already recognised "investment contracts" to adopt IFRS for "investment contracts", although this would only defer the requirement to make this change as it would be part of the proposed long-term solution.

Option 3

- Option 3, updating FRS 27 and the ABI SORP for Solvency II requirements, would promote greater consistency between the regulatory and accounting reporting bases and processes for insurance contracts in the short term, which is to be welcomed by some preparers as reducing workload and encouraging greater coherence in internal financial management. However, the two regimes would inevitably diverge again once IFRS 4 Phase II is introduced. Although IFRS 4 Phase II and Solvency II share similar measurement objectives, in practice financial reporting and solvency management will lead to different requirements not least for "investment contracts".

- Similarly, 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. This would ignore recognition and de-recognition issues and also would create anomalies with the asset measurement regime in that it does not reflect the possibility of an amortised cost basis for asset measurement.

- It is also the case that the Solvency II proposals are themselves uncertain and may be subject to considerable change before finalisation. This may well lead to insurers having only a short time to implement the rules at a time when they would be required to implement Solvency II itself.

- General insurance discounting is required in Solvency II but, as noted within the discussion paper, discounting is currently not permitted under UK/European law, which could result in sufficiently significant delays in the agreement of enabling legislation as to make the solution unviable.

Option 4

- Option 4, incorporating IFRS 4 Phase II as it currently stands into UK GAAP, has the potential advantage for UK insurers reporting under UK GAAP to go through only one change in their accounting but this depends heavily on the current version being adopted with only minor changes. A major change, for example in the presentation proposals, could necessitate significant re-working.

- Option 4 would produce the unusual position that unlisted entities would need to shoulder the burden of the initial interpretation and development that results from the implementation of a new standard. This would unnecessarily stretch the limited resources of unlisted insurers.

- As noted in the discussion paper and also mentioned above in respect of option 3, general insurance discounting is not currently permitted under UK/European law but is incorporated in the current IFRS 4 Phase II version. This would require enabling legislation.

(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 not explicitly considered the impact of the proposals on specific companies and our observations set out above are prepared from the perspective of our experience of work with a number of medium and small sized insurers.