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AFM response on FRED 49, FRS 103

1. I am writing in response to this discussion paper, on behalf of the Association of Financial Mutuals. The objectives we seek from our response are to:
 - Comment on the proposals in the consultation and highlight the possible impact on some AFM members.
2. The Association of Financial Mutuals (AFM) represents 53 member companies, most of which are owned by their customers. Between them, AFM members manage the savings, protection and healthcare needs of 20 million people, and have total funds under management of £100 billion. The nature of their ownership and the consequently lower prices, higher returns or better service that typically result, make mutuals accessible and attractive to consumers, and have been recognised by Parliament as worthy of continued support and promotion.
3. We recognise there has been careful thought put into the paper, and we see a number of positive outcomes; in particular we are in favour of:
 - a. the objective to allow entities to continue with their current accounting practice, pending a definitive IFRS standard and a new regulatory regime (possibly Solvency II) for insurers, is sensible; and
 - b. the linchpins of current accounting practice, alongside Company Law or “the Regulations” – the ABI SORP and FRS 27 – needed refreshing, and this has been achieved.
4. There are however a number of areas where we have concerns:
 - a. Whilst the logic for basing FRS 103 on IFRS 4 (as it stands) is understandable from a standard setting perspective, it is not very helpful for users. IFRS 4 was drafted to control further undesirable divergence in accounting in different international jurisdictions before a definitive standard could be developed. This is not what is required in the present circumstances.

- b. Thus Section 2 on “Accounting Policies, Recognition and Measurement” starts incongruously (given the objective not to change things) with a section title “Changes in accounting policy.” The references to use of “current market interest rates”, “prudence”, “future investment margins” and “shadow accounting” could be viewed as confusing, given the constraints laid down by the Regulations. There are a number of references in this section of the type “unless required or permitted by the Regulations...” For the UK, the Regulations are known and cover, for example, discounting of general insurance liabilities and establishing equalisation provisions; the way the FRS is drafted suggests that these might be exceptions rather than the norm.
 - c. The language of IFRS 4 also differs from that commonly used and understood in the UK (or from UK GAAP). Hence unfamiliar terms arise in Section 2 such as “liability adequacy test” (how does this relate to the more commonly used “unexpired risks provision?”), “shadow accounting” (what is this meant to cover, unit-linked business?), “embedded derivatives” (what sort of insurance products is this referring to in the UK context?), “unbundling of deposit components” (para 2.24 gives an example being what might commonly be understood to be “financial reinsurance” but cast entirely in IFRS language), and “discretionary participation features in insurance contracts” (is this just another term for with-profits business?).
 - d. Sections 3 and 5 covering long-term and with-profits business, and is drawn from FRS 27 and the SORP and reverts to UK language, similarly the Implementation Guidance.
 - e. All terms, from whichever quarter, are “defined” in the Glossary but this does not entirely deal with the overall confusion. Readers will need to understand the background and context to IFRS 4 to make head or tail of FRS 103.
5. The plans to review FRS 103 on the changes in regulatory reporting, noting Solvency II implementation in 2016, and completion of IFRS 4 Phase 2, now at further ED stage, appear sensible. On this front, given the current drafting, the main question is possibly whether Phase 2 can be considered (without modification) a suitable long-term solution for UK GAAP, particularly with respect to long-term business. For many, a practical solution would be to maintain the connection between financial and regulatory reporting.
6. We attach some specific drafting points and response to the specific questions raised in the consultation. We would be pleased to discuss further any of the issues raised by our response.

Yours sincerely,



Chief Executive
Association of Financial Mutuals

Specific drafting comments

Page 10 “Consequential amendment to FRS 101 Reduced Disclosure Framework”. The fact that equalisation provisions are required by the Regulations was not picked up in FRS 101 rather being consequential to FRS 103.

Page 16 Para 2.26, Spelling of “Business”

Page 26 Para 6.2, Last word should be FRS 103 not FRS 102

Page 26 Para 6.4 “Re-designation of financial assets”. This refers that on transition to FRS 103, if an insurer changes its accounting policies for insurance liabilities, it is permitted to reclassify financial assets at fair value through profit or loss. Given the objective to leave insurance liabilities where they are, it might be helpful to explain in what circumstances this might apply.

Implementation Guidance

Page 9 IG2.10 It is not clear why an entity should be precluded from introducing a policy such that no “adverse run-off deviation” is envisaged, particularly as the concept is discussed in the source paragraph of the SORP (SORP 95). Can this be clarified? “Adverse run-off deviation” is also not defined in the Glossary.

Page 15 IG2.50 Refers to certain long-term business funds of proprietary insurers being established in a way that allocation between equity and policyholders’ liabilities is not clear-cut and therefore it is appropriate to establish a FFA. Should this not also recognise the position of mutual insurers where the allocation as between working capital and policyholders’ liabilities is not clear-cut? A possible improvement of the original SORP paragraph.

Our responses to specific Questions

Question 1

Do you support the introduction of draft FRS 103, based on IFRS 4 and incorporating many of the requirements of FRS 27 Life Assurance and elements of the ABI SORP? Does it achieve its aim of allowing entities, generally, to continue with their existing accounting policies for insurance contracts? If not, why not?

Obviously not for those that still use the regulatory definition of insurance in circumstances where it conflicts with the accounting definition now applied to all. This might be seen as an improvement in technical accounting terms but it is questionable that it is helpful either to preparers or users of accounts for those affected. The constituency affected includes small and medium-sized mutual insurers, and some unlisted companies.

Question 2

Draft FRS 103 paragraph 2.3 includes the 'improvement' options from IFRS 4 (ie permitting entities to change accounting policies for insurance contracts in certain circumstances). Do you agree with the inclusion of these options in the draft FRS? If not, why not?

In general terms, many UK GAAP reporters are concerned for consistency with peers rather than accounting excellence. On this basis, the options are not helpful. Also given the intended short-term nature of the current FRS 103, it is questionable that they are necessary. However, the existence of the options in IFRS 4 has not had a significant impact in practice within the IFRS reporter sector since its introduction in 2005 so they appear unlikely to be harmful.

Question 3

Draft FRS 103 paragraph 1.5 requires new entrants to apply the same requirements as existing preparers in setting a benchmark for their accounting policies, but they are also permitted to utilise the improvement option where justified, in finalising their initial accounting policies.

Is there sufficient clarity on the application of the draft FRS by new entrants? If not, how should this be improved?

In practice, the Regulations and the Implementation Guidance (largely derived from the SORP) would be the most relevant items. These are both mentioned in FRS 103 para 1.5 though perhaps could be emphasised a little more pointedly. Overall, as discussed in the General Comments, IFRS 4 is not a helpful basis for defining accounting; most acutely for new entrants who may be unfamiliar with its history and context.

Question 4

Draft FRS 103 includes paragraphs from IFRS 4 on future investment margins. Paragraph 2.8 notes that an insurer need not change its accounting policies to eliminate future investment margins, however there is a rebuttable presumption that an insurer's financial statements will become less relevant and reliable if an accounting policy is introduced that reflects future investment margins in the measurement of insurance contracts (unless those margins affect contractual payments). Paragraph 2.9 describes how an insurer might overcome the rebuttable presumption.

Do you agree with the rebuttable presumption? If not, please describe your preferred measurement basis for insurance contracts and whether or not you would permit insurers to continue with their existing accounting policies in this area for the time being?

The paragraphs on this, 2.8 - 2.10, are slightly convoluted. In practical terms, it is helpful to allow long-term business insurers (for whom this is relevant) to base their liabilities on regulatory measurements subject to adjustments as set out on pages 13 to 14 of the Implementation Guidance. For consistency, this should apply equally to existing insurers continuing the approach and to any new entrants establishing accounting policies.

Question 5

Draft FRS 103 paragraph 4.7(c)(iii) has adopted the IFRS 4 requirement for claims development disclosures. Is the data for these disclosures readily available to preparers?

Generally yes.

Question 6

The requirement to provide capital disclosures is now contained in paragraph 34.31 of FRS 102 and Section 3 of the draft Implementation Guidance provides only guidance on how those disclosures might be made by insurers with long-term insurance business, rather than mandating a particular presentation.

Do you believe this approach is appropriate in the context of applying draft FRS 103 with FRS 102? Will it have an impact on the usefulness of the disclosures to users of financial statements?

We are comfortable with this.

Question 7

Do you think the guidance on providing capital disclosures, set out in Section 3 of the draft Implementation Guidance, should also be applicable to other financial institutions applying FRS 102, such as banking entities?

We do not have a view on this.

Question 8

Draft FRS 103, as with other accounting standards, is written in the context of a company and the relevant legal requirements. Appendix IV recognises that draft FRS 103 applies to other entities, including mutual insurers established under the Friendly Societies Act 1992. Are there any requirements of the draft standard or accompanying draft Implementation Guidance that you consider require amendment in order to be applied by insurers other than companies?

We refer to our above comments.

Question 9

Do you agree with the proposed effective date? If not, what alternative date would you propose, and why?

Arguably not critical given the objective not to change things, but appears reasonable.