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Ref: AC/FRC

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Dear Ms Carter

FRED 64 - Draft amendments to FRS 103 *Insurance Contracts Solvency II*

Introduction

Ernst & Young LLP welcomes the opportunity to comment on FRED 64 issued by the Financial Reporting Council ('the FRC').

Overall comments on FRED 64

In principle, we agree that FRS 103 should be amended to reflect the implementation of Solvency II.

However, we have concerns that the definitions 'established long-term insurance business liability basis' and 'realistic value of liabilities' are unclear, contain undefined terms, are potentially inconsistent with UK company law and, viewed in isolation, are not the same as the definitions that they replace (i.e. modified statutory solvency basis (MSSB) and realistic value of liabilities, respectively). Whilst the revised definitions state that the method for determining these liabilities shall be consistent with that applied in periods ending before 1 January 2016, an entity setting accounting policies in relation to insurance contracts for the first time in accordance with paragraph 1.5 of FRS 103 would, in our view, have difficulty applying these definitions without further guidance.

We believe that the solution is to delete Section 3 of FRS 103, as we proposed in our response to FRED 49 in 2013. Whilst the practical impact of the deletion of Section 3 is that there will be no benchmark against which entities setting accounting policies in relation to insurance contracts for the first time can assess those accounting policies, this is consistent with the situation that applies under both IFRS 4 *Insurance Contracts* and FRS 101 *Reduced Disclosure Framework*. The deletion will have no impact on those entities already adopting FRS 103.

Alternatively, if the FRC will not delete Section 3 of FRS 103 then either:

- the previous definitions of MSSB and realistic value of liabilities should be retained except that the words 'as at 31 December 2015' should be added to clarify that the phrases are 'grandfathered'; or
- the undefined terms in the definitions should be explained and wording should be added to the definition 'established long-term insurance liability basis' to ensure consistency with UK company law as explained in our response to Question 1 (Q1).

If you have any matters arising concerning the content of our response, please contact Tony Clifford on 0207 951 2250.

Yours sincerely



Ernst & Young LLP

Responses to FRC questions

FRED 64 Draft amendments to FRS 102 Fair value hierarchy disclosures

Question 1

Do you agree with the amendments proposed to FRS 103 and the related Implementation Guidance?
If not, why not?

In principle, we agree that FRS 103 must be updated to reflect the changes in the regulatory regime (i.e. Solvency II). However, we have the following concerns:

Definition of established long-term insurance business liability basis

We understand that the purpose of this definition is to adopt a principles-based approach to the valuation of long-term insurance liabilities. However, in our view the definition is very broad, contains words such as 'appropriate' (used three times) which require further guidance to interpret or audit, and is, in our view, inconsistent with the previous Modified Statutory Solvency Basis (MSSB). For example the MSSB did not require liabilities to be valued on a basis consistent with the valuation of assets. According to FRS 102, financial assets are held at either fair value or amortised cost whereas the MSSB valuation method for insurance liabilities was neither amortised cost nor fair value.

We are also concerned that a broad application of the definition would result in a basis for determining insurance liabilities which is not compatible with UK company law. For a UK company, paragraph 52 of Schedule 3 to the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 ('the Regulations') requires that the long-term business provision must in principle be computed separately for each long-term contract, save that statistical or mathematical methods may be used where they may be expected to give approximately the same results as individual calculations. The computation must be made annually by a Fellow of the Institute or Faculty of Actuaries on the basis of recognised actuarial methods, with due regard to the actuarial principles laid down in Directive 2002/83/EC of the European Parliament and of the Council of 5th November 2002 concerning life assurance. This is a more restrictive definition than contained in the exposure draft which refers to 'in accordance with generally accepted actuarial practice' without regard to the actuarial principles laid down the Directive and of the Council of 5th November 2002.

We note that the wording states that 'The basis applied by an entity shall be consistent with accounting policies applied in periods ending before 1 January 2016' and therefore existing FRS 103 users should not change their accounting policies when this definition changes. However, an entity setting accounting policies in relation to insurance contracts for the first time is not constrained by this wording and would, using the revised definition without additional guidance, calculate a long term business liability on a basis different to the MSSB because, for example, 'appropriate' can mean different things to different entities.

If the FRC's intention is that the definition of 'established long-term insurance liability basis' is meant to produce a liability valuation consistent with the MSSB then we recommend that the previous description is kept the same except that the words 'as at 31 December 2015' are added after 'statutory solvency basis'.

If, however, the FRC's intention is to provide more flexibility to insurers we would recommend a cross reference to paragraph 52 of the Regulations to remind UK insurers that their valuation techniques are subject to additional conditions. In addition, we recommend that the requirement that the valuation of liabilities be consistent with the valuation of assets is deleted.

Definition of realistic value of liabilities

The meaning of the previous description of this term could be obtained by reference to rule 1.3.40 in INSPRU. However, the new description:

- uses the undefined terms the terms 'with profits benefits reserves', 'future policy-related liabilities and 'realistic current liabilities'; and
- there is no longer a restriction on the current liabilities which are to be excluded from the fund so this appears to mean now that all current liabilities recognised separately in the statement of financial position must be excluded rather than only those within the definition in rule 1.3.90 of INSPRU.

Although the definition contains an 'override' to the effect that the method for determining the realistic liabilities shall be consistent with that applied in periods ending before 1 January 2016, this wording is of no value to an entity with no realistic liabilities prior to 1 January 2016 (i.e. an entity setting accounting policies in relation to insurance contracts for the first time according to paragraph 1.5 of FRS 102). We therefore do not believe that a new entity can properly determine its 'realistic liabilities' under this guidance given the undefined terms which make up the proposed definition.

If the intention is that the definition of 'realistic value of liabilities' is the same as under INSPRU then we recommend that the previous description is kept the same except that the words 'as at 31 December 2015' are added after 'INSPRU'.

Alternatively, the FRC should define the terms that make up the definition of realistic value of liabilities.

Question 2

Have you identified any other amendments that you consider should be made to FRS 103 or the related Implementation Guidance as a result of the changes in the regulatory framework? If so, please provide details of your proposed amendments and the rationale for them.

First-time adopters of FRS 103

Paragraph 1.5 of FRS 103 states that "Entities that are setting accounting policies in relation to insurance contracts...for the first time, shall first consider the requirements of Section 3, the Regulations and any relevant parts of FRS 102, as a means of establishing current practice as a benchmark before assessing whether to apply accounting policies that differ from those benchmark policies.

As explained in our answer to Q1 above, we do not believe that the new definitions of 'the established long-term insurance business liability basis' and 'realistic value of liabilities' provide sufficient guidance to a first time adopter of FRS 103.

Therefore, we believe that the FRC should revisit paragraph 1.5 and/or amend the definitions as recommended in Q1 above.

Section 3 of FRS 103

The issues arising in the new definitions which we describe in our answer to Q1 above, derive from Section 3 of FRS 103, a section that does not exist in the equivalent IFRS standard, IFRS 4. In our response to FRED 49, dated 31 October 2013, we expressed the view that we did not agree with the inclusion of Section 3 into FRS 103. We repeat this view and believe that Section 3 should be deleted. Whilst the practical impact of the deletion of Section 3 is that there is no benchmark against which entities setting accounting policies in relation to insurance contracts for the first time can assess those accounting policies this is consistent with the situation that applies under both IFRS 4 and FRS 101.