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By email to: ukfrs@frc.org.uk

28 February 2016

Dear Ms Carter

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

Deloitte LLP welcomes the opportunity to comment on FRED 64 Draft amendments to FRS 103 Insurance Contracts - Solvency II. We have set out our detailed responses to the consultation questions in Appendix 1 to this letter together with some additional drafting comments in the Appendix 2.

Overall we support the proposal to revise FRS 103 Insurance Contracts (FRS 103, the Standard) and the related Implementation Guidance for the changes in the insurance companies' regulatory requirements currently referred to in the Standard. Our key comments, which we expand on in the appendix to this letter are as follows:

- We agree with FRC's decision to retain the approach of allowing continuation of existing accounting policies and methodologies unless the introduction of new policies represents an improvement. We agree that no entity should be forced to adopt a Solvency II method of calculating their insurance liability provisions in their financial statements and that those entities who wish do so must follow the change of accounting policy guidance in the Standard. In our view, this would ensure consistency and comparability between entities and over time.
- We note that certain accounting requirements, such as the need for the equalisation reserve to be shown as provision in the insurer's balance sheet, are contained in the law. The introduction of Solvency II regulation from 1 January 2016 brings into question the interaction between the regulatory, statutory and financial reporting requirements. Please see our detailed comments on this issue in our answer to Question 1 contained in the Appendix 1 to this letter.
- We recommend clarifying the references in FRED 64 to 'regulatory framework' and 'statutory basis', in some cases to refer to the current position and in others to the position immediately prior to 1 January 2016. Currently this term is not defined and is used to convey a variety of meanings in different context. In our view, it is important to give clarity to this term to ensure precise application of the revised FRS 103 provisions and revised implementation guidance. We have also some additional comments on the drafting and the consistency of references to certain terms in the Appendix 2 to this letter.

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- Finally, we note that some of the definitions used in the standard relate to the previous UK regime. It will be necessary to include equivalent material for the Republic of Ireland in the finalised standard.

We would be happy to discuss our letter and the draft proposals with you. If you have any questions, please contact Francesco Nagari (+852 2852 1977 or fnagari@deloitte.co.uk) or Kate Kabanova (+44 (0)20 7303 8440 or kakabanova@deloitte.co.uk).

Yours sincerely

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Appendix 1 - Responses to detailed questions

Question 1 Do you agree with the amendments proposed to FRS 103 and the related Implementation Guidance? If not, why not?

We agree with the need to revise FRS 103 Insurance Contracts and the related Implementation Guidance for the changes in the insurance companies' regulatory requirements that are currently referred to in the Standard. We are broadly supportive of the FRC's approach to dealing with the introduction of Solvency II with the exception of the following comments.

References to 'regulatory framework' and 'statutory basis'

FRED 64 contains numerous references to the 'regulatory framework' and 'statutory basis', in some cases to refer to the current position and in others to the position immediately prior to 1 January 2016. Currently this term is not defined and is used to convey a variety of meanings in different context. In our view, it is important to give clarity to this term to ensure precise application of the revised FRS 103 provisions and revised implementation guidance.

Measurement of with-profits liabilities and related assets

The drafting of section 3 of FRED 64 is intended to require continuation of previous accounting policies for all long-term insurers and with-profit businesses falling within the scope of paragraph 3.1(b).

- We support the FRC's decision to describe more fully the current scope rather than to describe the scope by reference to Solvency II as explained in paragraphs 12 and 13 of the Accounting Council's draft advice to the FRC.
- Paragraph 3.11-3.15 of the original FRS 103 required continuation of the policies required by FRS 27 and the proposed revisions continue this position. However, the related implantation guidance in paragraph IG 2.39 is dependent on the definition of gross premium method in the Glossary to FRS 103. This definition refers to the 'relevant regulatory framework' but does not explain which one. We assume this is meant to refer to that applicable for periods ending before 1 January 2016 but this should be made clear.
- Paragraphs 2.2-2.4 of FRS 103 deal with changes of accounting policy. As paragraphs 3.11-3.15 require a specific treatment, it might be helpful to point out that 2.2-2.4 cannot be used to change policies to conflict with 3.11-3.15.

Entities wishing to use the Solvency II method of calculating their insurance liability provision would need to follow the change of accounting policy guidance in paragraph 2.2-2.4 in the Standard. This would require considering whether the new policies represent an improvement on existing ones, and whether the change makes the financial statement more relevant and not less reliable or more reliable and not less relevant.

The implementation guidance also requires amendment as it still refers to 'statutory requirements' and 'statutory basis' which is inconsistent with the fact that the term 'modified statutory solvency basis' (MSSB) is being replaced by the term 'established long-term insurance business liability basis'.

The original IG 1.3 referred to presentation of the value of profits expected to arise from non-participating business in a with-profits fund as an asset. IG 1.5 said that the amounts recognised under 3.12(c) or (d) should be presented as an adjustment to liabilities unless there was a statutory requirement to present this as a separate asset. As the proposed IG 1.3 no longer requires presentation as an asset (on the grounds that there is no longer a PRA rule requiring this), the end of IG 1.5 should be amended. Transitional guidance would be required.

Equalisation reserves / equalisation provisions

Under the Solvency I regime, the PRA Rulebook required general insurance companies to establish an equalisation reserve. Schedule 3 to SI 2008/410 requires that such reserves are presented as a liability in the balance sheet and paragraphs IG2.28 calls for disclosure of their nature and effect; this is explained further in paragraph 38 of the Accounting Council's advice to the FRC on adoption of the original FRS 103.

Under Solvency II, no such equalisation reserves are required and accordingly the PRA Rulebook no longer requires their calculation.

FRED 64 deals with equalisation provisions by amending both IG 2.28 and the glossary definition to refer to "the relevant regulatory framework". This raises the question as to whether such a reserve should continue to be calculated for financial reporting purposes.

- If this is the FRC's intention, the definition should be clarified to refer to the regulatory framework prior to 1 January 2016. As Schedule 3 only refers to amounts calculated in accordance with the PRA Rules or required by Council Directive 87/343/EEC (which is repealed by the Solvency II Directive), it could be argued that Schedule 3 would not require presentation of such amounts as a liability, and they could instead be presented as a reserve.
- If this is not the FRC's intention, it would be helpful if the standard clarifies the approach to the removal of the requirement. A legal reading of Schedule 3 would suggest that in the 2015 comparatives such a reserve would be required (as it was required by the then PRA Rulebook) and therefore required to be presented in liabilities. The release of such a reserve (accounted for as a provision) would ultimately be to the profit and loss reserve. From the amendments proposed to IG 2.28 it is not clear whether the release should be shown as an adjustment to opening equity or whether it should be shown through the profit and loss account for the first Solvency II year. We believe that there is a need for additional transitional guidance in this area.

Long-term funds for solvency

The amended IG 2.53 mentions a long-term fund for solvency purposes under the PRA rules. It then states that "When the regulatory framework does not require the entity to set up a long-term fund for its long-term insurance business, the entity shall make the allocations as appropriate between the technical and non-technical account and disclose the basis of its allocation in the notes to the financial statements."

We also note references throughout FRED to the PRA Rulebook. These include the glossary definitions of mutual and the methodology for net premium method (referred to in the glossary), and an establishment of an equalisation reserve in IG 2.28. We therefore believe that the proposed text of FRED 64 should be reviewed thoroughly to ensure that all references to statutory, regulatory or PRA requirements are consistent with their intended purpose and there are no possible misunderstandings.

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.

As mentioned above in our response to question 1 there is a need for more transitional guidance as a result of the changes to the previous statutory requirements in respect of equalisation reserves and the previous statutory requirement to present as an asset the present value of future profits on non-participating business written in a with-profits fund. This is referred to in IG 1.5.

Overall we would ask for clarity between references to current Solvency II capital requirements and the practices and methodologies that the entities should be required to continue even when the associated regulatory requirements have been abolished for prudential supervisory purposes from 1 January 2016.

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Appendix 2 - Additional comments on drafting

We suggest the following paragraphs would benefit from clearer wording as a result of the regulatory changes. We attach our proposed amendments below (with corrections in red).

IG1.2 The shareholders' share of projected future **bonuses** deducted in accordance with paragraph 3.12(a) of FRS 103 should be calculated as the value of future transfers to shareholders calculated using market consistent financial assumptions, and assuming that transfers take place at a level consistent with those assumptions used to calculate realistic value of liabilities ~~within the PRA realistic balance sheet~~. Where an explicit assumption is not required in order to calculate the **liabilities** ~~under the PRA's approach~~ then continuation of the current profit sharing arrangements should be assumed unless the firm has plans to change this approach. Non-economic projection assumptions should be consistent with those used ~~elsewhere~~ in determining the realistic value of liabilities ~~in the realistic balance sheet~~. The amount deducted in accordance with this paragraph should be taken to the **fund for future appropriations (FFA)**. If shareholders transfers have been included as part of the ~~PRA~~ **realistic value of liabilities** ~~**y**~~ (or otherwise included in liabilities) then the amount of such transfers should be taken out of liabilities and included in the FFA, together with any related tax liability. If shareholders transfers have not been set up as part of the ~~PRA~~ realistic value of liabilities ~~y~~ or elsewhere, no adjustment is required.

IG1.3 ~~Under the PRA realistic capital regime, a~~ In determining the realistic value of liabilities, a with-profits life fund may take account of ~~includes within assets~~ the value of future profits expected to arise from any **non-participating business** that forms part of the with-profits fund—sometimes referred to as the **value of in-force life assurance business (VIF)**. Excluding the VIF from the **statement of financial position** whilst recognising the realistic value of liabilities in full, and valuing the non-participating liabilities in the with-profits fund on an established long-term insurance business liability basis ~~statutory basis~~, would give rise to an inconsistency in the fund's net assets. An entity is therefore permitted to recognise the VIF if that business has been taken into account in measuring the liability, in the circumstances of paragraph 3.12(c) of FRS 103, even though there is not a direct link between the value of the asset and the amount of the liabilities. Where there is not a direct link between the value of the business and the amount of realistic liabilities, but the value is taken into account in determining those liabilities, it is appropriate to recognise the total value of the business. Although not separately identifiable, any excess value over that included in realistic liabilities will be taken to the FFA.

IG1.9 Paragraph 3.12(d) of FRS 103 permits that where a with-profits fund has an interest in a subsidiary or associate and the determination of ~~that is valued for PRA regulatory purposes~~ the realistic value of liabilities to with-profit policyholders takes account of a value for that interest at an amount in excess of the net amounts that would be included in the entity's consolidated accounts, an amount may be recognised representing this excess ~~if the determination of the realistic value of liabilities to with-profits policyholders takes account of this value~~. As explained in paragraph 3.15 of FRS 103 this situation could arise where the subsidiary or associate writes non-participating business and the value of the subsidiary or associate ~~recognised for PRA reporting purposes~~ incorporates the VIF of non-participating business written in the subsidiary or associate. If the ~~The~~ value of the subsidiary or associate previously recognised for regulatory reporting purposes ~~for PRA reporting purposes~~ ~~is~~ was reduced by the subsidiary's or associate's capital requirement ~~as noted in rule 1.3.33(3) of **INSPRU**~~ this reduction has to be reversed for financial reporting purposes. When preparing both consolidated and non-consolidated accounts, the excess value that may be recognised should therefore be taken as the excess before deduction of the subsidiary's or associate's capital requirement.

We would revise the amendments proposed for IG 2.60. The term 'long-term business' refers to 'insurance contracts (including reinsurance) falling within one of the classes of insurance specified in Part II of Schedule 1 to the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI 2001/544)'. The term 'long-term fund' refers to 'the fund or funds maintained by an undertaking in respect of its long-term insurance business in accordance with the PRA rules.' Accordingly, while we understand the intention to preserve existing accounting treatment in the absence

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of a regulatory requirement to maintain a long-term fund, the current FRED 64 wording opens the scope wider than was originally intended.

> IG2.60 On consolidation, the profit or loss of any non-insurance entity belonging to the long-term ~~fund~~ ~~business~~ fund under the regulatory requirements applicable for periods ending before 1 January 2016 may be included directly in the technical account for long-term business. Where material, more detailed disclosure should be provided in the notes to the financial statements. Where an entity carrying on general insurance business is ~~owned by~~ an asset of the long-term ~~fund~~ business, the profit or loss of this business should be transferred from the non-technical account to the technical account for long-term business using new lines for this purpose.