

Memorandum of Understanding concerning FRS 27 'Life Assurance'

Introduction and summary

- 1 In July 2004 the Accounting Standards Board (the Board) issued FRED 34 'Life Assurance'. That FRED proposed, for accounting periods ending on or after 23 December 2004, the implementation of a standard that would require various changes to the existing accounting practices (including disclosures) of entities with life assurance activities.
- 2 In normal circumstances the Board would probably have proposed implementation of the standard in 2005 rather than 2004. However, the introduction of the new IFRS reporting regime from 1 January 2005 meant that a UK standard implemented in 2005 would not be mandatory for entities preparing their 2005 financial statements in accordance with EU-adopted IFRSs. The Board therefore chose to propose implementing the standard for December 2004 year-ends, believing that implementation timetable to be tight but achievable. However, in the view of most respondents, the timetable proposed was unrealistic.
- 3 Recognising:
 - (a) the implications that a delay in implementation would have for the Board's ability to mandate industry-wide change, and
 - (b) the need for improvements in the existing accounting practices of entities with life assurance activities,

leading members of the life assurance and bancassurance sectors and the Association of British Insurers (the ABI) have volunteered to give certain undertakings to the Board to enable it to defer implementation of its standard for a year. This Memorandum of Understanding (the memorandum) sets out the undertakings given.

- 4 The memorandum shall be regarded as on the public record from one minute past midnight on the day that FRS 27 'Life Assurance' is published, but shall be regarded as confidential until then.

Undertakings given by entities with life assurance activities

- 5 The undersigned entities with life assurance activities undertake that:
 - (a) each UK reporting entity within their group that includes a business that is a life assurance business will, subject to the exemptions for subsidiaries and parent entities set out in paragraph 1 of Annex 1 to the memorandum, provide (in a statement attached to but separate from

any annual financial statements they prepare) for accounting periods ending on or after 23 December 2004 all the information described in paragraphs 2-8 of Annex 1 to the memorandum, except that they do not have to provide any such information if it is included in the financial statements themselves.¹

It is envisaged that many entities will choose to provide the information described in Annex 1 in the published Operating and Financial Review (OFR).

If the financial statements have been prepared in full compliance with FRS 27, there will be nothing to disclose outside of the financial statements under this subparagraph.

- (b) each UK reporting entity within their group that includes a business that is a life assurance business will, in any annual financial statements that have been prepared in accordance with EU-adopted IFRS and relate to an accounting period that begins on or after 1 January 2005, treat FRS 27 as if it were mandatory and applied directly to those financial statements except that:
 - (i) the restriction in paragraph 26 of the FRS (preventing the adoption of an accounting policy to recognise the value of in-force life assurance) shall not apply; and
 - (ii) if it is not possible to comply both with an EU-adopted IFRS and with FRS 27, FRS 27 should be departed from to the extent necessary to ensure compliance with EU-adopted IFRS.

The standard section of FRS 27 (issued in December 2004) is set out in Annex 2.

This undertaking does not amend the exemptions in FRS 27 so, although the above undertaking means that certain entities would need to comply with FRS 27, such compliance would remain subject to the exemptions set out in the standard; an entity that the standard exempts from having to provide a disclosure will still be exempt even if it is covered by the above undertaking.

The objective of subparagraph (i) is to ensure that this undertaking does not stand in the way of an entity that is preparing its financial statements in accordance with EU-adopted IFRS using embedded value in their financial statements to the extent permitted by IFRS 4.

¹ The term 'financial statements' is used through the memorandum to refer to the information in financial statements that is included within the scope of the true and fair view audit report or its equivalent.

The Board expects that any inconsistency that does arise between FRS 27 and EU-adopted IFRS will be short-lived because, as explained in paragraph 9, if it ceases to be possible to comply both with the requirements of FRS 27 and EU-adopted IFRS, the Board will amend FRS 27 to the extent necessary to address the problem.

- 6 In giving the above undertaking, the undersigned entities with life assurance activities understand and accept that:
- (a) the only undertakings from the Board that they are relying on are those set out in this memorandum; and
 - (b) the requirements of FRS 27 should not be regarded as superseded or amended by the implementation on 1 January 2005 of EU-adopted IFRS, particularly IFRS 4 'Insurance Contracts'; nor should they be regarded as superseded or amended by the implementation of the IFRS that will result from ED 7 'Financial Instruments: Disclosures'.

IFRS 4 sets out requirements on the accounting treatment of insurance contracts. FRS 27 applies to life assurance and, as a result, adds to those requirements, but does not vary them in any way.

Undertakings given by the Association of British Insurers

- 7 The Association of British Insurers (ABI) supports the undertakings given in the memorandum by the undersigned entities with life assurance activities and it undertakes:
- (a) to encourage entities with life assurance activities that are not a party to the memorandum to act as if they are party to it; and
 - (b) to revise its SORP to eliminate any inconsistencies that exist between it and FRS 27.

Undertakings given by the Accounting Standards Board

- 8 The Board confirms that:
- (a) FRS 27 will not be mandatory to accounting periods ending before 24 December 2005; and
 - (b) it is satisfied that the requirements of FRS 27 are consistent with the legal requirements that currently apply to annual financial statements prepared in accordance with UK requirements (rather than EU-adopted IFRS).

9 Should:

- (a) it become apparent that it is generally accepted by the auditing profession that compliance with the standard would automatically—regardless of the specific circumstances involved—result either in a qualified audit report being attached to the financial statements involved or to the inclusion in that audit report of a matter of emphasis paragraph; or
- (b) it cease to be possible to comply both with the requirements of the standard and with the requirements of EU-adopted IFRS,

the Board undertakes to amend the standard to the extent considered necessary to address the problem.

Amendments to FRS 27

- 10 If the Board amends FRS 27 for a reason not set out in paragraph 9 or for a reason set out in paragraph 9 but the amendments made go beyond those necessary to address the problem, this memorandum shall not apply to the revised version of the standard but will instead apply to the version of the standard the memorandum applied to immediately before the revision.

As far as the Board is concerned, the overall objective of the memorandum is to make it possible for the Board to change FRS 27's effective date from 'accounting periods ending on or after 23 December 2004' to accounting periods ending on or after 23 December 2005' and for *that* resulting standard still to be mandatory on entities preparing their financial statements from 1 January 2005 in accordance with EU-adopted IFRS. The objective of paragraphs 9 and 10 in particular is to ensure that the overall objective of the memorandum will not be frustrated because the Board *has* to amend the standard.

Although the Board does not currently envisage making any amendments that would not fall within paragraph 9, it would not wish to rule out the possibility that at some point in the future it might wish to change the requirements that apply to entities preparing their financial statements in accordance with UK standards and legal requirements. Entities preparing their financial statements in accordance with EU-adopted IFRS will not be required by the memorandum to apply those changes.

Amendments to the memorandum

11 This memorandum can be amended only by the agreement of all the undersigned.

This memorandum is signed by:

Mary Francis
Director General
Association of British Insurers

Ian Mackintosh
Chairman
Accounting Standards Board

Nathan Bostock
Finance & Markets Director
Abbey National plc

Andrew J Moss
Group Finance Director
Aviva plc

Philip W Moore
Group Finance Director
Friends Provident plc

Mark E Tucker
Group Finance Director
HBOS plc

Andrew Palmer
Group Director (Finance)
Legal & General Group plc

Helen Weir
Group Finance Director
Lloyds TSB Group plc

Philip Broadley
Group Finance Director
Prudential plc

John Hylands
Group Finance Director
Standard Life

December 2004

Annex 1:
Information to be disclosed outside of the financial statements in accordance with paragraph 5(a) of the attached memorandum

Scope

1 A reporting entity that:

- (a) includes a business that is a life assurance business, and
- (b) prepares financial statements that are intended to give a true and fair view of a reporting entity's financial position and profit and loss (or income and expenditure) for a period

shall provide the information described in this annex in a statement attached to, but not forming part of, each set of such financial statements unless both:

- (c) it is either a subsidiary undertaking where 90 per cent or more of the voting rights are controlled within the group or a parent entity, in relation to its individual financial statements; and
- (d) it is included in publicly available group financial statements which are accompanied by a statement that provides all the information described in this annex for the group as a whole,

in which case the entity need not provide the information described in paragraph 7 of this annex.

Realistic liabilities

2 Entities shall disclose, in respect only of UK with-profits funds required by the FSA, or choosing, to include 'realistic' information in their prudential returns:

- (a) the amount of the 'realistic' liabilities (including options and guarantees), adjusted to eliminate the shareholders' share of future bonuses, together with information that puts that 'realistic' liability in context; and
- (b) the amount of the excess of 'realistic' assets over 'realistic' liabilities.

Options and guarantees

3 Options and guarantees are features of life assurance contracts that confer potentially valuable guarantees underlying the level or nature of policyholder benefits, or options to change these benefits exercisable at the discretion of the policyholder. For the purposes of this annex, the term is used to refer only to those options and guarantees whose potential value is affected by the behaviour of financial variables, and not to those features of

life assurance contracts where the potential changes in policyholder benefits arise solely from insurance risk (including mortality and morbidity), or from changes in the entity's creditworthiness. It includes a financial guarantee or option that applies if a policy lapses, but does not include the option to surrender or allow a policy to lapse.

- 4 In relation to liabilities relating to life assurance, the entity shall disclose the following information:
- (a) those terms and conditions of options and guarantees relating to life assurance contracts that could in aggregate have a material effect on the amount, timing and uncertainty of the entity's future cash flows;
 - (b) the process used to determine the assumptions that have the greatest effect on the measurement of liabilities including options and guarantees and, where practicable, quantified disclosure of those assumptions.

For some assumptions that are used in the measurement of liabilities, it may be relatively easy to quantify the assumption used—for example, in the case of discount rates or general inflation, where the rate used should be disclosed. For other assumptions, such as mortality tables, it may not be practicable to disclose quantified assumptions because there are too many, or they cannot be expressed as single values, in which case it is more important to describe the process used to generate the assumptions. The description of the process would include the objective—whether a best-estimate or a given level of assurance is intended; the sources of data; whether assumptions are consistent with observable market data or other published information; how past experience, current conditions and future trends are taken into account; correlations between different assumptions; management's policy for future bonuses; and the nature and extent of uncertainties affecting the assumptions; and

- (c) information about exposures to interest rate risk or market risk under options and guarantees if the entity does not measure these for the purposes of the disclosure described in paragraph 2 of this annex at fair value or at an amount estimated using a market-consistent stochastic model.
- 5 The requirements of paragraph 4(c) will require, for options and guarantees that are not measured for the purposes of the disclosure described in paragraph 2 of this annex at fair value or at an amount estimated using a market-consistent stochastic model and that could have a material effect on the amount, timing or uncertainty of the entity's future cash flows, the following disclosures:

- (a) a description of the nature and extent of the options and guarantees;
 - (b) the basis of measurement for the amount at which these options and guarantees are stated, and the extent to which an amount is included for the additional payment that may arise under the option or guarantee, in excess of the amounts expected to be paid under the relevant policies if they did not include the option or guarantee feature;
 - (c) the main variables that determine the amount payable under the option or guarantee; and
 - (d) information on the potential effects of adverse changes in those market conditions that affect the entity's obligations under options and guarantees.
- 6 The requirement of paragraph 5(d) may be met by disclosing:
- (a) for options and guarantees that would result in additional payments to policyholders if current asset values and market rates continued unchanged (ie those that are 'in the money'), an indication of the change in these amounts if the variables moved adversely by a stated amount;
 - (b) for options and guarantees that would result in additional payments to policyholders only if there was an adverse change in current asset values and market rates (ie those that are 'out of the money'):
 - (i) an indication of the change in these variables, from current levels, which would cause material amounts to become payable under the options and guarantees; and
 - (ii) an indication of the amount that would result from a specified adverse change in these variables from the levels at which amounts first become payable under the options and guarantees.

The above disclosures may be made in aggregate for classes of options and guarantees that do not differ materially, or which are not individually material.

Capital position statement and supporting disclosures

- 7 Entities shall provide an integrated set of disclosures that explain the different sources of capital held within the life assurance business and the constraints that exist over the use of that capital to meet risks that might arise. The disclosures will comprise an analysis of available capital, but not

necessarily of the related regulatory capital requirements, together with supporting narrative disclosures about constraints.

(a) The analysis of available capital could take the form of the top half of the capital statement as set out in Appendix I of FRS 27.

(b) Alternatively, that table could be simplified and shown as follows:

(i) Total shareholders funds in the life assurance business

Add:

(ii) Adjustments to restate these amounts onto a regulatory basis

(iii) The FFA and other sources of capital (eg subordinated debt) included for regulatory purposes

To give:

(iv) Total available capital in the life assurance business to meet regulatory capital requirements (i + ii + iii)

A reconciliation of (i) and (iii) to the amounts shown in the balance sheet should be provided.

Analysis of total available capital in the life assurance business to meet regulatory capital requirements (ie (iv)) should be provided, showing:

- the available capital of each material UK with profits fund. For example, for a UK with-profits fund regulated on a 'realistic' basis, this number will be 'realistic' assets less 'realistic' liabilities. For this purpose 'realistic' liabilities shall be calculated before deduction of the shareholders' share of future bonuses;
- the available capital for the entity's other life assurance business. This should be supported by information showing the extent to which the various components of capital involved are subject to constraints or are available to meet risks.

There are a variety of forms this supporting disclosure could take and this annex does not intend to be prescriptive; the intention is that the entity should adopt the approach that it believes best reflects the particular circumstances of its own business. For example, the supporting disclosure could take the form of a sub-analysis between amounts of capital that are constrained and amounts that are freely available. It could involve a sub-analysis by reference to the nature of the capital constraints applying to each business unit: one category covering business units where there were no constraints on transferring surplus capital to other

parts of the group, and another covering those business units where surplus capital was constrained. (In either case it will be necessary to consider whether to show the amounts before or after deduction of relevant regulatory requirements.) Where the capital constraints are more complex, the entity may choose to add further analyses of the different types of constraint that apply. Under either approach, the information would need to be supplemented by narrative explaining the nature and effect of the constraints. Another approach might be to provide fuller narrative disclosure of the constraints and their effect rather than provide a sub-analysis and less narrative disclosure.

- (c) Entities shall also provide the following narrative disclosures to support the disclosures described above:
- (i) narrative disclosure of the basis of determining regulatory capital and the corresponding regulatory capital requirements and any major inconsistencies in this basis between the different sections of the business;
 - (ii) narrative disclosure addressing the sensitivity of liabilities and other components of total capital to changes in market conditions, key assumptions and other variables, and assumptions about future management actions in response to changes in market conditions; and
 - (iii) narrative disclosure of the entity's capital management policies and objectives, and its approach to managing the risks that would affect the capital position.
 - (iv) (where the reporting entity is a subsidiary undertaking) explanation of the extent to which the capital of the entity is able to be transferred to the parent or fellow subsidiaries, or the extent to which it is required to be retained within the reporting entity.
 - (v) disclosure of any formal intra-group arrangements that exist to provide capital to particular funds or business units, including intra-group loans and contingent arrangements. Where the reporting entity is a subsidiary undertaking, disclosure shall also be made of similar arrangements between the entity and its parent or fellow subsidiary undertakings.

Embedded value

- 8 This annex does not require any disclosures about embedded value to be provided.

Annex 2:

The standard section of FRS 27 (issued in December 2004)

OBJECTIVE

- 1 The objective of this FRS is to require appropriate measurement of, and disclosures relating to, liabilities and assets of life assurance business; and disclosures relating to the financial strength of entities carrying on life assurance business.

DEFINITIONS

- 2 The following definitions shall apply in the FRS and in particular in the Statement of Standard Accounting Practice set out in **bold type**.

The **Financial Services Authority (FSA) realistic capital regime** is that set out in section 7.4 of its integrated prudential sourcebook.²

The **realistic value of liabilities** is that element of the amount defined by rule 7.4.40 in the FSA's integrated prudential sourcebook, excluding current liabilities falling within the definition in rule 7.4.190 that are recognised separately on the entity's balance sheet.

An entity's **existing accounting policies** are the accounting policies adopted in its last annual financial statements before adoption of this FRS.

The **modified statutory solvency basis (MSSB)** for determining insurance liabilities is the statutory solvency basis adjusted, in accordance with the Statement of Recommended Practice of the Association of British Insurers (the ABI SORP), for the following items:

- (a) to defer new business acquisition costs incurred where the benefit of such costs will be obtained in subsequent accounting periods; and
- (b) to treat investment, resilience and similar reserves, or reserves held in respect of general contingencies or the specific contingency that the fund will be closed to new business, where such items are held within the long term business fund, as reserves rather than provisions. These are included, as appropriate, within shareholders' capital and reserves or the Fund for Future Appropriations.

The **statutory solvency basis** is the basis of determination of insurance liabilities in accordance with rule 7.4.27 of the FSA's integrated prudential sourcebook.

² References to the FSA's integrated prudential sourcebook for insurers, and to individual rules therein, are to the rules made on 18 November 2004 by the Integrated Prudential Sourcebook (Insurers and Other Amendments) Instrument 2004.

The **Principles and Practices of Financial Management (PPFM)** is the statement that the FSA requires each with-profits life fund to make available to its policyholders containing, inter alia, a description of the fund's investment management and bonus distribution policies.

The **Fund for Future Appropriations (FFA)** is the balance sheet item required by Schedule 9A to the Companies Act 1985 to comprise all funds the allocation of which, either to policyholders or to shareholders, has not been determined by the end of the accounting period.

Directive friendly societies and **non-directive friendly societies** are as defined in section 7 of the FSA Interim Prudential Sourcebook for Friendly Societies.

SCOPE

- 3 The FRS applies to all financial statements that are intended to give a true and fair view of a reporting entity's financial position and profit and loss (or income and expenditure) for a period, where the reporting entity includes a business that is a life assurance business (including reinsurance business).**

LIFE ASSURANCE LIABILITIES AND ASSETS

Measurement of with-profits liabilities and related assets

- 4 For with-profits life funds falling within the scope of the FSA realistic capital regime:**
- (a) liabilities to policyholders arising from with-profits life assurance business shall be stated at the amount of the realistic value of liabilities adjusted to exclude the shareholders' share of projected future bonuses;**
 - (b) acquisition costs shall not be deferred;**
 - (c) reinsurance recoveries that are recognised shall be measured on a basis that is consistent with the value of the policyholder liabilities to which the reinsurance applies;**
 - (d) an amount may be recognised for the present value of future profits on non-participating business written in a with-profits fund if:
 - (i) the non-participating business is measured on this basis for the purposes of the regulatory returns made under the FSA realistic capital regime;****

- (ii) **the value is determined in accordance with the FSA regulations³; and**
- (iii) **the determination of the realistic value of liabilities in that with-profits fund takes account, directly or indirectly, of this value;**
- (e) **where a with-profits life fund has an interest in a subsidiary or associated entity that is valued for FSA regulatory purposes at an amount in excess of the net amounts 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; and**
- (f) **adjustments to reflect the consequential tax effects of (a) to (e) above shall be made.**

Adjustments from the modified statutory solvency basis necessary to meet the above requirements, including the recognition of an amount in accordance with paragraph 4(d) or 4(e), shall be included in the profit and loss account. An amount equal and opposite to the net amount of these adjustments shall be transferred to or from the FFA (or, in the case of a mutual, its retained surplus) and also included in the profit and loss account.

- 5 **Amounts recognised under paragraph 4(d) or 4(e) shall be presented in one of the following ways:**
- (a) **Where it is possible to apportion the amount recognised under paragraph 4(d) or 4(e) between an amount relating to liabilities to policyholders and an amount relating to the FFA, these portions shall be presented in the balance sheet as a deduction in arriving at the amount of liabilities to policyholders and the FFA respectively.**
 - (b) **Where it is not possible to make a reasonably approximate apportionment of the amount recognised under paragraph 4(d) or 4(e), the amount shall be presented on the balance sheet as a separate item deducted from a sub-total of liabilities to policyholders and the FFA.**
 - (c) **Where the presentation under 5(a) or 5(b) does not comply with statutory requirements for balance sheet presentation applying to the entity, the amount recognised under paragraph 4(d) or 4(e) shall be recognised as an asset.**

- 6 The established accounting treatment for UK life assurance business is to measure liabilities for policyholder benefits on the modified statutory solvency basis (MSSB). The FRS does not require any change to the

³ FSA rule PRU 7.4.37

accounting for those funds not within the scope of the FSA realistic capital regime, but requires those UK with-profits funds that fall under that regime to use the realistic value of liabilities as the basis for the estimated value of the liabilities to be included in the financial statements. Where the entity's returns to the FSA have not been completed at the time of completion of the financial statements, an estimate of the amount may be used provided it is in accordance with the FSA regulations.

- 7 An entity may, but is not required to, adopt the requirements of paragraph 4 for UK⁴ with-profits funds that do not fall within the scope of the FSA realistic capital regime or for which the FSA has granted a full waiver from compliance with this regime.
- 8 Overseas insurance businesses that do not fall within the FSA's regulatory remit may determine insurance liabilities in accordance with local regulatory and accounting requirements. Adjustments on consolidation may be made to take account of the different bases of reporting, although insurance entities are exempt from the requirement in the Companies Act 1985⁵ applicable to other businesses to adjust amounts recognised in the financial statements of subsidiary undertakings onto a consistent basis for the purposes of consolidated financial statements. The FRS does not require any change to the accounting treatment of the liabilities of overseas businesses, but voluntary adoption of the requirements of paragraph 4 is permitted.
- 9 Liabilities determined in accordance with the FSA realistic capital regime include, in addition to amounts attributable to declared bonuses, amounts in respect of future bonuses, estimated in accordance with the entity's published Principles and Practices of Financial Management and representing a constructive obligation to policyholders. A liability is also included for policyholders' options and guarantees, measured at fair value or estimated using a stochastic model that has been calibrated to give market-consistent estimates of option and guarantee values.
- 10 An adjustment is made to the realistic value of liabilities to exclude the portion attributed to shareholders, which represents the shareholders' share of future bonuses. Similar adjustments should be made if other amounts due to shareholders would otherwise be included in the realistic value of liabilities.
- 11 Acquisition costs are deferred under MSSB to offset the effects of 'new business strain', being the requirement to establish liabilities on a statutory solvency basis on inception of a policy in excess of the premiums received. When liabilities are restated in accordance with the FSA realistic capital regime, there is no longer any justification for treating such costs as an asset. The FRS does not alter the treatment of deferred acquisition costs relating to

⁴ and Republic of Ireland with-profits funds

⁵ and equivalent Republic of Ireland and Northern Ireland legislation

business outside the scope of the FSA realistic capital regime (other than adjustments that may be made to deferred acquisition costs relating to business for which the value of in-force business is recognised under paragraph 4(d) or (e)).

- 12 Amounts recoverable under reinsurance contracts relating to life assurance shall be measured on a basis consistent with the measurement of the related liability, so that the net amount reflects the exposure of the entity. Changing the measurement of the liability may therefore give rise to a change in the related reinsurance asset. The amount of the change in the asset will depend on the terms of the reinsurance contract.
- 13 Under the FSA realistic capital regime, a with-profits life fund includes within assets the value of future profits expected to arise from non-participating business (ie life assurance policies that do not have a with-profits feature, such as term assurance, annuities and unit-linked policies) that form part of the with-profits fund—sometimes referred to as the value of in-force business. In the FSA realistic capital regime, this value is also taken into account in determining the returns earned by the fund and its financial strength, and thus gives rise to an increase in the estimated value of future bonuses included in the realistic value of liabilities, although there is not necessarily a direct link between the value of in-force business and the additional amount included in liabilities. To exclude from the balance sheet the value of in-force business whilst recognising the realistic value of liabilities in full, and valuing non-participating liabilities on a statutory basis, would give rise to an inconsistency in the fund's net assets. An entity is therefore permitted to recognise the value of in-force business if that business has been taken into account in measuring the liability, in the circumstances of paragraph 4(d), 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. Paragraph 4(d) applies only to non-participating business written in a with-profits fund and not to such business outside a with-profits fund.
- 14 The amount recognised under paragraph 4(d) or 4(e) may be regarded either as an additional asset, representing the value of future cash flows from the related insurance business; or as an adjustment to the measurement of liabilities and the FFA, being the deduction from these items of the obligation to transfer an unrecognised asset or other source of value. The FRS requires entities to adopt the latter interpretation, unless this would not be in compliance with the statutory requirements that apply to the entity, in which case it permits the amount to be recognised as an asset. Where the amount is treated as an adjustment to a liability, the FRS requires an entity

to apportion, if practicable, the amount between the amounts that have been taken into account in the measurement of liabilities and other amounts that should be shown as an adjustment to the FFA. Where this is not practicable, the amount recognised should be shown as an adjustment to a sub-total of the FFA and liabilities to policyholders.

- 15 The value of in-force non-participating business recognised within assets for regulatory purposes as described in paragraph 13 is determined as the discounted value of future profits expected to arise from the policies, taking into account liabilities relating to the policies measured on a statutory solvency basis. When adjustments are made onto an MSSB basis for the purposes of the financial statements (for example, to adjust liabilities to exclude certain additional reserves included in the liabilities for regulatory purposes, or where future income included in the value of in-force business covers deferred acquisition costs included in the MSSB balance sheet), a corresponding adjustment to the value of in-force policies will need to be made in order to ensure a consistent valuation.
- 16 A similar situation may arise where an entity chooses to value an interest in a subsidiary that is held directly in the with-profits fund at a value that includes the value of in-force business within the subsidiary in addition to its net asset value, as permitted by the FSA regulations. In such a case, the value taken into account in determining the realistic value of liabilities is greater than the net assets included in the consolidated accounts. To exclude from the balance sheet the additional value of the investment in the subsidiary whilst recognising the realistic value of liabilities in full would result in an inconsistency in the fund's net assets. An entity is therefore permitted to recognise the excess of the market value of the subsidiary over the net amounts included in the consolidated financial statements as a deduction from the sub-total of the FFA and liabilities to policyholders in the same way as the value of in-force business described in paragraph 13.
- 17 Where the amounts on a 'realistic' basis determined in accordance with paragraph 4 above are different from the amounts on a modified statutory solvency basis, a corresponding amount is transferred to or from the FFA, so that there is no effect on shareholders' funds. However, individual lines in the revenue (technical) account, including the line item for transfers to or from the FFA, will be affected. The potential shareholders' share corresponding to additional bonuses to policyholders that have been included in the policyholders' liability should be accounted for in the FFA. As a result, there will generally be no change in the profit for the financial year and, in the case of an entity that is not a mutual, generally no change to shareholders' funds. However, this will not be the case where the adjustments result in a negative balance on the FFA and the entity determines that this negative balance should result in a deduction from shareholders' funds through the profit and loss account.

- 18 In the case of a mutual, which has no shareholders, an FFA or retained surplus account is maintained that represents amounts that have not yet been allocated to specific policyholders. For such entities, the adjustments required by paragraph 4 will be offset within the profit and loss account by a transfer directly to or from this FFA or retained surplus account, with the result that overall profit or loss for the year will be unchanged.

Policyholders' options and guarantees

- 19 Entities with with-profits funds within the scope of the FSA's realistic capital regime are required to measure the liability of those funds in respect of options and guarantees relating to policyholders either at fair value or at an amount estimated using a market-consistent stochastic model in accordance with FSA regulations.
- 20 For all life assurance businesses, the best basis for measuring policyholders' options and guarantees is one that includes their time value⁶. Any deterministic approach to valuation of a policy with a guarantee or optionality feature will generally fail to deal appropriately with the time value of the option. In order to capture this time value it is necessary to use stochastic modelling techniques to evaluate the range of potential outcomes unless a market value for the option is available. The FSA realistic capital regime includes a requirement to value options and guarantees on this basis. For the liabilities of businesses not falling within the scope of the FSA realistic capital regime, entities are encouraged, but not required, to adopt these valuation techniques. Where options are not valued on this basis, additional disclosures are required; these are set out in paragraph 48(c).
- 21 Under the FSA realistic capital regime, a market-consistent stochastic method for estimating the value of guarantees and options involves:
- (a) determining the market variables whose value will affect the additional amount payable under the guarantee or option, and the period in which they have such effect;
 - (b) determining the likely distribution of each of those variables within that time period, using assumptions calibrated to market observations;
 - (c) constructing a large number of possible scenarios combining different changes in each variable over the time period, reflecting the expected distribution of values determined in accordance with (b);

⁶ The value of an option or guarantee comprises two elements, the intrinsic value and the time value. The intrinsic value is the amount that would be payable if the option or guarantee were exercised immediately – that is, the amount it is currently ‘in the money’, or nil if it is ‘out of the money’. The time value is the additional value that reflects the possibility of the intrinsic value increasing in future, before the expiry date of the option or guarantee.

- (d) evaluating the additional amounts payable under the option or guarantee under each scenario; and
- (e) combining these, weighted according to the probability of each scenario occurring, to determine the expected value of the liability.

In determining the amount payable under each scenario, the entity will take into account management actions it anticipates would be taken in response to variations in market variables (such as changing the balance of the investment portfolio between debt instruments and equity, varying the amount charged to policyholders, or varying its bonus policy) that will affect the amount payable under the guarantee or option. Such actions must be realistically capable of being implemented within the time-scale assumed in the scenario analysis, and be consistent with the entity's published Principles and Practice of Financial Management.

Disclosure and presentation relating to with-profits business

- 22 Entities shall present the FFA on the balance sheet separately from technical provisions and other liabilities.**
- 23 Where the balance on the FFA of a with-profits life fund is negative, as a result of the transfer made in accordance with paragraph 4 or otherwise, the entity shall include in the notes to the financial statements an explanation of the nature of the negative balance and the circumstances in which it arose, and why no action to eliminate it has been considered necessary.**
- 24 The FFA should be disclosed separately on the balance sheet, and not combined with technical provisions. Entities that consolidate interests in a life assurance entity on a basis that combines the FFA and technical provisions into a single amount of liabilities to policyholders are required to show these elements separately.
- 25 A negative balance on the FFA may arise, either under MSSB or as a result of adjustments made under paragraph 4. Sometimes this will result in the entity taking action that results in the elimination of the negative balance. Where no such action has been considered necessary, details of the negative balance are required by paragraph 23, including an explanation of why the entity considers it appropriate not to take action to eliminate this balance. Where an entity has more than one with-profits fund, a negative balance on the FFA in one fund should not be offset against a positive balance in another.

Value of in-force life assurance business

- 26 Where, other than under paragraph 4(d) and 4(e) above, an entity's existing accounting policies include the recognition of the value of in-force life assurance business as an asset (or as a deduction from a**

liability), it may continue to recognise such an item as an asset, but shall exclude from the value of that asset any value of in-force policies that reflects future investment margins.

- 27 Banking and other non-insurance entities with insurance subsidiaries⁷ sometimes account for the insurance business in their consolidated financial statements on an embedded value or similar basis under which, in addition to the value of the retained surplus in the insurance subsidiary, an asset is recognised for the discounted value of the future profit to shareholders expected to arise from existing insurance business. The FRS permits the continuation of such a practice only if the existing policy is amended, if necessary, to exclude from the measurement of the value of the in-force business any value attributable to future investment margins. Investment margins are the amounts by which assumed investment returns exceed the risk-free return on assets. As a consequence of excluding these margins, the embedded value will not vary with the choice of assets in which the fund is invested (ignoring different tax treatments of various types of asset). An example of an accounting policy that reflects those margins, and is not permitted under the FRS, is projecting the returns on the insurer's assets at an estimated rate of return in excess of the risk-free rate, discounting those projected returns at a lower rate and including the result as part of the measurement of the value of in-force business.
- 28 No value shall be attributed to in-force life assurance business other than:**
- (a) in accordance with paragraphs 4(d), 4(e) or 26 above; or**
 - (b) amounts recognised as an intangible asset as part of the allocation of fair values under acquisition accounting in accordance with FRS 7 'Fair Values in Acquisition Accounting', which are subject to the measurement requirements of that standard and not paragraph 26 above.**
- 29 Where the value attributable to in-force life assurance business recognised under paragraph 26 or paragraph 28(b) includes an amount in relation to non-participating business for which the entity also recognises an amount under paragraph 4(d) or 4(e), the amount recognised under paragraph 4(d) or 4(e) shall be reduced to exclude the amount that is included in relation to that business under paragraph 26 or paragraph 28(b).**

CAPITAL AND LIABILITIES

- 30 An entity shall present quantitative and narrative disclosures of its regulatory capital position, as set out below.**

⁷ and insurance entities and groups in the Republic of Ireland

- 31 An entity is not required to include the disclosures required by paragraphs 32 to 47 and 53 to 60 if it is:**
- (a) a subsidiary undertaking where 90 per cent or more of the voting rights are controlled within the group; or**
 - (b) a parent entity, in relation to its individual financial statements**
- provided the entity is included in publicly available group financial statements which provide information on a group basis complying with the FRS.**

Capital statement

- 32 An entity shall present a statement setting out its total capital resources relating to life assurance business. The statement shall show, for each section of that business as defined in paragraph 34:**
- (a) shareholders' funds (or in the case of a mutual, the equivalent, often described as disclosed surplus);**
 - (b) adjustments to restate these amounts in accordance with regulatory requirements;**
 - (c) each additional component of capital included for regulatory purposes, including capital retained within a life fund whether attributable to shareholders, policyholders or not yet allocated between shareholders and policyholders; and**
 - (d) the total capital available to meet regulatory capital requirements.**
- 33 Available capital will comprise a number of distinct elements, each of which will be separately disclosed, including:**
- (a) shareholders' funds as included in the published balance sheet, represented by surplus held within a life fund or by assets held separately from those of the fund itself;
 - (b) amounts that are wholly attributable to shareholders, but held within a life fund and where the distribution out of the fund is restricted by regulatory or other considerations;
 - (c) surplus held in life funds that has yet to be attributed or allocated between shareholders and policyholders (in the case of a mutual all such surplus is attributable to policyholders but is not treated as a liability); and
 - (d) qualifying debt capital, whether issued by the life entity itself or by another entity within the group.

34 The capital statement shall show as separate sections:

- (a) each UK⁸ with-profits life fund that is material to the group; and**
- (b) the entity's other life assurance business, showing the extent to which the various components of capital are subject to constraints such that they are available to meet requirements in only part of the entity's business, or are available to meet risks and regulatory capital requirements in all parts of the business.**

35 The purpose of the capital statement is to set out the financial strength of the entity and to provide an analysis of the disposition and constraints over the availability of the capital to meet risks and regulatory requirements. It is particularly important to show the various sources of capital separately and the extent to which the capital in each section is subject to constraint as to its ability to meet requirements in other parts of the entity. Such constraints can arise for any of the following reasons:

- (a) ownership—the capital may be subject to specific ownership considerations (for example, the FFA of a UK with-profits fund, for which the allocation between policyholders and shareholders has not been determined);
- (b) regulatory—local regulatory limitations may require the maintenance of solvency margins in particular funds or countries; or
- (c) financial—the availability of capital in certain cases can be restricted due to the imposition of taxes or other financial penalty in the event of the capital being required to be redeployed across the group.

36 An entity must consider how best to present information to meet the requirements of paragraph 34(b) in the particular circumstances of its own business. For example, those requirements might be met by sub-analysis of the part of the entity's life assurance business, other than the UK with-profit life funds, into two sections in the statement, one including amounts of capital that are constrained and the other amounts that are freely available to meet risks and regulatory capital requirements in all parts of the business. Alternatively, this information could be presented by means of a sub-analysis by the nature of the capital constraints applying to each business unit: one section in the capital statement would include those business units where there were no constraints on transferring surplus capital to other parts of the group, and another section in the statement would include those business units where surplus capital was constrained. Under either approach, the information would need to be supplemented by narrative explaining the nature and effect of the constraints. Where the capital constraints are more complex, it may be necessary to add additional sections

⁸ or, for an entity in the Republic of Ireland, each with-profits fund in the Republic of Ireland.

in the capital statement providing further analysis of the different types of constraint that apply. Another way of meeting this requirement would be to provide aggregated information supplemented by fuller narrative disclosure of the constraints and their effect.

37 The aggregate amount of regulatory capital resources included in the capital statement shall be reconciled to the shareholders' funds, FFA and other amounts shown in the entity's balance sheet, showing separately for each component of capital the amount relating to the entity's business other than life assurance. Where such other business is significant, an explanation shall be given of the extent to which this capital can be used to meet the requirements of the life assurance business.

38 Although the detailed requirements apply to life assurance business, entities will need to incorporate information on other parts of the business, together with consolidation adjustments, in order to demonstrate how the aggregated capital attributed to the life assurance business reconciles to the total shown in the consolidated balance sheet, and the extent to which capital outside the life assurance business may be made available to meet the capital requirements of the life assurance business. This reconciliation applies to each different type of capital shown in the capital statement.

39 Where the reporting entity is a subsidiary undertaking, narrative supporting the capital statement shall explain the extent to which the capital of the entity is able to be transferred to the parent or fellow subsidiaries, or the extent to which it is required to be retained within the reporting entity.

40 For life funds within the scope of the FSA realistic capital regime, in determining available capital, liabilities will be taken into account at their 'realistic' amount (unless the capital requirement is higher on the regulatory basis). Further adjustments are necessary to adjust the capital shown in the balance sheet to the amount for regulatory purposes. The most significant differences are:

- (a) the inclusion in capital of the fund for future appropriations;
- (b) the exclusion from capital of the shareholders' share of accrued bonus;
- (c) the exclusion of goodwill and other intangible assets, such as an amount attributed to the acquired value of in-force business; and
- (d) changes to the valuation of assets and the exclusion of certain non-admissible assets for regulatory purposes, for example any regulatory adjustment to a pension fund deficit that is recognised as a liability.

Disclosure of these adjustments should be sufficient to give a clear picture of the capital position from a regulatory perspective and its relationship to the shareholders' funds shown in the consolidated balance sheet.

- 41 Where the amount of a capital instrument that qualifies for inclusion as regulatory capital is restricted (for example, where a limited percentage of total regulatory capital may be in the form of debt) the full amount of the instrument shall be included, with a separate deduction for the amount in excess of the restriction.**
- 42 Disclosure shall be made of any formal intra-group arrangements to provide capital to particular funds or business units, including intra-group loans and contingent arrangements. Where the reporting entity is a subsidiary undertaking, disclosure shall also be made of similar arrangements between the entity and its parent or fellow subsidiary undertakings.**
- 43 Regulatory capital can include both shareholders' funds and surplus within the fund. Such surplus may be wholly attributable to shareholders, or form part of the fund that has not yet been appropriated and allocated between shareholders and policyholders. In a mutual fund, all surplus is attributable to policyholders. Debt instruments qualifying as capital may also be issued from the fund itself, or may form part of the shareholders' net assets outside the life fund; and a debt instrument issued by the fund to the shareholders may effectively transfer capital from the shareholders to the fund. Separate disclosure of each class of capital is important to an understanding of the funding of the business and the way any future losses would be absorbed or new business financed.
- 44 Intra-group arrangements should be included in the regulatory capital of a section only where they are subject to formal arrangements. Where capital in other parts of a group is available to meet the requirements of a particular section of the business, but no formal arrangement has been entered into to do so, no allocation of this capital to the section of the business should be shown in the capital position statement.

Disclosures relating to liabilities and capital

- 45 The capital statement shall be supported by the following disclosures:**
- (a) narrative or quantified information on the regulatory capital requirements applying to each section of the business shown in the capital statement, or on the capital targets set by management for that section;**
 - (b) narrative disclosure of the basis of determining regulatory capital and the corresponding regulatory capital requirements and any major inconsistencies in this basis between the different sections of the business;**
 - (c) narrative disclosure addressing the sensitivity of liabilities and the components of total capital to changes in market conditions, key assumptions and other variables, and assumptions about future**

**management actions in response to changes in market conditions;
and**

(d) narrative disclosure of the entity's capital management policies and objectives, and its approach to managing the risks that would affect the capital position.

46 Although the capital statement itself deals only with capital available to meet regulatory requirements, the narrative discussion should address both this and the related regulatory requirements. Narrative explanation of the capital position, setting out its capital management objectives and risk management policies and the sensitivity to changes in assumptions, is important to the user's ability to understand the management of capital by the entity, its financial adaptability in changing circumstances, and the resources available to each group of policyholders.

47 Narrative discussion of sensitivity to changes in market conditions, assumptions and other variables is required to address both liabilities, including options and guarantees given to policyholders, and the components of total capital. Measurement of liabilities, including options and guarantees, may be determined using stochastic methods that take into account actions that are assumed would be taken by management in response to changes in market conditions. Incorporating management actions in this way can substantially alter the value of liabilities and disclosure of the effect of changes in such assumptions is required. In relation to UK life funds, management actions that are taken into account should be consistent with those disclosed in the life fund's Principles and Practices of Financial Management available to policyholders.

48 In relation to life assurance liabilities, the entity shall include the following additional information:

(a) the process used to determine the assumptions that have the greatest effect on the measurement of liabilities including options and guarantees and, where practicable, quantified disclosure of those assumptions;

**(b) those terms and conditions of options and guarantees relating to life assurance contracts that could in aggregate have a material effect on the amount, timing and uncertainty of the entity's future cash flows;
and**

(c) information about exposures to interest rate risk or market risk under options and guarantees if the entity does not measure these at fair value or at an amount estimated using a market-consistent stochastic model.

49 It may be relatively easy to quantify some assumptions that are used in the measurement of liabilities – for example, discount rates or general inflation,

where the rate used should be disclosed. For other assumptions, such as mortality tables, it may not be practicable to disclose quantified assumptions because there are too many, or they cannot be expressed as single values, in which case it is more important to describe the process used to generate the assumptions. The description of the process would include the objective – whether a best-estimate or a given level of assurance is intended; the sources of data; whether assumptions are consistent with observable market data or other published information; how past experience, current conditions and future trends are taken into account; correlations between different assumptions; management’s policy for future bonuses; and the nature and extent of uncertainties affecting the assumptions.

- 50 Options and guarantees are features of life assurance contracts that confer potentially valuable guarantees underlying the level or nature of policyholder benefits, or options to change these benefits exercisable at the discretion of the policyholder. For the purposes of this FRS, the term is used to refer only to those options and guarantees whose potential value is affected by the behaviour of financial variables, and not to those features of life assurance contracts where the potential changes in policyholder benefits arise solely from insurance risk (including mortality and morbidity), or from changes in the entity’s creditworthiness. It includes a financial guarantee or option that applies if a policy lapses, but does not include the option to surrender or allow a policy to lapse.
- 51 **The requirements of 48(c) will require, for options and guarantees that are not measured at fair value or at an amount estimated using a market-consistent stochastic model, the following disclosures:**
- (a) **a description of the nature and extent of the options and guarantees;**
 - (b) **the basis of measurement for the amount at which these options and guarantees are stated, and the extent to which an amount is included for the additional payment that may arise under the option or guarantee in excess of the amounts expected to be paid under the relevant policies if they did not include the option or guarantee feature;**
 - (c) **the main variables that determine the amount payable under the option or guarantee; and**
 - (d) **information on the potential effects of adverse changes in those market conditions that affect the entity’s obligations under options and guarantees.**
- 52 The requirement of 51(d) may be met by disclosing:
- (a) for options and guarantees that would result in additional payments to policyholders if current asset values and market rates continued

unchanged (ie those that are 'in the money'), an indication of the change in these amounts if the variables moved adversely by a stated amount;

- (b) for options and guarantees that would result in additional payments to policyholders only if there was an adverse change in current asset values and market rates (ie those that are 'out of the money'):
 - (i) an indication of the change in these variables, from current levels, which would cause material amounts to become payable under the options and guarantees; and
 - (ii) an indication of the amount that would result from a specified adverse change in these variables from the levels at which amounts first become payable under the options and guarantees.

The above disclosures may be made in aggregate for classes of options and guarantees that do not differ materially, or which are not individually material.

Disclosure of analysis of liabilities

53 The capital statement shall show the amount of policyholder liabilities attributed to each section of the business shown in the statement, analysed between:

- (a) with-profits business;**
- (b) unit-linked business;**
- (c) other life assurance business; and**
- (d) insurance business accounted for as financial instruments in accordance with the requirements of FRS 26 (IAS 39) 'Financial Instruments: Measurement'.**

The total of these policyholder liabilities shall be the amounts shown in the entity's balance sheet.

54 The relationship between capital requirements and policyholder liabilities for each fund or business unit provides additional information on the interrelationship between the capital position and the extent of liabilities.

Movements in capital

55 An entity shall include an explanation of the movements in the total amount of available capital for life assurance business shown in the capital statement with the corresponding amounts at the end of the previous accounting period. This disclosure shall cover individually each

UK life fund⁹ that is separately shown in the capital statement required under paragraph 32, and other life assurance business in aggregate.

56 This disclosure shall set out in tabular form the effect of changes resulting from:

(a) changes in assumptions used to measure life assurance liabilities, showing separately the effect of each change in an assumption that has had a material effect on the group;

(b) changes in management policy;

(c) changes in regulatory requirements and similar external developments; and

(d) new business and other factors, describing any material items.

57 An understanding of the underlying causes of changes in the capital position is valuable, giving an insight into the development of the entity's life assurance business. It is important to separate movements relating to changes in assumptions and management policy from other movements arising from the business. Those other movements might arise from changing market prices affecting assets and liabilities and movements resulting from surrenders, lapses and maturities of existing policies and new business written, and would be identified, where material, in accordance with paragraph 56(d).

58 The movements analysis distinguishes between assumption changes, changes in management policy, and other factors. Changes in management policy relate to significant changes in the management of the fund such as changes in investment policy or changes in the use of the estate. Where management actions are clearly directly related to changes in assumptions or other factors, it will be appropriate to show the net impact but the narrative should discuss the constituent factors. An example might be the combined effect of a reduced level of bonuses assumed as a result of a reduction in the assumed level of future investment return and a reduction in investment returns earned in the period.

59 Although it is important to explain all movements in liabilities and capital during the period that are material to the group, this does not imply that the impact of each assumption change needs to be shown separately. Where there is a common cause for the change of assumption the impact can be grouped together. As an example, the impact of changes in investment return attributable to changing market circumstances does not need to be broken down between the various classes of investment.

⁹ or, for an entity in the Republic of Ireland, each life fund in the Republic of Ireland.

60 Determination of the effect of assumption changes involves considerable recalculation of valuations using both old and new assumptions and, particularly in the case of option and guarantee models, this may result in impracticable demands on computer systems. This is especially so in the first year of applying the FRS, when the FSA realistic valuation methodology is relatively new and untried, and estimation and approximation methods for analysing and explaining movements for management purposes are in the early stages of development. Accordingly, less detailed analysis of changes, and less quantification of movements, may be expected in the first year of applying the FRS as a result of these practical difficulties; paragraph 66 permits entities to present this information in non-tabular form for an accounting period ending before 23 December 2006.

DATE FROM WHICH EFFECTIVE AND TRANSITIONAL ARRANGEMENTS

- 61 Subject to paragraphs 62 and 63, the accounting practices set out in the FRS shall be regarded as standard for financial statements relating to accounting periods ending on or after 23 December 2005. Earlier adoption of all or part of the FRS is permitted.**
- 62 Entities that are directive friendly societies and are not within the scope of the FSA realistic capital regime are not required to apply the FRS for accounting periods ending before 23 December 2006.**
- 63 Entities that are non-directive friendly societies are not required to apply the FRS for accounting periods ending before 23 December 2007.**
- 64 Changes in accounting policy resulting from the adoption of the FRS shall be accounted for by restating prior periods in accordance with FRS 3 'Reporting Financial Performance', except that comparatives in the profit and loss account need not be restated for changes arising from the adoption of a new accounting policy in accordance with paragraph 4 where this is not practicable.**
- 65 For those entities that adopt the measurement requirements of paragraph 4, including adoption of the realistic value of liabilities as the basis of measurement, or adoption of stochastic methods for the measurement of options and guarantees, it may not be practicable to restate profit and loss account comparatives for the first year of adoption. Accordingly, the FRS permits such comparatives not to be restated. FRS 18 'Accounting Policies' sets out requirements for disclosures relating to changes in accounting policies.
- 66 For accounting periods ending before 23 December 2006, an entity is not required to set out the analysis of movements in tabular form as required by paragraph 56, but should include quantified disclosure of changes where practicable. The narrative disclosure required by paragraph 55 should address the movements as categorised in paragraph 56. For the first**

accounting period for which a table of movements is presented, comparatives for the previous period are not required.

- 67 Comparatives should be disclosed for the capital position statement, for the table of movements in the capital position and for the related disclosures. However, this may not be practicable in the case of the movements table for the first accounting period in which the FRS comes into effect. Accordingly, such disclosure is not required for that period, although it is encouraged if information is available.