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Comment on Exposure Draft FRED34 Life Assurance July 2004 *(for comment by 8th October, 2004)*

I set out below my comments on several of the issues raised by the Exposure Draft ('ED'). I welcome the ED's overall objective to make (necessarily limited) improvements in the financial reporting of with-profits life insurance business within the 'window of opportunity' in 2004, given that the IASB's own project is (at least temporarily) stalled. However, there remain difficulties in accepting some of the proposals in the ED, as discussed below. I frame my comments around the questions asked in the 'Invitation to Comment'. My comments are made in a wholly personal capacity. I have also sent a copy to IASB (pclark@iasb.org) and to ICAEW (iain.coke@icaew.co.uk].

Invitation to Comment

Measurement of with-profits liabilities and related assets

Q1 Paragraph 5 of the proposed standard would require the liabilities of with-profits life funds falling within the scope of the FSA's realistic capital regime to measure liabilities in accordance with the FSA's definition of realistic value of liabilities. However, for practical reasons, this requirement is not extended to smaller funds, UK non-participating businesses and overseas businesses.

(a) Do you agree that the realistic value of liabilities is more appropriate than the existing modified statutory solvency basis (MSSB)?

(b) Do you agree that the Board should not extend this requirement to smaller funds, UK non-participating businesses and overseas businesses at this stage?

(c) Do the FSA rules, supported by actuarial guidance, provide sufficient guidance for determining the value of these liabilities?

(d) Where an entity that falls within the FSA realistic capital regime has one or more smaller funds, it is possible that the FSA may waive the requirement for such funds to comply with that regime. Such funds would still be required to comply with paragraph 5 of the standard, subject only to the materiality of any adjustments arising. Are there any instances where a fund for which the FSA has granted a waiver would nevertheless give rise to material adjustments to the entity's liabilities?

Re (a), I agree that the proposed 'realistic' basis, in respect of the constructive liabilities for future bonuses established by the PPFM and of the value of

guarantees and options, is more appropriate than the existing MSSB basis.[1] The law already recognises that 'in the case of participating business' the calculation 'may take into account…future bonuses of all kinds' (Appendix IV, para 4.50 (b)). However I doubt that a change to the Technical Provision for Long-Term Business ('TPLB') from a 'prudent' to a 'best estimate' basis is legally permitted for the Companies Act accounts for 2004. Despite the arguments in Appendix IV paras. 4.47 and following, the law seems clearly to disallow a 'best estimate valuation' pointing out that 'a prudent valuation is not a "best estimate" valuation, but shall include an appropriate margin for adverse deviation of the relevant factors' (quoted at para. 4.53).

The justifications given in the ED for ignoring this legal requirement seem contrived—if not downright casuistical. 4.53(a)(i) suggests that a prudent measurement basis and a best estimate basis may produce the same result and 4.53(a) (iii) and (b) suggest that in the context of recognition of constructive obligations to pay additional bonuses the 'appropriate' margins may not be significant (both implying that the 'margin for adverse deviation' may in fact amount to zero and the valuation may therefore simply be a best estimate valuation). Para. 4.54 also notes that there is disagreement over the interpretation of what is meant by 'any liabilities…as far as can reasonably be foreseen'. Given these novel interpretations that the ASB is proposing it would seem that at the very least Counsel's opinion should be obtained as to whether they constitute a legitimate interpretation of the law.

A related concern arises in respect of the proposed elimination of Deferred Acquisition Costs ('DAC'). The implementation of the EU Insurance Accounts Directive in Schedule 9A of the Companies Act 1985 resulted in a major change in life insurance accounting practice (as actuaries had always generally argued that DAC were allowed for—either explicitly or implicitly—in the actuarial valuation of the liabilities in the TPLB (which necessarily takes into account future premiums receivable)). The revised Companies Act requires a separate DAC asset to be shown in respect of long-term business 'except in so far as allowance has been made in the computation of the long-term business provision… for (i) the explicit recognition of such costs, or (ii) the implicit recognition of such costs by virtue of the anticipation of future income from which such costs may prudently be expected to be recovered.' In the case of (i), disclosure of the amount of the costs so recognised is required. However, primarily at the insistence of the ICAEW who opposed 'netting off' of assets and liabilities, the IAD was interpreted in the UK by the SORP as requiring separate deferral of acquisition costs, with the role for accounting convention being to provide particular patterns of allocation over time to the years to which the DAC are deemed to relate. (The overall effect on net assets and profit has generally been zero, at least for with-profits business, as the additional DAC asset has been offset either by an increased insurance liability valuation or by an

[1] Appendix IV para. 1.1 describes the MSSB basis as the basis resulting from the modifications made by the ABI's SORP to the basis introduced into the Companies Act 1985 following the EU Insurance Accounts Directive ('IAD'). In fact the SORP gives guidance on how to implement the modifications made by the IAD (and consequently by Schedule 9A, CA1985) to the pre-existing statutory solvency basis ('SSB'), which itself remains in force for the purpose of determining distributable surplus and for regulatory purposes as one of the FSA's 'twin peaks'—as noted at Appendix IV, para. 1.7 (d). See Horton & Macve, 1995, Chapters 3 & 4; 1997, Chapters 3 & 5.

adjustment to the FFA, e.g. Horton & Macve, 1995, 1997.) Moreover there seems to be no basis in accounting principle for specifying, as the ED proposes in Appendix IV para. 4.56, that the DAC of with-profits funds all relate to the year in which incurred while the DAC of non-profits funds may relate to later years. It would seem that Counsel's opinion is needed to support such an unnatural reading of the legal requirements, and also as to whether or not, if FRED34's ban on deferral is legal, disclosure of the amount of DAC offset in the TPLB is still required. The SORP will also need to be revised.

Re. (b) to (d), while it does not appear practicable to widen the scope of the proposed requirements for 2004 (given the novelty of the FSA's own new regime), and while the Board cannot require changes to accounting principles for 2005 and beyond, nevertheless the SORP can presumably continue to give (non-mandatory) additional guidance and it should now recommend 'realistic' liability valuation for all insurance funds with the earliest practicable effect.

Q2 *Paragraph 5 of the proposed standard would require adjustments to restate liabilities from MSSB to a 'realistic' basis, together with consequential adjustments to assets, to be made to the FFA. Although shareholders are entitled to an amount (usually one-ninth) of bonuses declared, no transfer to shareholders' funds for their share of these adjustments is proposed, as the shareholders' right to this amount is not, in general, automatic but subject to future management confirmation.*

(a) *Do you agree that these adjustments should be made to the FFA rather than affecting net profit and shareholders' funds?*

(b) *Are there any situations where shareholders are automatically entitled to a fixed proportion of amounts attributed to policyholders?*

(c) *For mutuals, the adjustments referred to above are made to the FFA or retained surplus as a reserves movement. Do you agree that this is appropriate?*

Re. (a) and (c). Given that the IASB's insurance project has not yet made any significant progress on resolving the conceptual and practical issues of life assurance profit measurement it could hardly be expected that ASB would be able to do so within the timetable laid down for producing these proposals. It is however anomalous, within the standard setters' 'asset-liability' framework, for major changes to the basis of measurement of the main business liability to be proposed without any effect on profit measurement. It must also be recognized that, without any clear concept of life assurance profitability, the usefulness of the accounts to users (shareholders and policyholders) remains extremely limited. The Companies Act requires a 'true and fair view' both of the year-end net assets and of the profit for the year. The FRED34 proposals alter the classification of elements of the liabilities as between the TPLB and the FFA but do not alter liabilities overall (at least for 2004) so there is no overall effect on the 'bottom line' of profit and net assets.[2] The proposals cannot therefore assist

[2] Provided the adjustment to TPLB does not exceed the available FFA (cf. the deficit situation at the Equitable [*Penrose Report* Tables 6.21 and 19.1]). Other adjustments are summarised at Appendix IV, para. 4.41.

users to understand the profitability of life assurers[3] although the capital position statement may give some further insight into solvency and capital adequacy. Given the European industry's own efforts to develop appropriate performance measures (e.g. the 'European Embedded Value Principles' issued by the European CFO Forum in May 2004 referred to at Appendix IV paras. 2.19 and 7.8) it therefore seems inappropriate for this FRED to propose not to allow those entities who are not already doing so to adopt embedded value reporting for 2004 (see comment on Q.5 below).

A further issue arises with regards to mutuals, where the draft standard (paras. 5 and 16 and Appendix IV para.4.42) proposes that the adjustments be transferred to 'retained surplus'[4] as 'reserves movements'. This seems likely to cause unnecessary confusion. Leading mutuals such as Standard Life do not show a retained surplus but do show an FFA (with the annual transfer to/from the FFA being the 'bottom line' of their technical (P&L) account): so for them the adjustment should be as for proprietary companies with the overall effect that total liabilities and net assets are unchanged. If companies use an account described as 'retained surplus' (which has the appearance of equity, albeit policyholders' equity as members of the mutual (draft FRS, para. 33(b)), this will appear to frustrate the intention of the proposed standard not to change the profit recognition model (Appendix IV, para. 5.9c).

Q3 Paragraph 5 of the proposed standard takes account of certain differences between the valuation of assets for 'realistic' balance sheet purposes and accounting bases, and permits the recognition of an additional asset where the realistic value of liabilities has taken an additional value into account.

(a) Do you agree with permitting an additional asset to avoid a mismatch with the realistic value of liabilities?

(b) Do you agree that adjustments should be made for deferred acquisition costs, the change in reinsurance recoveries and consequential tax effects?

(c) Are there any other differences between the RBS rules and normal accounting practice that would also give rise to a mismatch and for which a further exemption should be made?

I agree with the need for these adjustments to be consistent with the basis of liability valuation (subject to the legal caveat in relation to DAC referred to under Q1. above). However it should be noted that the proposal to allow the inclusion in the balance sheet of subsidiaries at market value is a far greater departure from normal accounting practice than would be a proposal to allow the embedded value (or 'PVIF') of the with-profits business to be included. Where market value exceeds net asset value it is effectively a revaluation of goodwill which is prohibited by the Companies Act. Again it would appear that Counsel's opinion on the legality of this proposal is needed. It is also anomalous that, while the embedded value of the non-participating business written in the

[3] There will be (unspecified) changes to some line items in the technical accounts/P&L (draft standard para. 15).

[4] The wording in para.5 does not make clear that this is 'FFA or retained surplus'

with-profits fund is to be included, that of the with-profits business is still to be excluded.

Disclosure and presentation relating to with-profits business

Q4 The proposed standard, in paragraphs 17 and 19, would require disclosures relating to the assumptions used for the determination of the realistic value of liabilities, and separate presentation of the FFA on the balance sheet. Do you agree with these proposals?

Yes. Given the difficulties under the existing conceptual framework of determining how far the FFA is a 'liability' and how far 'equity' (Appendix IV, section 5) it is necessary that it be shown separately and explained in the notes to the accounts.

Value of in-force life assurance business

Q5 Paragraph 21 of the proposed standard would permit entities that currently adopt 'embedded value' methods of including interests in life assurance businesses in their financial statements to continue this practice subject to restrictions similar to those imposed on changes in accounting policies for insurance contracts by the IASB in IFRS 4. However, entities that do not currently adopt embedded value methods would not be permitted to do so under UK standards.

(a) Do you agree that the value of in-force life assurance business may, subject to restriction, be recognised as an asset by those entities already recognising it?

(b) Do you agree that the proposed restriction to exclude future investment risk margins is appropriate?

(c) Do you agree that the proposed restriction on investment management fees is appropriate? Is this capable of consistent interpretation without additional guidance?

I agree with the proposed restrictions in (b) and (c), but given these restrictions I can see no reason in (a) to circumscribe the recognition of PVIF solely to those entities (mainly banks) that already recognize it. As noted in Appendix IV paras. 7.9(a), 7.13, 7.17 (b) and 7.19, from 2005 all insurers will be able to recognize PVIF under IFRS4, subject to similar restrictions to those now proposed by the ED in respect of investment risk margins and management fees. This is also consistent with the 'European Embedded Value Principles' issued by the European CFO Forum in May 2004 (referred to at Appendix IV paras. 2.19 and 7.8). The proposed continuing ban will therefore be effective for only one year at most. Given that the inclusion of PVIF by those already recognising it is to be allowed provided the proposed restrictions are introduced, there can be no objection now—given the arguments in Appendix IV para.7.9 (b)— to allowing all insurers to include it on this basis, as canvassed in 7.14. As noted in 7.9 (b), this would considerably enhance the usefulness of the main accounts.

However, it has to be recognised that embedded value methodologies have been developed primarily for proprietary companies, focussing on shareholders'

value, so that fundamental issues relating to 'profit' determination for mutuals remain unresolved.

In this regard it is also important to ask how far there is now convergence between the FSA realistic valuation rules, the FRS12 approach to liabilities, and the embedded value approach. This is discussed at Appendix IV paras. 4.14-4.19; 7.12; and 8.6-7. Of the items in 8.7, items (a) and (c) are now set to disappear and item (b) (future premiums) is not a distinguishing feature of embedded value but is also at the core of the FSA's RBS methodology (4.18-19) and indeed of the overall actuarial basis for estimating the TPLB (as recognised by the law: 4.49). The most helpful way to identify the significance of any remaining differences would be to allow companies that wish to to report embedded values in their financial statements and provide a reconciliation to the RBS basis (similar to that in the proposed capital position statement). This would also overcome the difficulty that the Board cannot require a reconciliation of supplementary embedded value information (Appendix IV, para.8.9).

Policyholders' options and guarantees

Q6 The proposed standard, in paragraph 28, would require detailed disclosures relating to options and guarantees only if these are not measured on either a fair value basis or at a value estimated using a stochastic modelling technique. Although the proposed standard would require such valuation methods only in relation to with-profits funds falling within the scope of the FSA's realistic capital regime, it encourages their use for options and guarantees of smaller funds, non-participating businesses and overseas businesses.

(a) Should the Board require these valuation methods to be used for all options and guarantees for 2004, rather than requiring additional disclosures?

(b) If not, do you agree that these disclosures should only be required when options and guarantees are not valued in this way?

(c) Do the disclosures provide useful information to enable the effect of options and guarantees to be understood?

(d) Are the description of stochastic modelling and the scope of these requirements sufficiently defined?

It does not appear practicable to widen the scope of the proposed valuation requirements for 2004 and the Board cannot require changes to accounting principles for 2005 and beyond. However, given there is now general acceptance of the need for proper fair valuing[5] of options and guarantees (using stochastic models where necessary), the SORP should now recommend this for all insurers with the earliest practicable effect, as it is not required by IFRS4.

[5] Comments on the FASB's Exposure Draft on *Fair Value Measurements* (June 2004) are available at http://accfin.lse.ac.uk/staff/macve

Capital position statement

Q7 *The proposed standard would require entities to include a capital position statement as set out in paragraph 30, analysing the capital position of each main section of the life assurance business.*

- *(a)* *Do you agree that this statement will give useful information on the entity's financial position, showing its capital structure?*

- *(b)* *Do you agree that each material UK with-profits fund should be shown separately in this statement, but that other UK life assurance funds, and overseas business units, need only be shown separately where necessary to show restrictions over the transferability of capital held in the business?*

- *(c)* *Do you agree that the statement should require disclosure based on regulatory capital requirements and permit additional information based on management's own capital targets?*

- *(d)* *Do you agree with the supporting disclosures set out in paragraph 52 of the proposed standard?*

Q8 *Paragraph 47 would require the proposed capital position statement to include disclosure of regulatory capital requirements.*

- *(a)* *Are you aware of any circumstances where entities will not be able to make this disclosure without infringing legal restrictions on the disclosure of regulatory capital requirements?*

- *(b)* *Should the proposed standard permit the use of management targets for overseas business units if the regulatory requirements are not available at the time of finalising the accounts, or should estimates of the regulatory requirements be required?*

Q9 *The Board is proposing, in paragraph 35, an exemption from presenting a capital position statement for entities that are wholly-owned subsidiaries of a UK group which is required to present a consolidated capital position statement in its consolidated financial statements. Although it believes that this information is important to policyholders in the subsidiary's life fund, in most cases this information will be shown in the capital position statement of the group.*

- *(a)* *Do you agree that this information should not be required in the subsidiary's financial statements, and that group disclosures should be adequate, even though the subsidiary's life funds may not be disclosed separately in the group financial statements?*

- *(b)* *Should the exemption be limited to wholly-owned subsidiaries?*

Q10 *The Board is proposing, in paragraph 58, a requirement for a table of movements in total available capital and regulatory capital requirements, setting out the main changes in the period.*

- *(a)* *Do you agree that the classification of changes set out in paragraph 58 is appropriate?*

- *(b)* *Do you agree that the movements should be analysed individually for each UK life fund that is shown separately in the capital position statement, as well as in total?*

Q7-10. I support the proposals regarding the capital position statement. However under the ED's proposals the anomaly remains that the FFA is shown as a liability in the balance sheet (as legally required for 2004 and as probable practice under IFRS4 in 2005 and beyond—Appendix IV para. 5.5; cf. para 5.10) while being shown in the capital position statement (as illustrated in Appendix I) as adjusted onto the regulatory basis as available capital (Draft standard para. 39 and 41(a)). This emphasises the need for the ASB to continue to work with the IASB and the actuarial profession in 'Phase II' to resolve the conceptual difficulties as to the correct classification of the FFA and its elements and the related profit measurement issues (Appendix IV para. 5.9 (a)).

Effective date and transition provisions

Q11 The proposed standard would be effective for accounting periods ending on or after 23 December 2004, and the transitional provisions set out in paragraphs 61-64 would not require in the first year of adoption:

(a) restatement of comparatives for 'realistic' liabilities;

(b) comparatives for the capital position statement; or

(c) analysis of movements in the capital position statement.

Do you agree with the proposed implementation date and transition provisions?

Yes

Concluding comments: While it would be frustrating if legal requirements (which will no longer have force after the move to IFRS in 2005) may prevent the implementation of the ASB's proposals for 'realistic' liability valuation for 2004 there are, if needed, alternative mechanisms for achieving a similar result. The ASB proposals are based on the FSA's proposed requirements for the solvency returns for 2004. These will be published. So the statement of 'realistic' liabilities will be publicly available in 2005 and this aspect of responding to Penrose's concerns will thereby be met even if the Companies Act accounts continue to be prepared on a different basis. Moreover, if the Companies Act accounts continue to have to be prepared on a 'prudent' basis, the reconciliation to a 'realistic' basis can still form part of the proposed capital position statement.

Moreover, given that it is now generally agreed that guarantees and options need to be valued on market consistent bases (i.e. recognising time value) a significant element of understatement in the liabilities will have been removed. It is difficult in principle to know whether the balance of the remaining impacts of present practice (not allowing for constructive terminal bonus liabilities vs. 'prudent' estimates of liabilities) is to increase or reduce stated liabilities. This depends on the overall basis adopted for the actuarial valuation including the treatment of future premiums (e.g. 'net premium' vs. 'bonus reserve') and the role of 'asset shares'. At all events, the ASB's ED is not proposing any 'bottom line effect' as the restatements to the TPLB (and other related adjustments) are

to be offset by an equal restatement of the FFA.[6] The FFA is to be shown as a separate item but also as a liability (by law in 2004 and probably by general UK practice under IFRS4 in 2005 and beyond (Appendix IV para. 5.5; cf. para 5.10)). The total amount shown under insurance-related liabilities will therefore remain unchanged. Given that the 'realistic' liabilities will be shown in the published solvency returns to the FSA it is arguable whether the additional FRED34 proposals on this issue, however desirable, represent a *necessary* improvement to life assurance reporting for 2004. If the change is legally prohibited for 2004 (it will of course be available for companies to adopt under IFRS4 for 2005 onwards), then in the meantime the Companies Act accounts could carry an 'emphasis of matter' in the auditor's report (similar to that presently provided in respect of 'equalisation reserves') pointing out that the TPLB is stated on the basis required under the law and not on the basis as provided by FRS12.

What about 2005 and thereafter? It is true that the only window for ASB to introduce a new standard for life assurance accounting principles is for 2004, as once the IFRS4 is in force no additional new national requirements can be imposed. However, under IFRS4 insurers are permitted to change their accounting policies provided the criteria as to relevance and reliability are met (Appendix IV, para. 1.13). (FRED34 sets out *inter alia* requirements relating to Embedded Value that meet the IFRS criteria (draft FRS, para.21).) So although it will not be possible after 2004 to *require* changes it will still be possible to *recommend* them e.g. in a revised SORP, and one way forward therefore would be to introduce changes to the SORP in respect of liability measurement along the same lines as those currently proposed in FRED34, to take effect from 2005 once the legal requirements of the IAD/Companies Act are in abeyance. One would then be relying on peer pressure to ensure consistent reporting practice, but compliance with the SORP appears generally high, just as there is an emerging consensus on how embedded value reporting should be done which is in line with the ASB's current proposals in this ED (see the 'European Embedded Value Principles' issued by the European CFO Forum in May 2004, referred to at Appendix IV paras. 2.19 and 7.8)[7].

In summary, while I support the ASB's proposals re. realistic liability valuation, I believe Counsel's opinion on their legality should be obtained. If they are held to be illegal for 2004 I do not regard them as essential given the publication in 2005 of returns to the FSA that will show these realistic liabilities for 2004, and given the opportunity to include them in the reconciliation to the regulatory basis in the proposed capital position statement. I support the valuing of options

[6] See fn.2 above

[7] There remains a potential conflict in that IASB has indicated in IFRS4 that a tentative conclusion for Phase II is that 'in the absence of market evidence to the contrary, the estimated fair value of an insurance liability shall not be less, but may be more, than the entity would charge to accept new contracts with identical contractual terms and remaining maturity from new policyholders. It follows that an insurer would not recognise a net gain at inception of an insurance contract, unless such market evidence is available.' However, the IASB has now stated that work on Phase II will start with a clean slate (http://www.iasb.org/news/index.asp?showPageContent=no&xml=10_215_25_21092004_31122009.htm)

and guarantees at fair value, and believe this should be extended to all funds at the earliest practicable opportunity. I support the inclusion of the capital position statement. I also support the restrictions being placed on the way embedded value (PVIF) is to be measured but believe the ASB is being unnecessarily restrictive in maintaining its ban (which can anyway only be effective for one more year) on the adoption by insurers generally of embedded value on this more acceptable basis.

Counsel's opinion is also needed on Deferred Acquisition Costs and on the inclusion of subsidiaries at market value where this is higher than net asset value.

As proposed, 'Phase II' work needs to continue urgently, in collaboration with IASB and the actuarial profession, on the profit recognition model and the identification of 'liabilities' and 'equity' (including for mutuals); and on the remaining issues relating to the adoption of embedded value methodologies as the basis for reporting in the main accounts.

Richard Macve
23.9.2004

Additional References

Horton, J. and Macve, R. (1995), *Accounting Principles for Life Insurance: A True and Fair View?* (Research Board, ICAEW).

Horton, J. and Macve, R. (1997), *UK Life Insurance: Accounting for Business Performance* (London: FT Finance)