



LETTER OF COMMENT NO. 10

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International Accounting Standards Board
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Dear Sirs

IASB Discussion Paper, *Preliminary Views on Insurance Contracts*

Catlin Group Limited ('Catlin') is pleased to comment on the IASB Discussion Paper on insurance contracts. Catlin is one of the largest underwriters at Lloyd's of London, and has operations in Bermuda, the UK and the US, as well as a network of international offices. Catlin underwrites a diversified portfolio of direct and reinsurance property and casualty business, and uses outwards third-party reinsurance both to protect its capital base and to increase underwriting capacity.

Catlin is domiciled in Bermuda and listed on the London Stock Exchange. The consolidated group financial statements are prepared in accordance with US GAAP.

The enclosed appendix details our responses to selected questions raised in the Discussion Paper. Our principal observations are set out below.

Overall objectives

The introduction to the Discussion Paper notes that the final standard should address the need for users of an insurer's financial statements to receive relevant and reliable information, capable of preparation at a reasonable cost, as a basis for economic decisions; and that this information should enable users to compare the financial position and financial performance of insurers within a country and in different countries. We wholeheartedly agree that these objectives, of relevance, reliability, comparability and cost-effectiveness, should be central to the final standard.

In principle, we are in agreement with the framework and the building-block approach set out in the Discussion Paper, but we are concerned over the potential inconsistencies that will arise during implementation. We believe that, without more specific guidance, divergence in practice will lead to increased confusion and uncertainty for shareholders and other users of the financial statements. We feel that the proposed approach risks compromising the objectives of comparability and cost-effectiveness, whilst any improvements to relevance or reliability are as yet unproven.

Single model

We are not opposed to a single reporting model for all insurance contracts, but we believe that achieving the appropriate accounting treatment for different types of insurance is of greater importance. For many types of insurance business, most notably non-life insurance, current practices are widely accepted and understood by users of financial statements. We believe that incremental changes to these existing practices could be more beneficial than a fundamental change to the basis for measuring non-life insurance liabilities. Specifically, we believe that there may be benefit to an approach that aims for convergence of international practices by non-life insurers and is supported by disclosures explaining the associated uncertainties, as this would improve users' understanding of the risks to which insurance business is exposed. Although existing practices are not necessarily market-consistent, the fact that they involve less judgement can potentially result in more comparable, reliable and useful financial statements.

At the present time it is not evident that there will be convergence between IASB proposals, US GAAP and the Solvency II regulatory framework in Europe. One necessary condition for convergence will be the joint development of proposals between IASB and FASB. A second condition for convergence will be that the practical implementation of IFRS Phase II does not follow a very different trajectory to Solvency II. Without convergence in reporting bases, we are concerned that the outcome from the different bodies will be increased confusion for users as well as significant cost implications for the preparing companies.

Need for appropriate field testing

Whilst we acknowledge many of the theoretical merits of the approach described in the Discussion Paper, we believe that the full implications will only become apparent when the guidance is implemented in practice. Further evidence is therefore needed to demonstrate that the costs of implementing this new approach do not exceed the benefits. This is particularly relevant for non-life business: as indicated above, we believe that a robust model based on current practices for non-life insurance could prove more useful to users of insurance entity financial statements than a fundamental change in approach.

We would encourage either a process of rigorous field-testing prior to issuing a final standard, or alternatively a 'phased in' approach whereby entities report the effects of the new basis as supplementary disclosures for a number of reporting periods prior to full implementation.

It is already possible to learn lessons from the field-testing which has been carried out under Solvency II. There are messages already emerging for general insurers from Solvency II with obvious parallels to IFRS Phase II proposals. We would encourage the board to give consideration to the difficulties and ambiguities that have been encountered, even under Solvency II where there is much greater stipulation of methods and assumptions (relative to the high-level principles approach of the IASB Discussion Paper).

Adequate and specific guidance

We believe that the lack of specific guidance in the Discussion Paper on cash flows and risk margins allows a degree of subjectivity that could potentially create significant divergence in practice. This is clearly a potential area of difference with Solvency II that users of the accounts will find difficult to comprehend, particularly if there is not a consistent approach with regard to risk margins.

Market versus settlement model

The 'current exit value' is based on a theoretical transfer of liabilities to a third party at market rates; in practice, such transactions are rare due to the lack of a real market, and may also be subject to regulatory restrictions. Insurance liabilities are typically extinguished through settlement of claims and we therefore believe that a settlement-based model would be more consistent with economic realities. We would suggest the use of estimates of future cash flows and risk margins that are entity-specific, rather than market-based.

One of the difficulties with a market-consistent model is that, without an existing market, a wide range of legitimate interpretations can be applied, leading to a potential lack of comparability between insurers.

Reinsurance

As noted in the Discussion Paper, a reinsurance contract may not cover the same period as the underlying contract. Typically, outwards reinsurance is purchased at key renewal dates in the year with some underlying exposure sold evenly during the year. Recognition of both gross liabilities and reinsurance assets when the insurer becomes party to the contract potentially gives a mismatch between gross and net profit, which would, in our view, lead to inappropriate presentation.

We believe that financial statements that match the exposure on gross business and outwards reinsurance are important in understanding the strategy and performance of a non-life company.

Adequate disclosures

We believe that the uncertainties inherent in determining risk-adjusted discounted cash flows can only be understood with sufficient supplemental disclosure. IFRS 4 sets out disclosure principles, but additional specific guidance will be necessary in the context of the revised reporting basis under Phase II for insurance contracts.

Diversification

We strongly believe that risk margins used to measure insurance liabilities should reflect diversification between portfolios, and between reporting companies within a Group structure, as this is fundamental to how an insurance entity manages risk.

We would be happy to discuss any of our comments with you.

Yours faithfully



Christopher Stooke
Chief Financial Officer, Catlin Group Limited

cc. Financial Accounting Standards Board

QUESTIONS FOR RESPONDENTS IN PHASE II DISCUSSION PAPER

Chapter 2 RECOGNITION AND DERECOGNITION

Question 1

Should the recognition and derecognition requirements for insurance contracts be consistent with those in IAS 39 for financial instruments? Why or why not?

As described in the Discussion Paper, the effect of applying IAS 39 recognition criteria to insurance is that recognition occurs when an insurer becomes party to a contract. While in principle we are not opposed to this approach, we see two primary issues arising in cases where there is a gain or loss at inception.

Firstly, as described further below, an insurance entity can become party to reinsurance outwards contracts at materially different dates from the underlying insurance covered, leading to misleading net results.

Secondly, under the IAS 39 criteria, profit for a period is sensitive to short-term timing differences. An entity's profit for a period could potentially be materially different depending on whether insurance is written – or reinsurance purchased – before or after the period end. This could be a particular issue for reinsurance business, as significant volumes are written around the first of January and first of July each year. Such timing issues could lead to misleading distortions in an entity's results, and are also prone to manipulation.

Chapter 3 MEASUREMENT – CORE ISSUES

Question 2

Should an insurer measure all its insurance liabilities using the following three building blocks

- (a) explicit, unbiased, market-consistent, probability-weighted and current estimates of the contractual cash flows,*
- (b) current market discount rates that adjust the estimated future cash flows for the time value of money, and*
- (c) an explicit and unbiased estimate of the margin that market participants require for bearing risk (a risk margin) and for providing other services, if any (a service margin)?*

If not, what approach do you propose, and why?

We agree that the three building blocks represent a conceptually appropriate basis for measuring insurance liabilities. However, we are not convinced that sufficient evidence yet exists that in practice they will lead to significantly more relevant or reliable information for users of financial statements. This is particularly the case for non-life insurance, where existing practices are widely accepted and understood.

As indicated in our response to question 5, we believe that cash flows and margins are more relevant (and reliable) when based on entity-specific settlement expectations than when based on a notional market.

We also believe that if the building-block approach is used, there should be appropriate presentation and disclosure guidelines. For example, estimates of cash flows relating to unexpired periods of risk are more subjective than those relating to expired risks, and should therefore be disclosed separately.

Question 3

Is the draft guidance on cash flows (appendix E) and risk margins (appendix F) at the right level of detail? Should any of that guidance be modified, deleted or extended? Why or why not?

Subject to our previous comments on the use of market-based measures, we believe the guidance on cash flows and risk margins provides a clear and concise explanation of the general principles to be applied. However, we believe that without more specific guidance, particularly as regards risk margins, insurers are likely to develop practices that are not necessarily consistent with, or comparable to, each other.

In particular, unless there is a recommended standard approach to methodology and underlying capital of the proposed transfer "market" it will be extremely difficult if not impossible to compare two companies that have adopted different practices. For example how would one judge a 75th percentile approach compared to a factor based capital approach especially where one company considers a theoretical market to have more diversification (thus lowering cost of capital) compared to a company that considers a theoretical run off market being less diverse than itself (thus raising the cost of capital)? Without consistency comparisons across companies may become meaningless and perhaps more damaging to the more prudent company when the users of the accounts are unfamiliar with highly complex methods which have not been road tested alongside the existing reporting framework.

We would prefer a company specific cost of capital approach that is therefore relevant and explainable by the company.

Question 4

What role should the actual premium charged by the insurer play in the calibration of margins, and why? Please say which of the following alternatives you support.

(a) The insurer should calibrate the margin directly to the actual premium (less relevant acquisition costs), subject to a liability adequacy test. As a result, an insurer should never recognise a profit at the inception of an insurance contract.

(b) There should be a rebuttable presumption that the margin implied by the actual premium (less relevant acquisition costs) is consistent with the margin that market participants require. If you prefer this approach, what evidence should be needed to rebut the presumption?

(c) The premium (less relevant acquisition costs) may provide evidence of the margin that market participants would require, but has no higher status than other possible evidence. In most cases, insurance contracts are expected to provide a margin consistent with the requirements of market participants. Therefore, if a significant profit or loss appears to arise at inception, further investigation is needed. Nevertheless, if the insurer concludes, after further investigation, that the estimated market price for risk and service differs from the price implied by the premiums that it charges, the insurer would recognise a profit or loss at inception.

(d) Other (please specify).

We believe that alternative (c) is most consistent with the building-block approach. In principle, we do not oppose the recognition of profit or loss at inception. However, as described in our responses to questions 1 and 12, there are potential consequent implications in relation to the timing of recognition and to outwards reinsurance that may need to be addressed.

Question 5

This paper proposes that the measurement attribute for insurance liabilities should be the amount the insurer would expect to pay at the reporting date to transfer its remaining contractual rights and obligations immediately to another entity. The paper labels that measurement attribute 'current exit value'.

(a) Is that measurement attribute appropriate for insurance liabilities? Why or why not? If not, which measurement attribute do you favour, and why?

(b) Is 'current exit value' the best label for that measurement attribute? Why or why not?

In the overwhelming majority of instances an insurance entity extinguishes its insurance liabilities through settlement of claims rather than through an arm's-length transfer to a third party. In many cases, no deep or liquid market exists, and it is not uncommon for regulatory requirements to prohibit the transfer of insurance liabilities altogether. We do not therefore believe that the 'current exit value' as described corresponds to economic realities of insurance business. We would suggest that the measurement of insurance liabilities based on an entity's expectations of the amount and timing of settlements is a more relevant attribute.

A suitable label for this attribute might be 'current settlement value'.

Chapter 4 POLICYHOLDER BEHAVIOUR, CUSTOMER RELATIONSHIPS AND ACQUISITION COSTS

Question 6

We have no comments on question 6.

Question 7

We have no comments on question 7.

Question 8

Should an insurer recognise acquisition costs as an expense when incurred? Why or why not?

We believe that recognition of acquisition costs should be consistent with the final reporting basis. Therefore if the current proposal is confirmed then this would be consistent with the building-block approach.

Question 9

Do you have any comments on the treatment of insurance contracts acquired in a business combination or portfolio transfer?

We believe that the building-block approach described in the Discussion Paper is broadly consistent with the measurement requirements of IFRS 3 *Business Combinations*.

Chapter 5 MEASUREMENT – OTHER ISSUES

Question 10

Do you have any comments on the measurement of assets held to back insurance liabilities?

For non-life business, we do not believe that any specific measurement guidance is required for assets backing insurance liabilities.

Question 11

Should risk margins

- (a) be determined for a portfolio of insurance contracts? Why or why not? If yes, should the portfolio be defined as in IFRS 4 (a portfolio of contracts that are subject to broadly similar risks and managed together as a single portfolio)? Why or why not?*
- (b) reflect the benefits of diversification between (and negative correlation between) portfolios? Why or why not?*

Our view is that diversification is fundamental to the way in which insurance business is managed. Diversification is often managed at a Group and entity level, and this should be reflected in financial statements accordingly with both Group and entity diversification effects measured. We therefore strongly believe that risk margins should reflect the effects of diversification and negative correlation between portfolios.

Question 12

- (a) Should a cedant measure reinsurance assets at current exit value? Why or why not?*
- (b) Do you agree that the consequences of measuring reinsurance assets at current exit value include the following? Why or why not?*

- (i) A risk margin typically increases the measurement of the reinsurance asset, and equals the risk margin for the corresponding part of the underlying insurance contract.*
- (ii) An expected loss model would be used for defaults and disputes, not the incurred loss model required by IFRS 4 and IAS 39.*
- (iii) If the cedant has a contractual right to obtain reinsurance for contracts that it has not yet issued, the current exit value of the cedant's reinsurance asset includes the current exit value of that right. However, the current exit value of that contractual right is not likely to be material if it relates to insurance contracts that will be priced at current exit value.*

We believe that the measurement of reinsurance assets should be on a consistent basis with the underlying gross insurance exposure. If the building-block approach is applied to inwards insurance liabilities, associated reinsurance assets should be measured on a similar basis but allowing for the matching of gross and inwards reinsurance exposure (i.e. allowing for the expected future purchase of reinsurance to match gross exposure already sold or future selling of gross business to match reinsurance contracts already purchased). We believe this would be consistent with the current ICA approach in the UK. Unless this matching is allowed for, potential issues may arise from the timing of recognition of insurance liabilities and related reinsurance.

The combination of the IAS 39 recognition criteria and the potential for day one profits arising from the building-block approach could result in disparity between the recognition of outwards reinsurance and the covered inwards business. For example, it is quite common for outwards reinsurance to be purchased at key renewal dates in the year with the underlying exposure sold evenly during the year. In these circumstances, the proposals in the Discussion Paper could result in losses or gains on the purchase of reinsurance that do not match the corresponding gains or losses on the inwards insurance, resulting in distorted net results.

We would also add the observation that the guidance on reinsurance forms a relatively small part of the Discussion Paper. For many insurers, outwards reinsurance is a fundamental part of the way in which business is managed, and it would therefore be helpful if this guidance were expanded.

Question 13

We have no comments on question 13.

Question 14

(a) Is the current exit value of a liability the price for a transfer that neither improves nor impairs its credit characteristics? Why or why not?

(b) Should the measurement of an insurance liability reflect

(i) its credit characteristics at inception and

(ii) subsequent changes in their effect?

Why or why not?

We do not believe that the measurement of the insurance liability should reflect credit characteristics. Whilst there may be theoretical arguments for adjusting for credit characteristics, we do not believe that users of the financial statements would expect such adjustments or find them useful.

Question 15

We have no comments on question 15.

Chapter 6 POLICYHOLDER PARTICIPATION

Question 16

We have no comments on question 16.

Question 17

We have no comments on question 17.

Chapter 7 CHANGES IN INSURANCE LIABILITIES

Question 18

Should an insurer present premiums as revenue or as deposits? Why?

For non-life insurance, we see no reason why an insurer should not present premiums as revenue.

Question 19

Which items of income and expense should an insurer present separately on the face of its income statement? Why?

We believe that the current guidance in IAS 1 and IFRS 4 is adequate in respect of income statement presentation. Any amendments to this guidance should be considered in conjunction with the IASB's Financial Statement Presentation project.

Question 20

Should the income statement include all income and expense arising from changes in insurance liabilities? Why or why not?

We believe that under current IFRS, it would be appropriate to include all income and expense arising from changes in non-life insurance liabilities in the income statement. As indicated above, the income statement presentation of insurance contracts may be affected by the IASB's Financial Statement Presentation project.

Other matters

Question 21

Do you have other comments on this paper?

We note that the Discussion Paper does not include extensive discussion of disclosures around insurance contracts. Appropriate disclosures will be essential to understanding insurance liabilities measured using the building-block approach. The disclosure principles in IFRS 4 provide a suitable basis for such disclosures, but further application or implementation guidance would be helpful, particularly around the uncertainty inherent in insurance liability measurement.