Financial Crisis Advisory Group Written submission from the Association of British Insurers

Introduction

- 1. The ABI is the voice of the insurance and investment industry in the UK. Its members constitute over 90 per cent of the insurance market in the UK and 20 per cent across the EU. They control assets equivalent to a quarter of the UK's capital. They are the risk managers of the UK's economy and society. Through the ABI their voice is heard in Government and in public debate on insurance, savings, and investment matters.
- 2. The ABI is grateful to the Financial Crisis Advisory Group for the opportunity to respond to its invitation for written submissions from constituents.

ABI comments

- 3. It is clear that the financial crisis has stress-tested accounting standards to an unprecedented degree. Bank lending, not financial reporting, lay at the heart of the crisis. But the crisis has shown the limitations of over-reliance on accounts as a basis for assessing risk and safe levels of leverage. They provide information at a point in time and cannot predict all risk. These limitations need to be recognised by regulators and investors alike. We believe that the regulation of banks does need to be strengthened and that the financial consequences should be openly reported. That reporting must be done separately within the financial statements so that transparency of reporting to investors on financial performance is retained.
- 4. It is also important to establish what must be preserved:
 - Firstly, the current consensus that general-purpose financial reporting needs to be global should be pursued vigorously. Transactions and balances should be reported in the same way across the world's capital markets. Complex rules are more likely to be misapplied or gamed and absolve management and auditors from exercising sound judgment and making the basis of that judgment transparent to investors. Key priorities for the Boards should therefore be the development of new principles-based accounting standards for financial instruments on a global basis.
 - Secondly, the purpose of financial reporting is to account to shareholders on the financial position and performance of which they are the owners and, in so doing, provide information to investors and other capital providers. The interests of other stakeholders such as regulators (whose interests are much narrower), may be served at the same time, but never by impairing the transparency of reporting to investors.
 - Thirdly, the confidence that investors need in general-purpose financial reports is achieved only if accounting-standard setters are truly independent and justify that independence by having effective governance and processes. The independence

of the IASB from political interference should be reaffirmed. And to preserve this in the future we favour the IASB being given a standing in international law, so that it has greater global legitimacy and freedom from political interference. Good processes include effective engagement with all stakeholders (including on priorities) and responsiveness to events.

5. Full details of these and other comments are given in the attached annex.

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- 1. From your perspective, where has general purpose financial reporting helped identify issues of concern during the financial crisis? Where has it not helped, or even possibly created unnecessary concerns? Please be as specific as possible in your answers.
- 1.1 We have not reached final conclusions on the role of general-purpose financial reporting in the financial crisis. But we share the view of many commentators that at the heart of the crisis, was bad lending by banks. General-purpose financial reporting may not have identified all issues arising from this bad lending. But it gave much relevant information, especially through fair values. Indeed, it seems that fair values gave earlier indications of the losses that were only reported later for assets that were held on bases other than fair value.
- 1.2 We note that the SEC's wide-ranging empirical analysis did not identify fair value accounting as being pivotal in the USA's experience, and we are inclined to think that the same is true of the UK. Further, we understand that fair value accounting was brought into US GAAP precisely because previous accounting practices hadn't helped users. In its absence, for example, most derivatives wouldn't appear on balance sheets. However, the failure in the USA to report fully exposures to SPVs may have had a bigger role in the crisis and this experience tends to suggest the need for global principles-based standards (with appropriate guidance) rather than narrowly rules-based and less international ones that may be more open to gaming.
- 1.3 We note also that very many criticisms of current accounting requirements in this context reflect a desire generally to achieve some sort of smoothing of performance reporting, rather than accounting for events as they occur. We do not share this view. Accounting assumptions and judgements should be prudently arrived at but this should not meant that real economic volatility should be eliminated from general purpose financial reporting.
- 1.4 This is, of course, not to say that the IASB's and FASB's accounting standards cannot continue to be improved, as both Boards acknowledge in a number of ways including the commissioning of the work of the Financial Crisis Advisory Group.
- 2. If prudential regulators were to require 'through-the-cycle' or 'dynamic' loan provisions that differ from the current IFRS or US GAAP requirements, how should general purpose financial statements best reflect the difference: (1) recognition in profit or loss (earnings); (2) recognition in other comprehensive income; (3) appropriation of equity outside of comprehensive income; (4) footnote disclosure only; (5) some other means; or (6) not at all? Please explain how your answer would promote transparency for investors and other resource providers.
- 2.1 The objective of general-purpose financial reporting is to meet the needs of investors by providing information that is neutral. We consider that their needs should override those of prudential regulators in the case of a conflict between

the two. A regulator's objective is narrower. It is primarily to ensure solvency and achieve its systemic concomitant, financial stability). By contrast, an investor wants not only solvency but also to achieve a good and sustainable return on their investment. Their information needs are therefore different in many respects. The shareholder, for example, requires information that may give confidence that returns are being generated in an appropriate fashion and, if not, which allows them to engage effectively and discharge their ownership responsibilities.

- 2.2 If a regulator requires information that is not given in general-purpose financial statements, it normally has powers to obtain this information directly. By contrast, an investor cannot do this and has to rely instead on the information given in financial statements.
- 2.3 A regulator is concerned with much more than loan provisions, and uses criteria to value an entity's assets and liabilities that are often quite different from those used in general-purpose financial reporting. The result is, for example, that goodwill appears in many balance sheets but scarcely ever in regulatory capital. Regulators may no more assume that the regulatory values of loan assets should be the same as in general-purpose financial statements than they do for other assets and liabilities.
- 2.4 It follows that general-purpose financial statements should not reflect regulatory-driven 'through-the-cycle' or 'dynamic' loan provisions if these do not meet the needs of the investor. The investor wants transparency and neutrality of information to be able to assess the quality of the assets that the entity holds. Further, the investor wants to be able to look at the performance of the entity and compare it across time and with that of other entities.
- 2.5 Current IFRS or US GAAP requirements use an 'incurred loss' model for financial assets carried at amortised cost, such as loans. An alternative 'expected loss' model may be considered by the IASB and FASB. We support the IASB/FASB review.
- 2.6 Under either the 'incurred-loss' model or 'expected-loss' model, we consider that the modelling should be based on the entity's cash flow projections, and not the regulator's. The transparency and neutrality that the investor requires would be impaired were the regulators' anti-cyclical buffers to distort performance reporting. Accordingly, we do not support either 'alternative (1) recognition in profit or loss (earnings)', or 'alternative (2) recognition in other comprehensive income'.
- 2.7 A regulator's capital requirements reflect a great deal more than its view of an entity's loans. They may, for example, even reflect the regulator's view of the quality of the entity's management. A change in a regulatory loan provision is likely to be only one factor driving a change in a capital requirement, and its impact might be more than offset by changes in other factors. To identify and report on one aspect only of a regulatory regime does not, in our view, give transparency to investors.
- 2.8 Further, because regulatory values need not be, and often are not, the same as accounting values, to present them as if they are comparably-based does not, in our view, serve the needs of the investor.

- 2.9 It is worth noting that accounting generally does not mix up different bases of reporting. In the UK, dividends may only be paid out of 'distributable reserves' which are not the same as 'accounting reserves' and are not disclosed in consolidated accounts. Also, tax in the UK is assessed against taxable profits, which are not the same as accounting profits. Further, the statutory accounts of a regulated utility (eg, a water company) in the UK do not include key regulatory asset values on its balance sheet, being its regulatory asset base (RAB). The RAB is a proxy value of a utility's regulated operating assets, upon which the owners of the utility earns a return, and it is one of the major building blocks of the cap to the prices that the utility can charge. Instead, separate regulatory accounts are produced that do show the regulatory asset base, and, accordingly, do not satisfy the legal requirement for the accounts to show a true and fair view for the benefit of investors.
- 2.10 Lastly, it is not easy to see that the inclusion of regulatory reserves in a consolidated balance sheet would, any case, make sense for a multinational enterprise with complex structures and varying regulatory requirements across the world. Accordingly, we do not support 'alternative (3) appropriation of equity outside of comprehensive income'. Further, for the reasons outlined above taken together, we would choose 'alternative (6) not at all', in relation to any specific proposal to highlight regulatory provisioning for loans.
- 2.11 However, we do think, however, that it is vital that the investor understands the impact of regulation more generally. We appreciate that regulation may be complex, and that it may not be appropriate to communicate all its effects clearly through general-purpose financial reporting. Nevertheless, as general-purpose financial statements are a primary vehicle for informing investors generally, so they may be a vehicle for appropriate reporting on the impact of regulation generally. Where this impact is significant in relation to loan loss provisions, this information might be expected to be communicated to the investor.
- 2.12 We suggest that the requirements for disclosures of externally imposed capital requirements in 'IAS 1, Presentation of Financial Statements' should be reviewed to see if they remain appropriate (we note that the IASB's original proposals were watered down), and that the resulting disclosures are required to be covered in the management commentary.
- 3. Some FCAG members have indicated that they believe issues surrounding accounting for off-balance items such as securitizations and other structured entities have been far more contributory to the financial crisis than issues surrounding fair value (including mark-to-market) accounting. Do you agree, and how can we best improve IFRS and US GAAP in that area?
- 3.1 We understand that the issue of non-consolidation of SPVs in 2008 appears to have been primarily a US GAAP problem rather than one arising under IFRSs, though there have been concerns that there was insufficient disclosure in IFRSbased accounts (US GAAP has had more detailed disclosure requirements than have IFRSs).
- 3.2 The IASB and the FASB are currently consulting on improvements to their consolidation standards, including in relation to SPVs and disclosure requirements. The effect would be, we understand, that there would be many more SPVs on US GAAP based balance sheets and better information for

- investors on the relationships between entities and their off-balance sheet SPVs in IFRS-based accounts, and on related risks.
- 3.3 In principle, the Board's current consultation should provide the basis on which to go forward. We note that the Boards have accelerated this project in order to deal with concerns arising from the financial crisis.
- 3.4 Further, we are concerned whether an appropriate balance has been struck between a proposed principal control criterion and identifying where risks and rewards lie, in order to determine what should be on-, or off-, balance sheet; and whether so much information may be required disclosed about off-balance sheet entities that real risks are obscured. As insurers with substantial investments, we have significant concerns about the Boards' proposals in relation to the investment funds that we primarily operate to manage policyholder funds in our long-term savings business.
- 3.5 We note a recent renewal of interest in 'linked-presentation' as being a possible way of disclosing a continuing involvement in otherwise derecognised assets. This is UK practice, and we think that it has generally been considered to be informative.
- 4. Most constituents agree that the current mixed attributes model for accounting and reporting of financial instruments under IFRS and US GAAP is overly complex and otherwise suboptimal. Some constituents (mainly investors) support reporting all financial instruments at fair value. Others support a refined mixed attributes model. Which approach do you support and why? If you support a refined mixed attributes model, what should that look like, and why, and do you view that as an interim step toward full fair value or as an end goal? Whichever approach you support, what improvements, if any, to fair value accounting do you believe are essential prerequisites to your end goal?
- 4.1 We consider that financial reporting generally provides most useful information when it reflects most closely the way the business is managed. As insurers, we would wish to apply this approach across the board, and so to financial instruments as well as to insurance contracts. We see this as being the way to achieve the Boards' simplification goal, and that of having new principles-based accounting standards, both of which goals we support emphatically.
- 4.2 We consider that fair value generally provides the most relevant information to investors for many types of financial instruments. We note that studies such as the SEC's have confirmed this to be generally the view of investors. However, entities also hold some financial assets and many financial liabilities to maturity, for which fair value would not be relevant. Further, particularly as insurers reporting under Phase 1 of the IASB's insurance accounting project, without a final accounting standard for insurance contracts due in Phase 2, we need such a mixed attribute model to limit accounting mismatches.
- 4.3 We do not, therefore, consider that the Boards should commit to a long-term goal of having all financial instruments at fair value. We support, instead, a mixed attributes model that is principles-based and reflects the business model of the entity concerned and the activity supported by the financial instrument. We highlight the need for improved impairment accounting The impairment basis of available for sale assets and subsequent reversal should be re-examined and treated consistently, and the IFRS and US GAAP rules aligned. There should be

principles for the exercise of any options to elect for different bases or for the prescription of a particular base such as for instruments that are tradable – including by the issuer, in the case of financial liabilities – that recognise the commensurate need for reversals.

- 4.4 Some commentators have criticised a business model basis on grounds that it hinders comparability between entities. Those that make this criticism tend to prefer classification criteria that depend on the characteristics of the financial instrument. We think this concern to be overplayed. The different characteristics of different financial instruments will tend to promote different business usage that it is appropriate to account for differently. Further, we think that, though there may be some differences between sectors, comparability will be greater within sectors and that this is more significant to investors. Lastly, we think that requirements can be made for information can be disclosed on the effects of having adopted a different business model for example, disclosing fair values for financial instruments held at amortised cost.
- 4.5 We recognise, however, that there are many issues to be explored in the course of the Boards' forthcoming financial instruments project that is to establish new principles-based standards. Not least, for the insurance industry, is the need for changes to those standards to be consistent with developments in insurance contract accounting standards. We are keen, as an industry, to assist the Boards in their endeavours.
- 5. What criteria should accounting standard-setters consider in balancing the need for resolving an 'emergency issue' on a timely basis and the need for active engagement from constituents through due process to help ensure high quality standards that are broadly accepted?
- 5.1 Due process is vital for standard setting public consultation at the two major stages of standard development (discussion paper and exposure draft), continuous engagement with key stakeholders, transparency of Board discussions which are open to all observers, engagement with advisory groups and the IASB does this very well. Reductions in due process could result in lower quality standards.
- 5.2 However, there are always likely to be some occasions when emergency issues do not allow the time required for normal due process. It may not be possible to pre-set criteria for assessing when a shortened process should be used. Judgment will always be the key, together with appropriate consultation and approval processes for proposals that meet account cost/benefit criteria and are practicable. Indeed, even emergencies require formal processes that include public consultation without any curtailment to focus on selected constituents.
- 5.3 The Boards can call upon the support of National Standard Setters, that they set out in their Communiqué of 14 November 2008;
- 5.4 Steps can be taken to reduce the risk of emergency due process. Emergency issues are less likely to arise if standard setters engage effectively not just on their standards but also on their standard setting agendas and priorities, and if they undertake continuous pro-active monitoring and are alert to emerging difficulties in applying standards which should receive remedial action quickly. We consider that the IASB should improve the way in which it consults on its agendas and priorities. Such consultation should not be limited to discussions with the IASCF Trustees and the Standards Advisory Council. It should instead

- be as full and public as the IASB uses for its projects to improve individual standards.
- 5.5 The IASB could also build in some flexibility into its timetable and resources, so that there is scope to address emergencies.
- 5.6 Lastly, we suggest that an accelerated process of post-implementation review should be followed, perhaps also with an adapted process, for all changes to standards adopted other than though normal due process.
- 6. Are there financial crisis-related issues that the IASB or the FASB have indicated they will be addressing that you believe are better addressed in combination with, or alternatively by, other organizations? If so, which issues and why, and which organizations?
- 6.1 We are not aware of any issue that the IASB has been considering but should not do. We consider that the IASB and the FASB should consult with a wide range of users, whilst reserving its independence as accounting standards setters.

7. Is there any other input that you'd like to convey to the FCAG?

Independent accounting standard setting

- 7.1 The importance of independence in standard setting cannot be overestimated (and particularly to investors' confidence). The recent changes in the IASCF's constitution have had this objective, amongst others.
- 7.2 However, the experience of last autumn, when the IASB was threatened by the EC with a carve-out, suggests that the IASB's legitimacy, and its ability to withstand political pressure, might be strengthened further were the IASB to be given a status in international law by international treaty, we suggest.

Responsiveness to investors' needs

7.3 Although the IASB's framework asserts the primacy of the investor interest in general-purpose financial reporting, we do not believe that this is reflected fully enough in its governance. Investors are not represented in the new Monitoring Board, and they are very much in a minority among the members of the IASCF, the SAC, and the IASB. This needs to be addressed with a firm resolve to ensure appropriate representation is achieved.

Cross-cutting issues

7.4 The IASB needs to work out a way of dealing more effectively with cross-cutting issues. These seem much to have impeded it progress in recent years – for example, liability measurement has been addressed over and over again in a range of projects eg liability measurement, affecting revenue, insurance, pensions, leases and IAS 37 liabilities. It is perhaps at least arguable that these the underlying conceptual issues should really be addressed fully in the IASB's conceptual framework project, to which therefore greater priority would need to be given.

The Boards' priorities

7.5 We suggest that the Boards should consult fully and publicly on their priorities. They have limited resources, and we consider that many stakeholders, including investors, would give rather different priorities to those of the Boards. We give three examples: of the general projects, we think that the replacement of their financial instruments standards with new, fully principles-based ones, is a maximum priority; and we think that the upgrading of IAS 1, Presentation of Financial Statements is not one. Users of accounts would wish the project on Management Commentary to be advanced. Of the specialised projects, we would give maximum priority to insurance contracts because of its place at the centre at of accounting developments and because what it would replace, IFRS 4, is manifestly inadequate.

Complexity of financial reporting

- 7.6 Annual financial reports, including financial statements, are too long and complex, and have become more so as accounting standards have changed. They often to run to hundreds of pages. We think that key messages must inevitably be obscured. Although the IASB aims for greater simplicity in accounting standards, for example in the recognition and measurement requirements for financial instruments, it is more important that accounts themselves are simpler that is, more focused.
- 7.7 This complexity has, in turn, made the whole process of consultation on the development of new standards more challenging, and this undermines the ability of many users of accounts to contribute effectively in this regard and for their voice to be heard.