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Consultation Document

A response by

UK Society of Investment Professionals

About UKSIP

The UK Society of Investment Professionals ("UKSIP") is a professional organisation whose main aim is to foster and maintain high standards of professional ability and practice in investment analysis, portfolio management and related disciplines. It currently has over 4,500 members, who work or have an interest in the UK financial services industry. UKSIP is the second largest member society worldwide of the CFA Institute, and the largest in Europe. CFA Institute is a global non-profit organisation of more than 67,000 investment professionals, and is best known as the organisation that develops and administers the Chartered Financial Analyst (CFA©) Program.

UKSIP also oversees the Investment Management Certificate ("IMC"), the benchmark qualification for those working in investment management in the UK and currently held by over 15,000 investment professionals. UKSIP members who successfully completed UKSIP's former Associate examination, which was similar to the CFA, can use the designation ASIP.

About this Response

UKSIP's Accounting Advocacy Committee, under whose direction this response has been compiled, is grateful for the opportunity to comment.

Accounting for life assurance is a very important issue for shareholders, policyholders and indeed, given their central role in the savings industry, for Society as a whole. Accounting for life assurance is also highly complex.

It is quite clear that the levels of disclosure of life assurance businesses have been inadequate for some time. Indeed recent voluntary disclosures to the capital markets by “troubled“ companies, such as Royal & Sun Alliance and Abbey, have thrown refreshing new light upon the particular positions of their life funds.

There also seems to be a real concern from recent events that the financial complexity of the businesses may even have overtaken individual management teams themselves and this has been a part of the process that has required, the Financial Services Authority (FSA), to construct and adopt the new “realistic” basis regulation. UKSIP has long believed that good financial reporting by companies can help managers to manage their businesses more successfully. In these circumstances, it seems inconsistent for the companies to continue to produce financial information on one basis for shareholders and policyholders, whilst also publishing additional financial information on another - deemed “realistic” - basis for their regulator as the basis of their statutory supervision.

Indeed, it could be argued that the opacity of historical regulatory information has also hindered the understanding of these companies by the intelligent, interested outsider. Whilst the reporting required by a regulator may not always form the basis for reporting to shareholders, it does seem that, since regulatory supervision has made such great improvements, it is appropriate that such accounting developments are reflected in basic financial reporting to shareholders.

UKSIP also has significant reservations about the whole Embedded Value approach, despite the recent acknowledgement of some deficiencies by the entities themselves. Whilst it is very valuable for management and shareholders to have an understanding of the value of the in-force book of business based on a complex set of highly sensitive and inter-related assumptions, it does not seem appropriate to the Society that this should form the basis of statutory reporting. In particular, there is a complete disconnect between profit and the cash generated by the business in the Embedded Value model. It is worth noting that, in recent years, most large quoted Life Assurance businesses have reduced or eliminated their dividends to shareholders. Moreover, there is now an inconsistent treatment of Embedded Values between the life assurers and the bancassurers which does not make for good financial reporting.

UKSIP therefore supports the ASB’s two stage approach to tackle this issue. Urgent change is long overdue and the status quo is no longer acceptable. Given the complex nature of the issue, UKSIP agrees that an immediate interim step should be taken to improve current reporting, provided the ASB continues to participate in the IASB’s longer term project of improvement.

Incorporating the changes in 2004 reporting will clearly cause some immediate timing difficulties for the companies involved, especially given the very recent evolution of the FSA’s “realistic” approach. However, it seems that this may only apply to the first year of operation and since the basis of reporting is likely to remain unchanged for a considerable period thereafter, UKSIP hopes an acceptable solution to the short term timing difficulty could be found.

As Lord Penrose said in his report on Equitable Life:

> *“Proposals, exposure drafts and similar consultation exercises are not a substitute for normative standards. The continuing failure to produce acceptable standards and secure their implementation is a failure in a professional duty owed to the public…..Those with the responsibility to produce appropriate standards must have it impressed on them that what is required are practical standards of general application that will provide consumers of accounting information and their advisers with the ready means of assessing the financial positions of the providers of financial products. A search for perfection in this area will fail. To await agreement among the wide range of interests affected will involve interminable delay.”*

In summary, therefore, UKSIP considers the proposed new capital statement a considerable advance on current reporting and that the proposals to incorporate elements of the FSA realistic basis as a methodology for valuing certain assets and liabilities to be a significant step forward and has the Society's full support.

Response to questions

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)?*

Agreed.

(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?*

UKSIP agrees that in the present circumstances such a pragmatic approach is appropriate.

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

Given that they form the basis of regulation UKSIP certainly hopes so.

(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?*

UKSIP is not aware of any.

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?*

Agreed.

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

UKSIP has no comment to make.

(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?*

UKSIP has no comment to make.

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?*

Agreed.

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

Agreed.

(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?

UKSIP has no comment to make.

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?*

Agreed.

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?*

UKSIP is not in favour of allowing any entity to incorporate Embedded Value results within its statutory accounts. UKSIP would not, therefore, want the value of the in-force book, as presently estimated, to be included within the statutory accounts at all. Nevertheless it may be necessary in the short term to allow the bancassurers to continue to include something even if it is less than satisfactory. Accordingly, UKSIP reluctantly supports the measures proposed as a short term expedient only.

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

See (a)

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

See (a)

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?*

UKSIP believes that it is appropriate for the Board to require these valuation methods but accepts that in the short term it may not be practicable.

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

Agreed.

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

UKSIP has no comment to make.

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

UKSIP has no comment to make.

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?*

Agreed.

(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?*

Agreed.

(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?*

Agreed.

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

Agreed.

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?*

UKSIP has no comment to make.

(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?*

UKSIP would prefer the regulatory rather than management estimates, as they might generate a degree of certainty and comparability in these particular circumstances.

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?*

This would seem to be a fair approach.

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

Yes.

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?*

Agreed.

(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?*

Agreed.

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?

Normally the Society insists on full comparatives. Given the present short term timing difficulties for the companies involved, the lack of full comparatives would be acceptable provided that there were no other substantive changes to the Board's proposals.

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