THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

5 June 2009

Our ref: ICAEW Rep 69-09

Your ref: CEIOPS-CP-35/09

CEIOPS
Westhafenplatz 1
60327 Frankfurt am Main
Germany

By email: Secretariat@ceoips.eu

Dear Sirs

The Institute of Chartered Accountants in England and Wales (the ICAEW) is pleased to respond to your request for comments on the *Consultation Paper No. 35 Draft CEOIPS' Advice for Level 2 Implementing Measures on Solvency II: Valuation of Assets and 'Other Liabilities'*.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours faithfully

Shamim Diouman
Manager, Risk and Regulation
T +44 (0)20 7920 8412
F +44 (0)20 7920 8768
E shamim.diouman@icaew.com

THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

ICAEW Representation

ICAEW REP 69/09

CONSULTATION PAPER NO. 35: DRAFT CEIOPS' ADVICE FOR LEVEL 2 IMPLEMENTING MEASURES ON SOLVENCY II: VALUATION OF ASSETS AND 'OTHER LIABILITIES'

Memorandum of comment submitted in June 2009 by The Institute of Chartered Accountants in England and Wales, in response to the Consultation Paper No.35: Draft CEIOPS Advice for Level 2 Implementing Measures on Solvency II: Valuation of Assets and 'Other Liabilities' published in March 2009.

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Chartered Accountants' Hall
PO Box 433 Moorgate Place London EC2P 2BJ
www.icaew.com

T +44 (0)20 7920 8100
F +44 (0)20 7920 0547
DX DX 877 London/City

INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales (the ICAEW) welcomes the opportunity to comment on *Consultation Paper No.35: Draft CEIOPS' Advice for Level 2 Implementing Measures on Solvency II: Valuation of Assets and 'Other Liabilities'.*

WHO WE ARE

2. The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 132,000 members in more than 165 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 775,000 members worldwide.

3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The Institute ensures these skills are constantly developed, recognised and valued.

4. The ICAEW's Financial Services Faculty was established in 2007 to become a world class centre for thought leadership on issues and challenges facing the financial services industry, acting in the public interest and free from vested interests. It draws together professionals from across the financial services industry and from the 25,000 ICAEW members specialising in the sector. This includes those working for regulated firms, in professional services firms, intermediaries, and regulators.

MAJOR POINTS

VALUATION ADJUSTMENTS FOR SOLVENCY PURPOSES

5. We strongly agree with the use of IFRS as endorsed in the EU as the reference framework for these valuations. This provides a coherent basis for valuations and should enable a minimal need for restatement from financial statements. Although we recognise that Article 74 requires arm's length values we recommend that as far as possible any values permitted by IFRS are used even if they may not be strictly based upon a fair value.

6. We agree that it will be important for Level 3 guidance to be produced to address changes to IFRS as it evolves.

7. It would be helpful if the Level 3 guidance could identify areas where local GAAP is inconsistent with IFRS. This should assist insurers and supervisors in identifying additional valuations that require adjustment to align with Solvency requirements.

8. As an overview matter it would be helpful to clarify that the valuation principles in this CP only need to be applied if an asset is to be taken into account for solvency purposes. This would clarify that an insurer has the option of excluding an asset for solvency purposes rather than entering into cost and effort to meet

valuation requirements if the insurer is willing to exclude the asset for solvency purposes.

9. With regard to proportionality it would be helpful to clarify what amounts would be considered not significant to require valuation adjustment. Ideally this might be an amount of say 1% of the balance sheet total possibly with an amount limit as well. If the value of a class of assets were below this limit it could be considered that the value of those assets (which have obviously met an accounting test to be included on the balance sheet in the first place) could be accepted as sufficiently insignificant that they would not undermine the overall fair value requirements of the Level 1 text for the balance sheet even if this small element of the total assets had not been specifically subjected to fair value. With regard to proportionality, where fair value is only being used to support a carrying value in financial statements it seems reasonable that a less onerous test of fair value should be applied compared to circumstances where an insurer is seeking to establish an asset value for solvency above that used in its financial statements?

10. Does 'when required' refer to required by circumstance or required by supervisors? In either case guidance would be helpful regarding what is considered to be a significant change in terms of percentage or amount that should prompt such an independent valuation.

11. Without clear guidance it is difficult to identify when a further constraint should be applied to the value of an asset for liquidity or uncertainty. For simplicity such required adjustments should only be required where it is readily identifiable there is a significant constraint. Within the calculation of capital requirements there should be flexing for liquidity and uncertainty of balance sheet values which should address this issue on a more general basis which should be sufficient in circumstances other than where there is a specific issue with a significant asset.

GOODWILL ON ACQUISITIONS

12. We agree that it is reasonable to value goodwill to have a nil value for solvency.

13. We agree that it is reasonable to value future profits other than those that are part of the valuation of technical provisions at nil for solvency.

INTANGIBLE ASSETS

14. Although it seems reasonable (subject to any proportionality exemption) for intangible assets to be treated as nil if fair value cannot be demonstrated.

15. Within intangible assets there will often be purchased software or similar purchased assets. Where this is amortised over a small number of years (say 5 or less) the treatment for fixed assets that we suggest in our response to *paragraph 3.61* below might be reasonable.

16. Likely intangible assets might typically include software, brand values, licences and patents; many of these may be difficult to demonstrate a market value for but may have a clear cost and a defined useful life. A particular asset that may apply to several UK insurers is Lloyd's auction capacity. This has a market that provides observable prices each year from trading during a few months each summer. These prices are reasonably transparent, but the market can be fairly illiquid and there is no trading at the typical 31 December year-end for insurers. It would be useful to provide guidance as to whether this is considered an adequate

indicator of market value (as impairment should have been considered in arriving at the financial statement value).

PROPERTY, PLANT AND EQUIPMENT

17. With the exception of sometimes property, these classes of assets are usually valued in the financial statements at amortised costs. Within plant and equipment there is typically likely to be a large number of small value assets such as vehicles, computer equipment and furniture. Such assets are typically amortised over a small number of years (5 or less). It would potentially be burdensome for insurers to identify and document fair values for all of these assets. With proportionality in mind provided such assets did not comprise more than a given percentage of the balance sheet value (say 2%) could the amortised cost be considered to be a close enough proxy for fair value for such assets without any further proof provided they are amortised over a maximum of say 5 years, since impairment and useful lives will have been considered within the financial accounting values. Without such a concession the current fair value requirement may force many insurers to accept a nil value as the effort to demonstrate fair value may be excessive.

18. For property and some other assets in this class there may be higher value individual assets that are amortised over an economic life of a larger number of years. Where such assets exceed a certain level as a proportion of the total balance sheet or a monetary amount, it seems appropriate that external evidence of a fair value should be required.

PARTICIPATIONS/ASSOCIATES, SUBSIDIARIES AND JOINT VENTURES, SPVS

19. In *paragraph 3.80*, we believe that the word ‘entirely’ should read ‘entirety’.

20. In *paragraph 3.81 (iv)*, if this requirement is to be applied further explanation of what this requirement is anticipated to involve and its proportionality would be helpful.

21. In *paragraph 3.84*, in most cases these assets will be included in the insurer’s financial statements on basis similar to the other assets described in this CP, subject to there being no differences between local GAAP and IFRS. This would seem to be an appropriate framework from which to start for such assets. Any attempt to value such entities on a fair value basis may significantly inflate the value of the asset from its carrying value in the financial statements unless they are already valued on that in accordance with IFRS and their circumstances. As commented elsewhere in our response it would be helpful if there could be a de minimis applied below which further detailed evaluation of the make up of the asset value is not required. This should help to avoid significant expense and time being incurred for little risk or benefit. Above that threshold it does seem appropriate that there should be a requirement for consistency with this CP’s principles for valuing assets and other liabilities. Otherwise there is a risk of inappropriate and inconsistent valuation bases being allowed merely because of the structural differences between one entity and another. Such increases in value may be similar to goodwill which is ascribed a nil value for solvency.

FINANCIAL ASSETS

22. *International Accounting Standards 39 Financial Instruments: Recognition and Measurement (IAS 39)* is currently under review and this together with insurers’

reaction to the financial crisis may lead to an increased number of financial instruments being classified as held to maturity. As such assets are required to be reviewed for impairment in accordance with *IAS39,* there should be limited scope for such assets being held at values below ultimate maturity values. In such circumstances could such assets be considered to be valued at a value that is not significantly greater than their arm's length exchange value without the need to conduct a full fair value calculation? This would potentially avoid incurring significant time and expense and would potentially reduce volatility of asset prices. It would however introduce a risk of assets being included for solvency at above their fair value at least in the short term.

23. Within financial assets most insurers will hold loans and receivables including items such as premium debts, reinsurance recoveries due and prepayments of expenses which are not specifically held at fair value. There will typically be many small items comprising such amounts. It will be difficult to fully demonstrate that all amounts are shown at their fair value, even though allowance should have been made within the financial statements for any amounts considered irrecoverable. To avoid disproportionate effort or potential disallowances for such items could their valuation according to *IAS39* be permitted to be a proxy for fair value? There should possibly be a safeguard requirement for additional requirements to demonstrate fair value where the asset is not receivable within 12 months.

24. It would be helpful if the guidance could explain whether and how hedging can be taken into account within valuing financial assets. If so is this to be consistent with *IAS39* and if there are any additional constraints on their use and valuation further guidance would be helpful.

CONTINGENT ASSETS AND LIABILITIES

25. Within *IAS37* it is permitted not to make a provision in exceptional circumstances where no reliable estimate can be made. If such possible amounts were significant this could lead to a need to reflect such uncertainties in the audit opinion. It seems to us that in such circumstances solvency requirements should more forcefully require an estimate to be made and full disclosure of the relevant uncertainties and possible outcomes required to be disclosed.

26. It is not clear what *paragraph 3.104* in the CP is seeking to achieve.

DEFFERED TAX ASSETS AND LIABILITIES

27. We agree that it is prudent and reasonable to only recognise deferred tax assets and liabilities to the extent they are linked to specific identifiable assets or liabilities in the balance sheet. We do not think that identifying the amounts to adjust figures within the financial statements by to recognise this restriction would not be unduly burdensome.

28. It would be consistent with *IAS12* to allow the recognition of unused tax credits and tax losses to the extent that future profits are probable. However if future financial difficulties emerged which solvency is intended to protect against the future profits may not arise. It may also be more difficult to support the argument that such amounts of deferred tax are at their fair value.

29. We agree that it is reasonable to follow *IAS12* and not discount deferred tax assets and liabilities as a result of the potential uncertainties involved.

OTHER FINANCIAL LIABILITIES AND AMOUNTS PAYABLE

30. We agree that Approach 2 avoids a number of abnormalities in valuations that would otherwise be likely to arise for issued debt. This would also potentially avoid a need for complicated adjustments to amounts as presented in financial statements.

POST EMPLOYMENT BENEFITS

31. As this is an area that is presently under review within IFRS it does not seem appropriate to develop any separate rules for solvency at the present time. There is likely to be significant expense and effort required for insurers to generate an alternative valuation to that required by *IAS19*. Unless there are particular concerns that supervisors feel must be addressed, amending the *IAS19* requirements may represent considerable effort to address issues that may diminish as *IAS19* evolves. Only if the variations to *IAS19* are simple to address should they be introduced at this time, such as not permitting the corridor if that was considered unacceptable.

APPENDIX

32. The above comments are provided in the CEIOPS template in the Appendix below.

Email: shamim.diouman@icaew.com

APPENDIX - CONSULTATION PAPER NO.35 – VALUATION OF ASSETS AND 'OTHER LIABILITIES'

Comments on Consultation 35-09 Draft Advice on Valuation of Assets and 'Other Liabilities'		
Name company: Institute of Chartered Accountants in England and Wales		
Please insert your comments in the table below, and send it to secretariat@ceiops.eu in word format. In order to facilitate processing of your comments, we would appreciate if you could refer to the relevant section and/or paragraph in the Consultation Paper 35-09.		
Page No.	**Reference**	**Comment**
12	3.22	We strongly agree with the use of IFRS as endorsed in the EU as the reference framework for these valuations. This provides a coherent basis for valuations and should enable a minimal need for restatement from financial statements. Although we recognise that Article 74 requires arm's length values we recommend that as far as possible any values permitted by IFRS are used even if they may not be strictly based upon a fair value.
12	3.23	We agree that it will be important for Level 3 guidance to be produced to address changes to IFRS as it evolves.
12	3.24	It would be helpful if the Level 3 guidance could identify areas where local GAAP is inconsistent with IFRS. This should assist insurers and supervisors in identifying additional valuations that require adjustment to align with Solvency requirements.
12	3.24	As an overview matter it would be helpful to clarify that the valuation principles in this CP only need to be applied if an asset is to be taken into account for solvency purposes. This would clarify that an insurer has the option of excluding an asset for solvency purposes rather than entering into cost and effort to meet valuation requirements if the insurer is willing to exclude the asset for solvency purposes.
12	3.24	With regard to proportionality it would be helpful to clarify what amounts would be considered not significant to require valuation adjustment. Ideally this might be an amount of say 1% of the balance sheet total possibly with an amount limit as well. If the value of a class of assets were below this limit it could be considered that the value of those assets (which have obviously met an accounting test to be included on the balance sheet in the first place) could be accepted as sufficiently insignificant that they would not undermine the overall fair value requirements of

		the Level 1 text for the balance sheet even if this small element of the total assets had not been specifically subjected to fair value. With regard to proportionality, where fair value is only being used to support a carrying value in financial statements it seems reasonable that a less onerous test of fair value should be applied compared to circumstances where an insurer is seeking to establish an asset value for solvency above that used in its financial statements?
13	3.32	Does "when required" refer to required by circumstance or required by supervisors. In either case guidance would be helpful regarding what is considered to be a significant change in terms of percentage or amount that should prompt such an independent valuation.
13	3.33	Without clear guidance it is difficult to identify when a further constraint should be applied to the value of an asset for liquidity or uncertainty. For simplicity such required adjustments should only be required where it is readily identifiable there is a significant constraint. Within the calculation of capital requirements there should be flexing for liquidity and uncertainty of balance sheet values which should address this issue on a more general basis which should be sufficient in circumstances other than where there is a specific issue with a significant asset.
15	3.41	We agree that it is reasonable to value goodwill to have a nil value for solvency.
15	3.42	We agree that it is reasonable to value future profits other than those that are part of the valuation of technical provisions at nil for solvency.
16	3.47	Although it seems reasonable (subject to any proportionality exemption) for intangible assets to be treated as nil if fair value cannot be demonstrated
16	3.47	Within intangible assets there will often be purchased software or similar purchased assets. Where this is amortised over a small number of years (say 5 or less) the treatment for fixed assets that we suggest in our response to paragraph 3.61 below might be reasonable.
16	3.48	Likely intangible assets might typically include software, brand values, licences and patents; many of these may be difficult to demonstrate a market value for but may have a clear cost and a defined useful life. A particular asset that may apply to several UK insurers is Lloyd's auction capacity. This has a market that provides observable prices each year from trading during a few months each summer. These prices are reasonably transparent, but the market can be fairly illiquid and there is no trading at the typical 31 December year-end for insurers. It would be useful to provide guidance as to whether this is considered an adequate indicator of market value (as impairment should have been considered in arriving at the financial statement value).
18	3.61	With the exception sometimes of property, these classes of assets are usually valued in the financial statements at amortised cost. Within plant and equipment there is typically likely to be a large number of small value assets such as vehicles, computer equipment and furniture. Such assets are typically amortised over a small number of years (5 or less). It would potentially be burdensome for insurers to identify and document fair values for all of these assets.

		With proportionality in mind provided such assets did not comprise more than a given percentage of the balance sheet value (say 2%) could the amortised cost be considered to be a close enough proxy for fair value for such assets without any further proof provided they are amortised over a maximum of say 5 years, since impairment and useful lives will have been considered within the financial accounting values. Without such a concession the current fair value requirement may force many insurers to accept a nil value as the effort to demonstrate fair value may be excessive. For property and some other assets in this class there may be higher value individual assets that are amortised over an economic life of a larger number of years. Where such assets exceed a certain level as a proportion of the total balance sheet or a monetary amount, it seems appropriate that external evidence of a fair value should be required.
21	3.80	We believe the word “entirely” should read “entirety”.
21	3.81 (iv)	If this requirement is to be applied further explanation of what this requirement is anticipated to involve and its proportionality would be helpful.
22	3.84	In most cases these assets will be included in the insurer’s financial statements on basis similar to the other assets described in this CP, subject to there being no differences between local GAAP and IFRS. This would seem to be an appropriate framework from which to start for such assets. Any attempt to value such entities on a fair value basis may significantly inflate the value of the asset from its carrying value in the financial statements unless they are already valued on that in accordance with IFRS and their circumstances. As commented elsewhere in our response it would be helpful if there could be a de minimis applied below which further detailed evaluation of the make up of the asset value is not required. This should help to avoid significant expense and time being incurred for little risk or benefit. Above that threshold it does seem appropriate that there should be a requirement for consistency with this CP’s principles for valuing assets and other liabilities. Otherwise there is a risk of inappropriate and inconsistent valuation bases being allowed merely because of the structural differences between one entity and another. Such increases in value may be similar to goodwill which is ascribed a nil value for solvency.
23	3.94	IAS39 is currently under review and this together with insurers’ reaction to the financial crisis may lead to an increased number of financial instruments being classified as held to maturity. As such assets are required to be reviewed for impairment in accordance with IAS39, there should be limited scope for such assets being held at values below ultimate maturity values. In such circumstances could such assets be considered to be valued at a value that is not significantly greater than their arm’s length exchange value without the need to conduct a full fair value calculation? This would potentially avoid incurring significant time and expense and would potentially reduce volatility of asset prices. It would however introduce a risk of assets being included for solvency at above their fair

		value at least in the short term.
23	3.94	Within financial assets most insurers will hold loans and receivables including items such as premium debts, reinsurance recoveries due and prepayments of expenses which are not specifically held at fair value. There will typically be many small items comprising such amounts. It will be difficult to fully demonstrate that all amounts are shown at their fair value, even though allowance should have been made within the financial statements for any amounts considered irrecoverable. To avoid disproportionate effort or potential disallowances for such items could their valuation according to IAS39 be permitted to be a proxy for fair value. There should possibly be a safeguard requirement for additional requirements to demonstrate fair value where the asset is not receivable within 12 months.
23	3.94	It would be helpful if the guidance could explain whether and how hedging can be taken into account within valuing financial assets. If so is this to be consistent with IAS39 and if there are any additional constraints on their use and valuation further guidance would be helpful.
25	3.103	Within IAS37 it is permitted not to make a provision in exceptional circumstances where no reliable estimate can be made. If such possible amounts were significant this could lead to a need to reflect such uncertainties in the audit opinion. It seems to us that in such circumstances solvency requirements should more forcefully require an estimate to be made and full disclosure of the relevant uncertainties and possible outcomes required to be disclosed.
25	3.104	It is not clear what this paragraph is seeking to achieve.
27	3.117	We agree that it is prudent and reasonable to only recognise deferred tax assets and liabilities to the extent they are linked to specific identifiable assets or liabilities in the balance sheet. We do not think that identifying the amounts to adjust figures within the financial statements by to recognise this restriction would not be unduly burdensome.
27	3.118	It would be consistent with IAS12 to allow the recognition of unused tax credits and tax losses to the extent that future profits are probable. However if future financial difficulties emerged which solvency is intended to protect against the future profits may not arise. It may also be more difficult to support the argument that such amounts of deferred tax are at their fair value.
28	3.122	We agree that it is reasonable to follow IAS12 and not discount deferred tax assets and liabilities as a result of the potential uncertainties involved.
31	3.140	We agree that Approach 2 avoids a number of abnormalities in valuations that would otherwise be likely to arise for issued debt. This would also potentially avoid a need for complicated adjustments to amounts as presented in financial statements.
34	3.155	As this is an area that is presently under review within IFRS it does not seem appropriate to develop any separate rules for solvency at the present time. There is likely to be significant expense and effort required for insurers to generate an alternative valuation to that required by IAS19. Unless there are particular concerns that supervisors

		feel must be addressed, amending the IAS19 requirements may represent considerable effort to address issues that may diminish as IAS19 evolves. Only if the variations to IAS19 are simple to address should they be introduced at this time, such as not permitting the corridor if that was considered unacceptable.