Australian Government
Australian Accounting Standards Board

Staff paper

Measurement of assets backing insurance liabilities under the forthcoming IFRS 17

1. This paper:

   (a) provides an overview of the measurement requirements for assets backing insurance liabilities;

   (b) summarises the accounting policies of Australian and New Zealand insurers in relation to asset measurement;

   (c) analyses positives for either circumscribing or not circumscribing the accounting for assets backing insurance liabilities; and

   (d) seeks a Board decision on whether to retain the existing Australian and New Zealand requirements for measuring assets backing insurance liabilities in the forthcoming IFRS 17 *Insurance Contracts*.

Overview

2. The existing IFRS 4 (first issued in 2004) includes only high-level requirements and largely allows for the grandfathering of existing national insurance GAAP. Accordingly, when IFRS were adopted in Australia and New Zealand, both jurisdictions made sufficient amendments to address the high-level requirements of IFRS 4 and retained most of their national insurance GAAP.

3. At the time of adopting IFRS, Australia's and New Zealand's insurance GAAP included requirements to measure assets backing insurance liabilities at fair value through profit or loss (FVPL). The extent to which assets backing insurance liabilities could be measured at FVPL was constrained at the margins by IFRS dealing with asset measurement, but within those constraints, both jurisdictions decided to retain their asset measurement approach. Appendix A and Appendix B to this paper include the relevant extracts on measuring assets backing insurance liabilities under AASB 1023 *General Insurance Contracts* and AASB 1038 *Life Insurance Contracts*.[1]

4. The forthcoming IFRS 17 requires a largely current value measurement of insurance liabilities but, in common with the existing IFRS 4, has no specific requirements for measuring assets backing insurance liabilities.

5. The forthcoming IFRS 17 is intended to completely replace national GAAP. Accordingly, it is relevant for the Board to discuss whether the existing Australian/New Zealand

1 NZ IFRS 4 includes Appendix C *Life Insurance Entities* and Appendix D *Financial Reporting of Insurance Activities* that with some minor exceptions are the same as AASB 1038 and AASB 1023.

approach to measuring assets backing insurance liabilities should be retained, assuming the forthcoming IFRS 17 is adopted.

6. The impact of not requiring assets backing insurance liabilities to be measured at FVPL is that they could choose to measure such assets on the bases permitted in IFRS, including FVPL, fair value through other comprehensive income (FVOCI) or cost/amortised cost.

7. In broad terms, insurers will be able to reclassify financial instruments from one measurement basis to another on transition to the forthcoming IFRS 17. Based on the IASB's Feedback Statement, insurers will be:

   (a) permitted to newly designate financial assets under the fair value option as measured at fair value through profit or loss to eliminate (or significantly reduce) an accounting mismatch according to paragraph 4.1.5 of IFRS 9;

   (b) revoke previous fair value option designations for financial assets if the accounting mismatch that led to the previous designation according to paragraph 4.1.5 of IFRS 9 no longer exists;

   (c) permitted to newly designate an investment in an equity instrument as measured at fair value through OCI and revoke previous designations; and

   (d) permitted to newly assess the business model for managing financial assets that are accounted for in accordance with IFRS 9 and that the entity designates as related to contracts within the scope of IFRS 4 or within the scope of the new insurance contracts Standard.

8. What is not yet clear is whether the reclassification of other investments, such as investment property and interests in associates and joint ventures might be a transitional issue that needs to be specifically addressed by the IASB. Anecdotally, Australian and New Zealand insurers tend not to hold a material amount of their investments as direct property or associates or joint ventures, and staff plan to undertake more research in this area.

Accounting Policies of Australian and New Zealand Insurers

9. Practice has developed in Australia and New Zealand around what constitutes 'assets backing insurance liabilities'. Entities tend to regard all the assets they need to operate the insurance business as being assets backing insurance liabilities, including assets held to meet prudential requirements. Staff researched a sample of the accounting policies of Australian and New Zealand insurers identified in their most recent annual reports.

10. AMP, IAG, QBE and Suncorp each disclose accounting policies to the effect that all investment assets held to back insurance liabilities are managed and performance evaluated on a fair value basis in accordance with risk management strategies to the extent permitted under Australian Accounting Standards. Specifically, the accounting policy of QBE notes that:

    > Investment assets are designated as either assets that back insurance liabilities (policyholders' funds) or assets that back shareholders' funds. Investments are designated as fair value through profit or loss on initial recognition, being the cost of

acquisition excluding transaction costs, and are subsequently remeasured to fair value at each reporting date. [QBE Annual Report 2014-15, page 117]

11. Similarly, Tower Insurance New Zealand discloses that:

> The Group has determined that all assets within its insurance companies are held to back insurance liabilities, with the exception of property, plant and equipment and investments in operating subsidiaries. These assets are managed in accordance with approved investment mandate agreements on a fair value basis and are reported to the Board on this basis. [Tower Insurance New Zealand Annual Report 2014-15, page 41]

12. Public sector insurers disclose similar accounting policies. For example, the Victorian Transport Accident Commission (TAC) discloses that:

> The TAC has determined that all assets, except for plant and equipment and intangibles, are held to back insurance liabilities. Investments are designated at fair value through the comprehensive income statement on the basis that the investments are managed as a portfolio based on their fair values, and have their performance evaluated in accordance with documented risk management and investment strategies (refer note 9). Initial recognition is at cost in the balance sheet and subsequent measurement is at fair value with any resultant unrealised profits and losses recognised in the comprehensive income statement. [TAC Annual Report 2015, page 36]

13. Mutual insurers disclose similar accounting policies. For example, Farmers' Mutual Group (NZ) notes:

> As general insurance contract liabilities are measured as described in these accounting policies, assets backing such liabilities are measured at fair value, to the extent permitted under accounting standards. Realised and unrealised gains and losses arising from changes in the fair value are recognised in the income statement, to the extent permitted under accounting standards. The accounting policies for individual asset classes, and any restrictions on application of fair value, are described in the statement of accounting policies. [Farmers' Mutual Group Annual Report 2015, page 15]

Analysis

14. There are good reasons for either continuing or not continuing with the existing requirements for assets backing insurance liabilities assuming the forthcoming IFRS 17 is adopted.

15. Staff have identified the following benefits associated with retaining the existing requirements for assets backing insurance liabilities to be measured at FVPL under the forthcoming AASB 17 *Insurance Contracts*.

    (a) Consistent with existing Australian/New Zealand insurance GAAP, the liability measurement under the forthcoming AASB 17/IFRS 17 is largely a current value basis, with most movements in current value being recognised in profit or loss as they occur. Accordingly, a consistent fair value approach for asset and liability measurement would provide for a consistent reporting of earnings, which therefore could mean more useful profit or loss information. In broad terms, having different measurement bases on either side of the balance sheet can lead to spurious volatility in earnings because different measures lead to inconsistent asset/liability accounting responses to the same economic event(s).

(b) Insurers tend to have an objective of maximising investment returns in order to help them fund lower premiums and gain market share or generate better profits for owners. This can be particularly important for many public sector insurers and mutual private sector insurers that operate on a break-even basis after taking into account expected long-term investment returns. Given this is a core activity, total investment performance for the period should be reflected in the profit or loss.

(c) In Australia, APRA requires FVPL asset measurement for capital adequacy reporting. Allowing assets to be measured at other than FVPL would create a potential difference from APRA reporting.

(d) In Australia, given the emphasis on market value reporting under Government Finance Statistics, AASB 1049 *Whole of Government and General Government Sector Financial Reporting* would require FVPL measurement for investment assets of government-controlled insurers consolidated into whole of government and general government sector financial statements. It would be potentially costly and confusing if the government-controlled insurers, as separate entities, did not also apply FVPL measurement for those assets.

(e) If the constraint on measuring assets backing insurance liabilities at FVPL is retained, there will be greater consistency between the financial reports of Australian and New Zealand insurers' asset measurement (assuming both boards agree to retain the constraint).

16. Staff have identified the following benefits associated with not circumscribing the accounting for assets backing insurance liabilities.

(a) The contractual service margin (CSM) component of the insurance liability is to be measured on an amortised cost basis under the general model in the forthcoming AASB 17/IFRS 17. The contract inception date discount rate will be used for the purposes of accreting interest on the CSM and to calculate the present value of cash flows that offsets (unlocks) the CSM and the CSM will be recognised based on the passage of time over the coverage period. Insurers might require flexibility in measuring assets at cost to match the impacts of the measurement requirements for the CSM component of their insurance liabilities; and

(b) The forthcoming AASB 17/IFRS 17 will permit insurers to choose whether they present the impact of changes in discount rate (after inception) on insurance liabilities in profit or loss or in OCI. The choice is expected to be available on a portfolio-by-portfolio basis. It is possible that a world-wide industry practice will develop for particular types of insurance business. Australian insurers may want to conform to that practice and exercise the accounting policy choice to present the impact of changes in discount rate on insurance liabilities in OCI. Accordingly, they may want to measure assets backing those insurance liabilities at FVOCI to have a reasonable match between current value movements on both sides of the balance sheet.

(c) If the constraint on measuring assets backing insurance liabilities at FVPL is not retained, insurers will be able to exercise measurement choices, within the boundaries set by IFRS, that potentially allow their financial reporting to be more consistent with other types of entities. This might be particularly relevant to achieving consistent asset measurement bases within a group that includes an insurer and other businesses that both hold the same asset types.

Staff recommendation

17. Staff have gauged the general feeling among insurance stakeholders in Australia via AASB Project Advisory Panel members and note mixed views, but also an overall sentiment that the AASB should not retain the requirements to measure assets backing insurance liabilities at FVPL when permitted under IFRS.

18. Staff think that this sentiment is driven mainly by the fact that stakeholders:

    (a) are unsure at this stage about how the forthcoming AASB 17/IFRS 17 will impact on financial reporting of insurance liabilities in Australia and where changes in insurance liabilities will necessarily need to be presented; and

    (b) want the flexibility for Australian insurers to adopt international norms as they develop.

Staff recommendation: An AASB standard incorporating the forthcoming IFRS 17 should not include modifications requiring assets backing insurance liabilities to be measured at FVPL when permitted under IFRS.

Question for Board members

Q1 Does the Board agree with the staff recommendation?

Appendix A

Extracts from AASB 1023 relating to Assets Backing General Insurance Liabilities

15.1.1 Paragraphs 15.2 to 15.5 address the measurement of certain assets backing general insurance liabilities or financial liabilities that arise under non-insurance contracts. The fair value approach to the measurement of assets backing general insurance liabilities or financial liabilities that arise under non-insurance contracts is consistent with the present value measurement approach for general insurance liabilities, and the fair value measurement for financial liabilities that arise under non-insurance contracts, required by this Standard. Where assets are not backing general insurance liabilities or financial liabilities that arise under non-insurance contracts, general insurers apply the applicable accounting standards making use of any measurement choices available.

Measurement

15.2 Financial assets that:

(a) are within the scope of AASB 139;

(b) back general insurance liabilities; and

(c) are permitted to be designated as "at fair value through profit or loss" under AASB 139;

shall be designated as "at fair value through profit or loss" under AASB 139 on first application of this Standard, or on initial recognition.

15.2.1 An insurer applies AASB 139 to its financial assets. Under AASB 139 a financial asset at fair value through profit or loss is a financial asset that meets either of the following conditions:

(a) it is classified as held for trading; or

(b) it is designated as "at fair value through profit or loss" upon initial recognition. An entity may use this designation when it is a contract with an embedded derivative and paragraph 11A of AASB 139 allows the entity to measure the contract as "at fair value through profit or loss"; or when doing so results in more relevant information, because either:

(i) it eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as 'an accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases; or

(ii) a group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity's key management personnel (as defined in AASB 124 *Related Party*

Disclosures), for example the entity's board of directors and chief executive officer.

AASB 1 *First-time Adoption of Australian Accounting Standards* permits entities to designate financial assets as "at fair value through profit or loss" on first application of the Standard.

15.2.2 The view adopted in this Standard is that financial assets, within the scope of AASB 139 that back general insurance liabilities, are permitted to be measured at fair value through profit or loss under AASB 139. This is because the measurement of general insurance liabilities under this Standard incorporates current information and measuring the financial assets backing these general insurance liabilities at fair value, eliminates or significantly reduces a potential measurement inconsistency which would arise if the assets were classified as available for sale or measured at amortised cost.

15.3 Investment property within the scope of AASB 140 *Investment Property* and that backs general insurance liabilities shall be measured using the fair value model under AASB 140 and AASB 13 *Fair Value Measurement*.

15.4 Property, plant and equipment that is within the scope of AASB 116 *Property, Plant and Equipment* and that backs general insurance liabilities, shall be measured using the revaluation model under AASB 116.

15.5 When preparing separate financial statements, those investments in subsidiaries, joint ventures and associates that:

(a) are defined by AASB 10 *Consolidated Financial Statements,* AASB 11 *Joint Arrangements* and AASB 128 *Investments in Associates and Joint Ventures*;

(b) back general insurance liabilities; and

(c) are permitted to be designated as "at fair value through profit or loss" under AASB 139;

shall be designated as "at fair value through profit or loss" under AASB 139, on first application of this Standard or on initial recognition.

15.5.1 An insurer applies AASB 127 to its investments in subsidiaries, joint ventures and associates when preparing separate financial statements. Under AASB 127, in the parent's own financial statements, the investments in subsidiaries, joint ventures and associates can either be accounted for at cost or in accordance with AASB 139.

15.5.2 In the parent's separate financial statements, investments in subsidiaries, joint ventures and associates that are within the scope of AASB 127, that the insurer considers back general insurance liabilities, and that are permitted to be designated as "at fair value through profit or loss" under AASB 139, are designated as "at fair value through profit or loss" under AASB 139, on first application of this Standard or on initial recognition.

Appendix B

Extracts from AASB 1038 relating to Assets Backing Life Insurance Liabilities or Life Investment Contract Liabilities

10.1.1 Paragraphs 10.2 to 10.7.2 address the measurement of certain assets backing life insurance liabilities or life investment contract liabilities. The fair value approach to the measurement of assets backing life insurance liabilities or life investment contract liabilities is consistent with the present value measurement approach for life insurance liabilities required by this Standard and the fair value measurement approach for life investment contract liabilities required by this Standard. Where assets are not backing life insurance liabilities or life investment contract liabilities life insurers apply the applicable accounting standards making use of any measurement choices available.

Measurement 10.2 Financial assets that:

(a) are within the scope of AASB 139;

(b) back life insurance liabilities or life investment contract liabilities; and

(c) are permitted to be designated as "at fair value through profit or loss" under AASB 139;

shall be designated as "at fair value through profit or loss" under AASB 139 on first application of this Standard, or on initial recognition.

10.2.1 An insurer applies AASB 139 to its financial assets. Under AASB 139 a financial asset at fair value through profit or loss is a financial asset that meets either of the following conditions:

(a) it is classified as held for trading; or

(b) it is designated as "at fair value through profit or loss" upon initial recognition. An entity may use this designation when it is a contract with an embedded derivative and paragraph 11A of AASB 139 allows the entity to measure the contract as "at fair value through profit or loss"; or when doing so results in more relevant information, because either:

(i) it eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as 'an accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases; or

(ii) a group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity's key management personnel (as defined in AASB 124 *Related Party Disclosures*), for example the entity's board of directors and chief executive officer.

AASB 1 *First-time Adoption of Australian Accounting Standards* permits entities to designate financial assets as "at fair value through profit or loss" on first application of the Standard.

10.2.2 The view adopted in this Standard is that, in all but rare cases, financial assets within the scope of AASB 139 that back life insurance liabilities or life investment contract liabilities are permitted to be measured at fair value through profit or loss under AASB 139. This is because the measurement of life insurance liabilities under this Standard incorporates current information and measuring the financial assets backing these life insurance liabilities at fair value eliminates or significantly reduces a potential measurement inconsistency which would arise if the assets were classified as available for sale or measured at amortised cost. In addition, under AASB 139, a group of financial assets may be designated as at fair value through profit or loss where it is both managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy. In the vast majority of cases, financial assets backing life investment contract liabilities and financial assets backing life insurance liabilities would be managed and their performance would be evaluated on a fair value basis, in accordance with a documented risk management or investment strategy.

10.3 Investment property that is within the scope of AASB 140 *Investment Property* and that backs life insurance liabilities or life investment contract liabilities shall be measured at fair value using the fair value model under AASB 140 and AASB 13 *Fair Value Measurement*.

10.4 Property, plant and equipment that is within the scope of AASB 116 *Property, Plant and Equipment* and that backs life insurance liabilities or life investment contract liabilities shall be measured using the revaluation model under AASB 116.

10.5 Investments in associates that:

(a) are defined by AASB 128 Investments in Associates and Joint Ventures;

(b) back either life insurance liabilities or life investment contract liabilities;

(c) are held by mutual funds, unit trusts and similar entities including investment-linked insurance funds; and

(d) are permitted to be designated as "at fair value through profit or loss" under AASB 139;

shall be designated as "at fair value through profit or loss" under AASB 139 on first application of this Standard, or on initial recognition.

10.5.1 An insurer applies AASB 128 to its investments in associates. AASB 128 requires investments in associates to be accounted for using the equity method. When investments in associates are held by mutual funds, unit trusts and similar entities including investment-linked insurance funds, AASB 128 permits the investments in those associates to be measured at fair value through profit or loss in accordance with AASB 139.

10.6 Venturers' interests in joint ventures that:

(a) are defined by AASB 11 *Joint Arrangements*;

(b) back either life insurance liabilities or life investment contract liabilities;

(c) are held by mutual funds, unit trusts and similar entities including investment-linked insurance funds; and

(d) are permitted to be designated as "at fair value through profit or loss" under AASB 139;

shall be designated as "at fair value through profit or loss" under AASB 139, on first application of this Standard, or on initial recognition.

10.6.1 AASB 11 requires a joint venturer to recognise its interest in a joint venture as an investment and to account for that investment using the equity method in accordance with AASB 128 unless exempted from applying that method. AASB 128 permits mutual funds, unit trusts and similar entities including investment-linked insurance funds to measure investments in joint ventures at fair value through profit or loss in accordance with AASB 139.