



Australian Government
**Australian Accounting
Standards Board**

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2 December 2010

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UNITED KINGDOM

Dear David

Exposure Draft ED/2010/8 *Insurance Contracts*

The Australian Accounting Standards Board (AASB) and New Zealand Financial Reporting Standards Board (FRSB) are pleased to provide their comments on Exposure Draft ED/2010/8 *Insurance Contracts*. In formulating these comments, the AASB and FRSB sought and considered the views of Australian and New Zealand constituents. The comment letters received by the AASB are published on the AASB's website. The AASB and FRSB also held roundtable discussions on the proposals in ED/2010/8 with constituents.

AASB's and FRSB's overall views

Overall, the AASB and FRSB ('we') strongly support the general thrust of the proposals in ED/2010/8 because they are largely principles-based and would significantly improve financial reporting by insurers at a global level.

The characteristics of insurance contracts differ across jurisdictions. Life insurance contracts, for instance, differ significantly across jurisdictions with respect to the prevalence of guaranteed insurability as a significant factor and the level of bundling. The characteristics of markets for insurance contracts also differ significantly across jurisdictions with respect to features such as insurers' capacities to re-price individual contracts. Accordingly, we consider that, to achieve the IASB's stated objective of issuing a high-quality standard for insurance contracts that:

- (a) provides a consistent basis for accounting for such contracts; and
- (b) enhances comparability across entities, jurisdictions and capital markets;

the replacement Standard for IFRS 4 *Insurance Contracts* must be a principles-based Standard.

We also consider that, given the current diversity in accounting practices for insurance contracts across entities and jurisdictions and the significance of insurance activity to business and consumers, the IASB should attempt to adhere as closely as possible to its current timetable for a replacement Standard for IFRS 4, which anticipates a new IFRS for insurance contracts by June 2011.

Aspects of the ED that the AASB and FRSB support

We support the proposals for claims liabilities to be measured on the basis of the expected present value of the fulfilment cash flows. We also support the proposals for claims liabilities to include a residual margin, measured by reference to the initial premium, as a practical means of dealing with any ‘day-one’ gains on the inception of insurance contracts. While we would prefer a principles-based approach that facilitates insurers distinguishing between performance obligations in relation to services to be provided over the term of the contract and ‘pure’ gains to which no service obligations attach, we acknowledge that such an approach may not be cost-beneficial, particularly in the context of bundled products that comprise multiple components and service obligations. We also acknowledge that such an approach might, in some circumstances, involve insurers making arbitrary allocations to measure individual margins, which could diminish the reliability of the reported information.

We strongly support the IASB’s proposals for risk adjustments to be subject to separate measurement and remeasurement. As is evident from recent experiences in markets for insurance contracts, the price of risk changes as underlying conditions change and becomes more reliably measureable as new information becomes available. As insurers are in the business of accepting risk, we consider it would be incongruous to propose that they do not explicitly measure and remeasure risk adjustments. We also consider that risk adjustments can be reliably determined for insurance contracts, as demonstrated by insurers reporting under AASB 1023 *General Insurance Contracts* or Appendix D *Financial Reporting of Insurance Activities* to NZ IFRS 4 *Insurance Contracts*. Accordingly, we strongly disagree with the FASB’s proposed composite margin approach.

We also strongly support the IASB’s proposals for insurers to use discount rates for:

- (a) non-participating contracts that reflect the characteristics of the insurance contract liabilities and not those of the assets backing those liabilities; and
- (b) participating contracts that reflect their dependence on the performance of the related assets.

We consider that these proposed approaches would facilitate the provision of relevant information for users regarding insurance contract liabilities.

Aspects of the ED not supported by the AASB and FRSB

While we agree with the fundamental features of the proposed model for insurance contracts, we do not support those aspects of the proposals that appear to be inconsistent with principles-based standard setting and/or the requirements applicable in similar circumstances under other IFRSs. In particular, we do not support the IASB’s proposals for:

- (a) time-based criteria for determining the application of the proposed modified measurement approach for pre-claims liabilities. We consider the proposed approach would cause ostensibly similar insurance contracts to be treated differently;
- (b) requiring ‘locked-in’ residual margins. We consider that the proposed subsequent treatment of residual margins:
 - (i) is inconsistent with the proposed treatment of residual margins at inception; and

(ii) would potentially give rise to anomalous reporting outcomes.

Accordingly, we support residual margins being subject to remeasurement;

- (c) requiring a premium allocation approach for pre-claims liabilities of some short-duration insurance contracts. We consider it to be more consistent with a principles-based approach to standard setting to permit an insurer to apply a premium allocation approach for pre-claims liabilities when it would provide similar reporting outcomes as the proposed comprehensive measurement model. We regard a premium allocation approach to be a short-cut method that provides cost-beneficial reporting outcomes for pre-claims liabilities and therefore consider that it should not be required in its own right as it implies a revenue deferral model, which is not consistent with the Conceptual Framework. We also consider that interest should be accreted on pre-claims liabilities for insurance contracts measured using a premium allocation approach except when the effect of the time value of money is not material;
- (d) recognising and measuring an investment by an insurer in its own shares ('treasury shares') at fair value through profit or loss. In the absence of a principles-based justification that can be applied to all entities, including insurers, treasury shares should be accounted for in accordance with other applicable IFRSs;
- (e) requiring an insurer to present its statement of comprehensive income in accordance with the summarised margin approach. We consider that an insurer should be permitted to disclose 'volume' type information in relation to premiums, claims, benefits and other expenses in the statement of comprehensive income or in the notes; and
- (f) eliminating any existing residual margins against opening retained earnings upon transition to the proposed new reporting requirements. We consider that insurers should be permitted to determine for themselves whether retrospective application of the new IFRS for insurance contracts is impracticable in accordance with the relevant principles in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. We also recommend the IASB consider whether insurers could be permitted to transition into the new reporting requirements by using a fair value measurement of the residual margins in their insurance liabilities for the first day of the earliest comparative period presented.

Aspects of the ED to which further consideration should be given

Under the proposed comprehensive measurement model, an insurance contract would be measured using 'building blocks' that are not comparable because they have been determined at different levels of aggregation (units of account). In particular, we note that:

- (a) fulfilment cash flows would be determined at the individual contract level or 'portfolio of insurance contracts' (as defined in the ED) level;
- (b) risk adjustments would be determined at the portfolio level with portfolios being determined on the basis of inception dates (among other things);
- (c) residual margins would be determined at the portfolio level with portfolios being and on the basis of similar dates of inception and coverage periods (among other things);
- (d) acquisition costs would be included in the present value of the fulfilment cash flows when they are incremental at the individual contract level; and

- (e) contract boundaries would be determined on the basis of criteria applicable at the individual policyholder level.

We also note that, for the purpose of remeasurement, short-duration insurance contracts would be aggregated into a portfolio and, within a portfolio, by similar dates of inception.

We are concerned that these many different units of account might have significant implications for applying the proposals, particularly in relation to the number of portfolios an insurer might need to identify, and the reliability and consistency of measurements under the proposed comprehensive measurement model. While some of the main components of the proposed measurement model would be determined at the portfolio level of aggregation, we do not necessarily consider that all components should therefore be determined at this level. Nevertheless, we do consider that the IASB's reasoning in relation to the levels of aggregation at which the various components are determined needs to be robust and principles-based.

We also recommend the IASB give further consideration to reinsurance contracts being measured consistently with the manner in which the associated direct insurance contracts are measured given that there are two measurement models depending on contract duration, and that direct and reinsurance contracts can have different coverage periods.

Our specific comments on the questions in the ED's Invitation to Comment are set out in the attached submission.

If you have any queries regarding any matters in this submission, please contact either of us or Dean Ardern (dardern@asb.gov.au).

Yours sincerely,



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Chairman and CEO
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Joanna Perry
Chairman
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**AASB's and FRSB's Specific Comments on IASB Exposure Draft
ED/2010/8 *Insurance Contracts***

1. The AASB's and FRSB's views on the questions in the ED's Invitation to Comment section are as follows.

Question 1 – Relevant information for users

Do you think that the proposed measurement model will produce relevant information that will help users of an insurer's financial statements to make economic decisions? Why or why not? If not, what changes do you recommend and why?

2. The AASB and FRSB ('we') agree that the proposed comprehensive measurement model would produce relevant information that will help users of an insurer's financial statements to make economic decisions because:
- (a) the proposed 'building blocks' are relevant for an understanding of the financial implications of most types of insurance contracts;
 - (b) claims liabilities for all types of insurance contracts would be measured on a consistent basis; and
 - (c) insurance contract liabilities would be measured on a similar basis to other liabilities under IFRSs, such as defined benefit obligations and provisions.
3. However, as discussed below we consider that some of the proposals, particularly the proposals in relation to residual margins (Question 6), the statement of comprehensive income (Question 13) and transitional arrangements (Question 17), may undermine the relevance of the information for users. In addition, as discussed in paragraphs 40-47 of this response, we do not agree that a premium allocation approach for short-duration insurance contracts would necessarily provide equally or more relevant information for decision making by users than the proposed comprehensive measurement model.

Question 2 – Fulfilment cash flows

- (a) Do you agree that the measurement of an insurance contract should include the expected present value of the future cash outflows less future cash inflows that will arise as the insurer fulfils the insurance contract? Why or why not? If not, what do you recommend and why?
- (b) Is the draft application guidance in Appendix B on estimates of future cash flows at the right level of detail? Do you have any comments on the guidance?

IASB Question 2(a)

4. We agree that the measurement of an insurance contract should include the expected present value of future cash flows that will arise as the insurer fulfils the insurance contract because such an approach is consistent with:
- (a) a key focus for users of insurers' financial statements;

- (b) the way in which most insurers manage their insurance obligations, which is generally on the basis of the net obligations and rights under insurance contracts; and
 - (c) the way in which other similar liabilities are measured under IFRSs, such as defined benefit obligations, to the extent that current estimates of fulfilment cash flows are used.
5. Determining insurance liabilities using expected fulfilment cash flows that are adjusted for the time value of money provides a meaningful measure of the insurance risks to which an insurer is exposed, thereby providing users with a basis for understanding an insurer's financial position. Adjusting insurance liabilities for the effects of the timing and pattern of the underlying cash flows would also enhance the comparability of insurers' reported results in respect of short-duration and long-duration insurance contracts, thereby enhancing the comparability of financial statements between insurers and over time.

IASB Question 2(b)

6. We agree that the draft application guidance in Appendix B on estimates of future cash flows is broadly at the right level of detail. However, we note the guidance seems to anticipate that insurers would measure their insurance liabilities under the proposals using stochastic modelling rather than using a deterministic approach, which is arguably inconsistent with the principles-based nature of ED/2010/8. Accordingly, we recommend that the IASB review the application guidance in Appendix B with a view to ensuring it does not inadvertently favour any particular approach for modelling insurance liability cash flows, especially when more than one approach may be considered to be appropriate in the circumstances.

Question 3 – Discount rate

- (a) Do you agree that the discount rate used by the insurer for non-participating contracts should reflect the characteristics of the insurance contract liability and not those of the assets backing that liability? Why or why not?
- (b) Do you agree with the proposal to consider the effect of liquidity, and with the guidance on liquidity (see paragraphs 30(a), 31 and 34)? Why or why not?
- (c) Some have expressed concerns that the proposed discount rate may misrepresent the economic substance of some long-duration insurance contracts. Are those concerns valid? Why or why not? If they are valid, what approach do you suggest and why? For example, should the Board reconsider its conclusion that the present value of the fulfilment cash flows should not reflect the risk of non-performance by the insurer?

IASB Question 3(a)

7. We strongly agree with the proposals that the discount rate used by an insurer for non-participating contracts should reflect the characteristics of the insurance contract liability and not those of the assets backing that liability because:

- (a) such an approach would facilitate the measurement of insurance liabilities at amounts that reflect the estimated timing and pattern of cash flows, thereby:
 - (i) providing users of an insurer's financial statements with relevant information regarding the insurer's financial position; and
 - (ii) enhancing the comparability of financial statements between insurers and over time; and
- (b) using an expected earnings rate to discount non-participating contracts is likely diminish the comparability of financial statements between insurers and over time by giving rise to anomalous reporting outcomes. For instance:
 - (i) by investing in assets with higher expected returns (and therefore presumably higher risks), an insurer could reduce the measured amounts of its insurance contract liabilities, possibly even when the insurance risks to which it is exposed have remained the same or have increased; and
 - (ii) insurers that issue the same types of insurance contracts and are exposed to similar insurance risks could report their insurance liabilities at different amounts, depending on the assets in which they have invested.

IASB Question 3(b)

- 8. We agree with the proposal for an insurer to include, when appropriate, an illiquidity premium in the discount rate for insurance contract liabilities because such an approach is consistent with:
 - (a) principles-based standard setting; and
 - (b) the proposal that an insurer measure its insurance liabilities using discount rates that reflect the characteristics of the insurance contract liabilities.
- 9. Inclusion of an illiquidity premium in the discount rate for insurance liabilities would improve the comparability of insurers' reported results by ensuring that insurance liabilities reflect the extent to which an insurer needs to have capital available 'at call' to meet its insurance liabilities. However, as noted in paragraph 83 of this response, these proposals are inconsistent with the requirements for determining discount rates under other IFRSs, such as IAS 19 *Employee Benefits*.

IASB Question 3(c)

- 10. We disagree with the suggestion that the proposed discount rate may misrepresent the economic substance of some long-duration insurance contracts because such an approach would not facilitate an insurer distinguishing its investment performance from its underwriting performance. Discounting non-participating insurance contracts at expected investment earnings rates is inconsistent with:
 - (a) the proposal in ED/2010/8 that an insurer unbundle a component of an insurance contract if the component is not closely related to the insurance coverage specified in the contract; and
 - (b) the measurement approaches applicable to other similar liabilities under IFRSs, such as defined benefit obligations and provisions.

In addition, we agree that the present value of insurance contract fulfilment cash flows should exclude the risk of non-performance by the insurer. This is because a change in an insurer's own credit risk is not relevant under the proposed approach, which anticipates an insurer fulfilling its insurance contract liabilities.

Question 4 – Risk adjustment versus composite margin

Do you support using a risk adjustment and a residual margin (as the IASB proposes), or do you prefer a single composite margin (as the FASB favours)? Please explain the reason(s) for your view.

11. We strongly support the IASB's proposed 'two-margin approach' (risk adjustment and separate residual margin) for measuring insurance liabilities and, therefore, strongly oppose the FASB's proposed composite margin approach. This is because the IASB's proposals:
- (a) *would provide more useful information to users of an insurer's financial statements about the effects of uncertainty on the amount and timing of future claims liability cash flows, which is essential to an analysis of an insurance business.* Under the FASB's proposed composite margin approach, a risk adjustment would not be separately calculated and therefore not disclosed in an insurer's financial statements. Such an approach would deprive users of important information about insurance contract liabilities. As is evident from recent experiences in markets for insurance contracts, risk adjustments can change significantly with changes in the economic environment. In addition, the risk adjustment component of the FASB's proposed composite margin would be amortised to profit or loss over the coverage period and the claims handling period. As insurers are principally on risk during the coverage periods of their insurance contracts, the FASB's proposed approach would lead to insurers recognising profits in relation to insurance contracts in reporting periods in which they are not on risk in relation to the particular contracts;
 - (b) *would more readily facilitate insurance contracts being remeasured when the pricing of such contracts reflects factors other than the underlying insurance risks, such as the insurer's product mix.* Under the FASB's proposed composite margin approach, long-duration insurance contracts that have not been priced to reflect the underlying insurance risks would be less likely to be subject to remeasurement than they would be under the IASB's proposed two-margin approach because the amount that would otherwise be treated as a residual margin would act as a 'buffer' to any risk adjustment component; and
 - (c) *are consistent with the proposals in ED/2010/1 Measurement of Liabilities in IAS 37 – Proposed amendments to IAS 37 and the IASB's redeliberations to date in relation to these proposals.*

As demonstrated by insurers reporting under AASB 1023 *General Insurance Contracts* or Appendix D *Financial Reporting of Insurance Activities* to NZ IFRS 4 *Insurance Contracts*, risk adjustments can be reliably determined for insurance contracts.

12. We consider it essential that the risk adjustment be subject to separate measurement and remeasurement, which is explicitly within the IASB's proposals. It is widely accepted that business cycles impact on the price of insurance risk. In addition, insurers that operate ongoing insurance businesses have available to them new information that enables them to re-price risk as underlying conditions change. This is because those insurers are continuing to sell products and to price their products to reflect current market conditions. As insurers are in the business of accepting risk, we consider it would be incongruous to propose that they do not explicitly and separately measure and remeasure risk adjustments.

Question 5 – Risk adjustment

- (a) Do you agree that the risk adjustment should depict the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected? Why or why not? If not, what alternatives do you suggest and why?
- (b) Paragraph B73 limits the choice of techniques for estimating risk adjustments to the confidence level, conditional tail expectation (CTE) and cost of capital techniques. Do you agree that these three techniques should be allowed, and no others? Why or why not? If not, what do you suggest and why?
- (c) Do you agree that if either the CTE or the cost of capital method is used, the insurer should disclose the confidence level to which the risk adjustment corresponds (see paragraph 90(b)(i))? Why or why not?
- (d) Do you agree that an insurer should measure the risk adjustment at a portfolio level of aggregation (ie a group of contracts that are subject to similar risks and managed together as a pool)? Why or why not? If not, what alternative do you recommend and why?
- (e) Is the application guidance in Appendix B on risk adjustments at the right level of detail? Do you have any comments on the guidance?

IASB Question 5(a)

13. We agree with the proposal that a risk adjustment should depict the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those the insurer expects in relation to the insurance contracts.
14. Under the proposed definition, an insurer would measure a risk adjustment at the amount it would pay (but not necessarily the amount a market participant would require) to be relieved of the economic burden imposed on it by the relevant insurance contracts. Accordingly, the proposed definition is consistent with the notion that insurers generally fulfil their liabilities, rather than transfer them to third parties. Moreover, the proposed definition of a risk adjustment would require an insurer to measure the economic burden imposed on it by its insurance contracts in the context of the entity's approach for managing claims insurance risk. This information would be useful to users of insurers' financial statements as it would provide a 'reference point' for comparing different insurers and their perceptions of

uncertain future fulfilment cash flows in relation to different types of insurance contracts.

15. We also support the proposals that the risk adjustment depict:
- (a) the ‘maximum amount’ rather than an average or median amount because the measured amount is meant to reflect the insurer’s view, not an amalgam of other insurers’ or market participant views. However, we note that the phrase ‘maximum amount’ could introduce a conservative bias into the measurement of insurance liabilities; and
 - (b) the amount an insurer would ‘pay to be relieved of the risk’. While transfers of insurance liabilities to third parties is relatively uncommon and this situation may not change dramatically in the immediate future, the proposed approach would not prevent an insurer from using market prices to determine risk adjustments in the event that markets for insurance liabilities became relatively more common and/or active.

IASB Question 5(b)

16. We agree with the proposed techniques for estimating risk adjustments (confidence level, CTE and cost of capital techniques), but disagree with the proposal to limit the techniques to only those three identified because such an approach:
- (a) is inconsistent with principles-based standard setting; and
 - (b) would potentially prevent insurers using new and better risk measurement techniques in the future.

Accordingly, we consider that the proposals on measuring risk adjustments should be amended to include a rebuttable presumption that an insurer would be required to use one of the three identified techniques unless another method provides a more reliable measure of the risk adjustment.

17. We note that, in applying the cost of capital technique, it is our understanding that an insurer would estimate the risk adjustment on the basis of an annual rate of return that reflects the cost to the insurer of holding sufficient capital to provide a high degree of certainty that it will be able to fulfil its obligations to policyholders. As this annual rate of return is likely to implicitly incorporate entity-wide factors, such as diversification benefits that arise across portfolios of different types of insurance contracts, such an approach is arguably inconsistent with the proposals in paragraph 36 of ED/2010/8 to measure the risk adjustment at the portfolio level.

IASB Question 5(c)

18. We agree with the proposal that, if either the CTE or the cost of capital technique is used, the insurer should disclose the confidence level to which the risk adjustment corresponds because it would:
- (a) assist users, particularly those in jurisdictions where the confidence level technique is widely used; and

(b) enhance the comparability of financial statements between insurers and over time.

19. Other IFRSs, such as IFRS 7 *Financial Instruments: Disclosures* and IFRS 8 *Operating Segments*, require entities to disclose information in relation to the risks to which they are exposed, and how they manage those risks. As discussed in paragraph 14 of this response, the confidence level an insurer applies in determining risk adjustments would provide useful information to users of the insurer's financial statements about the entity's approach for managing claims insurance risk. Accordingly, we consider it appropriate that insurers be required to disclose the confidence level to which the risk adjustment corresponds if either the CTE or the cost of capital technique is used.

IASB Question 5(d)

20. While there may be a number of valid reasons for not permitting an insurer to measure risk adjustments at the entity level (such as consistency with the approach under IAS 36 *Impairment of Assets*), we do not consider a lack of 'fungibility' to be one of them, particularly as ED/2010/8 proposes that a portfolio of insurance contracts be largely determined on the basis of how the insurer groups its insurance contracts for management purposes. Moreover, most insurers, even those with statutory funds, can generally mitigate the effects of having surpluses and deficits across their portfolios. Accordingly, we recommend the IASB give further consideration to its reasons for proposing that an insurer not be permitted to measure risk adjustments at the entity level.
21. We also consider that, if insurers are required to aggregate insurance contracts into portfolios and, within a portfolio, by similar dates of inception and coverage periods (as proposed in relation to residual margins in paragraph 20 of ED/2010/8), this could lead insurers to recognise significantly larger numbers of portfolios than they might otherwise identify in operating that business. Consequently, any diversification benefits an insurer might gain from operating 'open' portfolios of insurance contracts might be severely limited, if not eliminated, under the residual margin proposals (this issue is discussed in more detail in paragraph 31 of this response). Accordingly, we consider that portfolios should not be defined by date of inception, unless that happens to be how the insurer operates its business.

IASB Question 5(e)

22. We agree that the draft application guidance in Appendix B on risk adjustments is broadly at the right level of detail.

Question 6 – Residual/composite margin

- (a) Do you agree that an insurer should not recognise any gain at initial recognition of an insurance contract (such a gain arises when the expected present value of the future cash outflows plus the risk adjustment is less than the expected present value of the future cash inflows)? Why or why not?
- (b) Do you agree that the residual margin should not be less than zero, so that a loss at initial recognition of an insurance contract would be recognised immediately in profit or loss (such a loss arises when the expected present value of the future cash outflows plus the risk adjustment is more than the expected present value of future cash inflows)? Why or why not?
- (c) Do you agree that an insurer should estimate the residual or composite margin at a level that aggregates insurance contracts into a portfolio of insurance contracts and, within a portfolio, by similar date of inception of the contract and by similar coverage period? Why or why not? If not, what do you recommend and why?
- (d) Do you agree with the proposed method(s) of releasing the residual margin? Why or why not? If not, what do you suggest and why (see paragraphs 50 and BC125–BC129)?
- (e) Do you agree with the proposed method(s) of releasing the composite margin, if the Board were to adopt the approach that includes such a margin (see the Appendix to the Basis for Conclusions)? Why or why not?
- (f) Do you agree that interest should be accreted on the residual margin (see paragraphs 51 and BC131–BC133)? Why or why not? Would you reach the same conclusion for the composite margin? Why or why not?

IASB Question 6(a)

- 23. As noted in the covering letter to this response, we agree with the proposal to prohibit an insurer from recognising any residual margin as a gain at initial recognition of an insurance contract as a practical (rather than a principles-based) solution for dealing with any difference between the expected present value of the cash inflows and outflows plus the risk adjustment on inception.
- 24. In many cases, residual margins would include material gains that are unrelated to any future service obligations. However, some of these ‘pure’ gains may be related to internally generated intangible assets, such as brand names and broker relationships, which are not currently permitted to be recognised under IAS 38 *Intangible Assets*. We also note that distinguishing between ‘pure’ gains and other components of residual margins, such as service margins and the recovery of portfolio-level fixed costs (overheads), may involve insurers making arbitrary allocations, which could diminish the reliability of the reported information. Accordingly, we consider that, as a practical solution, residual margins should be treated as a part of the insurance liability rather than the whole, or some part, of those margins being treated as a gain at inception.

25. While the measurement models in ED/2010/8 and the IASB's Exposure Draft ED/2010/6 *Revenue from Contracts with Customers* are different, treating residual margins as a part of the insurance liability (rather than as a gain on inception) would ensure that profit relating to services to be provided (performance obligations to be met) is treated in a similar manner under these different types of contracts with customers.

IASB Question 6(b)

26. We agree with the proposal that an insurer recognise a negative residual margin at initial recognition of an insurance contract as a loss immediately in profit or loss because such an approach is consistent with:
- (a) the recognition of day-one losses in respect of onerous contracts under other IFRSs, such as IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*; and
 - (b) the prospective measurement approach proposed in ED/2010/8.

IASB Questions 6(c) and 6(d)

27. We strongly disagree with the proposed subsequent treatment of residual margins for the following reasons.

The proposed treatment of residual margins is inconsistent with the proposed treatment of residual margins at inception

28. At inception, the measured amount of an insurance contract would reflect the entity's best estimate of the future (fulfilment) cash flows of the insurance contract and any expected profits in the form of margins (risk and residual) at that date. Accordingly, the residual margin could be thought of as representing a current value margin. However, by 'locking in' any residual margins at inception, insurance contracts would be subsequently measured using a model that is arguably 'mixed' in nature because it comprises some components based on current information and other components based on historical information.

The proposed treatment would potentially cause profit recognition to be influenced more by the assumptions used to measure insurance contract liabilities than actual experience

29. As noted above, a residual margin could be thought of as representing a current value margin which reflects the insurer's expectations of profits, both earned and unearned, at the inception date. By locking in residual margins at inception, changes in the insurer's expectations would be recognised only indirectly by way of changes in the expected fulfilment cash flows. Moreover, the impact of changes in assumptions regarding non-market variables, such as future claims handling costs, will be recognised in the current reporting period. We consider this approach to be potentially misleading and arguably unnecessary for insurers in many jurisdictions, principally because information for remeasuring residual margins in the form of market prices would be readily available for most types of insurance contracts as

insurers would be selling policies with similar terms and conditions year after year in active markets.

The proposed approach would give rise to anomalous outcomes in some relatively common circumstances

30. Under the proposals, an adverse change in the expected future fulfilment cash flows of an insurance contract would be recognised immediately as a loss. However, any residual margin attributable to the contracts at inception would continue to be recognised systematically as gains in profit or loss over the remaining coverage period.

Other issues

31. The proposal to aggregate residual margins on the basis of portfolios of contracts that have similar dates of inception and similar coverage periods helps to enforce the notion that residual margins are locked in (potentially year-by-year), thereby facilitating application of proposal to systematically run residual margins off to profit or loss. However, we note that these proposals have a number of other consequences. In particular, restricting portfolios to groups of contracts that:

- (a) are subject to broadly similar risks and managed together by the insurer as a single pool; **and**
- (b) have similar dates of inception (short-duration insurance contracts); **or**
- (c) have similar dates of inception and similar coverage periods (all insurance contracts other than those measured using a premium allocation approach);

is likely to cause insurers to recognise a significantly larger number of portfolios than they otherwise would if they were only required to group insurance contracts on the basis of similar risks. This is because insurers often identify and manage portfolios that comprise contracts with similar risks and have similar durations (a form of ‘open’ portfolio) rather than similar dates of inception. Moreover, while the proposals may seemingly have the potential to increase comparability between insurers’ portfolios, it is likely that the phrase ‘similar dates of inception’ will garner a broad range of meanings in practice, thereby undermining any potential comparability benefits. By restricting the size of portfolios of insurance contracts in practice, the proposals are also likely to require insurers to apply the remeasurement proposals for short-duration insurance contracts in paragraph 60 of ED/2010/8 more frequently than they might otherwise.

AASB and FRSB views

32. For the reasons outlined in paragraphs 28-31 above, we favour residual margins being subject to remeasurement. As discussed in paragraph 29 of this response, in many circumstances insurers would be selling policies with similar terms and conditions year after year. Accordingly, information for remeasuring residual margins in the form of market prices could provide the basis on which insurers would remeasure residual margins. Furthermore, when a particular type of insurance contract is not sold on a regular basis, or is sold only in relatively inactive markets, estimates of non-

market variables (non-financial assumptions) that have an impact on the expected net fulfilment cash flows in future periods could provide a reliable basis on which insurers could remeasure residual margins. In active markets, changes in estimates of non-market variables would generally be reflected in the residual margins of the same types of insurance contracts.

33. Under this approach, the criteria for similar coverage period and similar terms and conditions would be sufficient for aggregating residual margins in relation to 'open' portfolios of insurance contracts (and there would be no need to restrict portfolios by inception date). We also note that, if adopted in the context of the other proposals in ED/2010/8, the remeasurement of residual margins would only impact on long-duration insurance contracts, such as life insurance contracts.
34. If the IASB were to decide that residual margins should be locked in at inception, we recommend the order of priority proposed in paragraph 50 of ED/2010/8 in relation to the bases for recognising the residual margin in profit or loss be amended because it is inconsistent with a principles-based approach to standard setting. We consider that an insurer should be required to recognise the residual margin as income in profit or loss on the basis of:
 - (a) the expected timing of incurred claims and benefits; or
 - (b) the passage of time **only if** that pattern does not differ significantly from the expected timing of incurred claims and benefits.

IASB Question 6(e)

35. While we acknowledge that the proposed method of releasing the composite margin is consistent with the nature of such a margin, as stated elsewhere in this response we strongly disagree with the FASB's proposed composite margin approach.

IASB Question 6(f)

36. We agree with the proposal for interest to be accreted on the residual margin because it would facilitate consistency in the treatment of components of an insurance liability measured under the proposed comprehensive measurement model. However, as discussed in paragraph 46 of this response, we consider that insurers should be required to accrete interest on pre-claims liabilities except when the reported results would not differ materially from the results under the modified measurement approach.

Question 7 – Acquisition costs

Do you agree that incremental acquisition costs for contracts issued should be included in the initial measurement of the insurance contract as contract cash outflows and that all other acquisition costs should be recognised as expenses when incurred? Why or why not? If not, what do you recommend and why?

37. We agree that non-incremental acquisition costs and acquisition costs relating to unsuccessful underwriting efforts should be recognised as expenses when incurred because such an approach is consistent with the treatment of similar costs under other IFRSs. However, we disagree with the proposal that acquisition costs that are incremental at the individual contract level be included in the initial measurement of the insurance contract as contract cash outflows. On balance, we consider that insurers should be required to include acquisition costs that are incremental up to the portfolio level in the initial measurement of the insurance contract as cash outflows. However, if the IASB were to decide that the portfolio level of aggregation was not appropriate for acquisition costs, we would support insurers being required to recognise all acquisition costs as expenses when incurred.
38. The proposed approach in relation to incremental acquisition costs raises some significant conceptual and practical issues, including:
- (a) *consistency with the levels of aggregation (units of account) proposed in relation to other aspects of insurance contract accounting.* Most of the main components of the proposed comprehensive measurement model (fulfilment cash flows, risk adjustments and residual margins) would be determined at the portfolio level of aggregation. However, as noted in the covering letter to this response, we do not consider this to be a sufficient justification for all aspects of insurance contract accounting to be determined at the same level of aggregation, particularly if it would result in less reliable measurements of insurance liabilities (refer to paragraphs 38(c) and 39 below);
 - (b) *consistency with the overriding measurement objective.* The proposed comprehensive measurement model focuses on the cash flows that an insurer expects will arise through fulfilling its insurance liabilities, primarily through payment of benefits and claims to policyholders as they become due. Accordingly, the present value of the fulfilment cash flows is built up from an estimate of *future* cash flows as opposed to all (including past) cash flows. On this basis, it could be argued that including any acquisition costs in the initial measurement of the insurance contract as contract cash outflows is inconsistent with the notion of fulfilment cash flows as it is applied in ED/2010/8; and
 - (c) *reliability and comparability of reported outcomes.* Limiting the types of acquisition costs to be included in the insurance contract cash outflows to those that are incremental at the individual contract level may not enhance the reliability and comparability of insurers' reported results. For instance, under the proposals, ostensibly similar insurance contracts could be treated differently, subject to the nature of the insurer's sales structures (either directly through in-house sales teams or through third-party intermediaries such as brokers). We also note that:

- (i) some incremental acquisition costs are incurred prior to inception of a contract, and at this point in time it may be difficult to reliably determine which contracts will be implemented and, therefore, which individual contract costs should be included in contract cash outflows; and
 - (ii) some acquisition costs that are incremental at the contract level may not be capable of being reliably attributed to an individual contract, such as acquisition costs arising from insurance contracts sold as a package.
39. While some of the reliability and comparability issues noted above may be addressed by requiring insurers to include acquisition costs that are incremental up to the portfolio level in the initial measurement of the insurance contract as cash outflows, such an approach would also raise some further issues, including:
- (a) *the understandability of reported results under the proposals in relation to long-duration insurance contracts.* Under Australian and New Zealand GAAP (AASB 1038 *Life Insurance Contracts* and Appendix C *Life Insurance Activities* to NZ IFRS 4 *Insurance Contracts*), life insurers offset acquisition costs that are recognised as expenses on the inception of contracts by including in the cash flows used to determine insurance liabilities those acquisition costs expected to be recovered. Yearly increases in premiums may offset lapses to a large extent and, consequently, a life insurer might ‘run-off’ acquisition costs through planned margins over a long period of time (sometimes up to 40 years), notwithstanding that the average life of a policy in the portfolio may be significantly shorter (up to 10 years). This has the effect of creating on-going differences between reported profit or loss and cash flow amounts that are difficult for some users to understand and therefore such an approach may not be justified from a decision-usefulness perspective. However, we note that the proposal to aggregate residual margins on the basis of portfolios of contracts that have similar dates of inception and coverage periods could have the effect of limiting the period over which insurers run off their acquisition costs, particularly those insurers that currently manage their insurance contracts on an ‘open’ portfolio basis; and
 - (b) *whether to require an insurer to disclose the amount of incremental acquisition costs included in insurance contract liability cash flows as at the reporting date.* ED/2010/8 does not propose that an insurer disclose that part of insurance contract liabilities attributable to incremental acquisition costs, presumably because residual margins are a part of the total insurance liabilities (rather than a separate liability outside of the insurance liabilities). Nevertheless, as noted in (a) above, it is likely that some users of insurers’ financial statements would benefit from this information, particularly in the context of the proposed comprehensive measurement model.

Question 8 – Premium allocation approach

- (a) Should the Board (i) require, (ii) permit but not require, or (iii) not introduce a modified measurement approach for the pre-claims liabilities of some short-duration insurance contracts? Why or why not?
- (b) Do you agree with the proposed criteria for requiring that approach and with how to apply that approach? Why or why not? If not, what do you suggest and why?

IASB Question 8(a)

- 40. We agree with the proposal to introduce a modified measurement approach for short-duration contracts, but disagree with requiring such an approach to be applied to some short-duration insurance contracts because:
 - (a) *it is inconsistent with principles-based standard setting.* A premium allocation approach is generally regarded as a short-cut method of accounting for short-duration insurance contracts that provides a cost-beneficial measure of the pre-claims liabilities for such contracts. Accordingly, requiring insurers to use such an approach for short-duration insurance contracts introduces a ‘bright line’ into the accounting requirements which, in turn, is likely to give rise to inconsistencies in the treatment of similar types of insurance contracts; and
 - (b) *the objective of the ED.* As they currently stand, the proposals would prevent an insurer from applying the proposed comprehensive measurement approach, even when the comprehensive approach would provide more relevant and/or reliable information for users. The current proposals would also prevent an insurer with both short-duration and long-duration insurance contracts from using the same measurement model for all of its pre-claims liabilities, even when their short-duration (or alternatively long-duration) contracts comprise a relatively small proportion of their overall insurance business. This could have implications for the comparability of their reported results between the two types of contracts.
- 41. We do not agree that a premium allocation approach for short-duration insurance contracts would necessarily produce relevant information for decision making by users in all circumstances, such as when the fulfilment cash flows underlying a short-duration insurance contract have decreased significantly below what was expected at the inception of the contract. Accordingly, we recommend that the replacement Standard for IFRS 4 *Insurance Contracts* permit (rather than require) a premium allocation approach for short-duration insurance contracts when it would provide similar reporting outcomes as the proposed comprehensive measurement model.

IASB Question 8(b)

- 42. We have concerns with the following aspects of the proposed criteria for applying a modified measurement approach and the proposals in relation to applying that approach.

Application criteria

43. The proposed time-based criteria for distinguishing between short-duration and long-duration insurance contracts could lead to ostensibly similar insurance contracts being treated differently. In particular, we are concerned that some types of insurance contracts that typically have a coverage period in excess of one year, such as builders' warranty insurance, construction contract insurance and lenders' mortgage insurance, would be required to be measured using the proposed comprehensive model, whereas other contracts that expose the insurer to similar types and levels of risks but have a coverage period of a year or less would be measured using a premium allocation approach. Accordingly, and consistent with our response to IASB Question 8(a), we would support an approach that requires all pre-claims liabilities to be measured using the comprehensive measurement model, but permits an insurer to apply a premium allocation approach when it would provide similar reporting outcomes as the proposed comprehensive measurement model.

Criteria for recognising onerous contracts

44. As noted in paragraph 31 of this response, we are concerned about the implications of requiring short-duration insurance contracts to be aggregated into a portfolio and, within a portfolio, by similar dates of inception (paragraph 60 of ED/2010/8). If adopted, these proposals could also increase the volatility of an insurer's reported results above what might otherwise be case if they were required to apply the proposed onerous contract test to groups of contracts that are subject to broadly similar risks and managed together as a single pool ('portfolio of insurance contracts' as defined in ED/2010/8). It is relevant to note that the impact of these proposals on an insurer's reported results could be further exacerbated by the insurer offering discounts to a policyholder in the form of reduced premiums on all of the insurance policies purchased from the insurer, subject to how widely or narrowly the insurer defines its portfolios of insurance contracts.
45. As an aside, we note that ED/2010/8 does not specifically address whether an insurer should apply the same or a similar risk adjustment to remeasured pre-claims liabilities of short-duration insurance contracts as it does to claims liabilities for the same types of insurance contracts. Under Australian and New Zealand GAAP, the risk margins applied by some insurers to remeasured pre-claims liabilities are different from the risk margins they apply to claims liabilities for the same types of insurance contracts. Australian and NZ GAAP currently anticipate these types of situations and require insurers to disclose information explaining any differences in probabilities of adequacy adopted, and the reasons for any such differences.

Accreted interest

46. We disagree with the proposal that insurers be required to accrete interest on the pre-claims liabilities of all short-duration insurance contracts measured using a premium allocation approach because such an approach is:
- (a) inconsistent with the view that a premium allocation approach is a simplified or short-cut method for measuring particular types of insurance contracts; and

- (b) unlikely to significantly affect the amounts reported by insurers in relation to insurance contracts because the discounting period will generally be short.

Accordingly, and consistent with our response to IASB Question 8(b), we would support an approach that requires interest to be accreted on pre-claims liabilities of short-duration contracts except when the effect of the time value of money is immaterial. We note that paragraph BC148(b) of ED/2010/8 suggests that the IASB prefers such an approach. However, a literal reading of paragraph 59 of the ED would suggest that interest is to be accreted on the pre-claims liabilities of all short-duration insurance contracts measured using a premium allocation approach.

Treatment of ‘claims made’ insurance contracts

47. Paragraph 54(a) of ED/2010/8 proposes that the pre-claims liabilities of an insurance contract with a coverage period of approximately one year or less could be measured using a premium allocation approach [subject to the contract meeting the proposed criteria in paragraph 54(b) of the ED]. Such an approach is generally appropriate for insurance contracts written on a ‘claims incurred’ basis, such as motor vehicle and home and contents policies, as claims would generally be reported relatively soon after the insured event occurs. However, for contracts written on a ‘claims made’ basis, such as some professional indemnity insurance contracts, the coverage period may be one year or less but claims may arise many years after the insured event has occurred. In these circumstances, a premium allocation approach may not be an appropriate basis for measuring pre-claims liabilities. Accordingly, we recommend the IASB clarify how insurance contracts written on a claims made basis would be treated under the replacement Standard for IFRS 4. To this end, we note that paragraph BC146 of ED/2010/8 indicates that the IASB considers a premium allocation approach to be appropriate when the pre-claims period (rather than the coverage period) of the insurance contract is approximately one year or less.

Question 9 – Contract boundary principle

Do you agree with the proposed boundary principle and do you think insurers would be able to apply it consistently in practice? Why or why not? If not, what would you recommend and why?

48. We agree in principle with the proposed insurance contract boundary proposals because they are:
- (a) principles-based; and
 - (b) consistent with notion of insurance risk as defined in ED/2010/8.

However, we recommend the IASB give further consideration to the implications of its insurance contract boundary proposals for health insurers and compulsory accident insurance providers. We note that the health insurance arrangements in some jurisdictions, such as the United States, are currently undergoing significant legal and regulatory changes. Accordingly, as a part of any redeliberations on its insurance contract boundary proposals, we would recommend the IASB give particular consideration to the interaction between contract terms and the legal and regulatory environment in a jurisdiction with the view to assisting insurers to identify contract

boundaries consistently. We consider that most insurers are restricted to some extent in their abilities to fully reprice at the contract level to reflect the specific risks of individual policyholders. Accordingly, if applied strictly, most insurers would be required to measure most, if not all, of their insurance contracts under the proposed comprehensive measurement model.

49. The regulation of health insurance in Australia prevents insurers from re-underwriting the contracts of continuing policyholders, but re-pricing does occur at the portfolio level. The Australian health insurance environment is designed to ensure insurance is managed at the portfolio level because it includes portability without underwriting at the individual contract level. At the portfolio level, health insurers can adjust premiums (with government 'approval') and a whole benefit table can be adjusted (for example, by removing or adding excesses or claim limits on ancillary items, or changing the features of a particular benefit table) to reflect the emerging risks of the portfolio.
50. Similar factors are at work in those Australian States where compulsory third party motor accident insurance is provided either directly by government or by private sector insurers closely regulated by government. The overall aim of these arrangements is to provide all drivers with access to affordable insurance while allowing insurers to make a reasonable return on the business as a whole. Adjustments are made to premiums to reflect the overall risk experience, but an insurer cannot fully price risk for individual policyholders.
51. As noted above, while most insurers that offer health and compulsory third party motor accident insurance contracts are restricted in their capacity to re-price these types of contracts on an individual basis, they generally can re-price on a portfolio basis. They can also sometimes alter some of the terms under the policies, which would have a similar (but less substantial) economic effect as re-pricing. Accordingly, some argue that these insurers might be considered to be able to 'effectively' re-price their health and compulsory accident insurance contracts, notwithstanding that they might not be able to actually or fully change the premiums charged on individual contracts to reflect individual policyholders' specific risks. We also note that defining the boundary of an insurance contract as the point at which an insurer has the right to re-price the portfolio of insurance contracts to which the policy belongs would be consistent with the proposed levels of aggregation that would be applicable to other aspects of insurance contract accounting under ED/2010/8, including cash flows and risk adjustments.
52. There are some parallels between the accounting practices in Australia and New Zealand in relation to health and compulsory accident insurance contracts, notwithstanding that New Zealand health and compulsory accident insurers are subject to different regulatory arrangements.

Question 10 – Participating features

- (a) Do you agree that the measurement of insurance contracts should include participating benefits on an expected present value basis? Why or why not? If not, what do you recommend and why?
- (b) Should financial instruments with discretionary participation features be within the scope of the IFRS on insurance contracts, or within the scope of the IASB's financial instruments standards? Why?
- (c) Do you agree with the proposed definition of a discretionary participation feature, including the proposed new condition that the investment contracts must participate with insurance contracts in the same pool of assets, company, fund or other entity? Why or why not? If not, what do you recommend and why?
- (d) Paragraphs 64 and 65 modify some measurement proposals to make them suitable for financial instruments with discretionary participation features. Do you agree with those modifications? Why or why not? If not, what would you propose and why? Are any other modifications needed for these contracts?

IASB Question 10(a)

53. We agree that the measurement of insurance contracts should include participating benefits on an expected present value basis because:
- (a) they are a part of the bundle of rights and obligations that policyholders expect to receive from an insurance contract; and
 - (b) such an approach would facilitate participating benefits being measured on the same basis as other components of an insurance contract.

IASB Question 10(b)

54. On the basis of the way in which 'discretionary participation feature' is proposed to be defined, we agree that financial instruments with discretionary participation features should be within the scope of the IFRS on insurance contracts. Notwithstanding that a financial instrument with a discretionary participation feature would not generally transfer significant insurance risk, the cash flows attributable to such features are impacted by insurance risk. Accordingly, including financial instruments with discretionary participation features within the scope of the replacement Standard for IFRS 4 would facilitate such instruments being treated in a manner consistent with the treatment of related risks.
55. However, we are concerned that the proposed approach would require all financial instruments with discretionary participation features (as defined in ED/2010/8) to be treated as insurance contracts, irrespective of the significance of the insurance risk attributable to them and its anticipated impact on the expected fulfilment cash flows. We are also not entirely convinced that financial instruments with discretionary participation features would always be measured in substantially the same way as they would be measured under other IFRSs, such as IAS 39 *Financial Instruments: Recognition and Measurement*, particularly if the discretionary feature is in the nature

of equity. Accordingly, we recommend the IASB amend the proposals in ED/2010/8 to require only those financial instruments that expose an entity to 'significant insurance risk' (as defined in ED/2010/8) in relation to their discretionary participation features be accounted for under the replacement Standard for IFRS 4.

IASB Question 10(c)

56. Consistent with our response to IASB Question 10(b), we consider that only those discretionary participating features that expose an entity to significant insurance risk (as defined in ED/2010/8) should be within the scope of the replacement Standard for IFRS 4.

IASB Question 10(d)

57. While we agree that the modifications proposed in paragraphs 64 and 65 of ED/2010/8 would facilitate participating benefits being measured on the same basis as proposed in relation to other components of an insurance contract, consistent with our comments in paragraphs 32 and 34 of this response we:
- (a) favour residual margins being subject to remeasurement; and
 - (b) consider that the order of priority proposed in paragraph 65 of ED/2010/8 in relation to the bases for recognising the residual margin in profit or loss should be reversed. Accordingly, we consider that, if the IASB were to decide that residual margins should be 'locked in' at inception, an insurer should be required to recognise residual margins in respect of contracts with discretionary participating features as income in profit or loss on the basis of:
 - (i) the fair value of assets under management; or
 - (ii) the passage of time **only if** that pattern does not differ significantly from the pattern that would arise using the fair value of assets under management.

Question 11 – Definition and scope

- (a) Do you agree with the definition of an insurance contract and related guidance, including the two changes summarised in paragraph BC191? If not, why not?
- (b) Do you agree with the scope exclusions in paragraph 4? Why or why not? If not, what do you propose and why?
- (c) Do you agree that the contracts currently defined in IFRSs as financial guarantee contracts should be brought within the scope of the IFRS on insurance contracts? Why or why not?

IASB Question 11(a)

58. We agree with the definition of an insurance contract and related guidance, including the two changes summarised in paragraph BC191 of ED/2010/8.

IASB Question 11(b)

59. We agree with the proposal to scope fixed-fee service contracts out of the replacement Standard for IFRS 4. However, we are concerned by the proposal that other similar types of contracts, such as contracts that involve an entity providing goods and/or services to settle obligations, would be within the scope of the IFRS for insurance contracts, particularly if such contracts expose the issuer to the same or a similar level of insurance risk as a fixed-fee service contract. Accordingly, we recommend the IASB give further consideration to the scope exclusions in paragraph 4 of ED/2010/8 with a view to ensuring that all contracts that are similar in substance to fixed-fee contracts and expose the issuer to the same or a similar level of insurance risk are accounted for in a consistent manner.

IASB Question 11(c)

60. We consider paragraph 4(d) of (the existing) IFRS 4, whereby an entity can choose to account for financial guarantee contracts under IFRS 4 or IAS 39 upon transition into IFRS 4, to be inconsistent with principles-based standard setting. Accordingly, we support the IASB's efforts to facilitate financial guarantee contracts being treated similarly, irrespective of how they may have been treated in the past.
61. We also agree that the contracts currently defined in IFRSs as financial guarantee contracts should be brought within the scope of the replacement Standard for IFRS 4 in the manner proposed in ED/2010/8. This is because the proposal would facilitate financial guarantee contracts that expose the issuer to significant insurance risk being accounted for on the same basis as other types of contracts that expose the issuer to the same type and level of risk. However, we recommend the IASB consider including an option in the IFRS for insurance contracts for financial guarantee contracts permitting such contracts to be measured at fair value under IAS 39 or IFRS 9. While we acknowledge that many financial guarantee contracts would be measured at ostensibly the same amount under the proposed comprehensive measurement model for insurance contracts or IAS 39 [primarily for the reasons discussed in paragraph BC79(a)-(d) of ED/2010/8], we consider that including a fair value option for financial guarantee contracts would facilitate entities, particularly banks and other financial institutions for which insurance contracts are not a major focus of their activities, accounting for financial guarantee contracts on a similar basis as their other financial instruments.

Question 12 – Unbundling

Do you think it is appropriate to unbundle some components of an insurance contract? Do you agree with the proposed criteria for when this is required? Why or why not? If not, what alternative do you recommend and why?

62. We agree:
- (a) it is appropriate to require an insurer to unbundle some components of an insurance contract; and
 - (b) with the proposed criteria for unbundling insurance contracts because:

- (i) they would facilitate consistency and comparability in financial reporting by ensuring non-insurance components of insurance contracts are treated in a similar manner as financial instruments that are separate contracts but similar in all other respects; and
 - (ii) they represent a practical solution that avoids entities being required to report information based on arbitrary allocations of cash flows.
63. However, we recommend that the wording used in the unbundling proposals be clarified, particularly whether cash flows attributable to unbundled components need to be ‘closely related’ or ‘interrelated’. On balance, we prefer an approach based on ‘interrelated’ cash flows on the basis that it is more consistent (than ‘closely related’) with the IASB’s reasoning for not requiring unbundling when separating cash flows would involve arbitrary allocations between the various components.

Question 13 – Presentation

- (a) Will the proposed summarised margin presentation be useful to users of financial statements? Why or why not? If not, what would you recommend and why?
- (b) Do you agree that an insurer should present all income and expense arising from insurance contracts in profit or loss? Why or why not? If not, what do you recommend and why?

IASB Question 13(a)

64. We agree that summarised margin information would be useful to users of an insurer’s financial statements because it would link clearly with the proposed comprehensive measurement model. However, we are concerned that some diversified financial institutions would face significant challenges in integrating summarised margin information with the results from their other (non-insurance) activities. Accordingly, we recommend that an insurer be permitted to disclose ‘volume’ type information in relation to premiums, claims, benefits and other insurance-related expenses in the statement of comprehensive income or in the notes.

IASB Question 13(b)

65. Due to the lack of an explicit rationale for determining which items should be presented in profit or loss and which items should be presented in other comprehensive income, the proposed approach does not have a sound conceptual basis. This is a recurring problem in IASB proposals and one which we have highlighted in other submissions. Until that rationale is identified, we recommend the IFRS for insurance contracts permit all income and expense items arising from insurance contracts to be presented in either profit or loss or all presented in other comprehensive income.

Question 14 – Disclosures

- (a) Do you agree with the proposed disclosure principle? Why or why not? If not, what would you recommend, and why?
- (b) Do you think the proposed disclosure requirements will meet the proposed objective? Why or why not?
- (c) Are there any disclosures that have not been proposed that would be useful (or some proposed that are not)? If so, please describe those disclosures and explain why they would or would not be useful.

IASB Questions 14(a) and 14(b)

66. We agree:

- (a) with the proposed disclosure principles because they would facilitate an insurer disclosing useful information about the amounts recognised in its financial statements and the risks to which it is exposed in relation to insurance contracts; and
- (b) that the proposed disclosure requirements would meet the proposed objective. However, notwithstanding that we do not support the IASB's most recent proposals in Exposure Draft ED/2010/7 *Measurement Uncertainty Analysis Disclosure for Fair Value Measurements* regarding the disclosures of ranges of amounts for Level 3 fair value measurements, we recommend that the IASB seek to align, to the extent feasible, the disclosure requirements in the replacement Standard for IFRS 4 in relation to sensitivity analyses with the corresponding disclosure principles in the revised versions of IAS 19 for defined benefit obligations and IFRS 7 for Level 3 fair value measurements.

IASB Question 14(c)

67. We have not identified any additional disclosures that would be useful, or any proposed disclosures that would not be useful.

Question 15 – Unit-linked contracts

Do you agree with the proposals on unit-linked contracts? Why or why not? If not what do you recommend and why?

68. In contrast to the proposed approach in relation to discretionary participation features, the proposed definition of unit-linked contract implies potentially no relationship between such contracts and insurance risk. Accordingly, under the proposals all unit-linked contracts would be within the scope of the replacement Standard for IFRS 4, irrespective of whether the contracts have an insurance component and the significance of the associated insurance risks. Consistent with our comments in relation to participating features (IASB Question 10), we recommend the IASB amend the proposals in ED/2010/8 to require only those unit linked contracts that

expose an entity to ‘significant insurance risk’ (as defined in ED/2010/8) be accounted for under the replacement Standard for IFRS 4.

69. We support the IASB’s efforts to minimise accounting mismatches with respect to accounting for unit-linked insurance contracts and the assets underlying such contracts. However, we do not agree with the proposals in relation to investments by an insurer in its own shares (‘treasury shares’) because:
- (a) they are inconsistent with the treatment required under other IFRSs, such as IAS 32 *Financial Instruments: Presentation*; and
 - (b) we are not convinced that the prospect of accounting mismatches is sufficient to warrant industry-specific requirements in this case, especially as the proposals on unit-linked contracts would not eliminate all potential accounting mismatches. Under the proposals in ED/2010/8 (and other IFRSs), accounting mismatches would still arise in respect of, for instance, investments in subsidiaries that hold material internally generated intangible assets and/or internally generated goodwill.

Accordingly, in the absence of a principles-based justification for all entities being permitted or required to recognise treasury shares, we recommend that insurers should be required to treat treasury shares in accordance with the relevant requirements in other applicable IFRSs, such as IAS 32.

Question 16 – Reinsurance

- (a) Do you support an expected loss model for reinsurance assets? Why or why not? If not, what do you recommend and why?
- (b) Do you have any other comments on the reinsurance proposals?

IASB Question 16(a)

70. On balance, we agree with the proposal for an expected loss model for reinsurance assets, notwithstanding that we are opposed to the proposals in ED/2009/12 *Financial Instruments: Amortised Cost and Impairment* for an expected loss model in the context of an amortised cost measurement basis. We consider an expected loss model for reinsurance assets is more consistent with the proposed measurement approach for insurance liabilities (expected present value of the future cash flows) and therefore is less likely to give rise to asymmetrical accounting treatments. However, we remain generally uncomfortable with using methods that are not explicitly attached to a recognised measurement attribute that would have its place in the measurement part of the Conceptual Framework. Measurement approaches seem to be proliferating, sometimes seemingly because of (unstated) differences of view between the IASB and the FASB over Standards such as IAS 37.

IASB Question 16(b)

The recognition of gains on inception

71. We agree with the proposal for an insurer to recognise ‘negative’ residual margins as gains on inception of a reinsurance contract. Unlike residual margins arising from direct insurance contracts, from the insurer’s perspective a negative residual margin arising from a reinsurance contract does not comprise any additional benefits from services to be received over the term of the contract. Accordingly, all of a negative residual margin is in the nature of a pure gain. However, we have some concerns with the IASB’s justifications for proposing that negative residual margins arising from insurance contracts be recognised by the direct insurer as a gain. In particular, we note that, in contrast to the reasons outlined in paragraph BC236:
- (a) in some jurisdictions, such as Australia and New Zealand, reinsurance arrangements often give rise to negative residual margins on the inception of reinsurance contracts. This is because some reinsurers regard Australia and New Zealand as providing good geographic diversification in the context of other jurisdictions they are exposed to (such as the US and Europe) and, therefore, they may be willing to offer relatively attractive reinsurance arrangements to insurers selling contracts in Australia and New Zealand; and
 - (b) under the proposals in ED/2010/8, insurers would not be permitted to reflect diversification benefits across their portfolios in their accounting for insurance contracts. However, insurers would paradoxically be required to reflect the effects of the diversification benefits experienced by reinsurers in their accounting for the reinsurance arrangements.
72. In addition, we note that paragraph 50 of ED/2010/8, which appears to deal with the subsequent treatment of all residual margins (those related to direct and reinsurance contracts), states that:

“An insurer shall recognise the residual margin determined at initial recognition as income in profit or loss...”.

However, a ‘positive’ residual margin that arises in a reinsurance contract is in the nature of a loss. Accordingly, we recommend that, if the IASB adopts the proposals in respect of residual margins, paragraph 50 of the ED be amended to require the residual margin to be recognised as income **or expense** in profit or loss.

Consistent treatment of direct contracts and underlying reinsurance contracts

73. In some cases, insurance contracts that would be considered short-duration in nature are covered by ‘umbrella’ or ‘risk-attaching’ reinsurance contracts, which run for more than one year. In respect of these types of reinsurance arrangements, an accounting mismatch could arise under the proposals in ED/2010/8 if the direct insurance contracts were measured using a premium allocation approach whereas the associated reinsurance contract were measured using the comprehensive measurement model.

74. We note that paragraph BC231 of ED/2010/8 appears to anticipate symmetrical treatment of direct insurance contracts and associated reinsurance contracts. However, to ensure that this intention is clear we recommend the proposals be amended to explicitly state that reinsurance contracts for short-duration contracts should be treated as short-duration contracts. Accordingly, and consistent with our recommendations in relation to the application of the proposed modified measurement approach (paragraphs 40-43 of this response), we would recommend that a direct insurer be permitted (but not required) to apply a premium allocation approach for reinsurance contracts backing short-duration insurance contracts when it would provide similar reporting outcomes as the proposed comprehensive measurement model.

Question 17 – Transition and effective date

- (a) Do you agree with the proposed transition requirements? Why or why not? If not, what would you recommend and why?
- (b) If the Board were to adopt the composite margin approach favoured by the FASB, would you agree with the FASB's tentative decision on transition (see the appendix to the Basis for Conclusions)?
- (c) Is it necessary for the effective date of the IFRS on insurance contracts to be aligned with that of IFRS 9? Why or why not?
- (d) Please provide an estimate of how long insurers would require to adopt the proposed requirements.

IASB Question 17(a)

75. We agree with the proposed transition requirements except for the proposal that an insurer eliminate any existing residual margins against opening retained earnings upon transition on the basis that:
- (a) insurers that are currently accounting for insurance contracts on a similar basis to the proposals in ED/2010/8 could potentially apply the proposed requirements retrospectively and the IASB's 'normal' position under IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* is that retrospective application should be performed, subject to impracticability; and
- (b) it would potentially reduce the comparability of the financial statements of insurers that were reporting under IFRS 4 prior to transition and insurers that establish themselves after the transition to the new reporting requirements.

Accordingly, we consider that entities should be permitted to determine for themselves whether retrospective application of the replacement Standard for IFRS 4 is impracticable in accordance with the relevant principles in IAS 8.

76. With respect to determining the remaining amount of residual margins in relation to in-force business at the date of transition, we agree that it would be inappropriate for an insurer to use hindsight to determine prior period assumptions to measure insurance liabilities. However, it may be possible for some insurers, particularly those currently applying national GAAP that is similar to the proposals in ED/2010/8,

to apply the proposed model to in-force business on the date of inception. We also note that, if the IASB were to decide to amend its proposals in respect of residual margins to permit remeasurement, retrospective application of the proposed model would be potentially less impracticable for some insurers.

77. We also recommend the IASB consider whether insurers could be permitted to transition into the new reporting requirements by using a fair value measurement of the residual margins in their insurance liabilities for the first day of the earliest comparative period presented.

IASB Question 17(b)

78. We do not agree with the FASB's tentative decision on the treatment of the composite margin on transition for the reasons discussed in paragraph 75 of this response. We also note that the FASB's proposal for the margin included in an insurance liability on transition to the IFRS on insurance contracts to be the risk adjustment only (the residual margin would be set at zero) appears to be contrary to its stated views about the inherent difficulties in reliably measuring risk adjustments.

IASB Question 17(c)

79. We agree that insurers should:
- (a) not face two rounds of major changes in a short period; and
 - (b) be able to avail themselves of the measurement choices under IFRS 9 *Financial Instruments* to avoid potential accounting mismatches that might arise as a consequence of transitioning from their domestic GAAP to the replacement Standard for IFRS 4.

However, we note that the proposal to delay the effective date of IFRS 9 would potentially impose two effective dates for IFRS 9 on entities with both insurance and non-insurance activities. Accordingly, we consider that, if the IASB were to delay the effective date of IFRS 9 for insurers, the replacement Standard for IFRS 4 permit an insurer to apply IFRS 9 earlier in accordance with the requirements in IFRS 9.

IASB Question 17(d)

80. Given the similarities between the proposed model and Australian and New Zealand GAAP, we consider that Australian and New Zealand insurers are relatively well-placed to adopt the proposed requirements.

Question 18 – Other comments

Do you have any other comments on the proposals in the exposure draft?

Employers' assets and liabilities under employee benefit plans and retirement benefit obligations

81. Under the proposals in ED/2010/8, insurance benefits provided to members of defined benefit plans would be accounted for by the employer sponsor under IAS 19 and by the plan under IAS 26 *Accounting and Reporting by Retirement Benefit Plans*, whereas insurance arrangements provided to other types of members of retirement benefit plans, including defined contribution members, would be accounted for under the replacement Standard for IFRS 4. While similar in concept, the liability measurement approaches under IAS 19 and IAS 26 on the one hand, and ED/2010/8 on the other, could give different outcomes for the same liability.
82. We do not recommend that the IASB attempt to reconcile this potential inconsistency if this would delay issuing a replacement Standard for IFRS 4. However, we consider the treatment of insurance benefits provided as a part of retirement benefits to be significant and deserving of further consideration when the IASB has completed its current suite of high priority projects. As an interim measure, we recommend that the Basis for Conclusions to the IFRS on insurance contracts provide an explanation of the IASB's reasoning for this scope out.

Discount rate

83. We consider that the discount rate proposals in ED/2010/8 serve to highlight the inconsistencies that currently exist across IFRSs with respect to the determination of discount rates, particularly for liabilities that are similar in nature to insurance liabilities, such as defined benefit obligations. Accordingly, we consider that the IASB should commence a comprehensive project on discount rates once the current suite of high priority projects has been completed.

Question 19 – Benefits and costs

Do you agree with the Board's assessment of the benefits and costs of the proposed accounting for insurance contracts? Why or why not? If feasible, please estimate the benefits and costs associated with the proposals.

84. We agree with the IASB's assessment of the benefits and costs of the proposed accounting for insurance contracts. We consider that, overall, the proposals would lead to improvements in the relevance and reliability of the information reported by insurers at a global level that are cost-beneficial.