List of Submissions to ED 244 *Insurance Contracts*

1	QBE
2	AMP
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4	ICAA
5	CPA Australia
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ED244 sub 1

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27 September 2013

The Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West Victoria 8007
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Dear Sir,

Re: Exposure draft (ED) on insurance contracts standard

QBE fully supports the development of a high quality international accounting standard for reporting general insurance business and we will continue to utilise our global experience and expertise to provide input into the process of developing this standard.

We are in the process of developing our response to the IASB and performing our field-testing for the IASB in relation to the proposed insurance contracts standard and therefore our comments attached are necessarily draft at this stage.

Whilst we consider many aspects of the proposed insurance contracts standard are positive steps towards global consistency and comparability in insurance accounting, some aspects will result in potential inconsistency across companies, more volatile results and the use of historical discount rates at inception which bear little resemblance to the current economic environment in which the business is operating.

Significant improvements have been made in the development of the insurance contracts standard since the introduction of the first ED in 2010 and we fully support these developments. Changes which we fully support and consider essential to the effectiveness of the proposed standard are:

- **Unlocking the contractual service margin** – this change is essential to allow insurers to reflect up to date actual and expected loss profiles and in reducing unnecessary volatility.
- **Contract boundary changes** – the change to acknowledge re-pricing at a portfolio level is critical for a number of general insurance classes to ensure that similar portfolios are measured on a consistent basis. This also reflects the way the business is managed.
- **Diversification** – the IASB proposals now support appropriate measurement of diversification across portfolios which reflects one of the fundamental concepts of insurance business.
- **Eligibility for use of PAA** – the introduction of the reasonable approximation test will significantly improve the ability of general insurers to utilise the PAA.
- **Presentation of the BBA and PAA approaches** – alignment of the reporting of these two approaches in the profit or loss and balance sheet is a significant step forward allowing insurers who have business accounted for under both approaches to continue to report a combined result for their business.

There are, however, a number of areas where we feel the direction the ED has taken has not appropriately addressed the commercial realities of general insurance accounting, in particular the proposal to **present the discount unwind at an inception date rate in profit or loss and the remainder of the discount movement in "Other Comprehensive Income (OCI)"**. We believe this proposal will introduce more volatility into the reported results of many general insurers. The proposal and examples provided do not take into account the correlation between inflation and interest rates and assume a level of asset and liability matching that is unlikely to exist in practice for many general insurers.

This aspect of the proposals will also create a significant increase in the costs of applying the proposed requirements compared with the 2010 ED due to the data requirements to capture and unwind historical discount rates.

Details of our draft comments on the IASB specific questions are included in Appendix 1.

Included in Appendix 2 are our specific responses to the questions raised by the AASB.

We would be happy to discuss and further clarify any of the points raised in this letter. Please contact Anne Driver on anne.driver@qbe.com for coordination of further input. We look forward to working with you to achieve a high quality accounting standard that serves the needs of preparers and users of the financial statements alike.

Yours sincerely,

Neil Drabsch
Chief Financial Officer

Appendix 1 IASB questions and responses

Adjusting the contractual service margin (paragraphs 30–31, B68,

BC26–BC41 and IE9–IE11)

Paragraphs 30–31 propose that the contractual service margin should be adjusted for differences between the current and previous estimates of the present value of future cash flows that relate to future coverage and other future services, provided that the contractual service margin would not be negative. That proposal revises the IASB's conclusion in the 2010 Exposure Draft, which stated that all changes in the estimate of the present value of future cash flows should be recognised immediately in profit or loss.

Question 1—Adjusting the contractual service margin

Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial position and performance if differences between the current and previous estimates of the present value of future cash flows if:
(a) differences between the current and previous estimates of the present value of future cash flows related to future coverage and other future services are added to, or deducted from, the contractual service margin, subject to the condition that the contractual service margin should not be negative; and
(b) differences between the current and previous estimates of the present value of future cash flows that do not relate to future coverage and other future services are recognised immediately in profit or loss?

Why or why not? If not, what would you recommend and why?

Response

(a) We agree that differences between the current and previous estimates of the present value of future cash flows related to future coverage and other future services are added to, or deducted from, the contractual service margin (CSM), subject to the condition that the CSM should not be negative.

The CSM represents the expected profitability of a contract/portfolio. As the coverage period elapses, more information comes to light (regarding the actual vs expected claims experience, final adjustments to premium and actual vs expected claims and acquisition expenses) directly impacting the expected profitability of the contract/portfolio. It is logical to adjust this information against the CSM to reflect the current economic reality of the contract/portfolio and then to amortise the remaining CSM over the remaining life of the policy based on the pattern of transfer of services rather than taking all of the re-estimate at one point in time as proposed in the 2010 ED.

Treatment of changes in risk adjustment and discount related to the liability for future coverage:

We note, however, that changes in the risk adjustment and discount related to future coverage do not impact the CSM <Refer BC 32 (e) "the effects of changes in discount rates and in the risk adjustment do not affect the amount of unearned profit because those changes unwind over time. Accordingly, the contractual service margin would not be adjusted to reflect the effects of changes in the discount rate or in the risk adjustment.">. We do not agree with this assertion.

Where a risk adjustment relates to incurred claims then we agree changes should be included in reported profit or loss. Where the risk adjustment relates to future coverage and requires adjustment in response to a change in expected cash flows then the treatment of the change in cash flows and risk adjustment should align and both be adjusted against the CSM.

The risk adjustment related to future coverage reflects the inherent uncertainty in the cash flow estimates related to future coverage and is inexorably linked to, and based on, the methodology

and assumptions used in the determination of the future cash flows. Any changes in future cash flows result in a reassessment of the risk adjustment in order to revalidate the risk adjustment and as such the treatment of the risk adjustment needs to match that of the cash flow changes and therefore be reflected in the CSM.

We agree that the discount rate unwinds over time. However, discount changes are not just a function of time but also the changing estimate of cash flows and we believe the dependent nature of the cash flows related to future coverage and the resulting discount require the accounting treatment of both to be aligned. Therefore any discount relating to liability for future coverage should also be adjusted against the CSM.

In summary, the risk adjustment and discount related to future coverage are driven by the estimate of future cash flows and should be accounted for in a consistent manner by adjustment against the CSM. Including the movements in risk adjustment and discount related to future coverage in the profit and loss is an overly complex approach that will result in more volatility. The profit and loss is focused on earned revenue and associated expenses – inclusion of volatility related to business which has not yet earned will introduce unnecessary accounting mismatch into the profit and loss.

In reporting to our regulator, APRA, we are required to determine the valuation of premium liabilities which has similar features to the liability for future coverage. We can confirm from experience that the determination of both the risk adjustment and discount respond to the future cash flow assumptions made.

Recommendation: *Adjusting both the risk adjustment and discount relating to* ***future coverage*** *against the CSM will assist in reducing unnecessary volatility, provide a better accounting match and make financial statements less complex.*

(b) We agree with the IASB that differences between the current and previous estimates of the present value of future cash flows that do not relate to future coverage and other future services are recognised immediately in profit or loss.

Contracts that require the entity to hold underlying items and specify a link to returns on those underlying items (paragraphs 33–34, 66, B83–B87, BC42–BC71 and IE23–IE25)

Paragraphs 33–34 and 66 propose a measurement and presentation exception that would apply when the contract requires the entity to hold underlying items and the contract specifies a link between the payments to the policyholder and the returns on those underlying items. The 2010 Exposure Draft did not propose different accounting for such cash flows.

Question 2—Contracts that require the entity to hold underlying items and specify a link to returns on those underlying items

If a contract requires an entity to hold underlying items and specifies a link between the payments to the policyholder and the returns on those underlying items, do you agree that financial statements would provide relevant information that faithfully represents the entity's financial position and performance if the entity:
(a) measures the fulfilment cash flows that are expected to vary directly with returns on underlying items by reference to the carrying amount of the underlying items?
(b) measures the fulfilment cash flows that are not expected to vary directly with returns on underlying items, for example, fixed payments specified by the contract, options embedded in the insurance contract that are not separated and guarantees of minimum payments that are embedded in the contract and that are not separated, in accordance with the other requirements of the [draft] Standard (i.e. using the expected value of the full range of possible outcomes to measure insurance contracts and taking into account risk and the time value of money)?
(c) recognises changes in the fulfilment cash flows as follows:
(i) changes in the fulfilment cash flows that are expected to vary directly with returns on the underlying items would be recognised in profit or loss or other comprehensive income on the same basis as the recognition
of changes in the value of those underlying items;
(ii) changes in the fulfilment cash flows that are expected to vary indirectly with the returns on the underlying items would be recognised in profit or loss; and
(iii) changes in the fulfilment cash flows that are not expected to vary with the returns on the underlying items, including those that are expected to vary with other factors (for example, with mortality rates) and those that
are fixed (for example, fixed death benefits), would be recognised in profit or loss and in other comprehensive income in accordance with the general requirements of the [draft] Standard?

Why or why not? If not, what would you recommend and why?

Response
No comment.

Presentation of insurance contract revenue and expenses (paragraphs 56–59, B88–B91, BC73–BC116 and IE12–IE18)

Paragraphs BC73–BC76 describe the IASB's view that any gross measures of performance presented in profit or loss should be consistent with commonly understood measurements of revenue and expense. Accordingly, paragraphs 56–59 propose that an entity shall present insurance contract revenue that depicts the transfer of promised services arising from the insurance contract in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those services. Similarly, paragraph 58 proposes that an entity should exclude from insurance contract revenue and incurred claims presented in the statement of profit or loss and other comprehensive income any investment components, defined as amounts that an insurance contract requires the entity to repay to a policyholder even if an insured event does not occur.
This proposal revises the proposal in the 2010 Exposure Draft that entities would use a summarised-margin presentation, unless the entity was required to apply the premium-allocation approach. The summarised-margin approach proposed in the 2010 Exposure Draft would have presented, in profit or loss, information about changes in the components that make up the insurance contract liability. In effect, the summarised-margin approach would have treated all premiums as deposits and all claims and benefit payments as returns of deposits, by not presenting revenue and expenses in profit or loss.

Question 3—Presentation of insurance contract revenue and expenses

Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial performance if, for all insurance contracts, an entity presents, in profit or loss, insurance contract revenue and expenses, rather than information about the changes in the components of the insurance contracts?

Why or why not? If not, what would you recommend and why?

Response
We agree that presentation in profit or loss of an entity's insurance contract revenue and expenses more faithfully represents the entity's financial performance and the economic reality of the underlying products. However, we note some omissions and inconsistencies in the approach taken by the IASB to appropriately define the revenue and expenses and the related balance sheet amounts insofar as they relate to general insurance business applying the simplified approach set out in paragraphs 38-40. These inconsistencies are summarised below:

3.1 Inconsistency relating to premium recognition
*As part of the process of working through the PAA accounting requirements we note that paragraph 38 states that an entity may measure the liability for the remaining coverage using the "premium, if any, **received** at initial recognition".*

The emphasis on premium received results in a liability for future coverage largely driven by the pattern of premium receipts. The outcome is a balance sheet driven by a cash rather than accruals concept of accounting and which results in a different outcome for policies which are economically identical and which are sold as identical products but for which the cash payments may differ. In many classes of general insurance business it is common to have different payment options driving only the timing of cash receipts and not the economics of the policy sold.

We note also that the terminology used in part (a) of paragraph 38 above is different in Appendix B91 that better reflects the actual mechanics and economics of the general insurance contract as follows:

*"B91 ……When an entity applies the premium-allocation approach, insurance contract revenue for the period is determined as the amount of **the expected premium receipts** allocated in the period. The entity shall allocate the expected premium receipts as insurance contract revenue to each accounting period in the systematic way that best reflects the transfer of services that are provided under the contract."*

Recommendation: *We propose that paragraph 38 be reworded to refer to expected premiums. This approach will also better align the BBA and PAA approaches in respect of the balance sheet presentation and disclosure.*

3.2 Reinsurance presentation and disclosure

Paragraphs 54 and 55 require separate disclosure of insurance and reinsurance assets/liabilities. In addition, paragraph 63 prevents any offsetting of insurance and reinsurance income or expense. This would imply that the risk adjustment needs to be separately calculated for gross claims and reinsurance recoveries. However, the risk adjustment can only logically be calculated on a net of reinsurance basis to reflect the reinsurance as a risk mitigant.

Risk adjustments typically reflect the variability of the underlying insurance contract/portfolio or reinsurance contract/portfolio held. Mathematically, variability measures cannot be simply added together (e.g. the sum of the 90th percentile of two random variables X and Y is not equal to the 90th percentile of the random variable X+Y). Hence summing the risk adjustments for insurance contracts and reinsurance contracts held yields a total risk adjustment that may be inappropriate given the variability of the total risk presented (i.e. the insurance contract along with reinsurance contracts acting as a risk mitigant) and the insurer's overall risk tolerance (of which it is the residual risk that is important, that is the total risk presented after allowing for risk mitigants like reinsurance).

Recommendation: *The IASB clarify that the risk adjustment covers the insurance contracts risk after allowing for offsetting impact of the reinsurance contracts.*

Interest expense in profit or loss (paragraphs 60–68 and BC117–BC159)

Paragraphs 60, 64 and 66 propose that an entity should recognise:
(a) in profit or loss interest expense determined on an amortised cost basis; and
(b) in other comprehensive income the difference between the carrying amount of the insurance contract measured using the discount rates that were used to determine that interest expense, and the carrying amount of the insurance contract measured using the current discount rates.
These proposals are intended to segregate the effects of the underwriting performance from the effects of the changes in the discount rates that unwind over time. These proposals revise the conclusion in the 2010 Exposure Draft that the effects of changes in discount rates should always be presented in profit or loss.

Question 4—Interest expense in profit or loss

Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial performance if an entity is required to segregate the effects of the underwriting performance from the effects of the changes in the discount rates by:
(a) recognising, in profit or loss, the interest expense determined using the discount rates that applied at the date that the contract was initially recognised. For cash flows that are expected to vary directly with returns on underlying items, the entity shall update those discount rates when the entity expects any changes in those returns to affect the amount of those cash flows; and
(b) recognising, in other comprehensive income, the difference between:
(i) the carrying amount of the insurance contract measured using the discount rates that applied at the reporting date; and
(ii) the carrying amount of the insurance contract measured using the discount rates that applied at the date that the contract was initially recognised. For cash flows that are expected to vary directly with returns on underlying items, the entity shall update those discount rates when the entity expects any changes in those returns to affect the amount of those cash flows?

Why or why not? If not, what would you recommend and why?

Response
We agree with discounting of claims liabilities and the liability for future coverage to recognise the time value of money. However, we do not agree with the changes that have been made since the first ED to split discount into two components reported in the PROFIT OR LOSS (unwind of discount at inception rate discount rates) and OCI (differences arising from current movements in rates).

4.1 All discount movements should be reflected in the profit or loss

QBE is of the view that all movements in discount rate should be included in the profit and loss for the following reasons:

1. ***Reflecting the current business environment*** *- We deliver results to shareholders and policyholders based on and in the current economic environment – the profit or loss reported should reflect the current economic environment in which we do insurance business. The recognition of discount movement should be based on current rates i.e. opening versus closing reflecting the current economic environment the business is operating in.*

2. ***Clarity of reporting*** *- The composition of the movement in discount rates included in the profit or loss is very clear and unambiguous to investors and other users of our financial statements. Allocating discount movement between OCI and profit and loss adds complexity and at best can only be determined on an arbitrary basis.*
3. ***Natural offset against inflation movements*** *- General insurance claims are significantly impacted by changes in inflation. The recognition of discount movements in profit or loss provides a natural offset between explicit and implicit inflation movements in the claims incurred. This*

relationship is much less apparent for life insurance business where only a few isolated classes tend to respond to inflation.

There are two types of inflation:

Consumer price index – reflecting general price inflation trends impacting the direct claims cost associated with the insured loss. This element of inflation tends to trend with interest rates.

Superimposed inflation – generally relates to increased court awards and therefore reflects political and legislative risks that general insurers face.

AASB 1023: General Insurance Contracts was issued in 1991and contains specific mention of inflation as follows: " The longer the expected period from the end of the reporting period to settlement, the more likely it is that the ultimate cost of settlement will be affected by inflationary factors likely to occur during the period to settlement. These factors include changes in specific price levels, for example, trends in average periods of incapacity and in the amounts of court awards for successful claims. For claims expected to be settled within one year of the end of the reporting period, the impact of inflationary factors might not be material."

As a result it is common for Australian actuaries to specifically model inflationary factors, whereas our experience globally indicates this is not such a common practice elsewhere. This, and the fact Australian insurers discount claims, has allowed us to see demonstrable trends between inflation and discount rates.

4. ***Consistency** - Consistency in accounting approach is key to simplifying the financial statements of general insurers. Given that all changes in the liability for claims incurred and changes in the risk margin related to claims incurred are included in the profit and loss it is sensible to adopt the same approach for the discount movements which are derived directly from the claims liability.*

5. ***Comparability** - Requiring all insurers to account for the discount movement associated with earned business in the profit and loss will improve comparability. Any method which attempts to split discount movement requires significant assumptions to be made and will result in reduced comparability. We support inclusion in the profit and loss of the full discount movement accompanied by appropriate analysis of the drivers of discount movement.*

6. *D**emonstration of key general insurance metrics including duration mismatch** – Life insurance business has many products requiring an alignment of the duration of assets and liabilities. General insurance does not have such a compelling need to match duration. From our discussions with the IASB, we note the concern of some IASB Board members that an amortised basis of discounting is essential to allow users to understand duration mismatch. We do not believe this approach is necessary for general insurance. Depending on the risk tolerance of the general insurance entity, maintaining a level of duration mismatch may be a preferred approach to reduce risk. Such a mismatch is usually down to management decisions, taken now, and thus is part of the current business performance and current year's profit and loss account.*

4.2 Why the IASB proposal to report some discount movement through OCI is flawed

QBE is of the view that the IASB proposals to split the discount movement between an amortised component reported in profit and loss and a fair value movement reported in OCI are flawed for the following reasons:

1. ***Complexity** – The explanation of the unwind of discount in the current profit and loss at a historic rate that may bear no relation to prevailing discount rates or any other metrics within the profit and loss introduces additional complexity when explaining to users of financial statements.*

2. ***Mismatch of asset and liability** – The IASB proposal and supporting examples assume that assets perfectly match liabilities when in practice, the unwind of the discount at an inception based rate will continue regardless of the changes in asset profile. Mismatch may arise from many sources such as:*

- *Assets initially classified as amortised cost or FVOCI may be rolled over, sold or reclassified if the business investment strategy changes.*
- *General insurers may have a different investment philosophy depending on their risk tolerance. This may result in a significant component of assets in the FVP&L classification.*
- *Insurers also invest in many asset classifications, which are required to be valued at FVP&L, such as equities and derivatives, often using derivatives in conjunction with interest bearing securities to manage areas such as duration risk.*

3. ***Existence of latent claims*** *- Latent claims are a significant feature of the general insurance industry. Latent claims are claims not anticipated when the policy was underwritten and the premium determined and where the potential for claims to emerge at a much later date was not appreciated. Premiums and profits related to latent claims have generally been recognised in prior reporting periods (often many years previous). Claims emerge due to evidence of an issue and the ability (e.g. due to developments in technology or medicine) to link the loss to the cause. Examples of latent claims related to many years ago, which the insurance industry continues to deal with, include pollution, asbestosis, silicosis, industrial deafness. As the premium has been fully earned many years ago there are no assets supporting claims that could, or would, link to an inception date earning rate and therefore such an inception date rate has no relevance to discounting of liabilities.*

   The application of a discount rate based on the inception date of the policy is meaningless in the context of latent claims as by their nature no assets have been held to support latent claims.

4. ***Ignores inflation*** *- The proposals put forward by the IASB ignore the natural offset between inflation and discount rates relevant to most general insurance classes of business. Refer point 3 above.*

   In particular, for many long tail claims there may be specific links between discount rates and the inflation rates used to drive claims values. Long tail claims are claims for which there is an extended period between recognition of the claim and final determination of the payment amount and settlement. Long tail claims may include latent claims but are not limited to these claims. Where there is a significant period between recognition and settlement the impact of discount is particularly significant and there may be a defined link between the discount rate and the inflation rates used to determine the net loss – for example in Argentinian workers compensation business and Australian dust diseases.

5. ***No clear methodology*** *– There is no clear definition of the cohort required to measure inception discount rates. The requirement in paragraph 60 (h) to include in profit and loss the "interest expense on insurance contract liabilities determined using the discount rates specified in paragraph 25 that applied at "**the date the contract was initially recognised**" requires application to a cohort of contracts or portfolios. As interest and therefore discount rates move daily this could imply that the inception discount rate should vary daily. Alternatively a clear and unambiguous cohort already available in the world of general insurance is the underwriting year – being the calendar year the policy incepts.*

6. ***Cost*** *– There is significant cost associated with the requirement to analyse discount movement into two components. Adopting the concept of a cohort as an underwriting year requires entities to develop significant systems and collect previously unused data in order to track discount unwind. If this cohort is intended to be more granular then the level of data collected and the system complexity escalates accordingly. This results in significant escalation of costs.*

7. ***OCI Undefined*** *– The basis for OCI and the appropriate use of OCI continues to be undefined and thus OCI risks becoming a "dumping ground" for all unwanted volatility. Our view is that it is better to address volatility through appropriate disclosure.*

8. ***Multiple data for business combinations*** *– Acquired entities will be required to maintain two different discounts rates - one for the entity and one on consolidation. This would result in a different discount unwind in subsidiary vs consolidated results.*

4.3 Approach to a workable option

QBE recognises that some insurers consider that reporting all discount movements in the profit or loss does not appropriately reflect their business model and we therefore consider that the inclusion of an option to adopt the split approach for discount (profit or loss and OCI) may alleviate their concerns and we would support such an option ("the discount option").

The inclusion of an option for discounting needs to be worded with care to ensure that it does not inappropriately interact with the Fair Value Option (FVO) proposed in IFRS 9 which can be applied to reduce accounting mismatch. To ensure a sensible application of both options we propose:

- *The option to split the discount into two components is made at transition into the insurance standard or on first adoption.*
- *The option to elect to transfer the difference between historic unwind of discount and current discount rates is adopted at portfolio level and is irrevocable. The election would be made at portfolio level in order to allow composite insurers to elect the most appropriate business model for the business in that portfolio.*
- *In the event of a business combination a one off election is permitted at acquisition date.*
- *Elect the discount option first. We consider the FVO in IFRS 9 to be perfectly compatible with a discount option provided there is some simple guidance on application. IFRS 9 adopts a business model led approach in determining the classification of assets to accounting categories. The FVO for assets in the FVOCI category is applied to specific assets and can only be elected in the case of accounting mismatch. Therefore it is clearly necessary to elect the discount option first (either on transition, first adoption of a business combination) allowing entities to then determine whether the FVO in IFRS 9 should be applied.*

The fair value option in IFRS 9 proposals allows for a FVO to be applied to assets otherwise recognised as FVOCI in the case of accounting mismatch. This election is made on inception and irrevocable. However, assets are generally much more transferable than insurance liabilities allowing entities to buy and sell to drive investment outcomes. The FVOCI category has sufficient latitude to allow selling within investment objectives.

Effective date and transition (paragraphs C1–C13, BC160–BC191 and IE26–IE29)

Paragraphs C1–C13 propose that an entity should apply the [draft] Standard retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* when it is practicable. When it would not be practicable, paragraphs C5–C6 propose a modified retrospective application, which simplifies the transition requirements while maximising the use of objective information. These proposals revise those in the 2010 Exposure Draft, which proposed that the entity should recognise no contractual service margin for contracts in force at the beginning of the earliest period presented. These proposals increase the comparability of contracts in existence at the date of transition with those that are written after the date of transition. However, estimates of the contractual service margin may not be verifiable.

Question 5—Effective date and transition
Do you agree that the proposed approach to transition appropriately balances comparability with verifiability?

Why or why not? If not, what do you suggest and why?

Response
We consider the proposed transition requirements are a significant improvement on the first ED. Our major concern relates to the timing of the introduction of the insurance standard and the timing of mandatory application of IFRS 9. We believe the application dates of both standards need to be aligned due to the significant dependencies introduced through the added classification of "Fair Value through OCI". Whilst transitional arrangements can align the standards at a later date the extent of the changes arising from application of both the insurance standard and IFRS 9 is significant and further transition requirements related to IFRS 9 just increase the amount of work and associated costs of implementing a standard only to have to revise accounting approaches at a subsequent date.

The main issues arising on application of IFRS 9 will be application of the FVOCI vs FVP&L split which will cause significant accounting and systems changes. The existence of a workable fair value option would largely remove these issues. In addition, the existence of a fair value option for equities which does not recycle to the profit or loss and a FVOCI classification which does recycle is introducing inconsistency of accounting approach and more complexity in explaining results to users.

The likely effects of a Standard for insurance contracts

The proposals in this Exposure Draft result from the IASB's consideration of the comments received on its 2010 Exposure Draft. In the IASB's view, the revised proposals would result in a more faithful representation and more relevant and timely information about insurance contracts in the financial statements of entities that issue insurance contracts compared to the proposals in the 2010 Exposure Draft and with IFRS 4. In developing these proposals, the IASB has sought to balance those benefits with the costs of greater operational complexity for preparers, and any increased costs for users of financial statements in understanding the more complex information produced.
Those costs arise both on initial application and on an ongoing basis, and are described in the following sections of the Basis for Conclusions:
(a) adjusting the contractual service margin (see paragraph BC35);
(b) contracts that require the entity to hold underlying items and specify a link to returns on those underlying items (see paragraphs BC56–BC62);
(c) presentation of insurance contract revenue and expenses (see paragraphs BC99–BC100);
(d) interest expense in profit or loss (see paragraphs BC127–BC132);
(e) effective date and transition (see paragraphs BC164–BC173); and
(f) the likely effects of a Standard for insurance contracts (see Appendix B: Effect Analysis).

The IASB is particularly interested in receiving feedback on how its response to the comments on the 2010 Exposure Draft balance the costs of applying these proposals with the benefits of the resulting information provided.

Question 6—The likely effects of a Standard for insurance contracts

Considering the proposed Standard as a whole, do you think that the costs of complying with the proposed requirements are justified by the benefits that the information will provide? How are those costs and benefits affected by the proposals in Questions 1–5? How do the costs and benefits compare with any alternative approach that you propose and with the proposals in the 2010 Exposure Draft?

Please describe the likely effect of the proposed Standard as a whole on:
(a) the transparency in the financial statements of the effects of insurance contracts and the comparability between financial statements of different entities that issue insurance contracts; and
(b) the compliance costs for preparers and the costs for users of financial statements to understand the information produced, both on initial application and on an ongoing basis.

Response
Our view is that the current proposals further increase the complexity of reporting for general insurers and significantly increase the costs. The benefits of comparability and consistency are minimal given the general insurance industry has already in place some clearly defined metrics and measurement methods which required only minimal amendment by the IASB to arrive at a workable global solution. The desire of the IASB to blend both life insurance and general insurance together into a single solution has been the trigger for a deterioration in the overall outcome for general insurers.

A much more elegant solution would have been to deliver a general insurance standard based on generally accepted global principles with the addition of the key components of the IASB model i.e. expected cash flows, risk adjustment, discounting and contractual service margin representing unearned profit.

Clearly the greatest difficulty is arising in the life insurance space and the need to develop a standard that best reflects the economics and profitability of the products being sold in a way that is transparent to users. The push to resolve life issues between the first and second ED has resulted in a backward step for general insurers.

Our view is that the requirement to split discount between profit or loss and OCI stands out as a requirement which has no benefit in general insurance but requires significant tracking, data collection

and assumptions and significant cost. The ED does permit discount to be ignored for claims expected to settle within a year but the majority of general insurance claims take in excess of one year (the weighted average term to settlement of our portfolio is approximately 2.9 years) and to adopt the one year or less approach at contract level would mean splitting portfolios to reflect the different payout patterns of greater or less than a year – all additional tracking and data collection for no benefit.

Clarity of drafting

The IASB welcomes views on whether the proposals are drafted clearly and whether they reflect the decisions made by the IASB. If a proposed requirement is not clear, the IASB invites suggestions on how to clarify the drafting of the proposed requirement.

Question 7—Clarity of drafting

Do you agree that the proposals are drafted clearly and reflect the decisions made by the IASB? If not, please describe any proposal that is not clear. How would you clarify it?

Response
Our preliminary view is that the wording is complex and difficult to interpret. We see this as the inevitable result of trying to account for two quite different industries in one accounting standard. Generally accepted principles of general insurance have been omitted in the effort to deliver two quite different industries into one accounting standard. Whilst we acknowledge the overlap between some life products and general insurance a significant component of the life industry has more in common with the asset management industry than it does with general insurance.

As a global general insurer our business will primarily be reported under the simplified approach with some lines of business requiring the main measurement model. As such we have worked through the ED and illustrative examples for both the main and simplified models and note the following areas where we consider the drafting is unclear:

1. *Determination of liability for future coverage under simplified approach (refer response to question 3 above)*
2. *Implication that the risk adjustment can be calculated for gross claims and reinsurance recoveries separately (refer response to question 3 above)*
3. *Use of terms "portfolio" and "contract" in an inconsistent manner.*

We also note that the IASB has included many examples of the main measurement model but omitted to include any relating to the simplified model making it impossible to verify our conclusions and interpretations of how the simplified model is applied.

Recommendation
We recommend that worked examples for the PAA approach be included in the final standard and that the term portfolio is used consistently throughout the standard.

Appendix 2 AASB questions and responses

AASB question 1

Whether there are any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the proposals, particularly any issues relating to:
(a) not-for-profit entities; and
(b) public sector entities, including any GAAP/GFS implications;

Response
We have not identified any regulatory issues or other issues arising in the Australian environment at this stage of our analysis that may affect the implementation of the proposals.

AASB question 2
Whether, overall, the proposals would result in financial statements that would be useful to users

Response
Our major concern is the requirement to report a component of the discount movement in OCI. Our detailed comments on this area are included in our response to question 4 of Appendix 1.

AASB question 3
Whether the proposals are in the best interests of the Australian economy

Response
The AALC has concerns with respect to some aspects of the ED, as noted in our responses to the earlier questions. In the event that these are not resolved, however, it is still likely to be in the interest of the Australian economy to adopt the final IASB standard.

AASB question 4
Unless already provided in response to specific matters for comment 1 – 3 above, the costs and benefits of the proposals relative to the current requirements, whether quantitative (financial or non-financial) or qualitative.

Response
There are still aspects of the ED we consider require further development, change or clarification. However, we believe the insurance contracts project needs to be driven through to completion in the existing process to begin the process of a developing a more consistent international approach to accounting for general insurance.

27 September 2013

The Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West Victoria 8007
Australia

Dear Sir

Response to AASB Exposure Draft ED 244 *Insurance Contracts* ("the ED")

AMP is pleased to provide its response to the ED. AMP is supportive of the AASB's efforts to develop an accounting standard that will promote a consistent approach to accounting for insurance contracts and is capable of being adopted across all jurisdictions that have adopted IFRS.

Executive summary

In general we are supportive of the improvements made from the 2010 exposure draft, especially the changes to the transition rules and the unlocking of the contractual service margin.

However, we believe that the model currently proposed in the ED has issues that need to be addressed. These issues are presented below and are discussed in more detail in the body of our letter.

Overall, the ED proposals will give rise to a significant increase in the complexity of accounting for long term life insurance products relative to current practice in Australia and other jurisdictions. We believe that the complexity resulting from the proposals will decrease the understandability of financial statements and result in insurers increasing the use of non-IFRS reporting in order to interpret the IFRS result for users of the financial statements.

"Mirroring" of linked assets

The "mirroring" proposal related to contracts that require the entity to hold underlying items and specify a link to returns on those items is overly complex to apply in practice and we do not expect that it will provide a meaningful result to users of the financial statements.

Conceptually, we agree with the aim of eliminating accounting mismatches but we do not believe that the proposal in the ED succeeds in effectively eliminating accounting mismatches due to its complexity and also because it will not apply to contracts that are linked to underlying assets if the contracts are not classified as insurance contracts.

We recommend that the IASB require (or at least allow) a policy liability measurement that reflects a fair value through profit or loss measurement for both the asset and linked component of the liability in order to achieve a current valuation of insurance contracts. We further recommend that, for participating products, an adjustment to the contractual service margin be allowed for differences between actual and expected investment returns on underlying assets.

Use of Other Comprehensive Income (OCI)

The proposal to recognise interest expense in profit or loss based on discount rates that applied at the inception of the policy and the impact of current market discount rates through other comprehensive income (OCI) introduces significant and unnecessary complexity into the calculation of insurance liabilities and we do not expect that it will achieve its objective of eliminating the impact of current market rates from profit or loss.

We recommend that all changes in policy liabilities be recognised in profit or loss. If the IASB allows the use of OCI, it should be as an irrevocable election made on adoption of the standard, with profit or loss treatment being the default approach.

If the IASB decides to retain the use of OCI, we recommend as a simplification to the current proposal that the interest rate to be recognised in profit or loss should be determined using discount rates at the start of the reporting period rather than the inception of the contract.

Responses to the questions specified in the ED

IASB Question 1 – Adjusting the contractual service margin
Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial position and performance if differences between the current and previous estimates of the present value of future cash flows if: *(a) differences between the current and previous estimates of the present value of future cash flows related to future coverage and other future services are added to, or deducted from, the contractual service margin, subject to the condition that the contractual service margin should not be negative; and* *(b) differences between the current and previous estimates of the present value of future cash flows that do not relate to future coverage and other future services are recognised immediately in profit or loss?* *Why or why not? If not, what would you recommend and why?*

AMP broadly supports this proposal, which is a significant improvement from the approach proposed in the 2010 exposure draft.

We believe that excluding the impact of changes in expected cash flows relating to future coverage from current year profit or loss provides more useful and relevant information as current year performance is not obscured by the impact of changes in expected future profitability. The proposal is also conceptually consistent with the approach in the IASB's exposure draft for revenue from contracts with customers.

AMP recommends, however, that the proposal be modified as follows:

- Require that the contractual service margin be adjusted for changes in the risk margin that relate to future coverage, rather than requiring these changes to be recognised in current period profit or loss. In our view, changes in the risk margin relating to future coverage are similar to changes in the contractual service margin relating to future coverage in that they represent changes in expected future profitability and should result in a change in the profit margin to be released in future periods rather than being taken to current period profit or loss.

- When a portfolio has exhausted its contractual service margin, require that subsequent improvements in expected cash flows related to future coverage be recognised in current period profit or loss to the extent of previously recognised losses in order to achieve accounting symmetry. As the proposal stands now, the insurer is required to recognise unfavourable changes to assumptions for such products in the current period profit or loss but not favourable changes.

Question 2 – Contracts that require the entity to hold underlying items and specify a link to returns on those underlying items

If a contract requires an entity to hold underlying items and specifies a link between the payments to the policyholder and the returns on those underlying items, do you agree that financial statements would provide relevant information that faithfully represents the entity's financial position and performance if the entity:

(a) measures the fulfilment cash flows that are expected to vary directly with returns on underlying items by reference to the carrying amount of the underlying items?

(b) measures the fulfilment cash flows that are not expected to vary directly with returns on underlying items, for example, fixed payments specified by the contract, options embedded in the insurance contract that are not separated and guarantees of minimum payments that are embedded in the contract and that are not separated, in accordance with the other requirements of the [draft] Standard (ie using the expected value of the full range of possible outcomes to measure insurance contracts and taking into account risk and the time value of money)?

(c) recognises changes in the fulfilment cash flows as follows:

(i) changes in the fulfilment cash flows that are expected to vary directly with returns on the underlying items would be recognised in profit or loss or other comprehensive income on the same basis as the recognition of changes in the value of those underlying items;

(ii) changes in the fulfilment cash flows that are expected to vary indirectly with the returns on the underlying items would be recognised in profit or loss; and

(iii) changes in the fulfilment cash flows that are not expected to vary with the returns on the underlying items, including those that are expected to vary with other factors (for example, with mortality rates) and those that are fixed (for example, fixed death benefits), would be recognised in profit or loss and in other comprehensive income in accordance with the general requirements of the [draft] Standard?

Why or why not? If not, what would you recommend and why?

AMP does not support this proposal.

While AMP agrees that the accounting basis should be consistent for both the contract and linked underlying items, the proposed solution is unnecessarily complex to apply in practice and is not expected to achieve a sensible outcome in respect of participating products or situations where the underlying item is an equity or debt instrument issued by an entity within the same consolidated group.

Part of this complexity arises from the diversity of accounting treatments required for supporting assets, particularly due to the proposal to introduce a "fair value through other comprehensive income" category into IFRS 9, which for some portfolios results in some of the underlying assets being accounted for at fair value through profit or loss and other assets at fair value through OCI.

Under the ED's proposal, a single portfolio of insurance contracts could have various different accounting treatments used to measure its insurance contract liability balance as follows:

- Linked component backed by derivatives, complex debt instruments or investment properties measured at fair value through profit or loss;
- Linked component backed by simple debt instruments measured at fair value through other comprehensive income using the effective interest rate on the backing assets;
- Linked component backed by assets held at cost (such as controlled private equity investments) measured at the accounting bases applying to individual assets;
- Other components, such as surrender options, measured at expected values with changes offset against the contractual service margin;
- Unwind of discount on components not linked to underlying assets at the discount rate on inception of the contracts.

Accounting mismatches for life insurers also arise on investment contracts that are outside the scope of insurance contracts as defined in the ED and are therefore treated as financial instruments. As the "mirroring" concept is not included in IFRS 9, the proposal to implement it for insurance contracts will result in an inconsistent approach between these two standards and accounting mismatches that arise on investment contracts will continue to exist.

Further complications with mirroring arise on consolidation. In the AMP Limited group, there are contracts written by the life insurers that require the insurer to hold underlying assets and pass the returns from these assets on to the policyholder. The underlying assets include investments in investment funds operated by AMP's asset management business that are consolidated by AMP Limited in accordance with IFRS 10 and deposits with AMP Bank. For these assets, AMP Life Limited (the insurer) will be eligible to use mirroring in its stand-alone accounts, but the consolidated AMP Limited group will not be eligible to use the same accounting treatment.

Recommendation

AMP recommends that, as a principal, accounting mismatches are best addressed by achieving consistency between the measurement approaches of standards rather than by exceptions within the standards. For the purposes of this standard, minimisation of accounting mismatches is more effectively achieved by requiring (or at least allowing) measurement of the linked component of the liability at fair value through profit or loss. Where the underlying item is a financial asset, AASB 9 would then require the asset to also be measured at fair value through profit or loss as this reduces an accounting mismatch.

If the IASB decides to retain the use of "mirroring", AMP recommends that:

- an exception be introduced such that if mirroring is achieved for the insurer on a stand-alone basis, this treatment continue on consolidation, even where the underlying asset is consolidated; and
- "mirroring" should also be introduced for financial liabilities within the scope of IFRS 9 that have a similar link to underlying items.

With respect to participating products, AMP supports the proposal put forward by the IASB staff to the December 2012 meeting of the IASB that the contractual service margin for participating contracts is adjusted for changes in the value of the premiums by adjusting the margin for changes in the value of the underlying items as measured using IFRS.

Question 3 – Presentation of insurance contract revenue and expenses

Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial performance if, for all insurance contracts, an entity presents, in profit or loss, insurance contract revenue and expenses, rather than information about the changes in the components of the insurance contracts?

Why or why not? If not, what would you recommend and why?

AMP supports the proposal. In our view the presentation of an entity's insurance contract revenue and expenses in profit or loss provides relevant information that faithfully represents the entity's financial performance and the economic reality of the underlying products.

Question 4 – Interest expense in profit or loss

Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial performance if an entity is required to segregate the effects of the underwriting performance from the effects of the changes in the discount rates by:

(a) recognising, in profit or loss, the interest expense determined using the discount rates that applied at the date that the contract was initially recognised. For cash flows that are expected to vary directly with returns on underlying items, the entity shall update those discount rates when the entity expects any changes in those returns to affect the amount of those cash flows; and

(b) recognising, in other comprehensive income, the difference between:

(i) the carrying amount of the insurance contract measured using the discount rates that applied at the reporting date; and

(ii) the carrying amount of the insurance contract measured using the discount rates that applied at the date that the contract was initially recognised. For cash flows that are expected to vary directly with returns on underlying items, the entity shall update those discount rates when the entity expects any changes in those returns to affect the amount of those cash flows?

Why or why not? If not, what would you recommend and why?

AMP does not support this proposal as is introduces significant and unnecessary complexity into the calculation of insurance liabilities and we do not expect that it will achieve its objective of eliminating the impact of current market rates from profit or loss.

We understand that the aim of the IASB's proposal to present changes in the carrying amount of insurance contracts through other comprehensive income (OCI) is to disaggregate and separately present components of the entity's performance that have arisen as a result of changes to market variables during the period.

Whilst the removal of the impact of current discount rate movements from reported profit is conceptually appealing, it is unlikely to be fully achieved by these proposals as:

- some assets commonly used to back insurance contracts (such as investment properties, complex debt securities and interest rate derivatives) are not eligible to be measured at fair value through OCI under the proposed amendments to AASB 9;
- the durations of assets and liabilities may not always match;
- reported profit will be impacted by the entity's decisions to dispose of assets prior to their maturity; and
- liabilities will be measured using a yield curve whereas the backing assets will be measured using an effective (straight-line) discount rate.

In addition, the proposed approach is expected to add significant complexity for preparers of the financial statements. We believe that the cost of this complexity exceeds any benefits. In particular we highlight the following key concerns:

- The IASB proposes to require the use of 'locked-in' interest rates to accrete interest on insurance liabilities for presentation in the profit or loss statement, whereas the yield curve is locked in at initial recognition. This will likely require entities to record successive yield curves and associate them with the related insurance contracts, which will require significant modification to existing systems and processes in order to identify and maintain the required records. We believe that the information on discount rates that existed at the date of writing a contract is irrelevant to the users of the financial statements. In our view, interest should be accreted on insurance liabilities at current interest rates, consistent with the IASB's current value model.

- On transition, the requirement to ascertain and apply discount rates applicable at initial recognition for each insurance contract is likely to be impracticable, particularly for older contracts. For conglomerate groups that have acquired insurers, the date of initial recognition will be the date of policy inception for the insurance entity and date of acquisition for the financial statements of the consolidated group, which will result in different performance outcomes (between entity and consolidated group) over the remaining life of the policies.

In our view, the discount rate at inception is not a relevant consideration for users of the financial statements and therefore there is no benefit to support the cost of tracking and reporting information based on these discount rates.

We further note that the IASB has not yet developed a conceptual framework for the use of OCI. In our view it would be imprudent for the IASB to mandate the use of OCI for new purposes until such time as this framework is developed.

Recommendation

AMP proposes that all changes in insurance liabilities be taken through profit or loss. In our view this is more consistent with the current measurement approach adopted by the IASB and eliminates the unnecessary complexity which arises from the proposal set out in the ED.

Notwithstanding the issues discussed above, we are aware that there is strong support from some European insurers for the use of OCI (although this support is far from universal). We encourage the IASB to be global in its thinking and work towards a model that will provide a sensible accounting outcome across different jurisdictions and business models.

If the IASB decides to retain the use of OCI in the final standard, then we propose that:

- changes to the carrying amount of insurance liabilities be recognised through profit or loss as the primary approach, with an option to recognise these changes through OCI where:
    - all assets supporting the liabilities are recognised at fair value through OCI;
    - the insurer has a business model where assets supporting the liabilities are not normally purchased or sold after initial recognition of the liability; and
    - there is no link between the liabilities and underlying rates of inflation;
- amounts recognised in OCI be based on the difference between current interest rates at the start of the reporting period rather than the interest rate at inception of the contract.

Question 5 – Effective date and transition
Do you agree that the proposed approach to transition appropriately balances comparability with verifiability? *Why or why not? If not, what do you suggest and why?*

AMP is supportive of the fully retrospective approach, which is expected to allow meaningful consistent information to be reported post transition and addresses the concerns raised with respect to the proposal in the previous exposure draft to set the residual margins to zero at transition.

AMP also supports the explicit allowance for the use of a practical expedient where the full retrospective application is impracticable.

The three year transition period from the standard's publication appears to be a reasonable length of time to prepare for the adoption of the standard. We recommend that the IASB align the dates of application of IFRS 9 and IFRS 4. If alignment is not possible, we recommend that the IASB allow insurers to delay the application of IFRS 9 until the insurance contracts standard can be applied simultaneously.

Question 6 – The likely effects of a Standard for insurance contracts
Considering the proposed Standard as a whole, do you think that the costs of complying with the proposed requirements are justified by the benefits that the information will provide? How are those costs and benefits affected by the proposals in Questions 1–5? How do the costs and benefits compare with any alternative approach that you propose and with the proposals in the 2010 Exposure Draft? *Please describe the likely effect of the proposed Standard as a whole on:* *(a) the transparency in the financial statements of the effects of insurance contracts and the comparability between financial statements of different entities that issue insurance contracts; and* *(b) the compliance costs for preparers and the costs for users of financial statements to understand the information produced, both on initial application and on an ongoing basis.*

AMP is concerned about both the cost and unnecessary complexity that arise from the proposals for “mirroring” and the use of OCI. Our concerns in respect of these proposals are detailed in our responses to Questions 2 and 4 respectively.

In our view the costs of implementing these proposals is not supported by the benefits achieved.

Question 7 – Clarity of drafting
Do you agree that the proposals are drafted clearly and reflect the decisions made by the IASB? *If not, please describe any proposal that is not clear. How would you clarify it?*

AMP believes that the following areas could be drafted more clearly as suggested below:

- paragraph B32 states that an investment and insurance contract are highly interrelated if the lapsing or maturity of one product causes the lapsing or maturity of the other. In our view, this will not always be the case, as this relationship may exist for operational purposes rather than represent an economic interdependence. We recommend that this paragraph is modified so that the simultaneous lapsing is an indicator or gives rise to a rebuttable presumption.
- paragraph B66(i) – the use of the phrase “fiduciary capacity” could be open to interpretation and result in tax payments levied on the insurer to not be included in fulfilment cash flows.

  We recommend that this paragraph is modified to “payments by the insurer to meet tax obligations arising from insurance contracts in a fiduciary capacity or as a proxy for taxing policyholders”.
- paragraph 68 – if there are foreign insurance operations with a different functional currency than the parent’s presentation currency, exchange differences are to be recognised in other comprehensive income. The additional wording in paragraph 68 does not appear to allow for this scenario.

  We recommend that this paragraph is modified to read “Paragraph 20 requires an entity to treat an insurance contract as a monetary item under IAS 21 for the purpose of recognising foreign exchange gains and losses.”

AASB Specific Matters for Comment

Question 1 – Regulatory or Australian specific considerations
Whether there are any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the proposals, particularly any issues relating to: *(a) not-for-profit entities; and* *(b) public sector entities, including any GAAP/GFS implication*

AMP has not identified any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the proposals.

Question 2 – Usefulness of financial statements
Whether, overall, the proposals would result in financial statements that would be useful to users

As noted above, AMP has concerns that some aspects of the ED will decrease the understandability of the financial statements, specifically:

- the mandatory use of other comprehensive income to recognise some, but not all, of the impacts of interest rates on insurance contracts and their supporting assets is likely to result in new accounting mismatches in reported profit; and
- the application of "mirroring", particularly with respect to participating life insurance and investment contracts appears to be unnecessarily complex and may not result in the reporting of useful information.

Further discussion on these matters, together with other detailed comments are provided in our responses to IASB questions 2 and 4 set out above.

Question 3 – Australian economy considerations
Whether the proposals are in the best interests of the Australian economy

AMP has concerns with respect to some aspects of the ED, as noted in our responses to the earlier questions. In the event that these are not resolved, however, it is still likely to be in the interest of the Australian economy to adopt the final IASB standard.

Question 4 – Costs and benefits of proposals relative to the current requirements
Unless already provided in response to specific matters for comment 1 – 3 above, the costs and benefits of the proposals relative to the current requirements, whether quantitative (financial or non-financial) or qualitative.

In the view of AMP, although there are significant improvements that may be made to the proposals set out in the ED, it is imperative that this project be brought to a close, a final standard issued and insurers move from local standards to an a consistent international approach.

Thank you for the opportunity to comment on these proposals. If you would like to discuss these matters further, please contact me on (02) 9257 6784.

Yours faithfully

Graham Duff
Head of Accounting Policy & Accounting Advice

Accountants and Actuaries Liaison Committee

27 September 2013

The Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West Victoria 8007
AUSTRALIA

Dear Sir

Response to AASB exposure draft ED 244 *Insurance Contracts* ("the ED")

The Accountants' and Actuaries' Liaison Committee ("AALC") is pleased to provide its response to the ED. This response represents the views of the members of the AALC (and not necessarily their employing organisations or professional association).

The AALC is supported by The Institute of Chartered Accountants in Australia and the Institute of Actuaries of Australia. The AALC is primarily concerned with matters affecting both professions, including the development and implementation of accounting standards for the insurance industry. The AALC takes a practical approach to problems, as its members are all practitioners in insurance and related fields.

We are supportive of the move towards international consistency in the accounting for insurance contracts. The AALC continues to support the IASB's proposal to:

- use a current value approach; and
- measure outstanding claims on a basis that reflects the time value of money.

We also acknowledge the significant improvement in the proposals set out in the ED relative to the 2010 exposure draft, particularly with respect to:

- the unlocking of margins for changes in estimates relating to future coverage;
- contract boundaries;
- the treatment of diversification benefits;
- characterisation of the Premium Allocation Approach as an approximation for the Building Block Approach rather than an alternative model; and
- the approach to transition.

We have concerns, however with respect to some aspects of the ED, specifically:

- the mandatory use of other comprehensive income to recognise some, but not all, of the impacts of interest rates on insurance contracts and their supporting assets is likely to result in new accounting mismatches in reported profit; and

- the application of “mirroring” particularly with respect to participating life insurance and investment contracts appears to be unnecessarily complex and may not result in the reporting of useful information.

Further discussion on these matters, together with other detailed comments are provided below in our responses to the specific IASB and AASB questions set out below.

This letter sets out the collective view of the AALC members at the date of drafting. The proposals set out in the ED are complex and further issues may emerge as the proposals are further analysed. We will advise the AASB of any such issues identified.

Answers to Specific Questions - IASB

IASB Question 1 — Adjusting the contractual service margin

Do you agree that financial statements would provide relevant information that faithfully represents the entity’s financial position and performance if differences between the current and previous estimates of the present value of future cash flows if:

(a) differences between the current and previous estimates of the present value of future cash flows related to future coverage and other future services are added to, or deducted from, the contractual service margin, subject to the condition that the contractual service margin should not be negative; and

(b) differences between the current and previous estimates of the present value of future cash flows that do not relate to future coverage and other future services are recognised immediately in profit or loss?

Why or why not? If not, what would you recommend and why?

Response

Adjusting the contractual service margin for changes in expected future cash flows

The AALC is supportive of proposal to adjust the contractual service margin for differences between the current and previous estimates of the present value of future cash flows relating to future coverage. Specifically, the proposed approach:

- correctly characterises such changes in estimates as changes in expected future profitability rather than current period gains and losses;
- is more consistent with the approach proposed for other types of revenue in the IASB’s exposure draft “Revenue for Contracts With Customers”;
- provides a more sensible pattern of profit emergence and
- estimates of future cash flows related to future coverages typically involve a significant element of judgement and therefore we consider it appropriate that such impacts are not capitalised through profit or loss (for profitable contracts).

Changes to the risk margin

The AALC recommends that this approach also be adopted for changes in the risk margin which relate to future coverage. In the view of the AALC, such changes also reflect changes in expected future profitability rather than current year gains and

losses. Changes in the expected future cash flows will result in a reassessment of the risk margin and as such the treatment of the risk adjustment needs to match that of the cash flow changes and therefore be reflected as in the contractual service margin.

We understand that there are concerns that it may be difficult to separate risk margins between the component that relate to future coverage and those that do not. In our view, the allocation of the movement in risk margin between these components will be relatively straight forward as an insurer will have already separated changes in expected cash flows that relate to future coverage from other changes in cash flows for the purposes of adjusting the contractual service margin. It would therefore be relatively straight forward to separate the risk margin on the same basis as the expected cash flows.

Where risk adjustment relates to incurred claims then we agree changes should be included in reported profit or loss.

Loss recognition and reversal

The AALC proposes that, for products where the contractual service margin has been exhausted and changes in expected future cash flows have been losses through profit or loss, subsequent changes in expectations which result in a reduction in the value of fulfilment cashflows should be recognised through profit or loss as a reversal of the previously recognised losses. Under this approach, losses and profits are treated symmetrically which is more logical and for this reason it is also more likely to accord with the expectations of account users.

The approach proposed in the Exposure Draft of adjusting the contractual service margin for subsequent improvements in expectations would result in the inclusion an amount in reported profits over a number of periods which is not reflective of current maintainable earnings (relating to the release over time of past capitalised losses).

IASB Question 2 — Contracts that require the entity to hold underlying items and specify a link to returns on those underlying items

If a contract requires an entity to hold underlying items and specifies a link between the payments to the policyholder and the returns on those underlying items, do you agree that financial statements would provide relevant information that faithfully represents the entity's financial position and performance if the entity:

(a) measures the fulfilment cash flows that are expected to vary directly with returns on underlying items by reference to the carrying amount of the underlying items?

(b) measures the fulfilment cash flows that are not expected to vary directly with returns on underlying items, for example, fixed payments specified by the contract, options embedded in the insurance contract that are not separated and guarantees of minimum payments that are embedded in the contract and that are not separated, in accordance with the other requirements of the [draft] Standard (ie using the expected value of the full range of possible outcomes to measure insurance contracts and taking into account risk and the time value of money)?

(c) recognises changes in the fulfilment cash flows as follows:

(i) changes in the fulfilment cash flows that are expected to vary directly with returns on the underlying items would be recognised in profit or loss or other comprehensive income on the same basis as the recognition of changes in the value of those underlying items;

(ii) *changes in the fulfilment cash flows that are expected to vary indirectly with the returns on the underlying items would be recognised in profit or loss; and*

(iii) *changes in the fulfilment cash flows that are not expected to vary with the returns on the underlying items, including those that are expected to vary with other factors (for example, with mortality rates) and those that are fixed (for example, fixed death benefits), would be recognised in profit or loss and in other comprehensive income in accordance with the general requirements of the [draft] Standard?*

Why or why not? If not, what would you recommend and why?

Response

We agree with the principle that, for contracts which require the entity to hold underlying items and specify a link to returns on those underlying investments, the accounting basis should be consistent for the contract and the underlying items so as to avoid accounting mismatches.

Whilst the approach of "mirroring" the accounting for the underlying items provides a conceptual solution to this problem, it is complex to apply in practice and may not achieve a sensible outcome. This is particularly the case in respect of:

- products backed with a mixture of simple debt instruments, complex debt instruments and assets which are not financial instruments;
- participating products; and
- situations where the underlying item is an equity or debt instrument issued by an entity within the same consolidated group.

Part of this complexity arises from the diversity of accounting treatments allowed for supporting assets, particularly due to the proposal to introduce a "fair value through other comprehensive income" category into IFRS 9 *Financial Instruments*.

Under the proposal, a single portfolio of insurance contracts, could end up with the following accounting treatments within its insurance contract liability balance:

- Linked component to the extent backed by complex debt instruments and investment properties at fair value profit or loss;
- Linked component to the extent backed by simple debt instruments at fair value through other comprehensive income using the effective interest rate on the backing assets;
- Linked component to the extent backed by assets held at cost (such as controlled private equity investments) on the accounting bases applying to individual assets;
- Other components, such as surrender options measured at expected values with changes offset against the contractual service margin;
- Unwind of discount on components not linked to underlying assets at the discount rate on inception of the contracts.

In the AALC's view, the complexity of this approach makes it unsatisfactory, despite its conceptual appeal.

Further complications may arise on consolidation. The situation is likely to arise where, while the insurer is required to hold underlying items, these underlying items may be investments in or balances with entities that are consolidated into the same group. In such circumstances, mirroring will be applied by the insurer in its stand-

alone accounts, but not on consolidation. We have already identified this as a problem where the underlying item is a deposit with a bank or an investment vehicle that is consolidated into the same consolidated group.

The AALC further notes that accounting mismatches for life insurers also arise on investment contracts which are outside the scope of insurance contracts as defined in the ED and are therefore treated as financial instruments. As "mirroring" is not included within IFRS 9, the proposal to implement it for Insurance Contracts will result in an inconsistent approach between these two standards and accounting mismatches arising on investment contracts will continue to arise.

The AALC recommends that, as a principle, accounting mismatches are best addressed by achieving consistency between the measurement approaches of standards rather than by exceptions within the standards. In this instance, the reduction in accounting mismatch would be very easily achieved by requiring (or at least allowing) fair value through profit or loss measurement for both the asset and liability.

With respect to participating products, the AALC supports the proposal put forward by the IASB staff to the December 2012 meeting of the IASB that the contractual service margin for participating contracts is adjusted for changes in the value of the premiums by adjusting the margin for changes in the value of the underlying items as measured using IFRS. In our view this approach is more aligned to with the service provided by the insurer to the policyholder through the payment of bonuses over time.

The AALC further recommends that, to ensure consistency between the standards, if mirroring is introduced for insurance contracts, that mirroring also be introduced for financial liabilities within the scope of IFRS 9 which have a similar link to underlying items.

Furthermore, if mirroring is achieved for the insurer on a stand-alone basis, this treatment should continue on consolidation, even where the underlying asset is consolidated. In such cases the measurement of the insurance contract should be adjusted to align with the treatment of the underlying assets on consolidation.

IASB Question 3 — Presentation of insurance contract revenue and expenses

Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial performance if, for all insurance contracts, an entity presents, in profit or loss, insurance contract revenue and expenses, rather than information about the changes in the components of the insurance contracts?

Why or why not? If not, what would you recommend and why?

Response

The AALC agrees that the presentation in profit or loss of an entity's insurance contract revenue and expenses more adequately represents the entity's financial performance and the economic reality of the underlying products than a summarised margin approach. The AALC supports the inclusion of a measure of premium revenue and claims expense on the face of the income statement.

However, we note some omissions and inconsistencies in the approach taken by the IASB to appropriately define the revenue and expenses and the related balance sheet amounts insofar as they relate to general insurance business applying the simplified approach set out in paragraphs 38-40.

These inconsistencies are discussed further below.

Inconsistency relating to premium recognition

Under the premium allocation model, the measurement of the liability is made with reference to the premium received but excluding premium written but not yet received. This approach results in a liability for future coverage which is largely driven by the pattern of premium receipts and costs paid. This is a cash rather than accruals concept of accounting and which results in a different outcome for policies which are economically identical and which are sold as identical products but for which the cash payments may differ.

In many classes of general insurance business it is common to have different payment options which drive only the timing of cash receipts and not the economics of the policy sold. The current, and generally accepted, approach is to determine an unearned premium based on the total gross written premium, including business for which the entity has accepted risk but where final terms and conditions are being negotiated or business is simply not yet processed and the business has therefore not yet closed ("unclosed business").

Estimation of unclosed business is a significant and highly relevant aspect of determining all contractual obligations that an insurer is exposed to. We believe there is significant value to users of financial statements in being able to identify a liability for future coverage which includes all expected premium within the contract boundary rather than a more volatile balance sheet amount that fluctuates based on a pattern of premium receipts.

In addition, the recognition of gross written premium is essential for enabling adequate and timely credit control management of premium collection and control over the period premium is held which is a driver of insurance profitability.

The AALC proposes that paragraph 38 be reworded to refer to expected premiums and acquisition costs rather than those received or paid.

Reinsurance presentation and disclosure

Paragraphs 54 and 55 require separate disclosure of insurance and reinsurance assets and liabilities. In addition, paragraph 63 prevents any offsetting of insurance and reinsurance income or expense. This would imply that the risk adjustment needs to be separately calculated for gross claims and reinsurance recoveries. However, the risk adjustment can only logically be calculated on a net of reinsurance basis to reflect the reinsurance as a risk mitigant.

Risk adjustments typically reflect the variability of the underlying insurance contract/portfolio or reinsurance contract/portfolio held. Mathematically, variability measures cannot be simply added together (e.g. the sum of the 90th percentile of two random variables X and Y is not equal to the 90th percentile of the random variable X+Y). Hence summing the risk adjustments for insurance contracts and reinsurance contracts held yields a total risk adjustment that may be inappropriate given the variability of the total risk presented (i.e. the insurance contract along with

reinsurance contracts acting as a risk mitigant) and the insurer's overall risk tolerance (of which it is the residual risk that is important, that is the total risk presented after allowing for risk mitigants like reinsurance).

The AALC recommends that the IASB clarify that the risk adjustment covers the insurance contracts risk after allowing for offsetting impact of the reinsurance contracts.

IASB Question 4 — Interest expense in profit or loss

Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial performance if an entity is required to segregate the effects of the underwriting performance from the effects of the changes in the discount rates by:

- *(a) recognising, in profit or loss, the interest expense determined using the discount rates that applied at the date that the contract was initially recognised. For cash flows that are expected to vary directly with returns on underlying items, the entity shall update those discount rates when the entity expects any changes in those returns to affect the amount of those cash flows; and*
- *(b) recognising, in other comprehensive income, the difference between:*
  - *(i) the carrying amount of the insurance contract measured using the discount rates that applied at the reporting date; and*
  - *(ii) the carrying amount of the insurance contract measured using the discount rates that applied at the date that the contract was initially recognised. For cash flows that are expected to vary directly with returns on underlying items, the entity shall update those discount rates when the entity expects any changes in those returns to affect the amount of those cash flows?*

Why or why not? If not, what would you recommend and why?

AALC Response

The AALC does not support the proposal to allocate changes in insurance liabilities between profit or loss and other comprehensive income.

We understand that the aim of the IASB's proposal to present changes in the carrying amount of insurance contracts through other comprehensive income (OCI) was to disaggregate and separately present components of the entity's performance that have arisen as a result of changes to market variables during the period.

While we are supportive of this aim, the IASB's proposal will only present useful information on economic mismatches in limited circumstances, namely:

- All assets supporting the liabilities are recognised at fair value through OCI, and
- Assets supporting the liabilities are not purchased or sold after initial recognition of the liability, and
- There is no link between the liabilities and underlying rates of inflation.

In other circumstances, the IASB's proposal will not provide meaningful information to the users of the financial statements. Specifically:

- Accounting mismatches will arise for any liabilities that are supported by assets which are recognised at fair value through profit or loss. Such assets include derivatives, investment property and complex debt instruments.

These are commonly used by Australian insurers to support long term liabilities and to match asset portfolio durations to insurance liability where real assets of sufficient duration are not available.

- Accounting mismatches will arise where assets supporting the liabilities may be sold or mature during the period and the proceeds reinvested. The proceeds from the sale of an asset used to support the liabilities will be recognised in profit or loss with no corresponding change in liabilities, creating an accounting mismatch even though there has been no overall change in the entity's economic position. The effective interest rate on the asset will be the effective interest rate on the new instrument which will have been set at a different point in time (and potentially different interest rate environment) to the liability that it backs. In addition, for multi-premium policies, assets supporting the liabilities are progressively purchased, as those premiums are received. This would also result in movements in the profit or loss statement with no corresponding change in the liabilities and a further accounting mismatch.
- Accounting mismatches will arise where the liabilities are affected by the underlying rate of inflation. Underlying rates of inflation are closely linked to nominal interest rates. However, under the IASB's proposals, the impact of changes to the liabilities resulting from changes in nominal rates will be presented in OCI whereas changes to the liabilities resulting from changes in underlying inflation will be presented in the profit or loss statement. This presentation will be misleading to users as the profit or loss statement will imply that the liabilities are more sensitive to inflation than they in fact are because any offsetting impacts due to the impact of inflation on nominal interest rates will be presented in OCI.
- The use of policy inception date interest rates to discount expected cash flows that emerge from the discovery of unexpected latent claims from coverage provided in prior periods would be difficult to apply and does not provide information that is relevant to users.

In addition, we believe the IASB's current proposals will add significant complexity for preparers of the financial statements, and the cost of this complexity exceeds any benefits. In particular we highlight the following key concerns:

- The IASB proposes to require the use of 'locked-in' interest rates to accrete interest on insurance liabilities for presentation in the profit or loss statement, where the yield curve is locked in at initial recognition. This will likely require entities to record successive yield curves and associate them with the related insurance contracts. This will require significant modification to existing systems and processes in order to identify and maintain the required records. We believe that the information on discount rates that existed at the date of writing a contract is irrelevant to the users of the financial statements. In our view, interest should be accreted on insurance liabilities at current interest rates, consistent with the IASB's current value model.
- On transition, the requirement to ascertain and apply discount rates applicable at initial recognition for each insurance contract is likely to be impracticable, particularly for older contracts. We also note that, for conglomerate groups that have acquired insurers, the date of initial recognition will be the date of policy inception for the insurance entity and date of acquisition for the financial statements of the consolidated group. This will result in different performance outcomes (between entity and consolidated group) over the remaining life of the policies.

Consistent with a current measurement approach, the AALC believes that changes in the carrying amounts of insurance contracts, and the fair value of assets supporting them, should be recognised through profit or loss.

We further note that the IASB has not developed its contractual framework with respect to the use of OCI. The AALC is of the view that it is not prudent to allocate further amounts to other comprehensive income until such time that the IASB develops a framework for its use.

The AALC notes that, notwithstanding the issues discussed above, there is strong support from some European insurers for the use of OCI (although this support is far from universal). We encourage the IASB to be global in its thinking and work towards a model that will provide a sensible accounting outcome across different jurisdictions and business models. To that end, if the use of OCI is to be maintained, then the AALC proposes that:

- changes to the carrying amount of insurance liabilities be recognised through profit or loss as the primary approach, with an option for each portfolio to recognise these changes through OCI where:
    - all assets supporting the liabilities are recognised at fair value through OCI;
    - the insurer has a business model where assets supporting the liabilities are not normally purchased or sold after initial recognition of the liability; and
    - there is no link between the liabilities and underlying rates of inflation; and
- amounts recognised in OCI be based on the difference between current interest rates and interest rates applicable the start of the reporting period rather than the interest rate at inception of the contract.

If this alternative is adopted, the accounting treatment for the supporting financial assets under IFRS 9 would be determined by the approach adopted for the insurance contracts and not at the discretion of the insurer. Under the requirements of IFRS 9:

- if changes in insurance contracts are recognised through profit or loss, the supporting assets would be required to be measured at fair value through profit or loss so as to avoid an accounting mismatch; and
- if the impact of changes in discount rates are taken to OCI, measuring the assets of fair value through profit or loss would not remove an accounting mismatch and therefore would be not available if the assets met the criteria for measurement at fair value through OCI.

IASB Question 5 — Effective date and transition

Do you agree that the proposed approach to transition appropriately balances comparability with verifiability?

Why or why not? If not, what do you suggest and why?

Response

The AALC is supportive of the fully retrospective approach which is expected to allow meaningful consisted information to be reported post transition and addresses the concerns raised with respect to the proposal in the previous exposure draft to set the residual margins to zero at transition.

The AALC also supports the explicit allowance for the use of a practical expedient where the full retrospective application is impracticable.

The AALC expects that a period of 3 years from the standard's publication is a reasonable length of time to prepare for transition. We recommend, however that the IASB align the dates of application of IFRS 9 and IFRS 4, or, if this is not possible, allow insurers to delay the application of IFRS 9 until they can apply the insurance contracts standard.

The AALC also recommends that the IASB clarify that an entity is not required to reopen accounting for business combinations involving insurance contracts where the application of IFRS 1 *First Time Adoption of International Financial Reporting Standards* or the transition requirements of IFRS 3 *Business Combinations* do not require the business combination to be accounted for in accordance with the current version of IFRS 3.

IASB Question 6 — The likely effects of a Standard for insurance contracts

Considering the proposed Standard as a whole, do you think that the costs of complying with the proposed requirements are justified by the benefits that the information will provide? How are those costs and benefits affected by the proposals in Questions 1–5?

How do the costs and benefits compare with any alternative approach that you propose and with the proposals in the 2010 Exposure Draft?

Please describe the likely effect of the proposed Standard as a whole on:

(a) the transparency in the financial statements of the effects of insurance contracts and the comparability between financial statements of different entities that issue insurance contracts; and

(b) the compliance costs for preparers and the costs for users of financial statements to understand the information produced, both on initial application and on an ongoing basis.

Response

Costs

The requirement to calculate interest amounts based on discount rates at inception of contracts is expected to require significant investment in systems and processes. This requirement will result in the proposals set out in the ED being more costly to implement than those set out in the previous exposure draft.

In the view of the AALC, the interest rate at inception of a contract is irrelevant for the purpose of economic decisions that may be made using the financial statements of an insurer and accordingly there is minimal benefit to justify the cost of tracking this information. The AALC has proposed an alternative approach in our response to question 4 above.

The AALC also anticipates that there will be a significant one-off cost in performing the retrospective adjustments on transition to the new standard. This cost is driven in part by the complexity of the proposals set out in the ED and will be reduced if our our proposals set out in response to the other questions above are adopted.

Differing note requirements for BBA and PAA

It is expected that for many insurers who adopt the premium allocation approach (PAA), there will be some products that do not meet the criteria for applying PAA and therefore be accounted for under the building block approach (BBA).

Given that the PAA purports to be an approximation of the BBA we do not see the relevance of the additional disclosure notes for BBA included in paragraph 81. Requiring additional disclosures for portfolios accounted for under the BBA is likely to give undue prominence to these portfolios compared to those accounted for under PAA.

The AALC proposed that disclosures be aligned across PAA and BBA methodologies.

IASB Question 7 — Clarity of drafting

Do you agree that the proposals are drafted clearly and reflect the decisions made by the IASB?

If not, please describe any proposal that is not clear. How would you clarify it?

Response

Unit of Account

The ED alternates between the contract and the portfolio being the proposed unit of account. For instance:

- at paragraph 18 the ED outlines the initial accounting for an insurance *contract* as the sum of its fulfilment cash flows plus a contractual service margin yet at paragraph 22 the fulfilment cash flows are defined as those which relate directly to the fulfilment of the *portfolio* of contracts; and
- at paragraph 28, the ED requires consideration of whether the contract is onerous at a *portfolio* level before considering the fulfilment cash flows at a contract level in order to determine the contractual service margin for the *contract*.

The AALC recommends that the wording in the ED be modified to achieve consistency of unit of accounting. We propose consistent use of portfolio as the unit of account for the risk margin and contractual service margin.

Risk Adjustment

The ED appears inconsistent between the intention of the risk margin in the black letter of the draft standard and the Application Guidance.

At paragraph 22(a), the ED defines the intention of the risk margin as adjusting for "the effects of uncertainty about the amount and timing of those cash flows". In other words, the risk adjustment is designed to address estimation risk in the future cash flows.

The definition and guidance material for the risk adjustment, however, are drafted to allow consideration of broader issues than just estimation uncertainty when measuring the risk adjustment. Indeed, by measuring the risk adjustment as the level of compensation the entity requires to make it indifferent between fulfilling the insurance contract liability and a fixed liability, the ED introduces a quasi fair value measure for insurance liabilities.

In order to determine the level of compensation it requires for bearing risk, an entity would necessarily also need to consider matters such as:

- its risk appetite
- the relevant capital intensity of each portfolio,
- the timeframe over which that capital will be required to held for each portfolio and alternative uses to which that capital could be deployed within the entity.

While the proposed risk adjustment does convey information about the entity's perception of estimation uncertainty, it also reflects these non-estimation risk aspects of the underlying products which are unique to each product and entity. We believe these additional aspects of risk will distort the risk adjustment and jeopardise comparability of results across entities and jurisdictions, and possibly across portfolios or reporting periods within the single entity.

The AALC believes that the disclosure of a single probability of adequacy at an entity level by itself does not remedy this issue, as the risk adjustment would be required to be set at differing confidence levels across each portfolio having regard to these extraneous matters.

The AALC recommends a simplified approach which restricts the considerations relevant to the measurement of the risk adjustment to only the estimation uncertainty in the future cash flows. In Australian non-life insurance the probability of adequacy concept has proved an effective mechanism for financial reporting as it takes into account only the estimation uncertainty in the future cash flows.

Contract Boundary

The AALC acknowledges the improvements made in drafting the contract boundary, compared to the 2010 exposure draft. The 2010 exposure draft would have seen private health insurance contracts classified as long term contracts, given restrictions on risk selection and pricing at an individual policyholder level.

The recognition of repricing at a portfolio level goes a long way to addressing this classification issue, and should allow an appropriate recognition of private health insurance and like contracts as short duration risks. However, we believe the wording of the ED could be enhanced to recognise the ongoing regulatory requirement for government approval of price changes in private health insurance, compulsory third party (CTP) car insurance and similar classes. This pricing approval has regard both to financial sustainability of underwriters and consumer affordability.

The AALC recommends a modified wording at paragraph 23(b)(i) as follows:

> *The entity has the right or the practical ability to reassess the risk of the portfolio of insurance contracts that contains the contract and, as a result, can set a price or level of benefits that fully reflects the risk of that portfolio. <u>A requirement to obtain regulatory approval for price and benefit changes does</u>*

not, of itself, disprove the contract boundary. Other considerations may include the ability to reprice to achieve rates of return consistent with other issuers of like portfolios.

Answers to Specific Questions - AASB

AASB question 1

Whether there are any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the proposals, particularly any issues relating to:
(a) not-for-profit entities; and
(b) public sector entities, including any GAAP/GFS implications;

Response

The AALC have not identified any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the proposals, other than the matter discussed with respect to contract boundaries discussed in response to the IASB's question 7 set out above.

AASB question 2

Whether, overall, the proposals would result in financial statements that would be useful to users

Response

The AALC has concerns with respect to some aspects of the ED, specifically:

- the mandatory use of other comprehensive income to recognise some, but not all, of the impacts of interest rates on insurance contracts and their supporting assets is likely to result in new accounting mismatches in reported profit; and
- the application of "mirroring" particularly with respect to participating life insurance and investment contracts appears to be unnecessarily complex and may not result in the reporting of useful information.

Further discussion on these matters, together with other detailed comments are provided below in our responses to IASB questions 2 and 4 set out above.

AASB question 3

Whether the proposals are in the best interests of the Australian economy

Response

The AALC has concerns with respect to some aspects of the ED, as noted in our responses to the earlier questions. In the event that these are not resolved,

however, it is still likely to be in the interest of the Australian economy to adopt the final IASB standard.

AASB question 4

Unless already provided in response to specific matters for comment 1 – 3 above, the costs and benefits of the proposals relative to the current requirements, whether quantitative (financial or non-financial) or qualitative.

Response

In the view of the AALC, although there are significant improvements that may be made to the proposals set out in the ED, it is imperative that this project be brought to a close, a final standard issued and insurers move from local standards to an a consistent international approach.

Conclusion

This response reflects the nature and practical focus of the AALC. In this context we note that the comments and opinions set out in this response reflect the consensus views of the members of the AALC, and may not necessarily reflect the view of The Institute of Chartered Accountants in Australia, the Institute of Actuaries of Australia, nor the members' respective employers.

The current members of the AALC are:

Andrew Kitchen - Insurance Australia Group
Andrew Reeves - KPMG
Anne Driver - QBE
Brendan Counsell - EY
Declan Moore - QBE
Graham Duff - AMP
Kerry Hicks - Institute of Chartered Accountants in Australia
Mark Thompson – Hannover Life Re of Australasia
Michael Dermody - KPMG
Paul Harris - EY
Scott Hadfield - PricewaterhouseCoopers
Stuart Alexander - Deloitte
Tim Furlan - Russell Investment Group

Yours faithfully

Graham Duff
Chairman

Institute of
Chartered Accountants
Australia

26 September 2013

Mr Kevin Stevenson
Chairman
Australian Accounting Standards Board
PO Box 204
COLLINS STREET WEST VIC 8007

Via email: standard@aasb.gov.au

Dear Kevin

ED 244 Insurance contracts

Thank you for the opportunity to comment on ED 244 (the ED). We have considered the ED and our comments are set out below.

The Institute is the professional body for Chartered Accountants in Australia and members operating throughout the world.

Representing more than 73,000 current and future professionals and business leaders, the Institute has a pivotal role in upholding financial integrity in society. Members strive to uphold the profession's commitment to ethics and quality in everything they do, alongside an unwavering dedication to act in the public interest.

Chartered Accountants hold diverse positions across the business community, as well as in professional services, government, not-for-profit, education and academia. The leadership and business acumen of members underpin the Institute's deep knowledge base in a broad range of policy areas impacting the Australian economy and domestic and international capital markets.

We are supportive of the move towards international consistency in the accounting for insurance contracts. We continue to support the IASB's proposal to:

- Use a current value approach, and
- Measure outstanding claims on a basis that reflects the time value of money

We also acknowledge the significant improvements in the proposals set out in the ED relative to the 2010 ED, particularly with respect to:

- The unlocking of margins for changes in estimates relating to future coverage
- Contract boundaries
- The treatment of diversification benefits
- Characterisation of the Premium Allocation Approach as an approximation for the Building Block Approach rather than an alternative model
- The approach to transition.

Our major concern with the ED is the mandatory use of other comprehensive income (OCI) to recognise some, but not all, of the impacts of interest rates on insurance contracts and their supporting assets. As we have identified in previous submissions, including the IASB agenda consultation submission, we do not consider that the current ad-hoc approach to presenting items in OCI that should really be reflected in the profit and loss account, is acceptable. We understand that the IASB is currently looking at OCI as part of its conceptual framework project. Therefore we would prefer this work to be complete, before allocating further amounts to OCI. We do not consider the ad-hoc use of OCI, will provide useful information to stakeholders, as it does not address accounting mismatches and will add significant complexity to the IASB's current proposals.

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We recommend that the IASB amend the model to allow all changes to the carrying amounts of insurance contracts, and the fair value of assets supporting them, to be reflected in the profit or loss. This method would be consistent with the current measurement approach. While we understand there is strong support from some countries to use OCI, and for this reason we can accept that the IASB may want to continue to allow the OCI method as an allowable alternative if certain conditions are met. We note that historically, the IASB has not supported the notion of options within accounting standards. However, we consider it appropriate in this case if the use of OCI was restricted to address areas of accounting mismatch.

We understand through discussion with industry representatives that a number of other issues still exist with the proposals. These issues impact the practical application of the proposals, as well as the understanding by preparers and users. We support the submission of the Accountants and Actuaries Liaison Committee (AALC) which detail these concerns, as well as our concern relating to the use of OCI above. We have attached the AALC submission as an appendix to our letter. The areas of particular concern to industry participants, other than the OCI issue noted above, include:

- The application of 'mirroring', particularly with respect to participating life insurance and investment contracts, appears to be unnecessarily complex and may not result in the reporting of useful information
- The requirement to put changes in risk margin through the current period profit or loss, when some of these changes relate to future coverage, will not provide useful information to stakeholders.
- The OCI calculation currently refers to the use of interest rates at the inception of the contract, however maintaining such information will result in significant system costs in tracking this information, with little benefit
- Inconsistencies and omissions exist in the IASB approach to appropriately define revenue and expenses and the related balance sheet amounts as they related to general insurance business applying the simplified approach.

If you have any questions regarding this submission, please do not hesitate to contact Kerry Hicks at kerry.hicks@charteredaccountants.com.au

Yours sincerely

Yasser El-Ansary
General Manager – Leadership & Quality
Institute of Chartered Accountants Australia

Appendix A:

Accountants and Actuaries Liaison Committee

27 September 2013

The Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West Victoria 8007
AUSTRALIA

Dear Sir

Response to AASB exposure draft ED 244 *Insurance Contracts* ("the ED")

The Accountants' and Actuaries' Liaison Committee ("AALC") is pleased to provide its response to the ED. This response represents the views of the members of the AALC (and not necessarily their employing organisations or professional association).

The AALC is supported by The Institute of Chartered Accountants in Australia and the Institute of Actuaries of Australia. The AALC is primarily concerned with matters affecting both professions, including the development and implementation of accounting standards for the insurance industry. The AALC takes a practical approach to problems, as its members are all practitioners in insurance and related fields.

We are supportive of the move towards international consistency in the accounting for insurance contracts. The AALC continues to support the IASB's proposal to:

- use a current value approach; and
- measure outstanding claims on a basis that reflects the time value of money.

We also acknowledge the significant improvement in the proposals set out in the ED relative to the 2010 exposure draft, particularly with respect to:

- the unlocking of margins for changes in estimates relating to future coverage;
- contract boundaries;
- the treatment of diversification benefits;
- characterisation of the Premium Allocation Approach as an approximation for the Building Block Approach rather than an alternative model; and
- the approach to transition.

We have concerns, however with respect to some aspects of the ED, specifically:

- the mandatory use of other comprehensive income to recognise some, but not all, of the impacts of interest rates on insurance contracts and their supporting assets is likely to result in new accounting mismatches in reported profit; and
- the application of "mirroring" particularly with respect to participating life insurance and investment contracts appears to be unnecessarily complex and may not result in the reporting of useful information.

Further discussion on these matters, together with other detailed comments are provided below in our responses to the specific IASB and AASB questions set out below.

This letter sets out the collective view of the AALC members at the date of drafting. The proposals set out in the ED are complex and further issues may emerge as the proposals are further analysed. We will advise the AASB of any such issues identified.

Answers to Specific Questions - IASB

IASB Question 1 — Adjusting the contractual service margin

Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial position and performance if differences between the current and previous estimates of the present value of future cash flows if:

(a) differences between the current and previous estimates of the present value of future cash flows related to future coverage and other future services are added to, or deducted from, the contractual service margin, subject to the condition that the contractual service margin should not be negative; and

(b) differences between the current and previous estimates of the present value of future cash flows that do not relate to future coverage and other future services are recognised immediately in profit or loss?

Why or why not? If not, what would you recommend and why?

Response

Adjusting the contractual service margin for changes in expected future cash flows

The AALC is supportive of proposal to adjust the contractual service margin for differences between the current and previous estimates of the present value of future cash flows relating to future coverage. Specifically, the proposed approach:

- correctly characterises such changes in estimates as changes in expected future profitability rather than current period gains and losses;
- is more consistent with the approach proposed for other types of revenue in the IASB's exposure draft "Revenue for Contracts With Customers";
- provides a more sensible pattern of profit emergence and
- estimates of future cash flows related to future coverages typically involve a significant element of judgement and therefore we consider it appropriate that such impacts are not capitalised through profit or loss (for profitable contracts).

Changes to the risk margin

The AALC recommends that this approach also be adopted for changes in the risk margin which relate to future coverage. In the view of the AALC, such changes also reflect changes in expected future profitability rather than current year gains and losses. Changes in the expected future cash flows will result in a reassessment of the risk margin and as such the treatment of the risk adjustment needs to match that of the cash flow changes and therefore be reflected as in the contractual service margin.

We understand that there are concerns that it may be difficult to separate risk margins between the component that relate to future coverage and those that do not. In our view, the allocation of the movement in risk margin between these components will be relatively straight forward as an insurer will have already separated changes in expected cash flows that relate to future coverage from other changes in cash flows for the purposes of adjusting the contractual service margin. It would therefore be relatively straight forward to separate the risk margin on the same basis as the expected cash flows.

Where risk adjustment relates to incurred claims then we agree changes should be included in reported profit or loss.

Loss recognition and reversal

The AALC proposes that, for products where the contractual service margin has been exhausted and changes in expected future cash flows have been losses through profit or loss, subsequent changes in expectations which result in a reduction in the value of fulfilment cashflows should be recognised through profit or loss as a reversal of the previously recognised losses. Under this approach, losses and profits are treated symmetrically which is more logical and for this reason it is also more likely to accord with the expectations of account users.

The approach proposed in the Exposure Draft of adjusting the contractual service margin for subsequent improvements in expectations would result in the inclusion an amount in reported profits over a number of periods which is not reflective of current maintainable earnings (relating to the release over time of past capitalised losses).

IASB Question 2 — Contracts that require the entity to hold underlying items and specify a link to returns on those underlying items

If a contract requires an entity to hold underlying items and specifies a link between the payments to the policyholder and the returns on those underlying items, do you agree that financial statements would provide relevant information that faithfully represents the entity's financial position and performance if the entity:

- *(a) measures the fulfilment cash flows that are expected to vary directly with returns on underlying items by reference to the carrying amount of the underlying items?*
- *(b) measures the fulfilment cash flows that are not expected to vary directly with returns on underlying items, for example, fixed payments specified by the contract, options embedded in the insurance contract that are not separated and guarantees of minimum payments that are embedded in the contract and that are not separated, in accordance with the other requirements of the [draft] Standard (ie using the expected value of the full range of possible outcomes to measure insurance contracts and taking into account risk and the time value of money)?*

(c) recognises changes in the fulfilment cash flows as follows:

(i) changes in the fulfilment cash flows that are expected to vary directly with returns on the underlying items would be recognised in profit or loss or other comprehensive income on the same basis as the recognition of changes in the value of those underlying items;

(ii) changes in the fulfilment cash flows that are expected to vary indirectly with the returns on the underlying items would be recognised in profit or loss; and

(iii) changes in the fulfilment cash flows that are not expected to vary with the returns on the underlying items, including those that are expected to vary with other factors (for example, with mortality rates) and those that are fixed (for example, fixed death benefits), would be recognised in profit or loss and in other comprehensive income in accordance with the general requirements of the [draft] Standard?

Why or why not? If not, what would you recommend and why?

Response

We agree with the principle that, for contracts which require the entity to hold underlying items and specify a link to returns on those underlying investments, the accounting basis should be consistent for the contract and the underlying items so as to avoid accounting mismatches.

Whilst the approach of "mirroring" the accounting for the underlying items provides a conceptual solution to this problem, it is complex to apply in practice and may not achieve a sensible outcome. This is particularly the case in respect of:

- products backed with a mixture of simple debt instruments, complex debt instruments and assets which are not financial instruments;
- participating products; and
- situations where the underlying item is an equity or debt instrument issued by an entity within the same consolidated group.

Part of this complexity arises from the diversity of accounting treatments allowed for supporting assets, particularly due to the proposal to introduce a "fair value through other comprehensive income" category into IFRS 9 *Financial Instruments*.

Under the proposal, a single portfolio of insurance contracts, could end up with the following accounting treatments within its insurance contract liability balance:

- Linked component to the extent backed by complex debt instruments and investment properties at fair value profit or loss;
- Linked component to the extent backed by simple debt instruments at fair value through other comprehensive income using the effective interest rate on the backing assets;
- Linked component to the extent backed by assets held at cost (such as controlled private equity investments) on the accounting bases applying to individual assets;
- Other components, such as surrender options measured at expected values with changes offset against the contractual service margin;
- Unwind of discount on components not linked to underlying assets at the discount rate on inception of the contracts.

In the AALC's view, the complexity of this approach makes it unsatisfactory, despite its conceptual appeal.

Further complications may arise on consolidation. The situation is likely to arise where, while the insurer is required to hold underlying items, these underlying items may be investments in or balances with entities that are consolidated into the same group. In such circumstances, mirroring will be applied by the insurer in its stand-alone accounts, but not on consolidation. We have already identified this as a problem where the underlying item is a deposit with a bank or an investment vehicle that is consolidated into the same consolidated group.

The AALC further notes that accounting mismatches for life insurers also arise on investment contracts which are outside the scope of insurance contracts as defined in the ED and are therefore treated as financial instruments. As "mirroring" is not included within IFRS 9, the proposal to implement it for Insurance Contracts will result in an inconsistent approach between these two standards and accounting mismatches arising on investment contracts will continue to arise.

The AALC recommends that, as a principle, accounting mismatches are best addressed by achieving consistency between the measurement approaches of standards rather than by exceptions within the standards. In this instance, the reduction in accounting mismatch would be very easily achieved by requiring (or at least allowing) fair value through profit or loss measurement for both the asset and liability.

With respect to participating products, the AALC supports the proposal put forward by the IASB staff to the December 2012 meeting of the IASB that the contractual service margin for participating contracts is adjusted for changes in the value of the premiums by adjusting the margin for changes in the value of the underlying items as measured using IFRS. In our view this approach is more aligned to with the service provided by the insurer to the policyholder through the payment of bonuses over time.

The AALC further recommends that, to ensure consistency between the standards, if mirroring is introduced for insurance contracts, that mirroring also be introduced for financial liabilities within the scope of IFRS 9 which have a similar link to underlying items.

Furthermore, if mirroring is achieved for the insurer on a stand-alone basis, this treatment should continue on consolidation, even where the underlying asset is consolidated. In such cases the measurement of the insurance contract should be adjusted to align with the treatment of the underlying assets on consolidation.

IASB Question 3 — Presentation of insurance contract revenue and expenses

Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial performance if, for all insurance contracts, an entity presents, in profit or loss, insurance contract revenue and expenses, rather than information about the changes in the components of the insurance contracts?

Why or why not? If not, what would you recommend and why?

Response

The AALC agrees that the presentation in profit or loss of an entity's insurance contract revenue and expenses more adequately represents the entity's financial performance and the economic reality of the underlying products than a summarised margin approach. The AALC supports the inclusion of a measure of premium revenue and claims expense on the face of the income statement.

However, we note some omissions and inconsistencies in the approach taken by the IASB to appropriately define the revenue and expenses and the related balance sheet amounts insofar as they relate to general insurance business applying the simplified approach set out in paragraphs 38-40.

These inconsistencies are discussed further below.

Inconsistency relating to premium recognition

Under the premium allocation model, the measurement of the liability is made with reference to the premium received but excluding premium written but not yet received. This approach results in a liability for future coverage which is largely driven by the pattern of premium receipts and costs paid. This is a cash rather than accruals concept of accounting and which results in a different outcome for policies which are economically identical and which are sold as identical products but for which the cash payments may differ.

In many classes of general insurance business it is common to have different payment options which drive only the timing of cash receipts and not the economics of the policy sold. The current, and generally accepted, approach is to determine an unearned premium based on the total gross written premium, including business for which the entity has accepted risk but where final terms and conditions are being negotiated or business is simply not yet processed and the business has therefore not yet closed ("unclosed business").

Estimation of unclosed business is a significant and highly relevant aspect of determining all contractual obligations that an insurer is exposed to. We believe there is significant value to users of financial statements in being able to identify a liability for future coverage which includes all expected premium within the contract boundary rather than a more volatile balance sheet amount that fluctuates based on a pattern of premium receipts.

In addition, the recognition of gross written premium is essential for enabling adequate and timely credit control management of premium collection and control over the period premium is held which is a driver of insurance profitability.

The AALC proposes that paragraph 38 be reworded to refer to expected premiums and acquisition costs rather than those received or paid.

Reinsurance presentation and disclosure

Paragraphs 54 and 55 require separate disclosure of insurance and reinsurance assets and liabilities. In addition, paragraph 63 prevents any offsetting of insurance and reinsurance income or expense. This would imply that the risk adjustment needs to be separately calculated for gross claims and reinsurance recoveries. However, the risk adjustment can only logically be calculated on a net of reinsurance basis to reflect the reinsurance as a risk mitigant.

Risk adjustments typically reflect the variability of the underlying insurance contract/portfolio or reinsurance contract/portfolio held. Mathematically, variability measures cannot be simply added together (e.g. the sum of the 90th percentile of two random variables X and Y is not equal to the 90th percentile of the random variable X+Y). Hence summing the risk adjustments for insurance contracts and reinsurance contracts held yields a total risk adjustment that may be inappropriate given the variability of the total risk presented (i.e. the insurance contract along with reinsurance contracts acting as a risk mitigant) and the insurer's overall risk tolerance (of which it is the residual risk that is important, that is the total risk presented after allowing for risk mitigants like reinsurance).

The AALC recommends that the IASB clarify that the risk adjustment covers the insurance contracts risk after allowing for offsetting impact of the reinsurance contracts.

IASB Question 4 — Interest expense in profit or loss

Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial performance if an entity is required to segregate the effects of the underwriting performance from the effects of the changes in the discount rates by:

(a) recognising, in profit or loss, the interest expense determined using the discount rates that applied at the date that the contract was initially recognised. For cash flows that are expected to vary directly with returns on underlying items, the entity shall update those discount rates when the entity expects any changes in those returns to affect the amount of those cash flows; and

(b) recognising, in other comprehensive income, the difference between:

(i) the carrying amount of the insurance contract measured using the discount rates that applied at the reporting date; and

(ii) the carrying amount of the insurance contract measured using the discount rates that applied at the date that the contract was initially recognised. For cash flows that are expected to vary directly with returns on underlying items, the entity shall update those discount rates when the entity expects any changes in those returns to affect the amount of those cash flows?

Why or why not? If not, what would you recommend and why?

AALC Response

The AALC does not support the proposal to allocate changes in insurance liabilities between profit or loss and other comprehensive income.

We understand that the aim of the IASB's proposal to present changes in the carrying amount of insurance contracts through other comprehensive income (OCI) was to disaggregate and separately present components of the entity's performance that have arisen as a result of changes to market variables during the period.

While we are supportive of this aim, the IASB's proposal will only present useful information on economic mismatches in limited circumstances, namely:

- All assets supporting the liabilities are recognised at fair value through OCI, and
- Assets supporting the liabilities are not purchased or sold after initial recognition of the liability, and
- There is no link between the liabilities and underlying rates of inflation.

In other circumstances, the IASB's proposal will not provide meaningful information to the users of the financial statements. Specifically:

- Accounting mismatches will arise for any liabilities that are supported by assets which are recognised at fair value through profit or loss. Such assets include derivatives, investment property and complex debt instruments. These are commonly used by Australian insurers to support long term liabilities and to match asset portfolio durations to insurance liability where real assets of sufficient duration are not available.

- Accounting mismatches will arise where assets supporting the liabilities may be sold or mature during the period and the proceeds reinvested. The proceeds from the sale of an asset used to support the liabilities will be recognised in profit or loss with no corresponding change in liabilities, creating an accounting mismatch even though there has been no overall change in the entity's economic position. The effective interest rate on the asset will be the effective interest rate on the new instrument which will have been set at a different point in time (and potentially different interest rate environment) to the liability that it backs. In addition, for multi-premium policies, assets supporting the liabilities are progressively purchased, as those premiums are received. This would also result in movements in the profit or loss statement with no corresponding change in the liabilities and a further accounting mismatch.
- Accounting mismatches will arise where the liabilities are affected by the underlying rate of inflation. Underlying rates of inflation are closely linked to nominal interest rates. However, under the IASB's proposals, the impact of changes to the liabilities resulting from changes in nominal rates will be presented in OCI whereas changes to the liabilities resulting from changes in underlying inflation will be presented in the profit or loss statement. This presentation will be misleading to users as the profit or loss statement will imply that the liabilities are more sensitive to inflation than they in fact are because any offsetting impacts due to the impact of inflation on nominal interest rates will be presented in OCI.
- The use of policy inception date interest rates to discount expected cash flows that emerge from the discovery of unexpected latent claims from coverage provided in prior periods would be difficult to apply and does not provide information that is relevant to users.

In addition, we believe the IASB's current proposals will add significant complexity for preparers of the financial statements, and the cost of this complexity exceeds any benefits. In particular we highlight the following key concerns:

- The IASB proposes to require the use of 'locked-in' interest rates to accrete interest on insurance liabilities for presentation in the profit or loss statement, where the yield curve is locked in at initial recognition. This will likely require entities to record successive yield curves and associate them with the related insurance contracts. This will require significant modification to existing systems and processes in order to identify and maintain the required records. We believe that the information on discount rates that existed at the date of writing a contract is irrelevant to the users of the financial statements. In our view, interest should be accreted on insurance liabilities at current interest rates, consistent with the IASB's current value model.
- On transition, the requirement to ascertain and apply discount rates applicable at initial recognition for each insurance contract is likely to be impracticable, particularly for older contracts. We also note that, for conglomerate groups that have acquired insurers, the date of initial recognition will be the date of policy inception for the insurance entity and date of acquisition for the financial statements of the consolidated group. This will result in different performance outcomes (between entity and consolidated group) over the remaining life of the policies.

Consistent with a current measurement approach, the AALC believes that changes in the carrying amounts of insurance contracts, and the fair value of assets supporting them, should be recognised through profit or loss.

We further note that the IASB has not developed its contractual framework with respect to the use of OCI. The AALC is of the view that it is not prudent to allocate further amounts to other comprehensive income until such time that the IASB develops a framework for its use.

The AALC notes that, notwithstanding the issues discussed above, there is strong support from some European insurers for the use of OCI (although this support is far from universal). We encourage the IASB to be global in its thinking and work towards a model that will provide a sensible accounting outcome across different jurisdictions and business models. To that end, if the use of OCI is to be maintained, then the AALC proposes that:

- changes to the carrying amount of insurance liabilities be recognised through profit or loss as the primary approach, with an option for each portfolio to recognise these changes through OCI where:
  - all assets supporting the liabilities are recognised at fair value through OCI;
  - the insurer has a business model where assets supporting the liabilities are not normally purchased or sold after initial recognition of the liability; and
  - there is no link between the liabilities and underlying rates of inflation; and
- amounts recognised in OCI be based on the difference between current interest rates and interest rates applicable the start of the reporting period rather than the interest rate at inception of the contract.

If this alternative is adopted, the accounting treatment for the supporting financial assets under IFRS 9 would be determined by the approach adopted for the insurance contracts and not at the discretion of the insurer. Under the requirements of IFRS 9:

- if changes in insurance contracts are recognised through profit or loss, the supporting assets would be required to be measured at fair value through profit or loss so as to avoid an accounting mismatch; and
- if the impact of changes in discount rates are taken to OCI, measuring the assets of fair value through profit or loss would not remove an accounting mismatch and therefore would be not available if the assets met the criteria for measurement at fair value through OCI.

IASB Question 5 — Effective date and transition

Do you agree that the proposed approach to transition appropriately balances comparability with verifiability?

Why or why not? If not, what do you suggest and why?

Response

The AALC is supportive of the fully retrospective approach which is expected to allow meaningful consisted information to be reported post transition and addresses the concerns raised with respect to the proposal in the previous exposure draft to set the residual margins to zero at transition.

The AALC also supports the explicit allowance for the use of a practical expedient where the full retrospective application is impracticable.

The AALC expects that a period of 3 years from the standard's publication is a reasonable length of time to prepare for transition. We recommend, however that the IASB align the dates of application of IFRS 9 and IFRS 4, or, if this is not possible, allow insurers to delay the application of IFRS 9 until they can apply the insurance contracts standard.

The AALC also recommends that the IASB clarify that an entity is not required to reopen accounting for business combinations involving insurance contracts where the application of IFRS 1 *First Time Adoption of International Financial Reporting Standards* or the transition requirements of IFRS 3 *Business Combinations* do not require the business combination to be accounted for in accordance with the current version of IFRS 3.

IASB Question 6 — The likely effects of a Standard for insurance contracts

Considering the proposed Standard as a whole, do you think that the costs of complying with the proposed requirements are justified by the benefits that the information will provide? How are those costs and benefits affected by the proposals in Questions 1–5?

How do the costs and benefits compare with any alternative approach that you propose and with the proposals in the 2010 Exposure Draft?

Please describe the likely effect of the proposed Standard as a whole on:

(a) the transparency in the financial statements of the effects of insurance contracts and the comparability between financial statements of different entities that issue insurance contracts; and

(b) the compliance costs for preparers and the costs for users of financial statements to understand the information produced, both on initial application and on an ongoing basis.

Response

Costs

The requirement to calculate interest amounts based on discount rates at inception of contracts is expected to require significant investment in systems and processes. This requirement will result in the proposals set out in the ED being more costly to implement than those set out in the previous exposure draft.

In the view of the AALC, the interest rate at inception of a contract is irrelevant for the purpose of economic decisions that may be made using the financial statements of an insurer and accordingly there is minimal benefit to justify the cost of tracking this information. The AALC has proposed an alternative approach in our response to question 4 above.

The AALC also anticipates that there will be a significant one-off cost in performing the retrospective adjustments on transition to the new standard. This cost is driven in part by the complexity of the proposals set out in the ED and will be reduced if our our proposals set out in response to the other questions above are adopted.

Differing note requirements for BBA and PAA

It is expected that for many insurers who adopt the premium allocation approach (PAA), there will be some products that do not meet the criteria for applying PAA and therefore be accounted for under the building block approach (BBA).

Given that the PAA purports to be an approximation of the BBA we do not see the relevance of the additional disclosure notes for BBA included in paragraph 81. Requiring additional disclosures for portfolios accounted for under the BBA is likely to give undue prominence to these portfolios compared to those accounted for under PAA.

The AALC proposed that disclosures be aligned across PAA and BBA methodologies.

IASB Question 7 — Clarity of drafting

Do you agree that the proposals are drafted clearly and reflect the decisions made by the IASB?

If not, please describe any proposal that is not clear. How would you clarify it?

Response

Unit of Account

The ED alternates between the contract and the portfolio being the proposed unit of account. For instance:

- at paragraph 18 the ED outlines the initial accounting for an insurance *contract* as the sum of its fulfilment cash flows plus a contractual service margin yet at paragraph 22 the fulfilment cash flows are defined as those which relate directly to the fulfilment of the *portfolio* of contracts; and
- at paragraph 28, the ED requires consideration of whether the contract is onerous at a *portfolio* level before considering the fulfilment cash flows at a contract level in order to determine the contractual service margin for the *contract*.

The AALC recommends that the wording in the ED be modified to achieve consistency of unit of accounting. We propose consistent use of portfolio as the unit of account for the risk margin and contractual service margin.

Risk Adjustment

The ED appears inconsistent between the intention of the risk margin in the black letter of the draft standard and the Application Guidance.

At paragraph 22(a), the ED defines the intention of the risk margin as adjusting for "the effects of uncertainty about the amount and timing of those cash flows". In other words, the risk adjustment is designed to address estimation risk in the future cash flows.

The definition and guidance material for the risk adjustment, however, are drafted to allow consideration of broader issues than just estimation uncertainty when measuring the risk adjustment. Indeed, by measuring the risk adjustment as the level of compensation the entity requires to make it indifferent between fulfilling the insurance contract liability and a fixed liability, the ED introduces a quasi fair value measure for insurance liabilities.

In order to determine the level of compensation it requires for bearing risk, an entity would necessarily also need to consider matters such as:

- its risk appetite
- the relevant capital intensity of each portfolio,
- the timeframe over which that capital will be required to held for each portfolio and alternative uses to which that capital could be deployed within the entity.

While the proposed risk adjustment does convey information about the entity's perception of estimation uncertainty, it also reflects these non-estimation risk aspects of the underlying products which are unique to each product and entity. We believe these additional aspects of risk will distort the risk adjustment and jeopardise comparability of results across entities and jurisdictions, and possibly across portfolios or reporting periods within the single entity.

The AALC believes that the disclosure of a single probability of adequacy at an entity level by itself does not remedy this issue, as the risk adjustment would be required to be set at differing confidence levels across each portfolio having regard to these extraneous matters.

The AALC recommends a simplified approach which restricts the considerations relevant to the measurement of the risk adjustment to only the estimation uncertainty in the future cash flows. In Australian non-life insurance the probability of adequacy concept has proved an effective mechanism for financial reporting as it takes into account only the estimation uncertainty in the future cash flows.

Contract Boundary

The AALC acknowledges the improvements made in drafting the contract boundary, compared to the 2010 exposure draft. The 2010 exposure draft would have seen private health insurance contracts classified as long term contracts, given restrictions on risk selection and pricing at an individual policyholder level.

The recognition of repricing at a portfolio level goes a long way to addressing this classification issue, and should allow an appropriate recognition of private health insurance and like contracts as short duration risks. However, we believe the wording of the ED could be enhanced to recognise the ongoing regulatory requirement for government approval of price changes in private health insurance, compulsory third party (CTP) car insurance and similar classes. This pricing approval has regard both to financial sustainability of underwriters and consumer affordability.

The AALC recommends a modified wording at paragraph 23(b)(i) as follows:

> *The entity has the right or the practical ability to reassess the risk of the portfolio of insurance contracts that contains the contract and, as a result, can set a price or level of benefits that fully reflects the risk of that portfolio. A requirement to obtain regulatory approval for price and benefit changes does not, of itself, disprove the contract boundary. Other considerations may include the ability to reprice to achieve rates of return consistent with other issuers of like portfolios.*

Answers to Specific Questions - AASB

AASB question 1

Whether there are any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the proposals, particularly any issues relating to:

(a) not-for-profit entities; and

(b) public sector entities, including any GAAP/GFS implications;

Response

The AALC have not identified any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the proposals, other than the matter discussed with respect to contract boundaries discussed in response to the IASB's question 7 set out above.

AASB question 2

Whether, overall, the proposals would result in financial statements that would be useful to users

Response

The AALC has concerns with respect to some aspects of the ED, specifically:

- the mandatory use of other comprehensive income to recognise some, but not all, of the impacts of interest rates on insurance contracts and their supporting assets is likely to result in new accounting mismatches in reported profit; and
- the application of "mirroring" particularly with respect to participating life insurance and investment contracts appears to be unnecessarily complex and may not result in the reporting of useful information.

Further discussion on these matters, together with other detailed comments are provided below in our responses to IASB questions 2 and 4 set out above.

AASB question 3

Whether the proposals are in the best interests of the Australian economy

Response

The AALC has concerns with respect to some aspects of the ED, as noted in our responses to the earlier questions. In the event that these are not resolved, however, it is still likely to be in the interest of the Australian economy to adopt the final IASB standard.

AASB question 4

Unless already provided in response to specific matters for comment 1 – 3 above, the costs and benefits of the proposals relative to the current requirements, whether quantitative (financial or non-financial) or qualitative.

Response

In the view of the AALC, although there are significant improvements that may be made to the proposals set out in the ED, it is imperative that this project be brought to a close, a final standard issued and insurers move from local standards to an a consistent international approach.

Conclusion

This response reflects the nature and practical focus of the AALC. In this context we note that the comments and opinions set out in this response reflect the consensus views of the members of the AALC, and may not necessarily reflect the view of The Institute of Chartered Accountants in Australia, the Institute of Actuaries of Australia, nor the members' respective employers.

The current members of the AALC are:

Andrew Kitchen - Insurance Australia Group
Andrew Reeves - KPMG
Anne Driver - QBE
Brendan Counsell - EY

Declan Moore - QBE
Graham Duff - AMP
Kerry Hicks - Institute of Chartered Accountants in Australia
Mark Thompson – Hannover Life Re of Australasia
Michael Dermody - KPMG
Paul Harris - EY
Scott Hadfield - PricewaterhouseCoopers
Stuart Alexander - Deloitte
Tim Furlan - Russell Investment Group

Yours faithfully

Graham Duff
Chairman

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30 September 2013

Mr Kevin Stevenson
Chairman
Australian Accounting Standards Board
PO Box 204
COLLINS STREET WEST VIC 8007

Via email: standard@aasb.gov.au

Dear Kevin

ED 244 Insurance contracts

Thank you for the opportunity to comment on ED 244 (the ED). CPA Australia has considered the ED and our comments are set out below.

CPA Australia has more than 144,000 members working in 127 countries around the world. Our members work in diverse roles across public practice, commerce, industry, government and academia throughout Australia and internationally.

We are supportive of the move towards international consistency in the accounting for insurance contracts. We continue to support the IASB's proposal to:

- use a current value approach, and
- measure outstanding claims on a basis that reflects the time value of money.

We also acknowledge the significant improvements in the proposals set out in the ED relative to the 2010 ED, particularly with respect to:

- the unlocking of margins for changes in estimates relating to future coverage
- the contract boundaries
- the treatment of diversification benefits
- the characterisation of the Premium Allocation Approach as an approximation for the Building Block Approach rather than an alternative model, and
- the approach to transition.

Our major concern with the ED is the mandatory use of other comprehensive income (OCI) to recognise some, but not all, of the impacts of interest rates on insurance contracts and their supporting assets. As we have identified in previous submissions, including the IASB agenda consultation submission, we do not consider that the current ad-hoc approach to presenting items in OCI, which should really be reflected in the profit and loss account, is acceptable. We understand that the IASB is currently looking at OCI as part of its conceptual framework project. Therefore, we would prefer this work to be completed, before allocating further amounts to OCI. We do not consider that the ad-hoc use of OCI will provide useful information to stakeholders, as it does not address accounting mismatches and will add significant complexity to the IASB's current proposals.

We recommend that the IASB amend the model to allow all changes to the carrying amounts of insurance contracts, and the fair value of assets supporting them, to be reflected in the profit or loss. This method would be consistent with the current measurement approach. We understand there is strong support from some countries to use OCI, and for this reason we can accept that the IASB may want to continue to allow the OCI method as an allowable alternative if certain conditions are met. We note that historically, the IASB has not supported the notion of options within accounting standards. However, in this case, we consider appropriate the restricted use of OCI to address areas of accounting mismatch.

If you have any questions regarding this submission, please do not hesitate to contact Mark Shying at mark.shying@cpaaustralia.com.au.

Yours sincerely

Alex Malley FCPA
Chief Executive

Faculty of Business and Economics
Department of Accounting and Corporate Governance
MACQUARIE UNIVERSITY NSW 2109 AUSTRALIA

Mr Kevin Stevenson

Chairman

Australian Accounting Standards Board

By Email: standard@aasb.gov.au

4 October 2013

Dear Kevin,

Macquarie University's Department of Accounting and Corporate Governance is pleased to provide the Australian Accounting Standards Board (AASB) with its comments on Insurance Contracts which is a re-badged copy of the International Accounting Standards Board's (the Board) Exposure Draft ED/2013/7 (the ED). We have considered the ED, as well as the accompanying draft Basis for Conclusions.

Macquarie University's response reflects our position as a leading educator to the Australian and global community. This submission has benefited with input from discussions with key constituents, and in particular we appreciate the opportunity to be a participant at the AASB's Sydney Roundtable on 3 September 2013 where the ED was extensively discussed and was attended by representatives of the Board and IASB and AASB members and staff.

We do not support the ED as it is currently drafted, although we generally support the principles behind the ED which is have a single global accounting standard on Insurance Contracts. Our particular concern is that the ED is un-necessarily complex due to the numerous disclosure provisions which appear to be justified on what different users have argued is needed to properly understand the activities of an insurance entity.

Instead we suggest that the IASB should follow the lead of the UK Financial Reporting Council's Corporate Governance Code which is also being reflected in the Australian Securities Exchange's Corporate Governance Council's proposals for change to the similar Australian Code, and allow or indeed require the more complex and detailed disclosures via an entity's website. That should significantly reduce the 'clutter' which is in the current ED.

MACQUARIE UNIVERSITY

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On that basis we suggest that the IASB should embark on a major review of the current ED to determine what are the clear and essential requirements for understanding at a basis level, the operations and financial performance of an insurance entity.

If you require any further information or comment, please contact me.

Keith Reilly

Industry Fellow (International Governance & Reporting)

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