INSURANCE COUNCIL
OF AUSTRALIA

Mr Kevin Stevenson
Chairman
Australian Accounting Standards Board
PO Box 204
COLLINS STREET WEST VIC 8007
Email: standard@aasb.gov.au

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Dear Mr Stevenson

EXPOSURE DRAFT 201 INSURANCE CONTRACTS

The Insurance Council of Australia[1] (Insurance Council) appreciates the opportunity to comment on Exposure Draft (ED) 201: Insurance Contracts. The Insurance Council and its members endorse the goal of achieving a single accounting standard for insurance contracts that would be applied globally. This would enhance the transparency and understanding of the insurance industry's operations and allow for greater comparability between the financial statements of individual insurance entities.

This covering letter sets out the key issues that the Insurance Council would like to raise in relation to the model proposed for a single international accounting standard for insurance contracts. The Attachment details the Insurance Council's responses to the questions posed in the ED.

Risk Adjustment versus composite margin
The Insurance Council strongly endorses the International Accounting Standards Board (IASB) approach of splitting the risk adjustment and the residual margin. A risk margin is required so that the present value of fulfilment cashflows represents a reasonable estimate of the fair value of the liability. The residual margin is the profit arising upon inception earned over time. Consequently, the two should not be combined as they may have different characteristics.

Definition of Short Duration Contracts
The Insurance Council understands that the modified measurement approach is designed for general insurance. Consequently, the Insurance Council does not agree with a time based measurement approach i.e. the 12 months coverage test. This would exclude many types of general insurance from the use of the modified measurement approach for example

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[1] The Insurance Council of Australia is the representative body of the general insurance industry in Australia. Our members represent more than 90 percent of total premium income written by private sector general insurers. Insurance Council members, both insurers and reinsurers, are a significant part of the financial services system. June 2010 Australian Prudential Regulation Authority statistics show that the private sector insurance industry generates gross premium revenue of $33.2 billion per annum and has total assets of $99.2 billion. The industry employs approx 60,000 people and on average pays out about $95 million in claims each working day.

Insurance Council members provide insurance products ranging from those usually purchased by individuals (such as home and contents insurance, travel insurance, motor vehicle insurance) to those purchased by small businesses and larger organisations (such as product and public liability insurance, professional indemnity insurance, commercial property, and directors and officers insurance).

consumer credit insurance; lenders' mortgage insurance, warranty insurance; construction contract insurance and certain professional risks insurance such as cover to retiring professionals.

Given the range of general insurance types that could not be reported on a modified measurement basis if the time based definition is applied, a significant number of Insurance Council members would have to report on them using the standard approach while reporting the majority of their business on the modified measurement basis. The Insurance Council submits that this would impact considerably the value of the reporting of these insurers. It also raises practical difficulties for insurance groups where contracts of longer duration may be held by one subsidiary. The subsidiary may report on the standard basis at the entity level but need to report on the modified measurement basis upon consolidation.

The Insurance Council recommends strongly that the AASB consider ways of avoiding these difficulties. It has been suggested that the new standard contain clear definitions of life and non-life insurance. The life definition could be drawn from the OECD definition which extends to any form of insurance whose payment is contingent on the insured's health. Non life could be defined simply as everything that is not life. Recognising that this approach may be inconsistent with the goal having one standard applying to all insurance, another possibility would be to apply a materiality threshold. If the proportion of an insurer's book requiring the standard or modified approach fell under threshold, it would be reported on the same basis as the majority of the insurer's business.

Boundary Principles
The Insurance Council broadly supports the proposed boundary principles. However, the Insurance Council is concerned that the current draft principle defines the termination boundary too restrictively and would require provisioning for future renewal of certain fixed term contracts that are subject to particular regulatory constraints that limit the ability to price or underwrite individual risks on renewal. The application of the ED definition to different regulatory regimes for privately underwritten mandated insurance in the Australian States/Territories may result in different accounting outcomes according to jurisdiction despite the underlying insurance product being the same.

Measurement of Risk Adjustment
The Insurance Council strongly disagrees with the proposition that an insurer should measure the risk adjustment at a portfolio level of aggregation. To ignore the diversification benefits between portfolios of contracts will result in financial reports that do not reflect a true and fair view of the insurance operations of the entity.

The Insurance Council advocates that an insurer should measure the risk adjustment at the reporting entity level. The diversification benefit achieved by a company in bringing together particular portfolios is relevant information that will help users of the insurer's financial statements to make economic decisions.

Recognition Criteria
The ED requires exposures to be recognised at the earlier of 1) coverage period commencing or 2) irrevocable commitment to provide cover. The latter is similar to the APRA's concept of BBNI. The implications are that insurers would be required to estimate (or capture real data if they can) the BBNI and apply either the general measurement model (complex) or simplified model. This will introduce additional assets/liabilities into the insurers'

books at reporting date over and above current AASB1023 requirements, and be potentially subjective. If the insurers (or their auditors) require more fact and less estimation, this will have significant cost implications in amended processes and systems particularly for insurers distributing via intermediaries.

Recognition of non incremental acquisition costs
The Insurance Council considers that the cost of selling, underwriting and initiating an insurance contract should be included in the initial measurement of the insurance contract as contract cash flows. The proposals in the ED create the following issues:

- Lack of comparability and an unlevel playing field between intermediated distribution and direct distribution models. Commission expense represents the revenue of an intermediary's Profit and Loss account. That revenue supports all of the intermediary's operating costs. It appears inconsistent that such overheads can be (indirectly) recognised in deferred acquisition costs (DAC) as part of deferred commission expense but not recognised in DAC by a direct distributor.
- Companies will report losses at inception equal to the acquisition expenses other than those incremental at the contract level. These expenses may be material and include underwriting and other initial establishment costs.

If you require further information, please contact Mr John Anning, Insurance Council's General Manager Policy – Regulation Directorate at janning@insurancecouncil.com.au

Yours sincerely

Robert Whelan
Chief Executive Officer & Executive Director

INSURANCE COUNCIL OF AUSTRALIA

ATTACHMENT

Discussion Paper Questions	Comment
Question 1 – Relevant information for users (paragraphs BC13–BC50) Do you think that the proposed measurement model will produce relevant information that will help users of an insurer's financial statements to make economic decisions? Why or why not? If not, what changes do you recommend and why?	Overall, the proposed measurement model should improve consistency of information between national jurisdictions. However, the new standard should not result in a major impact on Australian general insurers as it is largely consistent with AASB 1023 with which they currently comply.
Question 2 – Fulfillment cash flows (paragraphs 17(a), 22–25, B37–B66 and BC51) (a) Do you agree that the measurement of an insurance contract should include the expected present value of the future cash outflows less future cash inflows that will arise as the insurer fulfils the insurance contract? Why or why not? If not, what do you recommend and why? (b) Is the draft application guidance in Appendix B on estimates of future cash flows at the right level of detail? Do you have any comments on the guidance?	(a) Agree. (b) The level of detail in the draft application guidance is satisfactory. The Insurance Council notes that the proposals in B61(h) and B62(f) differ from the current treatment in Australia. B61(h) – Value added taxes that are collected and forwarded directly to a government agency on a equal dollar value basis, should not be included in the future cash flows given that the insurer only acts as a conduit. B62(f) – by not including an allowance for overheads, this does not allow for insurers to consider the total costs in running off existing liabilities.

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Question 3 – Discount rate (paragraphs 30–34 and BC88–BC104) (a) Do you agree that the discount rate used by the insurer for non-participating contracts should reflect the characteristics of the insurance contract liability and not those of the assets backing that liability? Why or why not?	(a) Agree. The proposal would promote consistency between insurers as the assets do not necessarily reflect the returns on the assets chosen to back these insurance liabilities.
(b) Do you agree with the proposal to consider the effect of liquidity, and with the guidance on liquidity (see paragraphs 30(a), 31 and 34)? Why or why not?	(b) Not a significant issue for general insurers
(c) Some have expressed concerns that the proposed discount rate may misrepresent the economic substance of some long-duration insurance contracts. Are those concerns valid? Why or why not? If they are valid, what approach do you suggest and why? For example, should the Board reconsider its conclusion that the present value of the fulfillment cash flows should not reflect the risk of non-performance by the insurer?	(c) Not relevant to general insurers. However, the Insurance Council considers that it would be a mistake for the Board to reconsider the value of fulfilment cash flows.
Question 4 – Risk adjustment versus composite margin (paragraphs BC105–BC115) Do you support using a risk adjustment and a residual margin (as the IASB proposes), or do you prefer a single composite margin (as the FASB favours)? Please explain the reason(s) for your view.	The Insurance Council supports a risk adjustment and a residual margin as proposed by the IASB. It is the current practice in Australia and works well, increasing both transparency and consistency.

Question 5 – Risk adjustment (paragraphs 35-37, B67-B103 and BC105–BC123)	
(a) Do you agree that the risk adjustment should depict the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfillment cash flows exceed those expected? Why or why not? If not, what alternatives do you suggest and why?	(a) The Insurance Council considers the terminology used in the ED - "*the maximum amount the insurer would rationally pay to be relieved of the risk*" – to be confusing. The description implies an exit value basis of measurement. It would not be appropriate to combine a fulfilment objective and an exit value objective in the standard as this could lead to confusing outcomes. In addition, the use of the word "maximum" indicates the selection of an option which is at the top end of a range of options available. This implies inappropriate conservatism in the calculation. However, the guidance in BC110 seems to clarify that this is not the intent. Consequently, the Insurance Council supports the intent of the ED but would suggest that the wording of the ED be amended to be more consistent with the guidance.
(b) Paragraph B73 limits the choice of techniques for estimating risk adjustments to the confidence level, conditional tail expectation (CTE) and cost of capital techniques. Do you agree that these three techniques should be allowed, and no others? Why or why not? If not, what do you suggest and why?	(b) The Insurance Council does not object to the three suggested techniques for estimating risk adjustments. However, if the IASB is to specifically include them in the standard it limits the possibility of a future method being developed and used. We submit that it should allow some flexibility to allow other methods that are explained in the insurer's accounts. The Insurance Council notes that if the IASB goes with the proposal in 5(a) then the only realistic choice is the third technique.
(c) Do you agree that if either the CTE or the cost of capital method is used, the insurer should disclose the confidence level to which the risk adjustment corresponds (see paragraph 90(b)(i))? Why or why not?	(c) Yes, disclosure of the confidence level is necessary for comparability
(d) Do you agree that an insurer should measure the risk adjustment at a portfolio level of aggregation (i.e. a group of contracts that are subject to similar risks and managed together as a pool)? Why or why not? If not, what alternative do you recommend and why?	(d) The Insurance Council disagrees strongly with the proposal. The essence of insurance is the spreading of risk. Therefore, the estimation of the risk adjustment should be made at the company level to properly reflect the effects of this diversification.

(e) Is the application guidance in Appendix B on risk adjustments at the right level of detail? Do you have any comments on the guidance?	(e) There is adequate detail in the guidance in Appendix B. The Insurance Council notes that B69 differs from current practice by not providing for the inclusion of operational risk in the calculation of risk margins.
Question 6 – Residual/composite margin (paragraphs 17(b), 19–21, 50–53 and BC124–BC133) (a) Do you agree that an insurer should not recognise any gain at initial recognition of an insurance contract (such a gain arises when the expected present value of the future cash outflows plus the risk adjustment is less than the expected present value of the future cash inflows)? Why or why not? (b) Do you agree that the residual margin should not be less than zero, so that a loss at initial recognition of an insurance contract would be recognised immediately in profit or loss (such a loss arises when the expected present value of the future cash outflows plus the risk adjustment is more than the expected present value of future cash inflows)? Why or why not? (c) Do you agree that an insurer should estimate the residual or composite margin at a level that aggregates insurance contracts into a portfolio of insurance contracts and, within a portfolio, by similar date of inception of the contract and by similar coverage period? Why or why not? If not, what do you recommend and why? (d) Do you agree with the proposed method(s) of releasing the residual margin? Why or why not? If not, what do you suggest and why (see	(a) The Insurance Council agrees. Insurers are likely to get a smoother result (following transition) if this approach is adopted. (b) The Insurance Council agrees with this proposal as it is close to existing Australian practice that has worked well. (c) The Insurance Council disagrees strongly. As diversification is the essence of insurance, the residual margin should be calculated across the whole company reflecting the spread of risk. Defining the diversification benefit at portfolio level would not make commercial sense. (d) The Insurance Council agrees that the proposals have adequate flexibility.

paragraphs 50 and BC125–BC129)? (e) Do you agree with the proposed method(s) of releasing the composite margin, if the Board were to adopt the approach that includes such a margin (see the Appendix to the Basis for Conclusions)? Why or why not? (f) Do you agree that interest should be accreted on the residual margin (see paragraphs 51 and BC131–BC133)? Why or why not? Would you reach the same conclusion for the composite margin? Why or why not?	(e) The question is not applicable given that the Insurance Council does not support use of a composite margin. (f) The Insurance Council agrees.
Question 7 – Acquisition costs (paragraphs 24, 39 and BC135–BC140) Do you agree that incremental acquisition costs for contracts issued should be included in the initial measurement of the insurance contract as contract cash outflows and that all other acquisition costs should be recognised as expenses when incurred? Why or why not? If not, what do you recommend and why?	The Insurance Council considers that the cost of selling, underwriting and initiating an insurance contract should be included in the initial measurement of the insurance contract as contract cash flows. The proposals in the ED create the following issues: • Lack of comparability and an unlevel playing field between intermediated distribution and direct distribution models. Commission expense represents the revenue of an intermediary's Profit and Loss account. That revenue supports all of the intermediary's operating costs. It appears inconsistent that such overheads can be (indirectly) recognised in DAC as part of deferred commission expense but not recognised in DAC by a direct distributor. • Companies will report losses at inception equal to the acquisition expenses other than those incremental at the contract level. These expenses may be material and include underwriting and other initial establishment costs.

Question 8 – Premium allocation approach (paragraphs 54-60 and BC 145—148) (a) Should the Board (i) require, (ii) permit but not require, or (iii) not introduce a modified measurement approach for the pre-claims liabilities of some short-duration insurance contracts? Why or why not?	(a) The Insurance Council supports "permit but not require". While acknowledging the benefits in terms of comparability of requiring the use of one approach, insurers do not want to have to run two sets of books.
(b) Do you agree with the proposed criteria for requiring that approach and with how to apply that approach? Why or why not? If not, what do you suggest and why?	(b) The Insurance Council understands that the modified measurement approach is designed for non-life (general) insurance and, given its similarity to that currently required by the AASB, the Insurance Council supports adoption of this approach. The Insurance Council acknowledges the benefits in terms of comparability of requiring the use of one approach. However, the desire for consistency needs to be balanced to ensure that an insurance group's financial statements are "user friendly" and useful to all stakeholders. The effectiveness of an insurer's financial statements is affected if the general insurance component is stated on one basis while the life insurance component is on another. Consequently, the Insurance Council recommends: • an appropriate definition of the criteria for using the modified approach to ensure that it addresses general insurance as we understand to be the intention; or • There is some allowance for where a small proportion of an insurer's business would be otherwise be reported on a different basis, it is able to be reported consistently with the majority of the business. In view of the Insurance Council's understanding that the modified measurement approach is designed for general insurance, it does not agree with a time based measurement approach i.e. the 12 months coverage test. This would exclude many types of general insurance from the use of the modified measurement approach for example consumer credit insurance; warranty insurance; construction contract insurance and certain professional risks insurance such as cover to retiring professionals. Furthermore, it is not clear that several other forms of general insurance would meet the short duration definition: • Risk attaching reinsurance that is written over a 12 month period but is recognised over 24 months; and • Reinsurance contracts that are accounted on a 'clean cut' basis where the

	liabilities are settled between the parties at the end of each year, then the remaining liabilities are covered in a new contract in the new year (with a corresponding premium). This new contract accepts risks for another year, before the 'clean cutting' is performed again, and the contract renewed. Given the above types of general insurance that could not be reported on a modified measurement basis if the time based definition is applied, a significant number of Insurance Council members would have to report on them using the standard approach while reporting the majority of its business on the modified measurement basis. The Insurance Council submits that this would impact considerably the value of the reporting of these insurers. It also raises practical difficulties for insurance groups where contracts of longer duration may be held by one subsidiary. The subsidiary may report on the standard basis at the entity level but need to report on the modified measurement basis upon consolidation. The Insurance Council recommends strongly that the AASB consider ways of avoiding these difficulties. It has been suggested that the new standard contain clear definitions of life and non-life insurance. The life definition could be drawn from the OECD definition which extends to any form of insurance whose payment is contingent on the insured's health. Non life could be defined simply as everything that is not life. Recognising that this approach may be inconsistent with the goal having one standard applying to all insurance, another possibility would be to apply a materiality threshold. If the proportion of an insurer's book requiring the standard or modified approach fell under threshold, it would be reported on the same basis as the majority of the insurer's business.
Question 9 – Contract boundary principle (paragraphs 26-29 and BC 53-66) Do you agree with the proposed boundary principle and do you think insurers would be able to apply it consistently in practice? Why or why not? If not, what would you recommend and why?	While in broad agreement with the proposed boundary principles, the Insurance Council is concerned that the current draft principle defines the termination boundary too restrictively and would require provisioning for future renewal of certain fixed term contracts that are subject to particular regulatory constraints that limit the ability to price or underwrite individual risks on renewal. The application of the ED definition to different regulatory regimes in each of the Australian states may result in different accounting outcomes by state despite the underlying insurance product being the same in each state. For example, in NSW, there are multiple Compulsory Third Party (CTP) insurers and, although

	each insurer is obliged to offer renewal on each insured vehicle as the registration falls due to renewal, these insurers have the ability to re-price the risk each year and can take into account individual risk attributes to do this (for example age and change in driving record). In Queensland, the insurers can add or remove customer incentives based on changes to the risk profile, but the actual premium itself remains subject to community rating. In other Australian states, the CTP market is represented by state government owned monopoly insurers and their freedom to re-price individual risks each year is much more heavily constrained. Application of the ED requirements would appear to result in NSW having clear termination boundaries each renewal period but unclear termination boundaries for Queensland and ACT based contracts, and for the other states the termination boundary criteria would not appear to be satisfied. Further, in practice, if a provision for future renewals is required for CTP products in certain states, it would be difficult to quantify such a provision due to the difficulty of calculating the potential outcome of future multiple renewals and the likely impact caused by a competitive market dynamic where the insured can change insurer without penalty at renewal due date. In considering a more satisfactory definition of short duration insurance contracts, the need to clearly cover CTP and similar products.
Question 10 – Participating features (paragraphs 23, 62-66 and BC 67-75, BC198-203) (a) Do you agree that the measurement of insurance contracts should include participating benefits on an expected present value basis? Why or why not? If not, what do you recommend and why? (b) Should financial instruments with discretionary participation features be within the scope of the IFRS on insurance contracts, or within the scope of the IASB's financial instruments standards? Why? (c) Do you agree with the proposed definition of a discretionary participation feature, including the proposed new condition that the investment	These issues relate to life insurance and are not relevant to Insurance Council members.

contracts must participate with insurance contracts in the same pool of assets, company, fund or other entity? Why or why not? If not, what do you recommend and why? (d) Paragraphs 64 and 65 modify some measurement proposals to make them suitable for financial instruments with discretionary participation features. Do you agree with those modifications? Why or why not? If not, what would you propose and why? Are any other modifications needed for these contracts?	
Question 11 – Definition and scope (paragraphs 2-7, B2-B33 and BC 188-209) (a) Do you agree with the definition of an insurance contract and related guidance, including the two changes summarised in paragraph BC191? If not, why not? (b) Do you agree with the scope exclusions in paragraph 4? Why or why not? If not, what do you propose and why? (c) Do you agree that the contracts currently defined in IFRSs as financial guarantee contracts should be brought within the scope of the IFRS on insurance contracts? Why or why not?	(a) The Insurance Council agrees with the definition of an insurance contract and the related guidance. b) The Insurance Council agrees with the scope exclusions listed in paragraph 4. However, it would appreciate clarification whether retail product warranty contracts[2] are within the scope of the ED. It would appear to fall within the definition of insurance. (c) This is not a significant issue for general insurers.

[2] Insurers offering retail product warranty via indemnification of retailers (when the retailer has the warranty agreement with the end customer, but the insurer indemnifies the retailer for losses).

Question 12 – Unbundling (paragraphs 8-12 and BC 210-225) Do you think it is appropriate to unbundle some components of an insurance contract? Do you agree with the proposed criteria for when this is required? Why or why not? If not, what alternative do you recommend and why?	This issue relates to life insurance and is not relevant to Insurance Council members.
Question 13 – Presentation (paragraphs 69-78 and BC 150-183) (a) Will the proposed summarised margin presentation be useful to users of financial statements? Why or why not? If not, what would you recommend and why? (b) Do agree that an insurer should present all income and expense arising from insurance contracts in profit or loss? Why or why not? If not, what do you recommend and why?	(a) The Insurance Council supports the proposed summarised margin presentation because its similarity to current practice would make it familiar to Australian users of general insurer financial statements. However, consistent with our responses to Question 8, the value of financial reporting would be weakened if diversified general insurers are required to reports parts of their business on different bases. (b) The Insurance Council supports an insurer presenting all income and expense arising from insurance contracts in profit and loss. Such information will assist the users of an insurer's financial statements to understand its profitability and the risks associated with insurance contracts.
Question 14 – Disclosures (paragraphs 79-97 and BC 242 -243) (a) Do you agree with the proposed disclosure principle? Why or why not? If not, what would you recommend, and why? (b) Do you think the proposed disclosure requirements will meet the proposed objective? Why or why not? (c) Are there any disclosures that have not been proposed that would be useful (or some proposed that are not)? If so, please describe those disclosures and explain why they would or would not be useful.	(a) The Insurance Council agrees with the proposed disclosure principle. (b) The Insurance Council considers that the proposed disclosure requirements will meet the desired objective. (c) The Insurance Council cannot identify any additional disclosures that would be useful.

Question 15 – Unit-linked contracts (paragraphs 8(a)(i), 71 and 78, Appendix C, paragraphs BC 153-155 and BC 184-187) Do you agree with the proposals on unit-linked contracts? Why or why not? If not what do you recommend and why?	This issue relates to life insurance and is not relevant to Insurance Council members.
Question 16 – Reinsurance (paragraphs 43-46 and BC 230-241) (a) Do you support an expected loss model for reinsurance assets? Why or why not? If not, what do you recommend and why? (b) Do you have any other comments on the reinsurance proposals?	(a) Credit risk should not be included in this model as the ability to collect from reinsurers is better included under the impairment provisions of the accounting standards. Reinsurance assets should be calculated on an expected basis ignoring credit risk which is then subject to impairment analysis to be disclosed separately. (b) The Insurance Council has no further comments to make.
Question 17 – Transition and effective date (paragraphs 98-102 and BC 244-257) (a) Do you agree with the proposed transition requirements? Why or why not? If not, what would you recommend and why? (b) If the Board were to adopt the composite margin approach favoured by the FASB, would you agree with the FASB's tentative decision on transition (see the appendix to the Basis for Conclusions)? (c) Is it necessary for the effective date of the	(a) The Insurance Council generally agrees with the proposed transition requirements as compliance should be relatively straight forward for Australian general insurers. However, the transition provisions are likely to cause difficulty in regard to those GI products such as Lenders' Mortgage Insurance that come under the standard approach. The Insurance Council submits that the transition provisions should allow the reporting of the opening residual margin when the insurer has the ability to substantiate it. The Insurance Council notes that the transition provisions will have a detrimental effect on short to medium term profitability for life insurers and would support measures to recognise the transition adjustment in profit. (b) The question is not applicable given that the Insurance Council does not support use of a composite margin. (c) The Insurance Council considers that the two effective dates should be aligned. The two

IFRS on insurance contracts to be aligned with that of IFRS 9? Why or why not? (d) Please provide an estimate of how long insurers would require to adopt the proposed requirements.	standards are so interrelated that compliance would be facilitated if both were dealt with at the same time. (d) The time needed to comply with the proposed requirements will of course vary between insurers. However, the Insurance Council considers that two years would be a satisfactory period for transition.
Question 18 – Other comments Do you have any other comments on the proposals in the exposure draft?	There are no other comments that the Insurance Council wishes to make
Question 19 – Benefits and costs (BC 258-263) Do you agree with the Board's assessment of the benefits and costs of the proposed accounting for insurance contracts? Why or why not? If feasible, please estimate the benefits and costs associated with the proposals.	While agreeing with many of the foreshadowed benefits, in line with the comments made above, the Insurance submits that there is a need to adjust some of the proposals to improve the outcome and reduce some of the costs.