Institute of Actuaries of Australia

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Request for Comment on IASB Discussion Paper
Discussion Paper - Preliminary Views on Insurance Contracts

The Institute of Actuaries of Australia (the Institute) is the sole professional body for actuaries in Australia. It represents the interests of over 1,400 fellows and 2,000 other members. Our members have had significant involvement in the development of insurance regulation, financial reporting and related practices in Australia over many years.

The Institute welcomes the opportunity to submit comments to the AASB on the International Accounting Standards Board's (IASB's) Discussion Paper *Preliminary Views on Insurance Contracts*. Please note that we will also submit these comments to the IASB in November a forthcoming submission, in which we will further strengthen some arguments, especially those made in the area of Service Margins, under Question 21.

Again, thank you for the opportunity to comment on the AASB proposals. Please do not hesitate to contact the Chief Executive, John Maroney (02 9233 3466; email: john.maroney@actuaries.asn.au) if you wish to discuss any of our comments.

Yours sincerely

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IASB Discussion Paper
Discussion Paper - Preliminary Views on Insurance Contracts

General Comments

The Institute strongly supports the general thrust of the proposals in this discussion paper. We believe that a requirement that insurance liabilities should be measured as the expected present value of future cash flows, plus an appropriate margin for the economic value of the uncertainty about these cash flows. This will permit insurers to present internally consistent financial statements, if they also use the fair value option for those assets backing insurance liabilities.

Indeed, we believe that the IASB should go further and require internal consistency between the measurement of liabilities and backing assets and:

- Require the use of the fair value option for such assets to the extent that current standards allow fair value, as is the case in Australia; and
- Extend this fair value option to standards where fair value of assets is not currently allowed.

General Insurance

The approach proposed is very similar to that required for regulatory reporting in Australia and recommended for general insurance financial statement purposes by the HIH Royal Commission. The absence of some of the features now proposed by the IASB (such as a sound current estimate with risk margins) from Australian general insurance accounting standards up to the time of the HIH collapse was identified by the Royal Commission as a major contributor to the HIH collapse. The lessons learnt from that collapse have also led us to suggest some important clarifications to the proposals in the paper.

The main features of the Australian regulatory reporting regime have been in place since 2002 for general insurance. In our experience, this regime has worked well, with no major implementation problems. In part, this may be due to the fact that many of the aspects of the current approach have been part of good Australian accounting practice since the 1990s. In particular, claim provisions have been set on the basis of the expected present value of projected cash flows, with a risk based margin, since the 1990's. We anticipate that, when other jurisdictions become familiar with the proposed basis, they will appreciate its merits.

Life Insurance

The Australian life insurance regulatory reporting regime has used expected present values of future cash flows albeit with a service margin calibrated to price at issue (if positive), together with fair value of assets, as fundamental building blocks, since the mid 1990's. This, too, has worked well and while the inclusion of a specific risk margin in the liabilities will be new for life insurance, our general insurance experience demonstrates the merits of this approach and gives us confidence in the practicality of extending risk margins to life insurance.

Service margins

However, we find the role and nature of the service margin in the current exit value model very unclear. Parts of the discussion paper, in particular, the comparison with

IAS18, indicate that a retail or customer view of services is intended. If this is the case, there are potentially three services involved: Insurance, Investment Management and Advice.

Insurance includes a risk margin and we assume is not intended to also carry a service margin of itself, given the references to other services in the definition of current exit value. If desired, however, this would be one way of implementing a prohibition on profit at inception. Although investment management services can include advice, advice can and usually will be much wider than this. In particular, advice may be provided even when there is no investment management element, only insurance. A significant part of the advice will be provided at or prior to inception of the contract, although it can also be ongoing.

The discussion on service margins also makes reference to portfolio assembly and suggests that it would be treated as a service occurring at inception. This suggests a provider or wholesale view of service margins as, while portfolio assembly, underwriting, claims management and record keeping are capable of being treated as separate service elements by the provider, they are all simply part of the provision of insurance from the customer perspective. If a provider or wholesale view is taken, then the service margin would reflect the profit margin involved in outsourcing the provision of these services.

The discussion paper also suggests an expectation that service margins, for product priced to market, will result in little or no profit at inception. It points to the reporting of positive embedded values at inception for new business as evidence of some additional service beyond the bearing of risk for which a profit may be earned. As this is often the case for pure life risk business, and not just life insurance contracts involving a deposit or investment element, this indicates another fundamental feature, the substantial investment that some companies make in their brand and distribution and the extra return they are often able to generate as a consequence.

Under a pure current exit value approach this extra return will be recognised as profit at inception.

We do not believe this to be appropriate where this value arises from margins in future premiums or fees. This is, in effect, recognising internally generated goodwill, albeit goodwill that is tied to the continuation of the insurance contract. We would propose a two part approach to measurement of insurance contracts:

- **an insurance liability** being the current exit value including risk margins but excluding any service margins;
- **a service margin** calibrated to absorb any profit at inception arising from future premiums or fees after allowing fully for acquisition expenses and earned in proportion to the provision of insurance or other services. As this service margin essentially measures the margin in future premiums above the insurance liability current exit value arising from those premiums, it will, provided it remains positive, absorb any subsequent non-financial changes in assumptions. This does not reflect a view that margins should be used as a shock absorber; it is simply a consequence of its nature, as the difference between future premiums and the associated insurance liability arising from those premiums, and the exclusion of this internally generated goodwill from current profit.

We see this approach as having many benefits, including that;

- it retains the use of current estimates of future cashflows and risk margins for the measurement of the insurance liability and consistency with the use of fair value in other standards

- it provides a natural and appropriate liability adequacy test, a current exit value based insurance liability
- a current exit value based insurance liability provides the risk based foundation for the solvency regime, as desired by international regulators
- this use of the service margin is more consistent with profit recognition for service contracts under IAS 18;
- it avoids anticipating the outcomes of the current review of IAS 18. If this review finally settles on a fair value approach, as opposed to customer value, then this can be implemented for insurance contracts at the same time, consistently with other retail financial services (e.g. bank deposits, unit trusts, and unit linked contracts).

Furthermore, an appropriate and carefully considered treatment of service margins and the associated concept of profit at inception may well resolve many of the other difficult issues identified in the Discussion Paper and for which the solution currently proposed is not necessarily ideal.

Consistency with Regulatory Requirements

It is highly desirable that the regulatory and accounting reporting regimes should be, if not identical, at least compatible. Apart from the proposed service margins the current proposal is highly compatible with what appears to be emerging from the IAIS discussions and is also very similar to current Australian regulatory reporting standards.

Proxy Policyholder Taxes

We believe that an appropriate distinction needs to be made between taxes imposed on an insurer on shareholder profits and those imposed as a proxy for policyholders, which, directly or indirectly, affect the benefits payable to those policyholders. The former are properly handled under IAS 12, however the second category needs special consideration either in regard to the cash flows to be included in the determination of the insurance liability or under IAS 12 if a further accounting mis-match is to be avoided.

It is common in Australia and number of other jurisdictions for income tax to be charged on investment income on assets that support the provision of benefits to policyholders, as a proxy for taxing the policyholders. The issue arises where the benefits payable to the policyholder depend on the net investment income from those assets, as is the case for participating business. In such cases, the benefits ultimately payable reflect not only the future investment income but also the tax payable thereon.

As this future income has yet to arise, it does not give rise to a tax liability under IAS 12, and so it needs to be included in the cash flows used to determine the resulting insurance liability, which is the approach used in Australian Accounting Standard for Life Insurance (AASB 1038). It seems fairly difficult to properly capture it in IAS 12 because of its nature as a tax liability on future investment income, rather than a tax on profit, and also because of the blanket prohibition on discounting under IAS 12.

Diversification

We believe that the prohibition on recognising the benefits of diversification between portfolios in setting risk margins is inconsistent with:

- the way insurance contracts are priced;

- the way a deep and liquid market would reflect risk in the prices paid for transfer of insurance liabilities; and
- the IASB's stated preference that current exit value should be independent of the entity holding the insurance liabilities.

Diversification, or reduction in risk per unit of insurance for an entity, is achieved both by increasing the size of the portfolio by writing greater numbers similar contracts and also by assembling portfolios of different risks. As the size of each portfolio held by the entity is just as entity specific as the range of portfolios held by the entity, recognising diversification within the portfolio is just as entity specific as the prohibited recognition of diversification between portfolios.

The solution to this conundrum lies in the reason why both mono-line and small insurers are able to successfully co-exist in the market place, alongside large multi-line insurers, notwithstanding the substantial difference in gross risk that the former entities have. This is because these insurers are able to reduce their relative net risk to a level more commensurate with that of other market participants, through the use of reinsurance.

Further, in a deep and liquid market, the price for risk is not set by the entity characteristics of the selling entity but by diversification that exists across the range of possible purchasers. The more appropriate and market based solution is to require risk margins to be set by reference to a large insurer with a broad spread of business and commensurate reinsurance. This will result in unit risk margins which are much more market consistent and relatively independent of both the size of the particular portfolio held by the entity and the range of portfolios held by the entity, while remaining consistent with the nature of the risk inherent in the particular liabilities held.

Confusion due to different uses for Recognition

There is confusion because, in common accounting usage and throughout the Discussion Paper, the word "recognise" has at least three meanings.

1. It is used in the sense of whether something's existence should be reflected in the financial statements at all.
2. It is used in relation to where something should be reported in the accounts. We believe that there would be less confusion if the word "reported" were used for this meaning.
3. It is used in relation to whether particular cash flows should be included or whether particular circumstances should be allowed for in a measurement. Words and phrases such as "included", "allowed for" and "provided for" would give a clearer indication if this is the usage that is intended.

Where this causes problems in the discussion draft is when recognition criteria (meaning 1) are applied to measurement issues (meaning 3), in relation to future premiums (chapter 4) and participation features (chapter 6). In both cases, this seems to place unnecessary obstacles in the way of arriving at a sensible accounting treatment.

Answers to Questions

Chapter 2

Question 1

Should the recognition and derecognition requirements for insurance contracts be consistent with those in IAS 39 for financial instruments? Why or why not?

We believe that the recognition and derecognition criteria for insurance and reinsurance contracts, in the hands of an insurer or reinsurer, should be consistent with those in IAS 39. We do not comment on the criteria appropriate for non-insurer policyholders.

Recognition

An insurance or reinsurance policy should be recognised when it is written. This, however, is not as simple as it sounds.

Many insurance companies write business through intermediaries, who are given varying degrees of authority to accept business on behalf of the insurer. At any time, the insurer is unlikely to be aware of exactly what business has been accepted on its behalf. Similarly, general insurers routinely offer to "renew" policies on terms set out in the offer of renewal. There is typically a period after the expiry of the old policy during which those terms are held open. It is necessary to estimate this "pipeline" business.

It is also necessary to address the question of premiums paid in advance and the related issue of "cooling off" periods. There are at least four points at which premium revenue could be recognised under a prospective accounting paradigm:

- when the premium is paid by the policyholder;
- when the risk is accepted by the insurer;
- when the risk commences;
- when the "cooling off" period expires.

Of these, we favour risk acceptance, with allowance for refunds due to cancellation from inception within any "cooling off" period, on the basis of expected policyholder behaviour, as part of the liability. This is the point at which risk transfer, which is the essence of the insurance transaction, takes place.

Before acceptance, premiums should be treated as deposits in the hands of whoever is holding them and also where, as in Australia, the insurer is liable to cover intermediary default, in the hands of the insurer, offset by an "agents balance" asset.

In general insurance, it is common practice for the insurer to offer renewal of contracts, shortly before they are due to expire. Most commonly, this offer is conditional upon new underwriting, in which case the situation is no different from an entirely new contract. In some cases, however, the offer to renew is unconditional. In such cases, risk transfer occurs when the insured accepts the offer of renewal and this is when the contract should be recognised.

The same term, "renewal", is also used in relation to payment of subsequent premiums on ongoing contracts. The issue of whether this is the substance of the matter, in which case the whole contract is recognised at outset, or whether each renewal is a new contract, to be recognised seriatim, is discussed in chapter 4.

Some insurance policies include "insurability options", that allow the insured to effect future increases or new policies on guaranteed terms. Any future new policy or increase should not be recognised unless and until effected, but the option will usually have a value to be allowed for as part of the current policy liability.

For traditional life insurance policies, it is common practice, supported by the policy wording, that, if the policyholder ceases to pay premiums and the surrender value is

sufficient, the default position is that premiums are paid by raising a loan, on the security of the surrender value. Such loans should be recognised separately from the policies to which they relate.

Derecognition

An insurance or reinsurance policy should be derecognised when it expires or is extinguished. In many cases in general (property and casualty) insurance, this never happens, they just fade away.

An insurance policy, in the hands of an insurer, can be viewed as comprising one or more of a pre-claim liability, a claim liability and a premium asset. Both the pre-claim liability and any premium asset typically expire at the end of the policy term.

Under normal circumstances, the claim liability is extinguished when all possible claims under the policy are finally settled. In some cases this can be clearly determined, as when the sum insured under a life policy is paid on the death of the insured. In others, such as third party liability policies, multiple claims are possible and there is no certainty that further claims will not be lodged. Statutes of limitation help, but courts can have a degree of discretion in special circumstances. Claims can remain dormant for long periods and, depending on the terms of settlement, settled claims can sometimes be reopened.

While such delays and uncertainties are less common than in general insurance, they are not unknown in life insurance, especially, but not only, for both individual and group disability risks.

It is possible for liability to be extinguished by transfer to another insurer, but the more usual approach is through reinsurance, where the original insurer retains legal liability.

Partial Recognition

In chapters 4 and 6, there is discussion of whether to "recognise" certain future premiums and participation features respectively. This is a source of potential confusion, since this is the same term as is used in relation to the recognition or non-recognition of an insurance contract. Once a contract is recognised, it is recognised. What is at issue is measurement and, in the case of future premiums, whether they relate to a current contract (recognised) or to a potential future contract (not recognised).

Chapter 3

Question 2

Should an insurer measure all its insurance liabilities using the following three building blocks:

(a) explicit, unbiased, market-consistent, probability-weighted and current estimates of the contractual cash flows,

(b) current market discount rates that adjust the estimated future cash flow for the time value of money, and

(c) an explicit and unbiased estimate of the margin that market participants require for bearing risk (a risk margin) and for providing other services, if any (a service margin)?

If not, what approach do you propose, and why?

We believe that the approach described is appropriate. In Australia, we have been working with a similar approach for general insurance business (albeit without the

service margin concept, which is mainly applicable in the life insurance context) and have found it highly satisfactory.

We are, however, concerned that undue emphasis on market consistency, in the estimates of cash flows, could open the way for knowing understatement of liability provisions when there is a "soft" insurance market. This concern is mitigated, but not removed, by the distinction drawn, in E7, between market and non-market variables and the different approaches proposed in E8-9 and E10-15.

The problem is that prices for low volume, high risk and long delay lines of insurance vary markedly over the insurance cycle (historically, a period of around eight years). This variation is driven largely by the presence or absence of naïve investors, who do not properly appreciate the implications of the substantial (two to six years) delay in the emergence of reasonably reliable (in the general sense of the word) insurance profit results. This is a classic case of an inefficient market. Smaller, but still substantial, variations are observable in other general insurance lines, where there is a higher volume of more timely data, and even in life insurance, particularly disability where changes to underwriting and to the exact definition of disability under the cover can take time to emerge and also group life, where competitive forces are stronger.

In such circumstances, at either extreme of the cycle, it is possible to deduce, from market prices, claim cost levels that are wildly at variance with what can be observed from experience. If the phrase "market-consistent" is retained in relation to estimated cash flows, it could be argued that such implied cost levels should be preferred to solid historical evidence. This would have two damaging consequences. It would exacerbate the delays in the emergence of reliable historical results and, hence, lead to more extreme variation over the insurance cycle. And it provides a mechanism whereby a failing insurer (these problems almost always arise in a soft market) can justify inadequate liability provisions.

While market cycles are less pronounced in life insurance, they can still be significant, particularly, as noted above, for group life and disability products.

Another aspect of market inefficiency is that differences in marketing and underwriting practices mean that apparently identical products can behave very differently. We expand on this point in answer to subsequent questions.

Question 3

Is the draft guidance on cash flows (appendix E) and risk margins (appendix F) at the right level of detail? Should any of that guidance be modified, deleted or extended? Why or why not?

We believe that the guidance in Appendices E and F is, with relatively minor adjustments, both appropriate and at an appropriate level of detail. As we see it, the function of accounting guidance in this area is to define the objectives and broad outline of the approach to cash flows, discounting and risk margins. More detailed guidance should be left to actuarial standards, guidance and research and education. The merit of this approach lies in the fact that this is a developing area of actuarial expertise where a principles based approach in accounting standards is desirable so that new techniques, better suited to the objectives set out, can be adopted as they emerge.

Best practice to date for pricing has followed the cost of capital approach (F9(d)), but more work is needed on the quantum and price of capital and on the duration and pattern of release of that capital requirement. Reasonable results are, however, also possible with other approaches and research may reveal that one or other of these better reflects market behaviour or can be used as a good approximation to a more complex and costly approach.

Answers to Questions

Cash Flows

For the reasons set out in the answer to question 2, we would like to see an explicit statement that claim frequency, severity, disability income claim recovery rates and payment patterns are non-market variables (E7(b)).

The first sentence of E11 ("Market prices overrule all other forms of evidence.") is out of place in a discussion of non-market variables and should be removed. We would also argue that it is only true in a deep and liquid market and then only because the observed market price can be immediately accessed in such a market. In other contexts, observed prices should be accorded a degree of credibility depending on the depth, liquidity and efficiency of the market in which the price is observed.

The first sentence of E11 is also totally inconsistent with the idea of a liability adequacy test. It is thinking of this sort that has lead to many insurance failures. In Australia, it was a major contributor to the HIH collapse in 2001, and implicated in a number of earlier insurer failures. The historic process has often followed a pattern such as the following.

- Naïve insurers cut rates in order to gain market share.
- Competitors match rates to try to preserve market share or are more selective in their underwriting and only write risks where the lower rates are adequate. (Usually a mixture of the two, with stronger insurers leaning towards tighter underwriting.)
- The naïve insurers believe that their business is profitable, because their rates are in line with the market. They set their liability provisions on this assumption.
- The financial statements of the naïve insurers show emerging profit (because the liabilities are understated).
- This implies that current rates are adequate and, therefore, that there is more room to cut rates in order to gain market share.
- This loop can continue until the "adverse" claims experience finally emerges, by which time the under-reserving by some insurers can be such that they are found to be insolvent.

It would be a disaster if such a pattern of behaviour were embedded within the principles of an insurance accounting standard.

It should be made clear in E15 that direct evidence, such as observed claim frequencies, costs and payment patterns, is to be preferred over indirect evidence, such as prices charged. This is not to say that indirect evidence should not be used when the available direct evidence is insufficiently credible to stand on its own. Indeed, indirect evidence will often be assigned greater credibility than small volumes of direct evidence. If, however, an insurer has ample experience data, consistent with industry data, to establish valuation experience assumptions and what it considers to be sound premium rates, but has been forced to charge 20% less, in order to match competitors' rates, it should not weaken its valuation assumptions on that account.

The issue of entity-specific cash flows is a complex one. While we agree in principle that entity-specific cash flows should not be included, identifying such cash flows in practice will be difficult. To take the example of an insurer with its own motor repairer, it could well be that this is an approach that another insurer would adopt for this portfolio. There is also the question of the interaction between claim costs and claim management costs. It is commonly thought that claim costs can be reduced by spending more on management, and vice versa. In practice, except in the most extreme cases, we expect that the cash flows valued will reflect the entity's practices.

To avoid confusion, the distinction between entity-specific and portfolio-specific cash flows needs to be emphasised. Portfolio-specific cash flows arise from the characteristics of the portfolio and what the valuation process seeks to estimate. All competent observers would, given the information available to the entity, come to the same (within the range implied by inherent uncertainty) estimates of portfolio-specific cash flows. Entity-specific differences only arise to the extent that different entities would experience different synergies in relation to the portfolio.

In the absence of clear evidence to the contrary, an entity's own analysis of the experience of the portfolio should be sufficient evidence of what other analysts in the market would use – particularly if any efficiencies or inefficiencies would typically be transferred with the portfolio. It is particularly speculative and dangerous to assume that a different approach to claim management would result in a lower total (claims plus claim management) cost.

Claim costs are also very sensitive to underwriting standards and marketing approaches. For life disability income products, policy definitions, underwriting and claim management practices are entity specific and have a significant impact on both underwriting and claim management expenses, as well as claim costs. (We understand that claim costs can vary by up to 50% between contractually similar coverages).

Industry Data

In many cases, as noted in E11, data from the portfolio being valued will not be adequate to provide credible portfolio-specific estimates. In such cases, it may be possible to supplement portfolio data with data from related portfolios, industry data, population data or data from other sources. Because, as noted above, claim experience is sensitive to underwriting and claim management practices, it will often be necessary to adjust such data for the conditions that apply to the portfolio being valued. After such adjustment, credibility theory provides a theoretically sound basis for combining sparse but directly relevant data from the portfolio with other more voluminous but less directly relevant data.

Even if no adjustment is deemed necessary and the greatest weight is given to industry data, assumptions derived in this way are not necessarily market assumptions. Market assumptions are those that derive from market value judgements, as expressed in market prices. This should be distinguished from individual judgement, even if that judgement is applied to industry-wide data.

Margins

Paragraph F7 could be read as implying that it is acceptable to value insurance liabilities using a higher than risk-free discount rate for a debt security, as an allowance for risk. This false impression could be corrected by changing the second sentence to start "For example, if the discount rate for valuing a debt security of similar risk…". Ideally, the example should refer to liabilities, where the value of risk increases the value, rather than assets, where the value of risk reduces the value, but traded liabilities are not common.

Paragraph F8 is inconsistent with F3(b). Either F3(b) should be qualified or F8 should be changed to require the expected present value to be estimated and the margin obtained by difference.

Another consideration that could be included in F3 is that, other things being equal, a risk margin approach that users can easily relate to is preferable to one that is essentially a black box. This is a major reason why the cost of capital approach (F9(d)) is attractive, particularly for general insurance, as the underlying assumptions – required capital and the rate of return required on that capital – are more familiar to most users than sophisticated statistical constructs.

The main challenges in the cost of capital approach are to calibrate required capital and the required rate of return to the market. This is considerably more challenging for life business, with liabilities stretching out for more than 20 to 30 years.

At this stage, however, while the cost of capital approach looks promising, the other approaches in F9 should not be ruled out. Not enough is known of the approach taken by the market to the value of risk. (If, indeed, there is a discernible approach.) Even if, as we expect, the current International Actuarial Association project on risk margins develops robust guidance for the cost of capital approach in the near future, further research may reveal alternatives that are at least as good.

Taxation

E25 specifically excludes income taxes and requires them to be handled under IAS12. This is a potentially significant issue for a number of life insurance products in Australia and other jurisdictions where various "income taxes" are charged in respect of funding the policy liabilities. A common scenario is for "income tax" to be charged on investment earnings on the assets that support the policy liabilities. In this case, the policyholders typically receive "after tax" benefits from the life insurer.

The difficulty arises because, in such a case, these taxes as not "profit" taxes incurred by the life insurer to be charged against the insurers residual economic profits. Rather, they are effectively charged "above the line" in respect of the policyholders' benefits pre profit, and are typically payable irrespective of whether the life insurer makes any profit or not. Rather than require the insurer to report a share of investment earnings on policyholder funds to individual policyholders, to include in their individual tax returns, an average rate is applied to those earnings in the hands of the insurer, as proxy for its policyholders, who are not taxed on the policy proceeds. Such taxes are, however, *prima facie* caught within IAS12, because the taxes have the legal form of an "income tax" on the insurer.

In Australia, the requirement to treat tax under IAS12 could mean, for example, that the liability for participating products (all other things being equal) should fall short of the value of the supporting assets (i.e. assets that will exactly support future cashflows arising from the contract including discretionary benefits and any associated shareholder profits) by:

- the present value of the risk adjusted (for the impact of risk margins and market consistent option costs for shareholder guarantees) future shareholder profit margins (or losses); plus
- the present value of investment tax, payable on the future investment earnings stream from the supporting assets.

The first item is to be expected under a current exit value approach.

The second item will cause an accounting mismatch, as the offsetting item would either be an undiscounted provision under IAS12 or no provision at all.

A similar mismatch also arises in Australia under IAS39 for unit linked business, in respect of deferred tax provisions for existing unrealised gains on assets supporting policyholder benefits, where allowance for tax on existing unrealised gains is discounted in setting the unit prices. However, the participating policy liability case is somewhat different in that the mismatch does not relate to tax on existing unrealised gains but to the discounting of income tax payable on future investment earnings arising from the supporting assets, as the discretionary benefits in a particular scenario will be commensurate with the full distribution of the supporting assets and their net of tax investment income.

If the fair value of the supporting assets includes unrealised gains, then IAS 12 clearly requires an undiscounted tax provision be established for these. However IAS 12 does

not appear to require any additional provision to be established in respect of tax on future investment earnings (e.g. dividends, interest or further unrealised gains) that would naturally be expected to occur as a result of an intention to continue to hold the supporting assets. For this reason, the Australian accounting standard for life insurance, requires any tax on future investment income to be included in the cashflows used for measuring insurance liabilities where policyholder benefits are related to the return on those assets net of tax.

The final insurance accounting standard will need to properly and clearly deal with this issue, potentially including some override of IAS12 on the treatment of taxation obligations imposed on an insurer as a proxy for its policyholders.

[We note, as an aside, that similar difficulties also arise with the existing IAS19 and IAS12 standards, in respect of pension funds in jurisdiction such as Australia, where pension funds pay "income tax" on the investment earnings on their assets. Failure to allow for the effect of such taxes within the liability determination simply leads to an economically inadequate liability amount. Nonetheless, we understand that there remains disagreement within the accounting profession in Australia as to what is the correct technical approach to this issue, with a range of practices being applied].

Discount Rates

Unlike most insurance products, life annuity cash flows are highly predictable for asset/liability matching purposes and do not require liquid assets. Annuitants' ability to commute future payments is usually severely constrained and the terms are not guaranteed. For this reason, the main uncertainty about future cashflows comes from the longevity experience. If this is underestimated, then the original matched assets are still required to match the expected cashflows and a further injection of assets is required to match the additional cashflows arising from the additional surviving annuitants. However, if longevity is overestimated, then fewer payments are required and there is no need to sell assets to meet the reduced cashflow. For this reason, insurers do not need to hold liquid investments to match their annuity books, and competitive annuity market prices are set on this basis.

For most forms of general insurance, highly liquid investments are required, to match liabilities that are highly uncertain as to both timing and amount. In this context discount rates derived from liquid assets are required. Life insurance products other than life annuity lie between these extremes.

By their nature, market prices for illiquid assets are more difficult to observe and, hence, to calibrate to current market conditions. This task is complicated because the observed margins also include allowance for the credit risk inherent in these assets. In Australia, this has lead to a view that the appropriate risk free rate is possibly greater than the government bond curve but limited to zero-coupon swaps (which, while arguably having a similar credit risk (AA), clearly include no liquidity premium).

For these reasons, while we generally agree with the board's proposition that the discount rate should be consistent with the observable current market prices for cash flows whose characteristics match those of the insurance liability, in terms of timing, currency and liquidity, we believe that the requirement for observability should not rule out the use of discount rates which include an appropriate margin for illiquidity even if this is, of necessity, indirectly observed.

Question 4

What role should the actual premium charged by the insurer play in the calibration of margins, and why? Please say which of the following alternatives you support.

(a) The insurer should calibrate the margin directly to the actual premium (less relevant acquisition costs), subject to a liability adequacy test. As a result, an

insurer should never recognise a profit at the inception of an insurance contract.

(b) There should be a rebuttable presumption that the margin implied by the actual premium (less relevant acquisition costs) is consistent with the margin that market participants require. If you prefer this approach, what evidence should be needed to rebut the presumption?

(c) The premium (less relevant acquisition costs) may provide evidence of the margin that market participants would require, but has no higher status than other possible evidence. In most cases, insurance contracts are expected to provide a margin consistent with the requirements of market participants. Therefore, if a significant profit or loss appears to arise at inception, further investigation is needed. Nevertheless, if the insurer concludes, after further investigation, that the estimated market price for risk and service differs from the price implied by the premiums that it charges, the insurer would recognise a profit or loss at inception.

(d) Other (please specify).

While the opening question refers to calibration of margins, which we assume to be separate margins for risk and other services, the question as to which alternative we would prefer seems to be framed in terms of one unitary margin. This might be a recognition of the inherent calibration problem that arises if both the risk and service margins are to be calibrated against an observed price. One of these must be determined before the other can be calibrated.

This question is also based on what we consider to be a questionable assumption: that it is possible to reliably deduce a market based margin from the price charged. Because the profit margin, to which the market based margin is being calibrated, be it a risk or risk and service margin, is usually considerably smaller than the expected value of claims, this requires that the expected value, and also the other components of the price, be known with some precision. As the expected value is always uncertain, sometimes highly uncertain, and as different insurers perceptions of the expected cost can vary, it is seldom possible to reliably deduce a market based margin (or risk margin if there is no service margin) from the price charged, even if the impact of the insurance cycle was minimal or could be reliably adjusted for.

Also, in determining margins for a current exit value, it is necessary to distinguish risk margins from service margins as they are different in concept. Risk margins compensate for risk, and must be included as part of exit value, because the transferee needs that compensation. However, in a market transaction involving the sale of insurance portfolios, retail service margins, arising from brand and distribution, are part of goodwill and would accrue to the shareholders of the entity that generated them. The vendor will pass to the acquirer sufficient assets to cover future cash flows including any outsourcing margin and to compensate for the future bearing of risk. But the vendor will retain the value of the retail service margins since it represents the value of the business which they are selling to the acquirer – it is effectively the price which is paid for the business by the acquirer to the vendor.

In this context we believe that virtually all retail life insurance contracts have such a retail service component, not just those with an investment element, and, to be more consistent with other standards for non-insurance contracts and to avoid premature recognition of goodwill, we believe that this retail service margin should be calibrated to absorb any profit at inception arising from future premiums and fees, after allowing fully for acquisition costs and a current exit value for the insurance liability which only includes the risk margin. This is a modification of alternative (a), see our opening comments and the section on service margins in question 21 for further discussion of this point.

It is, however, possible, in the absence of a material service margin or future goodwill, which is generally the case for general insurance, to deduce a reasonably precise estimate of the implied expected value plus risk margin. We respond further to this question on that basis.

We believe that the role that prices should play in setting liability provisions depends on the quality of the other evidence available. If there is extensive historical experience data, this is the preferred basis. This is typically the case for high volume personal lines business and, to a lesser extent, high volume professional and small business lines. For short-tail personal lines business, there is usually an explicit actuarial pricing basis, based on that experience, and there is little variation in profit loadings over the insurance cycle. In this context, the valuation basis and the pricing basis will be similar because they are based on the same data but, in concept, the valuation basis should not depend on the prices charged.

For commercial lines, there is a greater variation between individual risks and less scope for averaging out those differences. In this context, individual, judgement-based underwriting becomes progressively more important for larger risks and as the volume of experience data becomes progressively less. As the quality of the conclusions drawn from the experience data weakens, it becomes necessary to place greater reliance on the subjective underwriting judgement embodied in the prices charged.

In this context, particularly for long-tail lines, where the emergence of solid profit estimates takes longest, the scope for under and over-pricing, depending on the state of the insurance cycle, is greatest.

Another problem is that market profit margins can vary substantially between insurers and even between distribution channels for a single insurer. The differences between individual and group life rates with identical coverage, for example, can seldom be wholly explained in terms of different expense structures. There are similar inconsistencies between direct market and broker business.

Accordingly, if there were no service margin or if the implied service margin is negative, we would be in favour of option (c) for calibrating the risk margin, in which preference is given to objective experience data and pricing data is used to the extent necessary because the experience data is not sufficiently credible. In practice, in the absence of a material service margin, the premium charged will often offer the best available evidence of exit value, but this will still be more of a guide to the expected cost.

Where there is a material service margin, it is necessary to estimate both expected cost and risk margin directly. The service margin is the balance of the premium. This is, in effect, what is proposed in the first sentence of option (a).

The conclusion drawn in the second sentence of option (a) does not, however, follow. What does follow is that the profit at inception cannot exceed the retail service margin component of any premium received at or prior to inception.

Where pricing data is used to assess the risk margin, it should be corrected for the state of the insurance cycle. This can be done on the basis of the movement of average prices for similar risks, after correction for known trends and changes in economic conditions.

Where there is heavy reliance on pricing data, this gives little or no guidance on the split between expected value and margin. A standard approach to the margin should be adopted, such as cost of capital, with the implied expected value found by difference, rather than the other way round.

Where there is a need for heavy reliance on pricing data, this is because the provision needed is most uncertain. We suggest that the market has a greater readiness to accept an implied loss at issue than an implied profit at issue. This is one of the

functions of a risk margin. In particular, a market value margin reflects the greater weight that the market places on unfavourable outcomes.

As noted earlier, this presumes that there is no material service margin arising from margins in future premiums or fees.

Question 5

This paper proposes that the measurement attribute for insurance liabilities should be the amount the insurer would expect to pay at the reporting date to transfer its remaining contractual rights and obligations immediately to another entity. The paper labels that measurement attribute 'current exit value'.

(a) Is that measurement attribute appropriate for insurance liabilities? Why or why not? If not, which measurement attribute do you favour, and why?

(b) Is 'current exit value' the best label for that measurement attribute? Why or why not?

Subject to the qualifications expressed elsewhere in this submission, we believe that current exit value is an appropriate measurement value for the **insurance liability** – but NOT the measurement attribute for the entire **insurance contract** (since under the two part approach that we propose, a service margin liability would be calibrated to absorb any profit at inception arsing from any margins in future premiums or fees).

That said, we believe that, while it is a bit of a mouthful, "current exit value" is reasonably descriptive and is a satisfactory label.

If it were simply a matter of the stated definitions, we believe that there would be no difference between current exit value and fair value. Fair value, however, has acquired a connotation, largely based on implementation guidance, that we believe is incompatible with the stated definition and that could, at some phases of the insurance cycle and/or for some insurers, lead to highly misleading representation of insurance liabilities.

The problem, as we see it, lies in the absolute priority given to the prices in observed market transactions. In insurance, most actual transactions occur between parties with different bargaining power and different knowledge. They are also, in most cases, unique transactions, in the sense that an insurable interest is required. Policies are not interchangeable between policyholders. Market prices in a deep and liquid market are fair value because the holder of an asset or liability can quit it at that price. Insurance transactions violate almost all of the assumptions that lead to the conclusion that actual prices represent fair value. It is therefore inappropriate to take a doctrinaire position that this is so.

Unless and until the guidance that insists that "Market prices overrule all other forms of evidence" is weakened to, at strongest, a rebuttable presumption for other thinly traded financial instruments, we believe that it is vital to maintain a distinction between "fair value" and "current exit value".

As the transferor would ordinarily expect to be compensated for the loss of service margin on transfer of business to a transferee, it follows that the service margin is NOT part of the current exit value. Hence, the exit value can only be the appropriate measurement attribute for the pure insurance liability component of the contract. A different measurement approach is required for any service component, which we believe should be calibrated to absorb any profit at inception arising from future premiums or fees after allowing fully for acquisition expenses and earned in proportion to the provision of services, which is more consistent with IAS 18.

Answers to Questions

Chapter 4

Question 6

In this paper, beneficial policyholder behaviour refers to a policyholder's exercise of a contractual option in a way that generates net economic benefits for the insurer. For expected future cash flows resulting from beneficial policyholder behaviour, should an insurer:

(a) incorporate them in the current exit value of a separately recognized customer relationship asset? Why or why not?

(b) incorporate them, as a reduction, in the current exit value of insurance liabilities? Why or why not?

(c) not recognise them? Why or why not?

We believe that the discussion, in the paper, of beneficial policyholder behaviour, in terms of identifiable groups of policyholders, is misconstrued, in that the insurer does not have the basis for identifying such groups. Unless the insurer actually collects and acts on such data, policyholder behaviour should be considered in aggregate.

On this basis, the question becomes one of what to do if the result, is an asset rather than a liability. This might arise, for example, if the original terms of business, which qualifies for recognition of future renewal premiums or fees (see question 7) were highly profitable, circumstances have changed advantageously, or if there were significant acquisition expenses to be recouped out of margins in future premiums. It is our view that such an asset should be fully recognised, both:

- as part of the current exit value of the insurance liability for the portfolio[1], rather than as a stand-alone asset; and
- in calibrating the service margin to absorb any profit at inception after allowing fully for acquisition expenses.

This gives a single consistent meaning to current exit value for insurance liabilities, that does not change depending on whether the future cash flows involved are beneficial or not. With the separate service margin being calibrated to absorb any profit at inception and run off with the provision of services, it will increase the overall liability for the insurance contract when added to the insurance liability. .

This is particularly important for stepped premium life insurance products, where a substantial part of the margin in future premiums is required to recoup acquisition expenses and there is often a further margin to provide a return on brand and distribution. Accordingly, we strongly prefer approach (b), as the recovery of past administrative costs is tightly related to the receipt of future premiums and expected margins emerging. This is most appropriately and directly reflected in the current exit value, without any need for adjustment, provided that all the cashflows arising from those premiums are allowed to be incorporated in the current exit value. Indeed, any other approach would be very difficult to calibrate to current market prices and margins, as market transactions will not incorporate such artificial restrictions but instead recognise the economic substance of the contract. In contrast, approach (a) requires a more artificial adjustment than the addition of a service margin on top of a current exit value insurance liability. It would be necessary to determine which part relates to acquisition expenses and to devise an appropriate approach to running that part off.

[1] A portfolio is a group of similar policies, managed together.

As future renewals of general insurance contracts seldom qualify for recognition, this question is mainly only relevant to multi-year life insurance policies, investment contracts and reinsurance treaties.

It does, however, relate strongly to the issue of service margins, discussed further under Question 21.

At a semantic level, the use of the term "recognize" in options (a) and (c), is confusing, since it carries a quite different meaning from its principal meaning, as in chapter 2. This could be avoided by substituting "report".

Question 7

A list follows of possible criteria to determine which cash flows an insurer should recognise relating to beneficial policyholder behaviour. Which criterion should the Board adopt, and why?

(a) Cash flows resulting from payments that policyholders must make to retain a right to guaranteed insurability (less additional benefit payments that result from those premiums). The Board favours this criterion, and defines guaranteed insurability as a right that permits continued coverage without reconfirmation of the policyholder's risk profile and at a price that is contractually constrained.

(b) All cash flows that arise from existing contracts, regardless of whether the insurer can enforce those cash flows. If you favour this criterion, how would you distinguish existing contracts from new contracts?

(c) All cash flows that arise from those terms of existing contracts that have commercial substance (i.e. have a discernible effect on the economics of the contract by significantly modifying the risk, amount or timing of the cash flows).

(d) Cash flows resulting from payments that policyholders must make to retain a right to any guarantee that compels the insurer to stand ready, at a price that is contractually constrained,

(i) to bear insurance risk or financial risk, or

(ii) to provide other services.

This criterion relates to all contractual guarantees, whereas the criterion described in (a) relates only to insurance risk.

(e) No cash flows that result from beneficial policyholder behaviour.

(f) Other (please specify).

In this question, "recognise" is used with another meaning which includes measurement.

While this question refers particularly to beneficial policyholder behaviour and arises out of concerns about the treatment of future premiums under life insurance policies, we believe that it has broader implications, for all future premiums under existing policies. In general terms, we think that approach (c) above comes closest.

We believe that the insurer should, in principle, include all contracted premium cash flows, and the corresponding benefit cash flows, on the basis of the respective probabilities of each policyholder behaviour scenario. In this context, contracted means required or established under the terms of the contract, whether or not the insurer has a practical means of enforcing the contractual requirement. Typically, this occurs in multi-year life insurance policies and investment contracts, but there are general insurance examples, particularly reinsurance treaties. The distinguishing features are that there is a presumption at issue, on the part of the insurer, that

policyholders intend to pay the premiums set out in the policy and the insurer is bound to accept them.

There is also often, for whole of life and endowment insurance, a contractual provision that automatically raises a loan, on the security of the policy, if the premium is not paid, or reduces the benefits payable. In such cases, the future premiums are clearly contracted premiums.

Most general insurance "renewals", however, are actually new policies. While the insurer may expect that the majority of policyholders will renew, there is no contractual requirement or presumption either that the policyholder renew or that the insurer accept renewal.

In many cases, the premiums set out in a multi-year insurance policy are fixed: either a constant amount or an increasing scale. In other cases, the policyholder is able to vary the amount or no premium amount is specified.

Most commonly, these variable policies involve a deposit component with fixed charges for insurance. If the premium paid is inadequate to cover the insurance charge, the difference is debited against the deposit. In these cases, these fixed charges are contracted premium cash flows for the insurance component of the contract.

In some cases, the policyholder has the option to purchase additional insurance coverage, on terms specified in the contract, by paying additional insurance premiums, under the contract. Unless and until such an option is exercised, it should be valued as an option. Once exercised, premiums on the revised basis become the contracted premiums and are reflected in the insurance liability valuation. The same effect can be achieved by an option to effect a new insurance and the treatment is the same. Under this approach, there is no need to draw a distinction between existing and new contracts, since the value is the same.

Rather less commonly, the insurer has the right to enforce payment of future premium payments. This arises, for example, when premiums under an employers liability policy are adjusted on account of actual wages. Such adjustments are clearly contracted premiums.

It is rather more difficult to know how future premiums under reinsurance treaties should be treated. We incline to the view that, in the hands of the reinsurer, future premiums (and the corresponding claims) should be included in respect of all direct insurances within the scope of an existing treaty, on a probability weighted basis in respect of direct business not yet written. This matches the treatment required, for regulatory purposes, by APRA in Australia and what we understand to be the IAIS position more generally.

In the hands of the direct insurer, future reinsurance premiums (and the corresponding recoveries) should be included in respect of existing direct insurances, with due allowance for uncertainty as to the terms of the reinsurance, if reinsurance for existing insurances falls into future treaties.

This difference in approach arises because the direct insurer has control over whether, and on what terms it writes future business. The reinsurer typically has no such control.

There will also be cases where past reinsurance premiums cover (usually part of the term of) direct business not yet written. Both insurer and reinsurer need to provide for the value of the resulting recoveries.

In all of this, we think that it is important to bear two over-riding principles in mind.

- If premiums are included, the corresponding claims must be included, and vice-versa.

- The status of future premiums under a given policy should be set at issue and only change in response to policy alterations.

If a guarantee approach ((a) or (d)) is adopted, it is essential that a wide interpretation of "contractually constrained" be adopted. A common guarantee is that the insurer will renew existing or issue further insurances on the same terms as are offered to new and existing insureds, but without the underwriting scrutiny that would be applied to new insureds. Such a guarantee becomes highly valuable if, for example, the health of the life insured deteriorates.

Question 8

Should an insurer recognise acquisition costs as an expense when incurred? Why or why not?

Acquisition costs should be treated as an expense. The alternative, setting up a deferred acquisition cost asset, only serves to add unnecessary complication. It is a hangover from the deferral and matching paradigm and, even there, is an example of an over-zealous application of the principle.

Question 9

Do you have any comments on the treatment of insurance contracts acquired in a business combination or portfolio transfer?

The approach proposed appears appropriate, provided that the insurance contracts are measured at fair value.

If this is not the case, then as the discussion paper notes, consideration needs to be given to retaining the existing expanded presentation under IFRS 4 to appropriately handle the difference. This would be the case if the service margin is calibrated to exclude profits arising from future premiums and fees. In such cases we believe that the extended presentation should be retained.

Chapter 5

Question 10

Do you have any comments on the measurement of assets held to back insurance liabilities?

We believe that the Framework should include a principle that related assets and liabilities should be measured consistently.

As current exit value is very close to fair value, insurers should be required to use the fair value option, where available, for assets backing insurance liabilities. This option also needs to be extended to a variety of assets, commonly included in those backing insurance liabilities, where it is not currently available. These include:

- owner-occupied buildings;
- subsidiaries;
- treasury shares.

The underlying principle is consistent measurement of liabilities and related assets. Failure to observe this principle results in spurious reported profit or loss (or lack thereof) when interest rates and market values of assets change.

The concept of consistent measurement is absolutely vital for unit-linked business, where policyholder benefits are explicitly expressed in terms of the value of a dedicated portfolio of assets, and for participating business where benefits are dependent on the performance of backing assets but extends much further. Accounting mismatch can give rise to spurious profits and losses for all forms of insurance business and, indeed, any business where assets are held to back financial liabilities.

Fair value option

As discussed above, we believe that insurers should be required to use the fair value option under IAS39 and other standards, for assets backing insurance liabilities. Similarly, to be consistent and to avoid accounting arbitrage, this option should also be adopted for other financial liabilities of an insurer. Where such an option does not currently exist under these standards, it should be provided.

While this could, as has been done in Australia under AASB1023 (General Insurance) and AASB 1038 (Life Insurance), be part of an insurance standard, it is a part of a wider issue. Wherever assets are held to back liabilities or other financial liabilities that form part of the overall business portfolio, there is the potential for accounting arbitrage and/or mis-match, giving rise to spurious profit or loss and/or hiding genuine profit or loss from economic mis-match. It would be desirable to have a general rule in the framework requiring consistent measurement of related assets and liabilities.

Question 11

Should risk margins:

(a) *be determined for a portfolio of insurance contracts? Why or why not? If yes, should the portfolio be defined as in IFRS 4 (a portfolio of contracts that are subject to broadly similar risks and managed together as a single portfolio)? Why or why not?*

(b) reflect the benefits of diversification between (and negative correlation between) portfolios? Why or why not?

Unit of account

In response to part (a) of this question, we believe that the risk margin for a portfolio of insurance contracts, under the exit value approach favoured in the Discussion Paper, is equal to the sum of the risk margins for any dissection of that portfolio into smaller parts. This applies on all scales, from the whole entity down to individual contracts. As a consequence, it does not matter, in principle, whether risk margins are determined on a portfolio basis, nor how that portfolio basis is defined.

As a practical matter, however, we believe that it is appropriate to determine risk margins on the basis of portfolios of broadly similar risks managed together, as required under IFRS 4. There are two major reasons for this, both practical.

- It would be unduly onerous to collate the statistical data necessary to assess risk margins at a more detailed level than is required for the management of the portfolio.
- Unless parts of the portfolio are to be managed separately, in which case these parts are, in terms of the proposed criterion, separate portfolios, there is mo practical use to which a finer subdivision of risk margins can be put.

Diversification and negative correlations

In relation to part (b) of this question, we believe that it needs to be considered in two parts, in relation to the entity being valued and in relation to the hypothetical entity

that stands as purchaser of the liabilities in the hypothetical transaction that defines exit value.

Under the exit value approach, the liability cash flows, and their associated uncertainty, are valued from the point of view of a hypothetical third party purchaser. As discussed in paragraphs 56 to 62 of the Discussion Paper, it is not permissible to allow for entity-specific influences on those cash flows, Since diversification and negative correlations *within the entity* are inherently entity-specific, they cannot be allowed to influence exit value and, hence, the risk margins included in exit value. From this point of view, therefore, we believe that the view in paragraph 202(b), that risk margins should not reflect the benefits of diversification between portfolios is correct, in so far as it relates to diversification within the entity being valued.

Exit Value

Exit value, however, is intended to reflect the way in which the market prices insurance risks. It is clear that, in the market, insurers set their prices in the context of their ability to diversify, including diversification through reinsurance.

The case put forward by the Board for the unit of account being a portfolio is a balance between the theory (i.e. that it should not matter whether the unit of account is a portfolio of similar risks or a contract) and practical considerations relating to how contracts are managed, priced and measured. The practical issues are seen to be unavoidable and it is acknowledged that measurement will include some value relating to diversifiable risk (paragraph 197 as outlined above).

Conceptually, a portfolio could be defined as a collection of contracts which are homogeneous in terms of risk. As this will seldom, if ever, be achieved in constructing a portfolio in practice, a buyer, hypothetical or otherwise, will be confronted with valuing a group of contracts that has an expected value influenced by varying levels of diversification resulting from the inexact process of collating contracts into a portfolio.

However, a line is drawn at the level of the portfolio and the Discussion Paper goes on to argue that the risk margins used in measurement should not reflect the effects of diversification between portfolios. That is, there should be no attempt to capture the value resulting from having portfolios which, between them, reduce the risks faced by the insurer. This is despite the fact that insurers can and do manage risk and price business based on the cross-portfolio position they enjoy. It is also despite the fact that different buyers may arrive at different groupings of contracts when constructing portfolios. For example, one entity, because of its size and state of development, may divide its contracts into A and B portfolios, whereas the market might always see AB as the portfolio.

In making their case on diversification between portfolios, the Board introduces a factor not addressed when accepting the portfolio as the unit of account, namely that the current exit value (of contracts?) should be independent of the entity that holds the asset or liability (paragraph 201). This seems to suggest that practicalities matter at the portfolio level, but efficient market considerations take over when multiple portfolios exist.

If efficient markets are to be assumed for purchases of insurance contracts, the hypothetical buyers would be fully diversified and unprepared to pay any premium for diversification. However, the market for portfolios of insurance contracts is never likely to be deep and liquid, especially given the existence of a relatively small number of large global insurers that make up the market and who compete for insurance business rather than trade in it at a portfolio level.

Thus the first level of concern to be expressed about the Board's views is that whilst practicalities have shaped its view that a portfolio should be the unit of account, it has reverted to pure efficient market theory when considering diversification risk. In

reality the difference between a portfolio and a group of portfolios, in terms of inextricable diversification risk, is a matter of degree.

Who is the buyer?

More fundamentally, the Discussion Paper does not focus on the characteristics to be assumed of the hypothetical buyer (e.g. is the buyer to be fully diversified?) and does not explain how that assumption would, if at all, lead to modification of any particular traded price observed in the market place to arrive at current exit price.

The nature of insurance contracts

Beyond the above concern is an uncertainty about valuing insurance contracts in a manner that assumes they are similar to investments traded in efficient markets. It may be that the theory of efficient markets should be applied to all assets in the balance sheet, but this does not sit well with the fair value hierarchies observed in various parts of IASB and FASB literature.

The fair value hierarchies are prejudiced towards prices observed in market places, whereas it is certain that "fully efficient buyer prices" would often not exist beyond the markets for listed securities. Indeed, the hierarchies would need to be inverted for most non-traded assets so that "efficient" prices (as opposed to partly relevant observed prices) would be estimated. But, of course, the fair value hierarchies exist for practical guidance purposes. Traded prices are accepted in the absence of better evidence and in lieu of theoretical valuations based on efficient markets. This is understandable and accepted.

However, we believe that the Board's own analysis of insurance contracts as customer relationship assets point to assets which are not in the nature of traded securities. Rather, the nature of insurance can be much more easily seen as service related or as a consumable product.[2] Would we normally try to determine fair value for an asset of this nature by assuming a fully diversified buyer, or would we tend to estimate fair value by reference to what evidence exists in an imperfect market place? Our surmise is that we would be using what evidence that could be found and that it would be impractical to ask reporting entities to remove from observed prices allowance for imperfection in the market.

Recommendation

Firstly, we believe the Board's analysis of diversification risks should have started not with the entity perspective, but rather from the perspective of the buyer. Secondly, we believe that the pragmatism allowed for in the analysis of portfolios needs to be explicitly dealt with at the cross-portfolio level, acknowledging that some diversification opportunities presented by portfolios will affect prices in imperfect markets. Thirdly, we would recommend that the nature of insurance assets, as identified in the Discussion Paper itself, should receive more attention and that this would lead the Board not to wish to force the valuation of portfolios of contracts into a straight-jacket much more easily worn by traded securities. The perspective is more that of an un-traded intangible.

We acknowledge that the objective is to value the assets and liabilities of an insurer, and not the entity as a whole. Accordingly, we do not expect that sum of the values recognised in the balance sheet will equal the value of the entity. However, we do not believe that all diversification effects can be excised from the valuation of portfolios of insurance contracts.

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[2] M. Johnston, Insurance Pricing and Capitalisation Given Market Incompleteness and Fractional Costs, *Australian Actuarial Journal,* 2004 Vol 10 Issue 3 Pages 441-483

The more appropriate and market based solution is to require risk margins to be set by reference to a large insurer with a broad spread of business. This will result in unit risk margins which are much more market consistent and relatively independent of the size of the particular portfolio held by the entity, as well as the range of portfolios held by the entity, while remaining consistent with the nature of the risk inherent in the particular liabilities held.

Question 12

(a) Should a cedant measure reinsurance assets at current exit value? Why or why not?

(b) Do you agree that the consequences of measuring reinsurance assets at current exit value include the following? Why or why not?

(i) A risk margin typically increases the measurement of the reinsurance asset, and equals the risk margin for the corresponding part of the underlying insurance contract.

(ii) An expected loss model would be used for defaults and disputes, not the incurred loss model required by IFRS 4 and IAS 39.

(iii) If the cedant has a contractual right to obtain reinsurance for contracts that it has not yet issued, the current exit value of the cedant's reinsurance asset includes the current exit value of that right. However, the current exit value of that contractual right is not likely to be material if it relates to insurance contracts that will be priced at current exit value.

The key result in an insurance liability valuation is the net liability. This needs, under the proposed measurement attribute, to be current exit value. This is the hypothetical price for the portfolio and its associated reinsurances, allowing for default risk on those reinsurances.

Because reinsurance is only meaningful in the context of the reinsured business, its value can only be determined in the context of the reinsured business. That value is the difference between the gross and net values. The answer to (a) is, therefore, yes – by definition.

We agree that the consequences following from this include those listed in (b).

Question 13

If an insurance contract contains deposit or service components, should an insurer unbundle them? Why or why not?

We believe that, if these are independent of the insurance component, then the insurer should be required to unbundle them. The financial statements are more transparent and meaningful, if they do not include policyholder elements relating to deposits, including investment income and tax thereon, and instead only the fees emerging to the shareholder from deposits are included in the profit & loss.

The current approach under IFRS 4 is too weak. It allows companies a choice of whether or not to unbundle. As we understand it, this flexibility was commonly used by European insurers to grandfather their unit-linked business under their existing insurance accounting standards, rather than to unbundle the investment linked component and bring it under IAS 39, as was done in Australia. This led our local insurance regulator, APRA, to mandate unbundling for regulatory purposes, to ensure that all unit-linked liabilities are accounted for on a consistent basis.

Measuring the Insurance Component as a Difference

There is a problem with the proposal to treat the insurance component as the balancing item in situations where there is interdependence but unbundling can be achieved in a non-arbitrary fashion. The proposal in the Discussion Paper may work if the deposit component is valued using the same principles as current exit value**,** but not otherwise. If the fair value option under IAS 39 is not used and the insurance component is measured as the residual, the difference, between the current exit value of the deposit and the measurement option chosen, becomes part of, and thereby distorts, the value of the insurance component, so that this component no longer gives meaningful information.

This can potentially be the case, even if the fair value option under IAS39 is applied to the deposit element, as the deposit floor under IAS 39 may effectively prohibit recognition of beneficial policyholder behaviour which may be incorporated into the current exit value of the overall contract.

A further measurement inconsistency can also occur due to the approach to acquisition costs under IAS39 and IAS18. These limit recognition to incremental expenses and require DAC to be treated as an asset separate from the liability. If this asset is not taken into the calculation of the insurance component, measured as a difference, then DAC would be effectively double counted. Even if DAC is taken into account, the fact that it only relates to incremental costs, rather than the full acquisition cost recovery implicit in the current exit value will still generate a distortion.

If an amount is derived as a difference, it is essential that the two components be measured consistently. This is particularly important if the two amounts are similar, as is the case when there is a relatively small insurance component. In not very extreme cases, the value of the insurance component could be negative when the equivalent stand-alone insurance has a positive value, and vice-versa.

To avoid accounting mis-match and accounting arbitrage, by separation into distinct contracts, the insurance component should either be valued independently or, if a difference approach is used, as the difference between the current exit value of the total and the current exit value of the deposit component.

Question 14

(a) Is the current exit value of a liability the price for a transfer that neither improves nor impairs its credit characteristics? Why or why not?

(b) Should the measurement of an insurance liability reflect

(i) its credit characteristics at inception and

(ii) subsequent changes in their effect?

Why or why not?

It is clear, from the discussion in Appendix H that this is a hotly debated topic. As we read it, the IASB preliminary view rests on seven propositions:

- Credit standing is a characteristic of the instrument, not the entity.
- No one disputes that debt liabilities should be measured allowing for credit standing.
- There is no reason to measure insurance liabilities differently from debt.
- Failing to allow for credit standing ignores limited liability and is incompatible with pricing and measurement models based on economic or regulatory capital.
- Credit standing makes an observable impact on insurance pricing.

- Transfer to another insurer of equivalent credit standing is possible.
- Credit standing is not entity-specific.

In our view, it is possible to challenge each of these, in whole or in part. There are also two other unstated assumptions that we consider even more doubtful:

- That investor users would prefer allowance for credit standing to be made; and
- That the information needs of users, other than investors, are unimportant.

Instrument or entity

Credit standing is a euphemism for the risk that the entity will default on its obligation. Clearly, this depends on the obligation. Indeed, because insurance obligations are uncertain obligations, there is an extra dimension to this dependence, not present in debt.

It is equally clear, however, that the risk of default depends on factors extrinsic to a particular insurance liability or portfolio of liabilities.

- It depends on the structure of the insuring entity. If this is a partnership or has contributing shares, for example, the claimant may have recourse to the owners, if the entity fails. Separate statutory funds (where applicable) protect the assets of one fund against claims arising in another.
- It depends on the quantum of assets of the insuring entity. If the insurer has more assets, for a given set of liabilities, the default risk is lower.
- It depends on the nature, particularly on the riskiness, of the assets of the insuring entity, and how well they are matched.
- It depends on reinsurance, both retentions and quality.
- It depends on the entity's non-insurance liabilities. Even lower-ranking liabilities can take precedence by virtue of earlier maturity.
- It depends on the entity's other insurance liabilities.
- It depends on the entity's claim management practices.

Overwhelmingly, the risk of default is dependent on factors extrinsic to a particular portfolio of liabilities. At most, only a limited element of the risk of default can be fairly seen as a characteristic of the individual liability. This is the risk that the claim outcome will be so extreme that even a large, well-reinsured, well-rated insurer could not cope.

The balance of the default risk is better seen as characteristic of the entity as a whole.

Debt liabilities

While few would dispute that it makes pragmatic sense to measure debt liabilities allowing for credit standing, this does not mean that it is correct in principle. Indeed, we would argue that it is a practice inherited from historical cost approaches to accounting, and that it has not been properly challenged. Nor is it clear that there is any effective mechanism for reflecting changes in credit standing for untraded debt instruments.

There are also two major distinctions that can be drawn between insurance liabilities and traded debt instruments.

- For a large class of traded debt instruments, the debtor is able to buy back the debt at market price. This is not an option for insurance liabilities.
- The interest rate implied by the market price of a debt instrument provides lenders with a clear indication of the market assessment of default risk. There is no comparable direct indicator for insurance. If insurance liabilities are

measured net of default risks, it is necessary to add this back, in order to assess solvency.

A much more transparent approach is to report the value of the default risk as a component of equity, so that a comparison of assets and liabilities gives a valid measure of solvency.

Limited liability

As suggested above, a much more transparent way to recognize limited liability, which is a benefit to shareholders, is to quantify its value as a component of equity.

If, as asserted in H12(d), economic and regulatory capital do include adjustments on account of default risk, these will be reflected in risk margins measured on that basis. A separate adjustment for default risk would be double counting.

Impact on pricing

The uncertainties in the insurance pricing process are such that it is most unlikely that any reliable information on credit standing can be deduced from market price information. Any correlation is more likely to arise because of differences in insurers' assessments of the expected cost of claims. Insurers who underestimate the cost of claims are more likely to get into trouble while, at the same time, thinking that they are including greater profit margins. Those policyholders that do distinguish on the basis of credit standing, do so largely by avoiding weaker insurers.

Transfer issues

Most jurisdictions place stringent restrictions on the transfer of insurance portfolios. In such jurisdictions, if the risk of default is material, the regulator will only permit transfer to an insurer of a certain minimum credit standing. In particular, the transferee will need a credit standing such that the risk of default, after the transfer, is not material. One of the functions of a minimum capital requirement is to increase the chances that the regulator will be able to step in and arrange such a transfer while a troubled insurer is still able to pay for a credit upgrade. As HIH and a number of other cases have shown, however, this does not always work.

Even where such transfers are possible, it may be necessary to envisage the transfer of parts of an insurer's liabilities. Because of the complex interactions, the relative default risks of different portfolios will not necessarily be the same in the hands of a different insurer. It is difficult to escape the conclusion that default risk is entity-specific and, therefore, excluded from consideration in exit value (paragraph 56). It is possible to achieve major changes in default risk by, for example, a generous approach to rapid settlement of some claims and fierce resistance of others.

Entity-specificity

In accordance with paragraph 56 of the Discussion Paper, "the measurement should not capture cash flows that are specific to the insurer and would not arise for other market participants holding an obligation that is identical in all respects (entity-specific cash flows)". A requirement that exit value should reflect credit standing would be in direct contradiction of this ban on entity-specificity.

Needs of users

While the primary focus of general purpose financial statements is, rightly, the information needs of investors, the needs of others should not be ignored if they can be accommodated without adding unduly to the burden on investors. If those needs can be accommodated by making matters clearer for investors, then the decision should be easy.

Hiding the credit standing adjustment as a reduction in the insurance liability provisions makes it fundamentally harder for policyholders and regulators to assess solvency. Transparency for those users is promoted by recognising it as an element of equity.

It is arguable that this treatment also clarifies the position for investors. We strongly question any suggestion that including movements on credit standing within the basic liability assessment will provide the most useful and valuable presentation of information for investors either.

Arguments against

To a large extent, the arguments, against valuing what the insurer is able to pay, as distinct from what it is liable to pay, are implicit in the preceding. Some other points are as follows.

- If material, allowing for credit standing in the insurance liabilities creates a misleading impression of the insurer's ability to meet its contractual obligations to policyholders. As a result, it is anathema to insurance regulators.
- It violates the principle that the value of the liabilities should, unless those liabilities are expressed in terms of those assets, be independent of the assets held to back the liabilities. The risk of default by an insurer is a reflection of:
    - the total asset and liability position of the insurer and the risks and volatility inherent in them, including diversification between as well as within portfolios;
    - access to further capital;
    - management skills and plans, strategies and markets;
    - any order of priority for liabilities; and
    - the timing of claims.
- To the extent that policyholders and claimants are aware of the credit rating of the insurer, the risk that the insurer might default on its obligations is already reflected in its historical claim experience, because a claimant is more likely to compromise if delay carries a risk of getting less. An explicit credit adjustment would be double counting.
- The other side of this is that, if an insurer is in financial difficulties, it is likely to "play hard-ball" with claimants and seek to minimise its liability provisions, by fair means or foul. Again, an explicit credit adjustment would be double counting.
- Insurance liabilities cannot be transferred without regulatory approval, nor to an entity other than an authorised insurer. Regulatory approval is unlikely to be given to a transferee with a rating below investment, and generally higher ratings would be typical. At this level, the expected policyholder deficit allowing for typical priority requirements, which is an estimator of the adjustment that should be made for credit standing, is immaterial.[3] This, therefore, represents an upper limit on the credit standing adjustment that could apply to a market transaction. To put this into context, the uncertainty in the expected value of an insurer's total net liabilities is unlikely to be as low as a coefficient of variation of 1%-2%. For an insurer with a major exposure to liability business, 10% to 20% is more common.

[3] Assuming a log-normal distribution, the expected policyholder deficit corresponding to a 99.5% probability of adequacy is less than 0.1%. for coefficients of variation (CoVs) up to 25% and less than 1% of the CoV for CoVs up to 80%

- In contrast to debt securities, where market prices are highly sensitive to the perceived credit standing of the issuer, the variation, in the prices charged by different insurers for essentially the same risks, is far greater than can be accounted for by credit standing and bears little or no correlation to credit standing. There is, therefore, no discernable market price for an insurer's credit standing.
- Even where it is material, except in the most extreme cases, an insurer's expected policyholder deficit is small relative to the uncertainty of the liability values to which it might be applied. That is, even though many users might believe that the difference that it makes to the reported liability values is useful information, that difference is not statistically significant and, therefore, meaningless. In contrast, if the expected policyholder deficit is recognised in its own right, it is extremely useful information.
- If the expected policyholder deficit is applied as an adjustment to insurance liabilities, it becomes necessary to apportion its impact between the various components of those liabilities. This is a non-trivial actuarial exercise since, in the context of a going concern, an actual shortfall will only arise in a small subset of scenarios, in which there is an unusually high cost of claims, and will only apply to claims settled after the shortfall becomes apparent. While the concept of probabilities applied to the outcome of different scenarios underlies the expected present value of the liabilities, it is only used, in practice, by a small number of very large insurers. The cost of assessment would likely prove prohibitive for smaller insurers.
- It is also an inherently arbitrary exercise, since liabilities can be managed in such a way as to manipulate the liabilities upon which the loss falls. This can be very simply done by selectively paying some claims in full, while disputing and dragging out payment of others.
- If the expected policyholder deficit is recognised as an adjustment to the insurance liabilities, it will be easier to hide its value in the notes to the accounts, than if it is recognised as a separate item.
- If HIH's credit characteristics, and other now failed insurers, had been factored into their liability valuations, they could have continued trading until they ran out of cash, without infringing accounting standards.
- This approach is part of the basis on which Ponzi and pyramid selling schemes operate.

Summary

From the above, it should be clear that our response to part (a) of this question is a resounding **NO**.

In relation to how default risk should be assessed for insurance entities, it is clear that default risk is a cash flow issue. In contrast to debt instruments, where the market price of the default risk is built into the interest rate offered, there is no natural nexus to the discount rate for insurance liabilities. Nor is there any clear nexus to the risk margin.

In response to (b) we believe that the value of the default risk is vital information. It is, however, a characteristic of the entity, not of the liability. It is not meaningful, therefore, to talk in terms of a value at inception of a particular liability.

If material (that is, hardly ever, for a sound insurer) the value of the default risk should be recognized on the face of the accounts, as a component of equity. Placed there, it allows direct calculation of solvency as the difference between assets and liabilities. It also ensures that profit or loss is not polluted by movements in the value of default. Hidden in the notes, as it would be if incorporated as a reduction to the liability provisions, it is far more likely to be missed.

Movements in the value of the default risk should be recognised as they occur, as changes in equity.

Alternatively, by analogy with internally generated goodwill, the value of default risk could be not recognised at all. One argument for this treatment is that this value can only be recognised in liquidation and therefore has no place in accounts prepared on a going concern basis.

The reason we are so passionate about this issue can be summarized in three letters – HIH. If this approach is adopted, no insurer would ever again need to appear insolvent, on the face of its accounts, as the value of the assets becomes an absolute upper limit to the value of the liabilities. This may be sound economics, but totally ridiculous accounting.

Question 15

Appendix B identifies some inconsistencies between the proposed treatment of insurance liabilities and the existing treatment under IAS 39 of financial liabilities. Should the Board consider changing the treatment of some or all financial liabilities to avoid those inconsistencies? If so, what changes should the Board consider, and why?

As noted in our opening comments, we believe it is vital that insurers are able to present internally consistent financial statements, and for this reason, in addition to the inconsistencies identified in Appendix B, we have also commented on other inconsistencies that need to be addressed.

Initial Measurement and Acquisition Costs

The difference here arises only because IAS 39 allows amortised cost to be used as a measurement basis, in addition to fair value which we believe to be the only appropriate foundation for an insurer's financial statements. Ideally, this inconsistency should be addressed by removing amortised cost as measurement option from IAS39. However, we also recognise that eliminating non fair value options from IAS 39 to make it more consistent with the proposed insurance standard would be difficult, given the recent European push back on having an open fair value option in IAS39. Provided that the fair value option remains open to insurers, we do not see removal of this inconsistency as vital.

Gain or Loss at Inception

As indicated in our answers to questions 2, 3 & 4 we believe that it is unwise to place too much weight on market prices in setting the insurance liabilities, however the reasons for this are less applicable to financial instruments. For this reason we do not see a strong reason to change IAS 39 in this regard.

Subsequent Measurement

Our comments with respect to Initial Measurement are also applicable here.

Surrender Value Floor and Policyholder Behaviour

While believe that it is important that policyholder behaviour be able to be recognised in determining fair value, as market participants allow for this in setting prices. We would caution against removing the surrender value floor from IAS 39, as it is one of the elements of IAS 39 that helps simplify the accounting for investment contracts. For most investment contracts, it results in the account or unit balance being the basis of the liability and thus precludes recognition of margins in future fees;

Unit of Account

We do not believe that the inconsistency is significant, especially if it is recognised that a market price for transfer of a portfolio would recognise the diversification benefits that would be available to a well diversified acquirer.

Presentation of Premiums

Refer to our answers to questions 13 and 18. Where practicable, we believe that insurers should be required to unbundle any deposit element.

Separation of Investment Management Component

As discussed in our opening comments, we believe that it would be helpful if in establishing the insurance contract liability if the service margin element is separated out from the current exit value insurance liability with the risk margin included in the current exit value.

Chapter 6

Question 16

(a) For participating contracts, should the cash flows for each scenario incorporate an unbiased estimate of the policyholder dividends payable in that scenario to satisfy a legal or constructive obligation that exists at the reporting date? Why or why not?

(b) An exposure draft of June 2005 proposed amendments to IAS 37 (see paragraphs 247–253 of this paper). Do those proposals give enough guidance for an insurer to determine when a participating contract gives rise to a legal or constructive obligation to pay policyholder dividends?

To exclude benefits that will ultimately flow to policyholders (be it current or future policyholders) from the measurement of the liability under participating contracts, would misrepresent the economic substance of participating business and lead to an initial overstatement of a life insurer's equity and its reversal as the business runs off over time. This would create an accounting mis-match. For this reason we believe it is both appropriate and necessary that the cashflows incorporate an unbiased estimate of policyholder dividends that will ultimately flow under that scenario to both existing and future policyholders. In doing this, it is usual, for ease of modelling, to assume full distribution to existing policyholders, rather than include future policyholders. It is not clear whether the proposed amendments to IAS37 allow recognition of a constructive obligation to future as well as present policyholders.

Life insurers in Australia have discretion over the timing of the vesting of policyholder dividends to policyholders, including between generations, but not as to their ultimate payment to policyholders.

Question 17

Should the Board do some or all of the following to eliminate accounting mismatches that could arise for unit-linked contracts? Why or why not?

(a) Permit or require insurers to recognise treasury shares as an asset if they are held to back a unit-linked liability (even though they do not meet the Framework's definition of an asset).

(b) Permit or require insurers to recognise internally generated goodwill of a subsidiary if the investment in that subsidiary is held to back a unit-linked liability

(even though IFRSs prohibit the recognition of internally generated goodwill in all other cases).

(c) Permit or require insurers to measure assets at fair value through profit or loss if they are held to back a unit-linked liability (even if IFRSs do not permit that treatment for identical assets held for another purpose).

(d) Exclude from the current exit value of a unit-linked liability any differences between the carrying amount of the assets held to back that liability and their fair value (even though some view this as conflicting with the definition of current exit value).

As we have commented in our responses to earlier questions, we believe that it is important that insurance liabilities and the assets backing them be measured on a consistent basis. To do otherwise creates a misleading impression, on the face of the financial statements, as to the insurer's true position and performance. In practice, companies are careful to ensure that the amount and impact of these accounting mis-matches are disclosed, so that investors can strip them back out when interpreting the financial results. Furthermore, they are normally excluded from investor presentations and compendiums. To have such accounting mis-matches included in an insurer's legal accounts does not enhance the creditability of IFRS.

Accordingly, we believe that the answer to each of (a) to (c) above is yes. As noted above, the general principle, that assets and related liabilities should be measured consistently, applies far more widely than to just unit linked business.

With regard to (d), this is effectively an alternative, involving an adjustment to the liability measurement to compensate for the inconsistent asset measurement – akin to shadow accounting. We do not see that such an approach can possibly provide clarity of understanding unless the adjustment is appropriately disclosed and can only reluctantly, on principle, support an approach that "two wrongs can make a right". We also note that if insurers are required to unbundle the deposit component (as we believe should be the case), then the unit linked liability will come under IAS39 and any such adjustment would need to apply after application of the deposit floor minima to the unit liability. .

We also note that similar accounting mis-match issues can occur with respect to participating business and we believe that (a) to (c) should apply to participating as well as to unit linked business.

Chapter 7

Question 18

Should an insurer present premiums as revenue or as deposits? Why?

The treatment should follow unbundling. Where a contract is unbundled, the premium for the insurance component should be treated as revenue, while that for the deposit component should be treated as a deposit. Where there is no unbundling, the insurance premium should be treated as revenue.

Question 19

Which items of income and expense should an insurer present separately on the face of its income statement? Why?

We believe that the following insurance income and expense items should be presented on the face of the income statement:

- gross written premium;

- reinsurance premium written;
- gross claims incurred, including movement in gross liability provisions, but net of salvage and subrogation;
- reinsurance recoveries incurred, including movement in recovery provisions;
- management expenses paid, net of exchange commission;
- investment income,

together with appropriate totals.

This is intended to be a minimal set, but consistent with the requirement to show reinsurance separately, with more detailed disclosure in the notes.

Question 20

Should the income statement include all income and expense arising from changes in insurance liabilities? Why or why not?

Yes, for both the insurance liability and the service margin.

Other matters

Question 21

Do you have other comments on this paper?

Interdependence

It is important to recognize that many of the choices that the IASB must make are interdependent. It is vital that the standard finally adopted should form a coherent whole. Some of these relationships are obvious and others are more subtle. In the Board's desire to present a comprehensive discussion paper, it has included discussion of some issues as if they were independent.

For example, the issue of diversification is relevant in an entity-specific accounting model, but not under the proposed exit value model, which incorporates market value margins, which will naturally reflect the diversification available to market players.

As a further example, by definition, the premium charged is the sum of the expected present value of the cost, the risk margin, the service margin (if any) and the profit or loss at inception. If a zero profit or loss model is imposed, then either the risk margin or the service margin at inception is a balancing item.

It is also vital that the treatment of future premiums, acquisition costs and service margins should be consistent. In particular if, as is common for some life insurance and investment products, acquisition costs cannot be supported out of the initial premium, a mechanism is needed to allow for their subsequent recovery. This requires allowance for future premiums and is affected by the treatment of service margins.

Service Margins

The role and nature of the service margin, in the current exit value model, as set out in the Discussion Paper, is very unclear. Parts of the Discussion Paper, particularly the comparison with IAS 18, indicate that a retail or customer view of services is intended. If this is the case, there are potentially three services involved: Insurance, Investment Management and Advice.

Insurance includes a risk margin. We assume is not also intended to carry a service margin of itself, given the references to other services in the definition of current exit

value. Although investment management services can include advice, the advice provided can and usually will be much wider than this. In particular, advice may be provided even when there is no investment management element, only insurance. A significant part of the advice will be provided at or prior to inception of the contract, although it can also be ongoing.

The discussion on service margins also makes reference to portfolio assembly and suggests that this would be treated as a service occurring at inception. This suggests a provider or wholesale view of service margins as, while portfolio assembly, underwriting, claims management and record keeping are capable of being treated as separate service elements by the provider and even separately outsourced, they are all simply part of the provision of insurance from the customer perspective. If a provider or wholesale view is taken, then the service margin could reflect the profit margin involved in outsourcing the provision of these services. However, this could be much more simply and directly done by requiring provision for future expenses to be based on the market cost of outsourcing their provision.

The discussion paper also suggests an expectation that service margins, for product priced to market, will result in little or no profit at inception. It points to the reporting of positive embedded values at inception for new business as evidence of some further service, beyond the bearing of risk, for which a profit may be earned. As this is often the case for pure life risk business, not just life insurance contracts involving a deposit or investment element, this indicates another fundamental feature, the substantial investment that some companies make in their brand and distribution and the extra return they are often able to generate as a consequence.

Under a pure current exit value approach, this extra return will be recognised as profit at inception.

We do not believe this to be appropriate where this value arises from margins in future premiums or fees. This is, in effect, recognising internally generated goodwill, albeit goodwill that is tied to the continuation of the insurance contract. Further, although this goodwill can be seen as arising from past expenditure on brand and distribution, the maintenance of these margins in future premiums and fees is also dependent on the insurer maintaining the standing of its brand and distribution in the market place.

We would propose a two part approach to measurement of insurance contracts:

- **an insurance liability** being the current exit value including risk margins but excluding any service margins; and
- **a service margin** calibrated to absorb any margin arising from future premiums or fees after allowing fully for acquisition expenses.

As this service margin essentially measures the margin in future premiums, above the insurance liability current exit value arising from those premiums, it will, provided it remains positive, absorb any subsequent non-financial changes in assumptions relating to these elements. This does not reflect a view that margins should be used as a shock absorber; it is simply a consequence of its nature, as the difference between future premiums and the associated insurance liability arising from those premiums, and the active re-estimation required each reporting period, to ensure that only future internally generated goodwill as at the reporting date is excluded from current profit.

This is somewhat different to the Margin on Services (MoS) accounting used for life insurance in Australia, in that there is no spreading of margins between current and future periods, with the current premium being included in revenue and any insurance risk arising from the acceptance of the premium expensed if the claim is paid or included in the insurance liability current exit value if not, so that any margin in the current premium falls into current period profit.

Our main reason for recommending such an approach is that avoids moving the treatment of insurance too far ahead of other retail financial services. As noted in the discussion paper, IAS 18 does not take a fair value approach to the recognition of service revenue, prohibiting profit at inception and spreading margins over the life of the service. Furthermore, although IAS 39 has a substantial fair value element, for most investment contracts, due to the deposit floor, it results in the account or unit balance being the basis of the liability and thereby effectively rules out the recognition of any margins in future premiums and fees. In addition, the existence of an amortised cost option enables fair value to avoided for retail bank deposits. Indeed, following the limitation of the fair value option due to European concerns, it is almost mandatory under IAS 39 for such contracts.

We see this approach as having many benefits, including that;

- it retains the use of current estimates of future cashflows and risk margins for the measurement of the insurance liability, consistent with the use of fair value in other standards;
- it provides a natural and appropriate liability adequacy test, a current exit value based insurance liability;
- a current exit value based insurance liability provides the risk based foundation for the solvency regime, as desired by international regulators;
- it makes goodwill and future beneficial customer behaviour much less of an issue in allowing the inclusion of future premiums in the measurement of insurance contract liabilities;
- this use of the service margin is more consistent with profit recognition for service contracts under IAS 18, although profit will emerge on inception (or receipt of the premium if later) if there is sufficient margin in the premium. This is more likely to occur for general insurance and single premium life insurance contracts (e.g. annuities) and very unlikely for life risk insurances which usually involve regular premiums and high acquisition costs.
- it also provides the user with additional useful information, in that the service margin provides a measure of the goodwill that would potentially be realised by the insurer, if the insurance contract were to be transferred to a purchaser..
- it avoids anticipating the outcomes of the current review of IAS 18. If this review finally settles on a fair value approach, as opposed to customer value, then this can be implemented for insurance contracts at the same time, consistently with other retail financial services (e.g. bank deposits, unit trusts, and unit linked contracts).

Furthermore, an appropriate and carefully considered treatment of service margins and the associated concept of profit at inception may well resolve many of the other difficult issues identified in the Discussion Paper and for which the solution currently proposed is not necessarily ideal.

Disclosure

Based on Australian experience with the introduction of risk margins for general insurance, proper disclosure of the key elements of both assumptions and approaches adopted, in respect of risk margins, is key to ensuring that an appropriate level of consistency will emerge while allowing methodologies and understanding to develop.

Also, as the current exit value will in practice be constructed, proper disclosure is important to drive convergence and aid user understanding of how the current exit value is constructed. This should include separate disclosure of expected values, risk and service margins and the key assumptions and approaches underlying both the

current estimates and the margins and of the impact of changes in those key assumptions and approaches.

With current exit value having the potential, depending on how it is implemented, to be very volatile and include value from future periods, it is important that users be able to separate out (and understand) the impact of current experience from future assumption changes.

It is also vital that users should have the information needed to form an understanding of the uncertainty underlying the expected value and risk margin. While the risk margin itself may provide some insight into this, we believe that explicit disclosure of uncertainty is also required. This can be provided in a variety of forms, including:

- sensitivity analysis (impact of change of key assumptions);
- assessed probable ranges of outcomes;
- assessed coefficient of variation.

Taxation

A further important area of accounting mismatch is in the treatment of deferred tax assets and liabilities. Under IAS 12, deferred tax assets and liabilities must be measured on an undiscounted basis, even if the underlying amounts, used to determine the tax position, are on a fair value or discounted basis. This is incompatible with the fundamental principle that requires consistent measurement for meaningful results.

It also means that, where deferred tax is a factor in determining policyholder benefits, which is the case for participating life insurance products, a parallel, discounted measurement is required. Use of undiscounted values in the context of determination of policyholder benefits would be inequitable to those policyholders.

We believe that the logic in paragraph 54 of IAS 12 is flawed, in that comparability between dissimilar entities in what is typically a relatively minor element in the accounts is less important than presenting meaningful results on an entity by entity basis. Comparability between similar entities could be achieved by permitting discounting where the financial statements are predominantly prepared on a discounted or fair value basis, and requiring it where discounting of the IAS12 quantities is needed to be consistent with the determination and application of the other asset and liability amounts.

There are two possible ways of resolving this problem.

- One is to amend IAS 12 to allow deferred tax assets and liabilities to be measured on a fair value or discounted basis. This could even be required, where financial statements are prepared predominantly on a fair value or discounted basis or where the tax relates to items measured at fair value or discounted. This would be a general solution.
- The other is specific to insurance and is to require insurers to measure all deferred tax assets and liabilities (or all except taxes on profits) on a discounted basis.

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