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Professor David Boymal
The Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West VIC 8007

Request for comment on IASB Discussion Paper *Preliminary Views on Insurance Contracts*

Dear David,

Please find attached the AMP Limited (AMP) response to ITC 13 *Request for Comment on IASB Discussion Paper - Preliminary Views on Insurance Contracts* issued by the Australian Accounting Standards Board (AASB) in May 2007.

We commend the International Accounting Standards Board (IASB) on what we consider to be a very clear and well-presented discussion paper. We also applaud its efforts in agreeing many workable elements of an accounting model for insurance contracts.

Responses to the individual questions in the request for comment are included in the main body of this submission but the major issues, from an AMP perspective, are as follows.

Current Exit Value

Whilst we understand the principles behind the current exit value model, and see how it works in theory, we feel there would be significant practical issues in overlaying a market value concept to a liability that is not actively traded. Many aspects of the methodology pay lip service to market considerations (to ensure consistency with the model) but the practical application often reverts to entity specific or non-market measures.

A more appropriate model would recognise this fact and take a settlement approach to an insurer's obligations, similar to that used in IAS 37 for provisions. Such a change in emphasis would not require a wholesale re-working of the methodology and most of the considerations set out in the discussion paper would still apply.

Accounting Mismatches

It is worth reiterating the difference between *economic mismatches*, which arise from differences in the timing of cash flows from related assets and liabilities, and *accounting mismatches*, which arise when the accounting treatment of an asset differs from that applied to the related liability. Managing economic mismatches is part of the everyday operations of an insurer but identifying and eliminating accounting mismatches is the responsibility of accounting standard bodies. (All references to mismatches hereafter relate to *accounting* mismatches).

Accounting Mismatches *continued*

The mismatch issue stems from the fact that the current IASB accounting framework considers the recognition and measurement of assets and liabilities in isolation and, as yet, does not have the capacity to deal with a scenario where an asset and liability are inextricably linked, such as in the case of investment-linked contracts.

AMP strongly encourages the AASB and IASB to recommend a workable solution to these mismatches as they continue to have a significant impact on our profit (with the mismatch effect representing 16% of pre-mismatch profit at 30 June 2007). The issue has reached such a magnitude that the AMP Audit Committee and Board insist that additional disclosure is required on the face of the income statement before they can approve the financial report as being true and fair.

In addition, feedback from the users of the AMP financial report has indicated that mismatches lead to counter-intuitive results (for example, an increase in the AMP share price leads directly to a corresponding fall in profit) and this raises concerns over the integrity of the financial report as a whole.

Whilst the discussion paper covers insurance contracts rather than unit-linked financial instruments (investment-linked contracts - where most of the accounting mismatch issues lie for AMP) the IASB has signalled its intention to address the wider issue as part of this consultation process.

The IASB's preferred option of reducing the liability is considered unworkable for investment-linked contracts due to the 'deposit floor' restriction in IAS 39. AMP also believes that this option understates the obligation to the policyholder.

We believe therefore that the IASB should use an insurance accounting standard (or a revised financial instruments standard) to define the concept of an investment-linked or unit-linked contract and create exemptions to the asset recognition and measurement criteria in this one, limited scenario.

In the absence of such a solution from the IASB, we have identified a partial solution that would come into effect when Australia transitions to a global insurance standard and which could be brought forward by the AASB with minor amendments to the current life insurance standard. It relates to the issue of 'control' in the context of the consolidation of investment vehicles backing Australian investment-linked contracts.

The Australian life insurance standard defines a life insurance entity as being the interests of both shareholders and policyholders so control (being the ability to direct operations of an entity to obtain benefits from its activities) is determined at this level. AMP is therefore required to consolidate 'controlled' investment vehicles that are held for the beneficial ownership of investment-linked contract holders.

If a life insurer were considered to just represent the interests of the shareholders (whilst still recognising that it holds assets on behalf of, and has a liability to, policyholders) then it would not be required to consolidate investment vehicles held to back investment-linked contracts as the shareholder does not directly obtain benefits from their activities.

Accounting Mismatches *continued*

It is within the AASB's power to make such an amendment to the local life insurance standard that would resolve, for Australian investment-linked contracts, the internally generated goodwill and, to the extent that they are indirectly held, treasury share and owner-occupied property mismatches. See our response to Question 17 for more details on how these accounting mismatches arise.

AMP would welcome the opportunity to discuss its views with you or to answer any questions you may have. Please do not hesitate to contact myself or Gareth Mitchell (on 02 9257 3188) if you have any queries in respect of our response.

Yours sincerely

Paul Leaming
Chief Financial Officer
AMP Limited

AMP Limited

Preliminary Views on Insurance Contracts IASB Discussion Paper

Responses to Questions

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?

Response

We believe that, in principle, the recognition and derecognition criteria for insurance contracts should be consistent with those in AASB 139 and IAS 39 i.e.:

- An entity shall recognise an asset or liability on its balance sheet when, and only when, the entity becomes a party to the contractual provisions of the instrument;
- An entity shall derecognise an asset when, and only when the contractual rights to the cash flows from the asset expire or are transferred; and
- An entity shall remove a financial liability from its balance sheet when, and only when, it is extinguished – that is, when the obligation specified in the contract is discharged, transferred, cancelled or expires.

However, these relatively simple concepts take on additional complications when applied to insurance contracts. For example, there are various interpretations of when an insurance policy incepts (receipt of premium, signing date, risk commencement etc) and it is often difficult to determine when risk is fully extinguished, particularly on long tail and reinsurance contracts.

There are also issues relating to risk transfer that would need to be clarified. If a portfolio of business is 100% reinsured, has the risk been transferred or should the insurer show a gross liability and a reinsurance asset? And what criteria would distinguish this scenario from a portfolio transfer?

In summary, the principles of recognition and derecognition should reflect those in other international accounting standards and the *Framework for the Preparation and Presentation of Financial Statements* (the Framework) but we recommend that detailed, insurance specific, criteria and guidance should be incorporated into any future accounting standard on insurance contracts.

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 flows 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?

Response

The Three Building Blocks

Subject to other recommendations and observations made below, we agree that the use of the three building blocks as defined in the discussion paper is an appropriate method of measuring the liabilities arising from insurance contracts.

Discounted cash flow techniques are currently used for life insurance liabilities and risk margins have been applied successfully to the general insurance industry in Australia for a number of years. Whilst there are still likely to be some complications in applying the risk margin concept to life insurance, the existence of established methodologies will greatly ease the transition.

Profit Volatility

One aspect of applying the current exit value, however, will be the introduction of significant levels of volatility in the profit reported in respect of life insurance contracts in any one period.

The current 'margin on services' methodology for accounting for life insurance contracts in Australia calibrates the insurance liability to the premium received (less acquisition costs incurred). As a result, no profit is recognised on inception as profits arising from current or future premiums are recognised as part of the life insurance contract liability and systematically earned over the life of the policy. This, and the fact that changes in assumptions for profit making business are also recognised over the life of the policy, mean that there is very little volatility arising from life insurance contracts under this methodology.

The current exit value methodology, however, allows for profit on inception if the premium (less acquisition costs) exceeds the insurance contract liability. As stated in our response to Question 4, AMP agrees that the valuation of the insurance contract liability should not be calibrated to the premium and that, in theory, a profit can be recognised on inception. This profit represents the return on the entity's investment in brand and infrastructure that has meant it can charge a higher premium than others in the market.

We accept that this, and the fact that changes in assumption will impact current year profit, will result in more volatility in our profit. We are confident that adequate disclosure and education of investors and other stakeholders will ensure that this does not have a detrimental impact on the market perception of the value of our business.

Question 2 *continued*

Response *continued*

Service Margins

It is unclear from the discussion paper what the IASB mean by a service margin, for which types of insurance contract they would expect to see such a margin and what that margin represents.

The discussion paper states that a service margin in relation to an insurance contract is one that compensates the insurer for services other than the bearing of risk.

The example given of such services are investment management. However, investment management services are not seen as applicable to insurance risk contracts or to the risk element of an unbundled contract. This is because pure risk insurance contract holders would not generally perceive investment management as part of what they are purchasing. Investments in this context are managed for the benefit of the insurer such that they can pay claims as and when they fall due.

As unbundling is a regulatory requirement in Australia, the only potential for there to be an investment management element in the service margin for an insurance contract would be in respect of discretionary participating business. This is not expected to have a significant impact in isolation.

It is unclear what additional services to the policyholder would need to be provided for in a service margin for insurance contracts. The consistent usage of the terminology 'if any' in the context of service margins throughout the discussion paper would appear to indicate that the IASB are not expecting there to be a high instance of such services.

Also, current terminology in use in the Australian 'margin on services' methodology for valuing life insurance contracts and references made in paragraph 88(h) to embedded value appear to have introduced an element of confusion as to what the service margin is intended to achieve.

The Institute of Actuaries of Australia (IAAust) have suggested that a service margin could be used to limit the recognition of profit arising from brand and infrastructure in respect of *future* rather than current premium receipts (as they consider this to be an internally generated intangible asset). These discussions are ongoing but AMP feel that consideration of the intangible asset arising from customer relationships is adequately covered by the IASB in recommendations in respect of Question 6 below.

We agree that when an obligation to perform services other than the bearing of risk exists as part of an insurance contract, then these other services should be recognised as part of the liability to the insurance contract holder. However, it is recommended that the IASB more clearly define the purpose of the service margin and the nature of the other services they expect to be included.

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?

Response

We refer the AASB and the IASB to detailed comments made in response to Question 3 by the IAAust on behalf of the Australian actuarial profession. This paper endorses, with some recommendations for improvement, the guidance offered by the IASB in the appendices to the discussion paper and AMP support their conclusions.

Tax mismatch

One issue raised by the IAAust is worth particular note as it potentially creates another accounting mismatch. Paragraph E25 (e) specifically excludes income tax payments and receipts from the cash flows used to estimate the insurance liabilities and requires them to be handled separately under IAS12 *Income Taxes*.

This is a potentially significant issue for participating life insurance products in Australia where 'income tax' is deducted from investment earnings prior to distribution to policyholders.

These taxes are not charges against the profit of the life insurer as they are effectively charged against the taxable benefit attributable to the policyholders who then receive benefits net of tax. These taxes are typically payable irrespective of whether the life insurer makes any profit or not.

The insurer will apply a weighted average rate of tax to these earnings as a proxy for the amount that would be payable by each individual policyholder in their tax returns if they were to receive their benefits gross of tax. As a result, even though these taxes are typically payable irrespective of whether the life insurer makes any profit or not, such taxes are caught within IAS12 because they have the legal form of an income tax on the insurer rather than the policyholder.

The result of this is that the (post-tax) liability to participating contract holders will fall short of the (pre-tax) value of the supporting assets. This will result in an accounting mismatch, as the offsetting item would either be an undiscounted provision under IAS12 or no provision at all.

We recommend that the IASB make a specific exemption to the exclusion of tax in estimates of future cash flows against assets that back contracts that include tax in the estimate of benefits payable to the participating policyholder.

Question 4

What role should the actual premium charged by the insurer play in the calibration of margins, and why?

(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).

Response

The question refers to the calibration of 'margins', which presumably means both risk and service margins. The first question is therefore:

(a) Should the risk and service margin be independently valued and not calibrated to the premium charged?

(b) Should the risk margin be independently valued and the service margin be calibrated to the premium charged?

(c) Should the service margin be independently valued and the risk margin calibrated to the premium charged?

(d) Should the sum of the risk and service margins be calibrated to the premium charged and the allocation between the two elements estimated?

If the answer is (a) then the question of whether the premium charged plays any role in the estimate becomes applicable.

As risk and service margins are conceptually different, they should be valued independently of each other. For the reasons set out below, neither should be calibrated directly to the premium charged.

Question 4 *continued*

Response *continued*

Risk Margins

We believe that the role that prices should play in setting liability provisions depends on the quality of the other evidence available. AMP favours option (c) for calibrating the risk margin, in which preference is given to objective experience data, with pricing data only being used when there is insufficient reliable experience. This reflects the fact that premiums are subject to the cyclical nature of the insurance cycle and the valuation of the liability should be independent of this cycle.

In practice, in the absence of a material service margin (as discussed below), the premium charged will often offer the best available evidence of exit value. 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.

When pricing data is used at inception, however, it is unclear how this will support subsequent valuations of the margin. Current methodologies that rely on calibration to consideration received lock these assumptions in for the life of the contract and are not periodically reassessed. As the current exit value requires a reassessment of the risk margin at each reporting period end, valuation methodologies will need to be developed to address subsequent estimates when pricing data is used on inception.

Service Margins

To the extent that service margins are expected to exist in Australia, for reasons similar to that given for risk margins above, they should be valued independently of the premium charged but use pricing data as supporting evidence in the valuation. This ensures consistency with the current exit value concept.

As noted in paragraph 88(g) of the discussion paper, this method does result in an inconsistency in the accounting for the managed services element of a financial instrument (under IAS 18 and IAS 39) and the service margin on a participating insurance contract, which are conceptually the same.

Given that participating business tends not to be actively marketed in Australia and a large part of the value of the contract lies in the margins arising from the sharing of experience (and the assessment of the risks attaching to the shareholder), the deposit received is not likely to be the best evidence of the value of the margin. In most cases, the practical application is therefore likely to result in a different outcome for these types of contract.

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?

Response

Whilst we understand the principles behind the current exit value model, and see how it works in theory, we feel there would be significant practical issues in overlaying a market value concept to a liability that is not actively traded. Many aspects of the methodology pay lip service to market considerations (to ensure consistency with the model) but the practical application often reverts to entity specific or non-market measures.

A more appropriate model would recognise this fact and take a settlement approach to an insurer's obligations, similar to that used in IAS 37 for provisions. Such a change in emphasis would not require a wholesale re-working of the methodology and most of the considerations set out in the discussion paper would still apply to such a model.

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 recognised 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?

Response

See responses to Question 7 below for a discussion of which future cash flows we consider should be incorporated into the valuation of the insurance contract liability.

If future cash flows result in a net liability then it is clear that this should be incorporated into the insurance contract liability. The main issue arises when the net future cash flows result in an asset rather than a liability.

We agree with the comments in paragraph 139 of the discussion paper that, once the basis for recognising future cash flows is determined (per Question 7) all such cash flows arise as a result of the obligations of the contract rather than a separately identifiable customer relationship. We recommend, therefore, that all future cash flows should be included in the valuation of the insurance contract liability, regardless of whether they result in a net asset or liability, and be presented together in aggregate i.e. option (b).

As noted below, as future renewals of general insurance contracts would seldom qualify for recognition, this is only likely to be applicable to multi-year life insurance policies, participating investment contracts and some reinsurance contracts.

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 modifying significantly 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).

Response

We believe that the insurer should include all contracted cash flows arising from existing insurance contracts on the basis of the respective probabilities of each policyholder behaviour scenario, regardless of whether the scenario is beneficial or detrimental to the insurer. 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.

This then raises the issue of how to determine existing from new contracts.

The presumption should be that, as in the case of most general insurance products, each premium receipt or renewal would define a new contract. The insurer may expect that the majority of policyholders will renew, but there is no contractual requirement or presumption either that the policyholder renew or that the insurer accept renewal.

The nature and substance of other types of insurance contract, however, contain features that indicate that future premiums are contracted and the insurer is bound to accept them and pay claims arising in the period covered by those premiums.

These types of contract include multi-year life insurance policies, participating investment contracts and some reinsurance contracts. In Australia, whole of life and endowment insurance will often contain a contractual provision that automatically raises a loan (secured against the value of the policy) or reduces the sum assured if the premium is not paid. In such cases, the future premiums are clearly contracted.

Question 7 *continued*

Response *continued*

In many cases, the premiums set out in a multi-year life insurance policy are fixed at either a constant amount or on a pre-determined 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 recognised as a reduction in the deposit. In these cases, the fixed charges are contracted premium cash flows for the insurance component of the contract.

In other instances the insurer has the right to enforce payment of future premiums. This arises, for example, when premiums under an employer's liability policy are adjusted to reflect changes in salary. Such adjustments are clearly contracted premiums.

For reinsurance treaties the reinsurer would recognise future premiums (and the resulting claims) for all direct insurances within the scope of an existing treaty and a probability weighted estimate in respect of direct business not yet written. This is because the reinsurer is obliged under the treaty to reinsure this new business.

In summary, option (b) is preferred to the recommended option (a) as placing 'guaranteed insurability' restrictions on upside cash flows and no restrictions on the downside cash flows is considered to be at odds with the current exit value concept i.e. a market participant would certainly not place these restrictions on future cash flows when considering purchasing a portfolio of insurance contracts.

For many multi-year life insurance portfolios in Australia, the insurer has the ability under the contract to increase the premium but only at the portfolio level, not at the level of the individual policyholder. Under the current definition of 'guaranteed insurability' it is not clear whether the insurer is price constrained in this scenario because contractually it can be altered but commercially there is a limit to the extent 'healthy' policyholders would accept price rises to accommodate deterioration of 'unhealthy' policyholders.

If the notion of guaranteed insurability were to be incorporated into the insurance contracts standard, we would recommend the definition be amended to incorporate such a scenario.

Question 8

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

Response

Acquisition costs should be treated as an expense when incurred.

Amounts paid by insurers to acquire new multi-year life insurance contracts are traditionally well in excess of the initial premium (on the presumption that there will be few or no lapses in the early years of a contract and amounts will be recouped over this period).

Other accounting models based around the matching principal require these acquisition costs to be deferred to smooth profit emergence but we believe the commercial reality is that the expenses have been incurred and should be recognised in that period's income statement.

This is considered to be more intuitive and involve less complexity than deferring and matching revenue and expenses.

Question 9

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

Response

To the extent that there remains a theoretical difference between the fair value of the insurance liabilities acquired in a business combination (or via a portfolio transfer) and the current exit value recognised by the acquirer on initial recognition, the expanded presentation under IFRS 4 would need to be retained to handle the difference.

A difference could arise if the value the acquirer places on the liabilities is different to that placed by the theoretical well-diversified insurer used for the current exit value calculation.

Question 10

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

Response

Prior to the adoption of IFRS in Australia, local insurance standards mandated that insurers value the assets backing their insurance contract and investment linked liabilities at net market value. Net market value was, subject to mid-bid price adjustments and treatment of transaction costs, equivalent to fair value through profit and loss.

Upon transition to IFRS the grandfathered local standards continued to require assets backing insurance and investment contract liabilities to be valued at fair value through profit and loss, where that option was available in the relevant standard.

To the extent that the fair value option did not exist in certain standards (e.g. owner occupied property) or that the asset recognition criteria were not met (e.g. treasury shares and internally generated goodwill in investment subsidiaries) the transition to IFRS gave rise to accounting mismatches. These are discussed in more detail in the response to Question 17.

With the exception of these mismatches, however, Australian insurers have operated in a fair value environment for both financial and regulatory reporting for many years.

Paragraph 181 of the discussion paper states that the IASB does not intend to mandate the fair value option for assets backing insurance liabilities. Whilst it is conceded that not allowing insurers the full range of options available to other market participants is at odds with the Framework, this is seen as a backward step in Australia.

As further noted in paragraph 181, the taking of the option will be largely self-regulating (as insurers will want to eliminate differences between regulatory and financial reporting and accounting mismatches) but pressures placed on local subsidiaries of overseas insurers to align with group reporting may contribute to a reduction in the comparability of financial statements in Australia.

The issue is further complicated by the fact that, on the presumption that responses to Question 13 will recommend unbundling and separate reporting of investment business, many assets held by life insurers will be held to back investment-linked financial instruments and will be outside the scope of a standard on insurance contracts.

In theory, it would be preferable for there to be a consistent measurement basis for all assets and liabilities held by insurers. However, the opening up of all asset valuation options to local insurers is seen as an unfortunate but necessary consequence of the Framework and the current set of standards as issued.

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?

Response

We refer the AASB and the IASB to submissions made by industry bodies such as the IAAust, the Accountants and Actuaries Liaison Committee (AALC) and the Insurance Council of Australia (ICA) whose comments in response to this question we largely endorse.

Given that AMP's general insurance business is in an advanced state of run-off, issues that mostly impact general insurers are not expected to have a significant impact on AMP by the time any new insurance accounting standard becomes effective.

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.

Response

We refer the AASB and the IASB to submissions made by industry bodies such as the IAAust and the ICA whose comments in response to this question we largely endorse.

Reinsurance does not form a significant part of our life risk business and our general insurance business is in an advanced state of run-off. As a result, issues surrounding the measurement of reinsurance are not likely to have a material affect on AMP.

Question 13

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

Response

AMP strongly believes that when an insurance contract contains deposit or service components (other than for the bearing of risk) that are independent of the insurance component, the insurer should be required to unbundle them. The financial statements are more transparent when such elements are separated and only risk premiums and claims and investment-linked fees and expenses are included in the income statement.

Any future insurance accounting standard should mandate unbundling of the investment-linked component and bring it under IAS 39, as was done in Australia on transition to IFRS. This will greatly improve the international comparability of insurance company financial statements.

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?

Response

We refer the AASB and the IASB to submission made by the IAAust, whose comments in response to this question we largely endorse.

There appears to be a lack of clarity in the discussion paper as to what the credit characteristics represent and what they are trying to achieve. If the IASB feel that such characteristics are an essential component of the current exit value liability then they should clarify this further in future consultations with the industry.

However, in line with our comments in response to Question 5, we believe that removing a pure market bias from the valuation of the liability would remove the need to consider credit characteristics.

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?

Response

AMP considers that consistency between standards, where relevant, is preferable. However, given that there are significant differences between insurance contracts and financial instruments there is no theoretical reason why they should be directly comparable.

We do not propose any amendments other than those recommendations included in the responses to other questions.

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?

Response

As noted above, life insurers in Australia have discretion over the timing of the vesting of benefits to policyholders, including between generations, but not over the ultimate percentage allocation to policyholders. As a result, there is not just an expectation (a constructive obligation) but also a statutory obligation to pay these dividends at some point in the future.

To exclude benefits that will ultimately flow to policyholders (be it current or future policyholders) from the measurement of the liability under these contracts would misrepresent the economic substance of participating business and lead to an initial overstatement of a life insurer's equity.

It is common practice in Australia to assume full distribution to existing policyholders rather than allocating any to future policyholders. It is not clear from the discussion paper whether this assumption is consistent with the current exit methodology and, if not, whether an obligation to future as well as present policyholders could be recognised. We recommend that the IASB provide further clarification on this issue in future consultations with the industry.

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).

Response

On the presumption that responses to Question 13 will recommend unbundling and separate reporting of investment business, most of the mismatches described above will be outside the scope of an accounting standard on insurance contracts as they arise from assets held to back unit-linked financial instruments. The only mismatches that will fall directly into the scope of an insurance standard will be in respect of participating business.

How Mismatches Arise

The two key mismatches for AMP are:

Treasury shares – AMP offers a number of investment options to its investment-linked contract holders. The product disclosure statements for these options will often contain a strategic asset allocation to Australian shares and in particular, the ASX 200. To deliver on this mandate, AMP is required to purchase its own shares and the market regulator gives us an exemption from ownership restrictions in this particular circumstance.

These shares are held purely for the beneficial ownership of the investment-linked policyholders and their full value recognised in the liability to those policyholders. The Framework, however, does not allow the recognition of the treasury share asset on our balance sheet. Profit is affected to the extent that movements in the asset value (either from purchases, sales or unrealised gains/losses) are not recognised in the income statement but the corresponding effect on the liability is. As a result, an increase in AMP's share price results in a corresponding loss in the income statement.

The Framework prohibits the holding of treasury shares so that movements in an entity's share price do not affect its profit, yet this is the direct outcome of the treasury shares mismatch for AMP.

Question 17 *continued*

Response *continued*

How Mismatches Arise

Internally generated goodwill – again, some of the investment-linked options require an element of high-risk, high-return private capital entities as part of their asset allocation. AMP achieves this exposure via dedicated unit trusts that purchase such entities and hold them on behalf of the investment-linked policyholders. To reflect the value created by the underlying companies, the unit price is based on earning multiples and other valuation techniques. This value is also used to determine the liability to the policyholder.

No mismatch arises in the life insurer parent entity financial statements; the mismatch only arises on consolidation. As the Australian life insurance standard deems that a life insurer controls an entity even if it is held for the beneficial ownership of policyholders, AMP is required to consolidate the unit trusts holding the private capital companies.

The underlying net assets of such companies are traditionally much lower than value of the units as the price incorporates goodwill arising from future earning potential. On consolidation, the unit price value of the asset is replaced with the underlying net assets of the companies, but the liability to the policyholder remains at the higher value.

As a result, the mismatch arising from the write-off of goodwill directly impacts profit.

Unit Linked Financial Instruments

We recommend that the IASB either extend the jurisdiction of the insurance accounting standard or amend IAS 39 to include a specific definition of a unit-linked financial instrument (investment-linked contract) and directly address the issue of accounting mismatches.

The IASB's preferred option (d) of netting-off of the liability with the unrecognisable assets would be limited to the IAS 39 'deposit floor' for investment-linked contracts. Also, in line with the comments made in paragraph 282, AMP believes that this option understates the obligation to the policyholder.

We recommend therefore that the IASB should use an insurance accounting standard (or a revised financial instruments standard) to create exemptions to the asset recognition and measurement criteria in options (a), (b) and (c) in this one, limited scenario.

In the absence of such a solution from the IASB, we have identified a partial solution that would come into effect when Australia transitions to a global insurance standard and which could be brought forward by the AASB with minor amendments to the current life insurance standard. It relates to the issue of 'control' in the context of the consolidation of investment vehicles backing Australian investment-linked contracts.

The Australian life insurance standard defines a life insurance entity as being the interests of both shareholders and policyholders so control (being the ability to direct operations of an entity to obtain benefits from its activities) is determined at this level. AMP is therefore required to consolidate 'controlled' investment vehicles that are held for the beneficial ownership of investment-linked contract holders.

Question 17 *continued*

Response *continued*

Unit Linked Financial Instruments

If a life insurer were considered to just represent the interests of the shareholders (whilst still recognising that it holds assets on behalf of, and has a liability to, policyholders) then it would not be required to consolidate investment vehicles held to back investment-linked contracts as the shareholder does not directly obtain benefits from their activities.

It is within the AASB's power to make such an amendment to the local life insurance standard that would resolve, for Australian investment-linked contracts, the internally generated goodwill and, to the extent that they are indirectly held, treasury share and owner-occupied property mismatches.

Participating Business

In Australia, the liability arising from financial instruments with a discretionary participating feature (participating business) is directly linked to the performance of the assets held to back them. It is only the timing of the allocation of profit to shareholders and participating policyholders that is at the discretion of the insurer. As a result, accounting mismatches have a similar impact for this type of business.

AMP concede that the definition of participating business has different connotations in other jurisdictions and that demonstrating a nexus between the asset and liability is not so straightforward as for investment-linked contracts.

It is recommended therefore that a modified version of option (d) be applied to participating business. Such a method would recognise that cash flows from the liability and the asset backing it form part of a single contract and that they should be combined to arrive at a net liability to participating contract holders.

If cash inflows from treasury shares, owner-occupied property and investment subsidiaries could be considered as part of the valuation methodology for this liability then the accounting mismatch issue would be largely eliminated.

Question 18

Should an insurer present premiums as revenue or as deposits? Why or why not?

Response

Receipts in respect of pure insurance risk contracts, the risk element of an unbundled contract and any contract that is unable to be unbundled meet the definition of revenue and should be recognised in the income statement as such.

Receipts against investment linked contracts and the investment element of an unbundled contract should be treated as deposits and increase the liability to the policyholder.

AMP considers that this treatment reflects the commercial substance of the transactions and provides more clarity to the users of the financial report.

Question 19

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

Response

AMP does not believe that an insurance accounting standard should override the requirements of IAS 1 for an entity to fairly present the results of its operations on the face of the income statement whilst giving it the flexibility to tailor this to its particular circumstances.

The prominence of items arising from insurance contracts will depend on the nature of the entity reporting them. This will vary significantly between a large diversified multinational insurer, a bancassurer and a privately owned mono-line insurer.

There should be extensive disclosure requirements in any insurance accounting standard but what elements of this are recorded on the face of a primary statement or in a note should be left at the discretion of the entity.

There is a temptation to mandate the format of an insurance company income statement to promote international comparability but the industry should be allowed to self regulate this whilst still being able to respond to the needs of the primary users of its financial report.

Question 20

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

Response

All movements in insurance liabilities arising from income and expense should, by their very definition, be included in the income statement. Deposits and withdrawals, by their very nature, should not be recognised in the income statement. It makes sense therefore to show a reconciliation of opening and closing liabilities (including amounts recognised in the incomes statement and amounts directly impacting the liability) in the notes to the financial statements.