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Sir David Tweedie
International Accounting Standards Board
30 Canon Street, London, EC4M 6XH
United Kingdom

CC:
Mr. Kevin Stevenson
Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West
Melbourne, VIC, 8007

By Electronic Submission at: www.iasb.org

IASB Exposure Draft *Insurance Contracts*

Dear David

We are responding to the IASB Exposure Draft *Insurance Contracts*.

Our responses to the questions included within the exposure draft are provided in the attached Appendix.
In Australia, we already apply an approach that has similarities to that proposed under the Exposure Draft *Insurance Contracts* and our experience has been positive. We are very supportive of the Board continuing with the proposed approach. However there are some areas in the Exposure Draft *Insurance Contracts* where we believe further development by the IASB is required. These are detailed in the appendix attached to this letter.

If you have any questions in relation to this submission, please do not hesitate to contact myself (+61 2 8232 8670) or Frank Palmer (+61 2 8232 5193).

Yours sincerely

Stuart Dyson
Group Financial Controller
Macquarie Group

About Macquarie Group

Macquarie Group is a global provider of banking, financial, advisory, investment and funds management services.

Macquarie's main business focus is making returns by providing a diversified range of services to clients. Macquarie acts on behalf of institutional, corporate and retail clients and counterparties around the world. We have expertise in specific industries, including resources and commodities, energy, financial institutions, infrastructure and real estate.

Macquarie Group Limited is listed in Australia (ASX:MQG; ADR:MQBKY) and is regulated by APRA, the Australian banking regulator, as the owner of Macquarie Bank Limited, an authorised deposit taker. Macquarie also owns a bank in the UK, Macquarie Bank International Limited, which is regulated by the FSA. Macquarie's activities are subject to scrutiny by other regulatory agencies around the world.

Macquarie's management approach fosters an entrepreneurial culture among staff. Strong prudential management is fundamental to this approach. Robust risk management practices are embedded in business unit management with central oversight of credit, market, funding, compliance and operational risk. These, together with a strong and committed team, are key drivers of Macquarie's success.

Founded in 1969, Macquarie now employs more than 15,500 people in over 70 office locations in 28 countries. At 30 September 2010, Macquarie had assets under management of $A317 billion.

APPENDIX

Question 1 – Relevant information for users (paragraphs BC13–BC50)
Do you think that the proposed measurement model will produce relevant information that will help users of an insurer's financial statements to make economic decisions? Why or why not? If not, what changes do you recommend and why?

We agree that the proposed measurement model will provide relevant information to users that will help users of an insurer's financial statements to make economic decisions.

However we consider some of the proposals such as the transitional rules, aspects of the residual margin and the income statement presentation may not achieve this objective. These are explained in more detail below.

Question 2 – Fulfilment cash flows (paragraphs 17(a), 22–25, B37–B66 and BC51)
(a) Do you agree that the measurement of an insurance contract should include the expected present value of the future cash outflows less future cash inflows that will arise as the insurer fulfils the insurance contract? Why or why not? If not, what do you recommend and why?

We support the fulfilment model.

(b) Is the draft application guidance in Appendix B on estimates of future cash flows at the right level of detail? Do you have any comments on the guidance?

We agree that the guidance is sufficiently detailed.

Question 3 – Discount rate (paragraphs 30–34 and BC88–BC104)
(a) Do you agree that the discount rate used by the insurer for non-participating contracts should reflect the characteristics of the insurance contract liability and not those of the assets backing that liability? Why or why not?

We agree that the discount rate should reflect the characteristics of the insurance contract liability, subject to the comments in (c) below.

(b) Do you agree with the proposal to consider the effect of liquidity, and with the guidance on liquidity (see paragraphs 30(a), 31 and 34)? Why or why not?

We agree that the proposals should consider the effect of liquidity, and agree that the guidance is sufficient without becoming rule-based. However we note the highly judgemental nature of measuring an appropriate liquidity margin.

(c) Some have expressed concerns that the proposed discount rate may misrepresent the economic substance of some long-duration insurance contracts. Are those concerns valid? Why or why not?
If they are valid, what approach do you suggest and why? For example, should the Board reconsider its conclusion that the present value of the fulfilment cash flows should not reflect the risk of non-performance by the insurer?

We agree that the discount rate should match the nature of the liabilities rather than the assets backing those liabilities.

Question 4 – Risk adjustment versus composite margin (paragraphs BC105–BC115)

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

We support the use of a risk adjustment and a residual margin. Whilst the calculation of a risk adjustment may be challenging it does provide useful additional information to users who can better evaluate the risks faced by an insurer.

Question 5 – Risk adjustment (paragraphs 35-37, B67-B103 and BC105–BC123)

(a) Do you agree that the risk adjustment should depict the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected? Why or why not? If not, what alternatives do you suggest and why?

We agree that the risk adjustment should depict the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected.

(b) Paragraph B73 limits the choice of techniques for estimating risk adjustments to the confidence level, conditional tail expectation (CTE) and cost of capital techniques. Do you agree that these three techniques should be allowed, and no others? Why or why not? If not, what do you suggest and why?

We agree with the proposals to allow the three techniques to measure the risk adjustment. The techniques for measuring risk adjustments are widely recognised in the industry and the choice allows different insurers who issue different types of insurance policies to select the technique that best models the insurance policy written. However, we do not agree with limiting the techniques to the three identified, because it does not allow for future improvements in measuring risk.

(c) Do you agree that if either the CTE or the cost of capital method is used, the insurer should disclose the confidence level to which the risk adjustment corresponds (see paragraph 90(b)(i))? Why or why not?

We agree that given multiple techniques are allowed under the ED that where a certain technique is adopted then this should be disclosed. Disclosure will enhance the comparability of insurer's financial statements over time.

(d) Do you agree that an insurer should measure the risk adjustment at a portfolio level of aggregation (ie a group of contracts that are subject to similar risks and managed together as a pool)? Why or why not? If not, what alternative do you recommend and why?

In principle, we generally support that an insurer should measure the risk adjustment at a portfolio level of aggregation. This reflects the economic nature of an insurance business where insurance contracts are pooled and risks shared.

However, where an insurer writes insurance contracts with different but potentially offsetting risks (eg term life insurance and annuities) this allows realisation of the benefits of diversification. The ED would determine that the profile of each of these risks is not similar and therefore a separate risk margin would apply to each portfolio. In this circumstance, it is our view that these two types of risks should be aggregated together for determining an aggregate risk adjustment.

(e) Is the application guidance in Appendix B on risk adjustments at the right level of detail? Do you have any comments on the guidance?

We agree that the guidance is sufficiently detailed.

Question 6 – Residual/composite margin (paragraphs 17(b),

19–21, 50–53 and BC124–BC133)
(a) Do you agree that an insurer should not recognise any gain at initial recognition of an insurance contract (such a gain arises when the expected present value of the future cash outflows plus the risk adjustment is less than the expected present value of the future cash inflows)? Why or why not?

We agree that an insurer should not recognise any gain at initial recognition of an insurance contract and that it is appropriate for profit to be recognised over the life of the contract.

(b) Do you agree that the residual margin should not be less than zero, so that a loss at initial recognition of an insurance contract would be recognised immediately in profit or loss (such a loss arises when the expected present value of the future cash outflows plus the risk adjustment is more than the expected present value of future cash inflows)? Why or why not?

We agree that an insurer should recognise a loss on an insurance contract immediately in the profit or loss as this is consistent with the treatment of onerous contracts under other IFRSs.

(c) Do you agree that an insurer should estimate the residual or composite margin at a level that aggregates insurance contracts into a portfolio of insurance contracts and, within a portfolio, by similar date of inception of the contract and by similar coverage period? Why or why not? If not, what do you recommend and why?

We believe that the residual margin should be estimated at a portfolio level (subject to our comments in question 5d), regardless of the date of inception. This view is based on;

- a portfolio level better reflects the way in which insurers manage their risks (subject to our comments in 5(d),
- insurance contracts may be written over an extended period of time with similar expected margins or with slight variations in margins to respond to changes in demographic trends or market conditions – this process would be expected to be managed to preserve 'residual margins' at the portfolio level rather than for a single cohort of new business (eg. price changes would be balanced against the potential impact on lapse rates for existing business),
- the measurement of the residual margin at a cohort level is inconsistent with the measurement of the risk adjustment which is calculated at a portfolio level. The measurement of insurance contracts for each level of the building block approach should be at the same level of aggregation; and
- a portfolio level approach is more consistent with our support for a process of re-measurement of the portfolio residual margins over time to reflect changes in business performance and expected future experience (see (d) below).

(d) Do you agree with the proposed method(s) of releasing the residual margin? Why or why not? If not, what do you suggest and why (see paragraphs 50 and BC125–BC129)?

We support the concept of releasing the residual margin over the life of the insurance contract as this is consistent with the principles set out in IAS 18 *Revenue* of recognising revenue in the year the service is provided.

We disagree with the method of releasing the same historical residual margin on re-measurement of assumptions used to value insurance contract liabilities. If the (non-economic) assumptions underpinning the value of the insurance liability change, the initial calculation of the residual margin (and therefore future profit recognition under the insurance contract) can become arbitrary. Over-time ongoing profitability reflected in the income statement may bear little resemblance to the actual performance of the contract.

We disagree with the ED proposal that changes in the estimates used to calculate the insurance liabilities should be immediately recognised in the statement of comprehensive income rather than initially offset through residual margins. We disagree with this proposal for the following reasons;

- profit will potentially be influenced more by assumption changes used to measure insurance liabilities than actual experience;
- the proposal does not recognise the economic impact of the change in estimates used to calculate insurance liabilities over the period the service is provided which is inconsistent with the revenue recognition criteria in IAS 18 *Revenue*;
- once the estimates used in the measurement of insurance liabilities have been re-measured the residual margin becomes arbitrary (as noted above);
- reliable information for re-measuring residual margins would be readily available for most types of insurance contracts, and;
- disclosure of the residual margins and changes in residual margins due to assumption changes will provide useful information to the users of accounts without unnecessary profit volatility.

We consider that;

- the residual margin should be subject to re-measurement following a change in assumptions used to value insurance contract liabilities.

(e) Do you agree with the proposed method(s) of releasing the composite margin, if the Board were to adopt the approach that includes such a margin (see the Appendix to the Basis for Conclusions)? Why or why not?

As noted in Question 4, we favour an explicit risk adjustment and residual margin approach over a composite margin approach.

(f) Do you agree that interest should be accreted on the residual margin (see paragraphs 51 and BC131–BC133)? Why or why not? Would you reach the same conclusion for the composite margin? Why or why not?

We support the proposal for interest to be included on the residual margin.

Question 7 – Acquisition costs (paragraphs 24, 39 and BC135–BC140)

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

We disagree with the proposal that non-incremental acquisition costs are to be expensed when incurred, because the pattern of recognising profits will be distorted by the recognition of a large day one loss that may be particularly acute for a growing insurance business which is writing a significant amount of new business. Whilst comparability within the insurance industry may be understood, comparability with other industry sectors may be unfavourable.

The ED requires the estimate of cash flows and the risk adjustment be calculated at a portfolio level but for incremental acquisition costs to be calculated at a contract level. We agree with the principle that an insurance contract should be measured at a portfolio level and that this should be applied consistently in the ED. Using this same approach, rather than the approach in the ED, for acquisition costs would also reflect the underlying economics of insurance and the main feature of the business model which is the pooling of risks in order to receive the benefit of diversification.

We consider that;

- non-incremental acquisition costs should be included as a contract cash outflow in the calculation of the insurance liability, and;

- acquisition costs should be calculated at a portfolio level.

Question 8 – Premium allocation approach
(a) Should the Board (i) require, (ii) permit but not require, or (iii) not introduce a modified measurement approach for the pre-claims liabilities of some short-duration insurance contracts? Why or why not?
(b) Do you agree with the proposed criteria for requiring that approach and with how to apply that approach? Why or why not? If not, what do you suggest and why?

We agree with the proposal to introduce a modified measurement approach for short term duration contracts. This short cut method for valuing the pre-claim liability for short duration contracts is a practical approach for measuring such contracts, whereas the alternative is full application of the fulfilment model which would bring added complexity and volatility (as noted below).

Question 9 – Contract boundary principle
Do you agree with the proposed boundary principle and do you think insurers would be able to apply it consistently in practice? Why or why not? If not, what would you recommend and why?

While we generally support the contract boundary principle we believe the defined wording may cause problems for some short-term life, general and health insurance contracts that may inadvertently have to apply the fulfilment model. Given our comments elsewhere in this submission, we believe that the fulfilment value approach may lead to an inappropriate level of volatility for annually renewable contracts where the premium charged for insurance risk is expected to be generally matched to claims cost incurred on a period-by-period basis (and future contract premiums are expected to respond to portfolio experience).

We consider that;

- where insurers are unable to apply the modified measurement approach under the contract boundary principles, an insurer should be permitted to assess the spirit of the contract boundary principles to enable the short term contracts identified above to apply the modified measurement approach,

Question 10 – Participating features
(a) Do you agree that the measurement of insurance contracts should include participating benefits on an expected present value basis? Why or why not? If not, what do you recommend and why?
(b) Should financial instruments with discretionary participation features be within the scope of the IFRS on insurance contracts, or within the scope of the IASB's financial instruments standards? Why?
(c) Do you agree with the proposed definition of a discretionary participation feature, including the proposed new condition that the investment contracts must participate with insurance contracts in the same pool of assets, company, fund or other entity? Why or why not? If not, what do you recommend and why?
(d) Paragraphs 64 and 65 modify some measurement proposals to make them suitable for financial instruments with discretionary participation features. Do you agree with those modifications? Why or why not? If not, what would you propose and why? Are any other modifications needed for these contracts?

This question does not specifically impact our insurance business and as such we have not assessed the proposed treatment of participating benefits.

Question 11 – Definition and scope
(a) Do you agree with the definition of an insurance contract and related guidance, including the two changes summarised in paragraph BC191? If not, why not?

We agree with the definition of an insurance contract and related guidance. However, we think residual value guarantees provided by a manufacturer, dealer or retailer, and a lessee should be accounted for similarly.

(b) Do you agree with the scope exclusions in paragraph 4? Why or why not? If not, what do you propose and why?

We agree with the scope exclusions.

(c) Do you agree that the contracts currently defined in IFRSs as financial guarantee contracts should be brought within the scope of the IFRS on insurance contracts? Why or why not?

We disagree that contracts currently defined in IFRSs as financial guarantee contracts should be brought within scope of the IFRS on insurance contracts.

We consider that;

- financial guarantees should continue to fall within the scope of the financial instruments standard.

Question 12 – Unbundling
Do you think it is appropriate to unbundle some components of an insurance contract? Do you agree with the proposed criteria for when this is required? Why or why not? If not, what alternative do you recommend and why?

We agree with the proposals to unbundle some components of an insurance contract however believe that materiality principles would also apply.

Question 13 – Presentation
(a) Will the proposed summarised margin presentation be useful to users of financial statements? Why or why not? If not, what would you recommend and why?

We agree with the presentational changes on the statement of comprehensive income as it is consistent with the building block approach proposed in the fulfilment model in the measurement of insurance liabilities.
We agree with the approach that allows insurers to reflect assets underlying unit-linked contracts and the associated liabilities, and income and expenses from unit-linked contracts, separately as a single line item on the face of the statement of financial position and statement of comprehensive income respectively.

We agree that the proposed summarised margin presentation will be useful to users of financial statements.

However we disagree that this presentation should be on the face of the income statement because;

- the margin approach is an actuarial view rather than an accounting view;

- for non-sophisticated users of a conglomerate's financial statements, the presentation of margin information on the face of the income statement may be confusing.

We consider that;

- premiums, benefit payments and claim expenses should be included on the face of the income statement with the margin approach presented separately in the notes to the financial statements.

(b) Do agree that an insurer should present all income and expense arising from insurance contracts in profit or loss? Why or why not? If not, what do you recommend and why?

We agree that the insurer should present all income and expenses arising from insurance contracts in profit and loss.

Question 14 – Disclosures
(a) Do you agree with the proposed disclosure principle? Why or why not? If not, what would you recommend, and why?

We agree with the disclosure principles

(b) Do you think the proposed disclosure requirements will meet the proposed objective? Why or why not?

We agree that the proposed disclosure requirements would meet the proposed objective. However we note that there is a significant amount of overlap with the disclosures required by IFRS 7 Financial Instruments: *Disclosures*, and that the disclosures seem excessive.

We consider that;

- the IASB should consider aligning the disclosures that would be required under the insurance standard with IFRS 7 Financial Instruments: *Disclosures*.

- there is a risk that the amount of information provided may reduce the usefulness of the financial statements to non-sophisticated users of accounts.

(c) Are there any disclosures that have not been proposed that would be useful (or some proposed that are not)? If so, please describe those disclosures and explain why they would or would not be useful.

We have not identified any additional disclosures that would be useful.

Question 15 – Unit-linked contracts
Do you agree with the proposals on unit-linked contracts? Why or why not? If not what do you recommend and why?

We agree with the proposal to recognise and measure at fair value through profit and loss, an insurer's own shares issued and held as assets underlying unit-linked contracts. This removes the accounting mis-match that currently arises when an insurer holds its own shares.

We consider that;

- the IASB consider the same approach to address the mismatch that arises when a consolidated investment fund holds its parent's own shares for the benefit of fund investors. This too creates an accounting mismatch, which on the basis of the changes proposed in the insurance project seems to now have a reasonable basis for amending.

Question 16 – Reinsurance
(a) Do you support an expected loss model for reinsurance assets? Why or why not? If not, what do you recommend and why?

We do not support the reinsurance model which states that if a reinsurance treaty is profitable to the cedent, then the present value of the net cash flows should be recognised immediately in profit or loss for the following reasons;

- in our view recognising a profit on establishment of a reinsurance treaty is inconsistent with IAS 18 *Revenue* of not recognising profit until services are provided. The nature of a reinsurance contract is that it is not a closed transaction and the cash flows arising from it will change depending on experience;
- a reinsurance profit (to the cedant) at inception often simply implies that the cedant has a more conservative view of likely future experience on the contract. This may be driven by a smaller volume of data on which to base assumptions at policy commencement and the two views may tend together over time. In such a scenario it would be inappropriate to recognise this profit at inception.
- the proposals would demand disclosure in the accounts of commercially sensitive information relating to the profitability of reinsurance contracts.

We consider that;

- the residual margin should be recognised on the reinsurance contract at inception and released over the coverage period.

(b) Do you have any other comments on the reinsurance proposals?

No further comments

Question 17 – Transition and effective date
(a) Do you agree with the proposed transition requirements? Why or why not? If not, what would you recommend and why?

The transitional rules propose that for any contracts in force at transition, insurance contracts would be remeasured *excluding* any residual margin. Consequently, the difference between the insurance liability measured under existing standards, and the liability that would be measured under the ED on transition are immediately recognised in equity. We would prefer to include the residual margin at transition in the liability by restating the liability using the new model, or using "best estimates", rather than the proposed zero residual margin approach for the following reasons;

- insurers in jurisdictions that are currently accounting for insurance contracts on a similar basis to the proposals in the ED (such as Australian and New Zealand insurers) will have information available to accurately calculate the value of the insurance liability and the residual margin under the ED and be in a position to reliably restate prior periods. This would be consistent with the principles in IAS 8 *Accounting policies, changes in accounting estimates and errors,* which would allow full retrospective implementation of the new standard;
- the zero margin approach is not an equitable solution for prudent insurers. A prudent insurer is penalised by not being able to report future profits through the income statement whilst an imprudent insurer can write off losses at transition directly through equity, and;
- the transitional rules are inconsistent with IAS 18 *Revenue*, which requires that revenue is recognised in the reporting period in which the service was rendered.

We consider that;

- the transitional arrangements should allow insurers to assess whether retrospective application is practical. Where insurers identify that information is available to calculate the insurance liability under the new arrangements then they should be allowed to do so using a 'best estimate' approach. This might involve accurately re-constructing the insurance liability over the past say 3 years and then using a 'best estimate' for periods before this where detailed information may not be available, and;

- we recognise that the IASB has considered proposals to retrospectively apply the ED and determined that this exercise would be too difficult and costly for the insurance industry to undertake, but we believe that the insurance industry is up to the challenge and that ultimately the benefits from undertaking this exercise will outweigh the costs.

(b) If the Board were to adopt the composite margin approach favoured by the FASB, would you agree with the FASB's tentative decision on transition (see the Appendix to the basis for Conclusions)?

No comment.

(c) Is it necessary for the effective date of the IFRS on insurance contracts to be aligned with that of IFRS 9? Why or why not?

We will comment upon this when we respond to the IASB's request for Views, *Effective dates and Transition Methods.*

(d) Please provide an estimate of how long insurers would require to adopt the proposed requirements.

We are well placed to adopt the new proposals

Question 18 – Other comments
Do you have any other comments on the proposals in the exposure draft?

No further comments.

Question 19 – Benefits and costs
Do you agree with the Board's assessment of the benefits and costs of the proposed accounting for insurance contracts? Why or why not? If feasible, please estimate the benefits and costs associated with the proposals.

We agree with the Board's assessment of the benefits and costs associated with the proposed accounting for insurance contracts. We do not think that it is feasible to accurately determine the benefits and costs associated with the proposals.