TOWER

29 November 2010

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London
United Kingdom EC4M 6XH

Dear Sir David Tweedie,

Exposure Draft ED/2010/8 Insurance Contracts

TOWER Australia is a specialist life insurer that sells risk only life insurance contracts such as death, total and permanent disablement, trauma and income protection insurance via direct and intermediated distribution channels. Contractual premiums increase annually to reflect age and inflation and are adjusted to reflect claims experience. TOWER Australia's strategy is to change the way life insurance is viewed from being a financial product to a service where TOWER provides a service to its customers in a time of need.

As one of Australia's largest life insurers with over $1.2 billion of inforce premiums and the only listed life insurer specialising in risk only insurance, TOWER Australia is in a unique position to comment on the impact of the proposed standard having 15 years experience calculating policy liabilities on a basis similar to that proposed in ED/2010/8 Life Insurance Contracts.

It is this experience that has prompted TOWER Australia to invest considerable time and energy in modelling the impacts of the new standards, meeting with industry peers, working with industry associations, the Australian Accounting Standards Board, representatives from the general and health insurance industries and members of the IASB.

In considering TOWER Australia's response to this ED, our objectives are to:

- Ensure the financial information assists users of the financial statements in making economic decisions by ensuring the measurements and presentation are appropriate for the type of insurance contract.
- Eliminate inconsistencies and improve comparability between risk only service style life, general and health insurance contracts that are economically similar.

TOWER Australia is supportive of ED/2010/8's objectives and recommends minor changes to ED/2010/8 to ensure risk only service style insurance contracts are treated consistently across insurance sectors. TOWER Australia acknowledges that the IASB may have considered these issues in the past but wishes to add weight to the discussion given TOWER Australia's experience in this area.

TOWER Australia recommends the modified approach for short duration contracts (which we refer to as the 'modified approach' hereafter) **be extended and applied across all risk only service style insurance contracts unless the contracts contain embedded options that significantly affect the variability of cash flows.** This would align the treatment of economically similar contracts across insurance sectors and enable greater consistency between insurance and other service industries.

In making this recommendation TOWER Australia is conscious that policy liabilities for long term insurance contracts with guarantees which are unable to be reflected in future pricing (i.e. premiums are locked in) are best valued using discounted projected cash flow techniques and has attempted to retain this requirement for those types of insurance contracts when drafting recommended wording for ED/2010/8.

TOWER Australia submits that the modified approach provides an appropriate approximation of the discounted cash flow methodology and is more appropriate for risk only service style insurance contracts because:

- TOWER Australia's experience is that capital markets do not understand and distrust the projection of cash flows for variable premium risk only service style insurance contracts where the measurement approach is inconsistent with market experience (i.e. the economic substance) of the contract. The capital markets understand that the average customer lapses risk only life insurance contracts at between 6 and 8 years but do not understand why it is premiums and claims are projected out 40 years or more because of the legal interpretation of the contract terms. The capital markets see that there is no latent risk (as premiums increase each year with age and inflation and where there is adverse claims experience, premiums are increased to remove this risk) hence does not expect it to be measured and distrust the number when it is.

- Capital markets now demand that TOWER Australia present its financial information in respect of these insurance contracts in a format consistent with the general and health insurance markets because of the view these contracts share similar if not identical economic features. Immediately following release of TOWER's Australia's financial results on 25 November 2010, four of Australia's largest funds managers/analysts and two writers within the financial press publically complimented TOWER Australia on its disclosures and the consistency of disclosure with general insurers. For example, "FY10 Result: Impressive Numbers, Enhanced Disclosure" (source: report heading from Goldman Sachs).

- TOWER Australia has evidence showing that capital markets fail to understand the difference between distributable earnings (i.e. cash profits) and reported profit from risk only service style (yearly renewable) insurance contracts that significantly increases with the adoption of a measurement model that requires the full projection of future cash flows.

- Locked in amortisation of the residual margin where underlying contract premiums regularly change is inconsistent and will cause an ever increasing negative policy liability that the capital markets will not understand.

- Non disclosure of premiums, claims and expenses on the face of the income statement is inconsistent with how the business is managed and does not allow users to consider inter-relationships between income and expense items to assess performance and trends. TOWER Australia believes that the proposed disclosure for long duration business if applied to risk only service style insurance contracts would misrepresent the economic substance of these contracts.

TOWER Australia's extensive experience has shown that applying discounted cash flows methodology along the lines that ED/2010/8 proposes to risk only service style insurance contracts (where premiums change to reflect any change in risk), creates complexity and inconsistencies that reduce the usefulness of the financial statements and may lead to dysfunctional behaviour by some market participants. TOWER asks that the IASB consider the attached detailed submission that recommends minor changes to ED/2010/8 that should allow the IASB meet its scheduled release date.

Yours Sincerely

John de Zwart
Chief Financial Officer

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Background

Ensure relevant information for users and improving comparability with other industries by expanding the application of the modified methodology

The Australian Life Insurance Industry

Complicated traditional insurance contracts that contained a mixture of savings and insurance features largely ceased to be sold in Australia in the early 1990's. A significant portion of these contracts remain inforce and continue to pay ongoing premiums but they are generally termed 'legacy products' and are closed to new business. Since the early 1990s Australians separately consider their life insurance and savings needs and buy separate unbundled products to meet those needs.

On sale life insurance products in Australia are generally limited to death, total and permanent disablement, trauma and income protection insurance standards via direct, intermediated and group distribution channels. These insurance contracts pay the policyholder or their family a lump sum or income stream if the policyholder should die, have an accident or suffer a medical condition. The policyholder generally holds an option to renew the contract (i.e. guaranteed renewability) with no obligation imposed on the policyholder to pay future premiums. For group contracts a premium guarantee of three years is common but again there is no obligation imposed on the policyholder to pay future premiums.

These life insurance contracts are typically described as yearly renewable term (YRT) or risk only service style life insurance contracts and differ from other life insurance contracts in that the premium rate increases each year with the policyholder's age and inflation and where the life company adjusts the premium to reflect the claims experience of the portfolio. These contracts are more similar to general insurance and health contracts than to traditional level premium life insurance contracts. An individual pricing segment will typically be determined by gender, smoking status, age, and year of issue.

A key feature within the Australian market is the ability for the policyholder to change insurers (often on improved terms) or cease paying premiums without penalty other than loss of cover. So yearly renewable term contracts do not lock in customers to long term arrangements and are often structured as a perpetual contracts (i.e. with no end date) where the contract remains in force as long as premiums are received. In this way these contracts are very similar to contracts in other industries such as the utility industry and banking industry where the contract continues until the customer decides to terminate or cease paying.

TOWER Australia's experience with the discounted cash flows

As one of the few listed life insurance companies that specialise in these yearly renewable term contracts, TOWER Australia has firsthand experience that:

- Capital markets do not understand and distrust the projection of cash flows for variable premium risk only service style insurance contracts where the measurement approach is inconsistent with market experience (i.e. the economic substance of the contract).

- The lack of comparability to other industries has increased the cost of capital for life insurers. Capital markets now demand that TOWER Australia present its financial information in respect of these insurance contracts in a format consistent with the general and health insurance markets because of the view these contracts share similar if not identical economic features.

- The lack of transparency around the financial position and financial performance of life companies has lead to the misallocation of capital in relation to service style insurance contracts because the disclosures are inconsistent with these types of contracts. Disclosing the premiums, claims and expenses on the same basis as the business is managed best reflects the economic substance of these contracts and better aligns internal management and external users of the financial statements.

While complexity in life insurance accounting is a major communication challenge for TOWER Australia when presenting its financial results, the biggest issue continues to be the lack of comparability to other industries. TOWER Australia used to present its financial information in a format similar to that contemplated by the ED/2010/8 (margin style) for long duration contracts and found that shareholders and analysts would not invest time in understanding the presentation style. Shareholders and capital markets consistently stated that the measurement and presentation of insurance contracts was inconsistent with the underlying nature of the contracts. Ultimately, investors and analysts would decide not to hold TOWER Australia shares due solely to their inability to invest time in understanding the financial statements because they could not compare the financial metrics of service style insurance contracts to other industries such as general insurance where the contracts were ostensibly the same.

TOWER Australia welcomes any attempt to address these issues. In particular, it is TOWER Australia's experience that service style life insurance contracts do not have features that distinguishes them from other industries. For reasons that we shall describe later, service style life insurance contracts share the same commercial issues as other industries. Suggestions that service style life insurance contracts are somehow unique are light on fact and are counterproductive because such suggestions result in measurement and disclosure complexities that do not reflect the underlying economic nature of such contracts.

TOWER Australia acknowledges that complicated contracts with participating profit features or embedded options warrant the projection method and is supportive of ED/2010/8's proposals in this regard.

TOWER Australia is supportive of the International Accounting Standards Board (IASB) objective to improve comparability. However, TOWER Australia's interpretation of Exposure Draft (ED/2010/8) Insurance Contracts leads TOWER Australia to the conclusion that some of the clauses will impede the proposed standard from achieving its stated objectives.

SUBMISSION 1

Case for expanding the application modified measurement approach for the pre-claims liabilities of short-duration insurance contracts

Joint response to:

Question 1 – Relevant information for users
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?

Question 2 – Fulfilment cash flows
(a) Do you agree that the measurement of an insurance contract should include the expected present value of the future cash outflows less future cash inflows that will arise as the insurer fulfils the insurance contract? Why or why not? If not, what do you recommend and why?
(b) Is the draft application guidance in Appendix B on estimates of future cash flows at the right level of detail? Do you have any comments on the guidance?

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?

TOWER Australia recommends the modified approach taken for short duration contracts be extended and applied across all risk only service style life insurance, general (property and casualty) insurance and health insurance contracts unless the contract contains embedded options that cannot be reflected in the pricing of future premiums or policy fees.

TOWER Australia submits that there should be a rebuttable presumption that all yearly renewable term insurance contracts (including contracts without contract terms that are contingent upon the payment of future premiums) and single premiums contracts should be accounted for under the modified approach unless it can be demonstrated there are onerous embedded options that impose on the insurer a material obligation to accept future risks or make future payments that cannot be priced into future premiums.

This objective could be achieved by redefining the contracts that may use the modified approach by replacing the concept of short duration with a new concept of risk only service style insurance contracts. This definitional change is aimed at removing the link to duration because this leads to legal interpretation of the contract terms rather than a definition that focuses on the economic substance and risks of the contract.

While introducing the concept of risk only service style insurance contracts is TOWER Australia's preferred option it is recognised that this represents a significant change and that a more pragmatic approach may be to amend the existing definitions of contract boundary and short duration contracts.

These definitional changes aim to allow the continued use of the long duration contract methodology to situations where the contract is long term in nature and where the insurer is accepting risks that it cannot be adequately compensated as evidenced by embedded options or participating profit share arrangements.

TOWER Australia's supporting arguments for expanding the definition of the modified approach are:

- **Significantly improves the relevance of financial information to users of the financial statements**

  Measurement - The Australian experience demonstrates that discounted future premiums and claims are not well understood by capital markets and those who are not life insurance specialists. The investors we spoke to stated that they remain sceptical of these valuation techniques and the resulting profit for risk only service style insurance contracts that do not exhibit the risks that are implied in such long term projections. This valuation approach has not worked for many Australian companies, most of whom now use an accumulation methodology akin the modified approach. This is consistent with the capital markets scepticism and distrust of embedded value models in Europe.

  Disclosure - Presenting the financial performance of risk only service style insurance contracts on a 'premiums less claims less expenses basis' will significantly improve the usefulness of the income statement by improving simplicity, transparency and comparability. This will avoid the proliferation of different investor reporting formats used by insurers offering risk only service style life insurance contracts.

  Internal consistency – Expanding the number of contracts that fall into the modified approach will reduce the number of companies that have contracts falling into two categories, e.g. many general insurers who offer property and casualty but with different durations will benefit by having only one valuation and disclosure approach. This will simplify both measurement and disclosure requirements improving the usefulness of the financial statements.

- **Risk only service style insurance contracts offered to retail customers are designed to share risk and are regularly priced and underwritten on a portfolio rather than individual basis**

  In Australia almost all general, health and risk only life insurance contracts are priced on a portfolio rather than individual basis. Most insurers who deal with the general public will be commercially obligated to renew the contract at the client's request and there are few cases where an insurer individually priced contracts or re-underwrites contracts notwithstanding the legal terms of the insurance contract may allow them to do so. With many thousands of clients, it is impractical to reprice individual contracts and in many instances a commercial or social consideration prevents individual pricing and in many instances the underwriting of individual contracts. Therefore, looking to the legal terms of the contract as the ED/2010/8 proposes is not reflective of economic substance or risk incurred.

- **Eliminating inconsistencies across industries and contracts that share similar if not identical economic features.**

  Notwithstanding many insurance contracts are economically the same, the legal form will mean some are classified, measured and disclosed differently to others. For example, disability insurance sold by a general insurer will typically be classed as short duration whereas a life insurer will be required to classify the contract differently even though the economics of the contract are identical.

- **Eliminating inconsistencies across industries and contracts due to interpretational flexibility**

  There appears to be interpretational flexibility with regards to what contracts may fall within the modified methodology that will create inconsistencies between insurers in the same industry or between industries even though the features of the contracts are the same. One of TOWER Australia's peers in an industry forum has already stated that they would change the legal phrases used in their policy documents (implying no change to the product features) so that it is not captured by the modified method in order to increase the negative policy liability. This interpretational flexibility comes about because the legal structure of the contract can be amended giving rise to a different accounting treatment even though the economic substance of these contracts is the same.

- **Locked in amortisation of the residual margin even though underlying contract premiums regularly change.**

  A significant weakness in the current approach to the measurement of residual margin is that it fails to fully take into account future changes to premiums. The modified approach removes the need to calculate the residual margin and allows profit to emerge in line with actual experience. It is TOWER Australia's contention that this better reflects economic reality.

- **Emphasis on legal form versus economic substance**

  Increasing consumerism in Australian and other markets throughout the world has led to simpler terms and conditions that are more readily understood by policyholders. One of the contractual changes is not to specify a contract term or end date. Rather to make it easier for the policyholder to understand the contract, the contract remains in force as long as the policyholder continues to pay premiums. As such this is no longer a yearly renewable term but rather a monthly premium contract similar to that issued by electricity or other service provider. Similar to an electricity provider, the contract cannot be individually priced and as is the case for insurers the electricity provider finds it difficult to decline the provision of power unless payments are not received. So it is becoming increasingly necessary to consider the economic substance rather than legal form of the contract. Therefore, any definition needs to link back to commercial practice and market evidence rather than legal form.

  Example: Guaranteed insurability

  Embedded options exist in many contracts either due to features like guaranteed insurability or community based pricing. Commercial pressure ensures these options are priced into the contract and are not onerous but their mere existence without reference to economic value causes these contracts to be classed as long duration. The commoditisation of insurance contracts and increased consumerism means that this guaranteed insurability has little or no value to the insured and less cost to the insurer. Life policyholders regularly change insurers for better prices or better service similar to a general insurance or health insurance product. Approximately one in seven policyholders terminates their policy with an insurer each year with more than two thirds of these purchasing a similar contract with another insurer. Interestingly, because customer demand simplicity and ease, the majority of TOWER Australia's policyholders no longer go through traditional underwriting and will generally be automatically accepted on-risk provided they are employed or do not have any existing poor health conditions.

  As the insurer retains pricing power, guaranteed insurability is not onerous. To illustrate this, TOWER Australia had acquired a contract with a number of policyholders as part of a business acquisition and moved to increase premiums significantly in order to be compensated for the risks associated with this product. The regulator had been made fully aware of this and supports the approach taken as they are keen to see a rational and sustainable life insurance market.

The implied presumption within the ED/2010/8 that guaranteed insurability signifies an onerous contract is inconsistent with Australian experience.

- **Governance issues**

  Risk only service style life insurance contracts are managed on a premium less claims less expenses basis. TOWER Australia's remuneration model is designed on this basis. To adopt a projection method that allows for volatility in profit due to professional judgement or 'accounting adjustments' will mean either the reported profit no longer reflects the economic profit for risk only service style life insurance contracts and cannot be included in performance measures or remains in performance measures and is subject to manipulation where assumptions or contractual terms can be changed to give a different outcome. Given the opaqueness of the accounting disclosures it would be difficult for a user of the financial statements to recognise for a number of years i.e. at least 5 years if those assumptions were incorrect. From a capital markets perspective this is a risk that cannot be mitigated and hence they have to reflect this risk of discounts to valuations and higher risk premiums.

Expanding the application of the modified measurement approach for the pre-claims liabilities of some short-duration insurance contracts does present some challenges, such as:

- **Matching principle**

  The modified approach does not attempt to arrive at the true economic profit each year or to spread the profits of the insurance contract over the expected life of the contract in a manner reflecting the service delivery. It is TOWER Australia's opinion that for risk only service style life insurance contracts the modified approach will provide a more accurate measure of policy liabilities and improved disclosures compared to the discounted projected cash flows approach. TOWER Australia believes that arguments put forward that the discounted projection of cash flows somehow provides a better indicator of profit or is at least an attempt to spread the profit over the contract period, are based on the belief that professional judgement can accurately mirror reality with very significant movements in assumptions either respread through the profit margin each year or taken to profit. There is ample evidence in Australia this is not the case for risk only life insurance contracts where premiums change with changes in experience. A more pure result calculated using the modified approach, which is transparent and easily understood by users of the financial statements, results in revenues being recognised as premiums are earned with any fluctuations resulting from the pricing of claims risk. TOWER Australia acknowledges there is an argument that calculating a residual margin to reflect the service element is an attempt to better reflect the services delivery and that the modified approach makes no explicit attempt to spread the profit. However it is TOWER Australia's view that the practical application of the modified approach will ensure profits are recognised is a way which better represent the services provided.

- **Possible accelerated amortisation of incremental acquisition costs**

  The modified approach results in the incremental acquisition costs being amortised over a shorter period. The financial impact is expected to be small because the incremental costs still form part of the pre-claims liability calculation but it is acknowledged that in getting to this outcome the insurer may take the view that the coverage period is shorter than would otherwise be the case.

Implication for other insurance contracts that do not meet the proposed short duration definition

TOWER Australia believes that the discounting of probability weighted claims liabilities including risk margins is appropriate for complex life insurance contracts.

Conclusion

Application of the onerous contract tests will mean that extending the definition of short duration contracts to capture more contracts will ensure policy liabilities are appropriately measured and that there is no risk of misstatement as a result of extending the definition.

It is TOWER Australia's experience that discounted cash flow accounting creates complexity such that the users of the financial statements do not fully understand the subjective nature of the long term projections and come to mistrust the financial statements. TOWER Australia's experience has resulted in TOWER Australia preparing investor information along the lines proposed under the modified measurement approach for the pre-claims liabilities of some short-duration insurance contracts in contrast to the presentation style of Australian accounting standards. TOWER Australia has received very positive market commentary and has received investor communication awards for its presentation approach. Most recently TOWER Australia tested its disclosure approach with four of Australia's largest fund managers before making this submission who unanimously supported TOWER Australia's views.

Recommendation

Reflecting the progress the IASB has made to date and being mindful of the time constraints the IASB is under TOWER Australia recommends in paragraph 54 to change the reference to "coverage period" to "contract boundary" as follows:

> 54 Paragraphs 55–60 apply to insurance contracts that meet both of the following conditions:
>
> (a) The ~~coverage period~~ *contract boundary* of the insurance contract is approximately one year or less.
>
> (b) The contract does not contain embedded options or other derivatives that significantly affect the variability of cash flows, after unbundling any embedded derivatives in accordance with paragraph 12."

Then amend paragraph 27(b): change the words "the particular policyholder" to either "the portfolio of insurance contracts" or "policyholders" or simply remove reference to "the particular policyholder". The revised paragraph 27 (b) would then read as:

> 27 The boundary of an insurance contract distinguishes the future cash flows that relate to the existing insurance contract from those that relate to future insurance contracts. The boundary of an insurance contract is the point at which an insurer either:
>
> (a) is no longer required to provide coverage, or

(b) has the right or the practical ability to reassess the risk of the ~~particular policyholder~~ *the portfolio of insurance contracts* and, as a result, can set a price that fully reflects that risk. In assessing whether it can set a price that fully reflects the risk, an insurer shall ignore restrictions that have no commercial substance (i.e. no discernible effect on the economics of the contract).

Alternatively, if the IASB's process and timetable permit, TOWER's Australia's strong preference is to replace the concept of short duration with a new concept of risk only service style insurance contract. Risk only service style insurance contract would then become a defined term aimed at ensuring consistent treatment across contracts that share the same economic features. This approach would still require the changes outlined above but removes reference to duration which TOWER Australia believes is a major obstacle in achieving the objectives set out in ED/2010/8.

This preferred alternative is principles based and removes the focus on legal form rather than economic substance that comes with a definition that refers to duration. For the reasons stated above, references to duration have unintended consequences and will lead to inappropriate and inconsistent treatment of contracts even though they share the same economic features.

Submission 2.

Premium allocation approach

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?

TOWER Australia submits that the Board should 'require' a modified measurement approach be adopted for the pre-claims liabilities of some short-duration insurance contracts. This is because of the importance of consistency across industries, similar contracts and the requirements to ensure information is relevant to the users of financial statements.

The criteria for requiring the use of the modified measurement approach should be extended to capture all insurance contracts where the premiums change to reflect the change in risk except to the extent there exists a material long term embedded option. This pricing test should be applied at a portfolio level reflecting the basis on which such contracts are priced and managed. It is inappropriate to limit the modified model to contracts where the risks are underwritten each year because it is valid for changes in risk to be managed through changes to prices as well as changing contract terms or denying the risk (i.e. terminate the contract). What is important is that the insurer receives premiums that reflect the fair value of the risk being accepted and this economic substance should be reflected in the ED/2010/8.

Submission 3

Expensing incremental acquisition costs

Question 7 – Acquisition costs (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?

It is TOWER Australia's experience that the deferral of acquisition costs and non disclosure of deferred acquisition costs results in misallocation of resources, lost transparency and leads to a disconnect between regulatory capital and reported financial position of the insurer. This is evidenced by the following:

- Lost transparency because it is not possible to identify the amount of deferred acquisition costs in any of the 32 Australian life insurers today. For many this is their largest asset but it is not shown anywhere in their financial statements as it is netted and disclosed within policy liabilities and defined as a policy liability.

- Modelling shows that Australian insurers issuing risk only service style life insurance contracts will have 90% of the deferred acquisition cost on the balance sheet after 10 years and 10% of the deferred acquisition costs will still be on the balance sheet after 40 year or longer (as contracts are either open ended or provide coverage up to age 80) even though these contracts remain in force on average for less than 7 years. The application of ED/2010/8 will almost certainly lead to a prolonged amortisation schedule which is heavily skewed to the later years and does not reflect the service delivery.

- Deferral of acquisition costs is not well understood by internal line managers and external stakeholders including capital markets. Including deferred acquisition costs in the policy liabilities means that policy liabilities are negative in respect of risk only service style life insurance contracts. This negative policy liability then continues to grow which is counter intuitive and as evidenced by the Australian experience, capital markets have not been able to understand.

- Deferral of acquisition costs can lead to inefficient allocation of resources because it means that managers are prepared to incur more costs as these do not impact profit. This leads to significant governance issues because management can decide to incur more and more costs to growth market share or short term profit and not be accountable for it.

- An analysis of the acquisition/maintenance expense allocation splits for Australian life insurers indicates that the proportion of costs deferred can vary significantly due to interpretational and judgment considerations after adjusting for different business models. This results in significantly different profit signatures for extended periods of time despite the products being the same, and no apparent difference in lapses, claims or unit costs. The Australian experience demonstrates there is no consistency in the treatment of acquisition costs even where the deferral treatment is fairly well defined. Determining the amount of acquisition costs deferred requires significant judgement and is a function of allocation methodology where there is little industry guidance and one of the major drivers of profit in the current period.

- Deferral of acquisition costs erodes the comparability of financial results and ultimates leads to scepticism amongst the users of the financial statements.
- Deferral of acquisition costs misleads investors into thinking the net tangible assets are much stronger than are actually the case. In Australia there are examples of life insurers with deferred acquisition costs that represent more than 50% of their net tangible assets. In a company wind up situation this 'asset' is unrecoverable as all policyholders will have lapsed.
- The key difference between TOWER Australia's regulatory capital and reported financial position (net equity) is deferred acquisition costs. TOWER Australia is of the view that this is not well understood by the financial markets and is a key reason why financial markets do not understand the regulatory capital requirements of Australian life insurers when compared to Australian general insurers. As a result the cost of capital is increased due to the perceived uncertainty of the life insurer's capital requirements.

Comparability with other industries

TOWER Australia acknowledges that incremental acquisition costs for risk only service style insurance contracts in Australia are significant. Most of this cost is due to the cost of advice which is incurred at the time the contract commences.

While incremental acquisition costs are significant many other industries face similarly high acquisition costs yet are required to expense these costs when incurred. The obvious example in Australia is a financial planner selling a superannuation (pension) investment contract and a life insurance contract. Under Australian regulations both require a fact find and statement of advice to be prepared. A manufacturer may supply both the superannuation contract and the life insurance contract. The superannuation acquisition costs would be expensed immediately while the life insurance acquisition costs are deferred. This is despite both contracts going through the same sale process. Underwriting costs today in Australia are minimal as a contract sold through an adviser in 75% of cases are underwritten within 20 minutes through a combination of electronic and tele-underwriting.

TOWER Australia is not aware of any other features that point to a uniqueness in the insurance industry that would require the deferral and amortisation of such costs and TOWER Australia seeks consistency with other industries.

Notwithstanding the need to estimate the contract boundary to project future cash flows, acquisition costs are not a future cash flow and given the judgement involved and impact on profit recognition it is concluded that the proposed ED/2010/8 would result in a wide variation in amortisation approaches across the industry.

Further, TOWER Australia has three ways of distributing its services and products and notes that the amount of acquisition costs that can be deferred will differ significantly across these distribution channels. TOWER Australia is concerned that the different treatment of acquisition costs and resulting impact on profit recognition will give rise to adverse economic outcomes because services and products sold via a third party distribution arrangement with variable costs will appear to be more profitable than those sold via insurer owned (non-variable acquisition cost) distribution model.

The modified approach will result in a materially different profit signature to the discounted cash flow projection approach. Over 10% of deferred acquisition costs of a portfolio sold today would still exist in 40 years on a typical portfolio of risk only service style insurance contracts sold today. The cumulative profit under the modified approach with exactly the same customer behaviours and experience will differ to the base projection approach by the unamortised deferred acquisition costs at any point in time. Same applies to net cash flows and net tangible assets. As these deferred acquisition costs build up year after year, a material cumulative difference emerges in annual and cumulative profits over time.

A moderately profitable yearly renewable life insurance contract in Australia would generate on average the equivalent of one year's premium over the life of the contract. Yet, upfront sales commissions in Australia range between 110-130% depending on the insurer which means that the amount of deferred costs will almost always exceed the amount of expected profit. Therefore if one insurer decides to use the discounted cash flow projection method and the other the modified approach, the discounted cash flow projection insurer would have a higher profit year on year forever assuming the companies are both growing. This is despite the insurer using the modified approach having greater net cash flows, embedded value and higher net tangible assets because of the different tax treatment.

TOWER Australia's recommendation

TOWER Australia strongly urges the removal of the ability to defer acquisition costs and recognise expenses on a basis consistent with other industries.

If deferred incremental acquisition costs are to be retained it is recommended that these not form part of the residual margin and be separately recognised on the balance sheet as an asset and that separate disclosure of the amortisation charge as an expense either on the face of the income statement or notes thereto.

TOWER Australia understands that the IASB and its staff have previously considered such a proposal and request that this be reconsidered given the severe ramifications from including it in policy liabilities. TOWER Australia's experience is that this additional disclosure will significantly improve the usefulness of the financial statements. Separate disclosure will also mean that the period over which it may be amortised be limited to the earliest date at which either party may cancel or elect not to renew the policy or some other mechanism that ensures the amortisation period is over a much shorter time frame.

Submission 4

Transition provisions for discounted probability weighted projected cash flows

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 transition provisions mean that equity will significantly increase on transition and future profits will significantly decline. Further this will result in different accounting for business inforce at transition date compared to that written after transition. TOWER Australia cannot see any accounting or commercial justification for such an approach and strongly recommends that the transition rules be modified to allow an insurer where practicable to retrospectively recalculate balances using existing guidance or alternatively use the fair value to measure the insurance contract or the present value of fulfilment cash flows on a basis consistent with paragraph 42.

Submission 5

Residual margins

Question 6 – Residual/Composite margin (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?

TOWER Australia expects that under the long duration method under ED/2010/8 it will hold a negative policy liability that will increase further due to the proposed treatment of residual margins.

TOWER Australia is concerned that the locking in of residual margins will lead to greater profit volatility and contributes to a greater negative policy liability being recorded on the balance sheet. Modelling shows that a modest 10% adjustment to claims will be sufficient to eliminate or double reported profit in a year. In addition to undermining the validity of the reported profit result and resulting proliferation of alterative financial reporting methodology outside of the financial statements, this will place onerous pressure on the assumption setting process and introduce significant governance issues. TOWER Australia recommends the ED be modified to require that non economic assumption changes that impact future cash flows be offset in the first instance against the residual margin. Where the residual margin is nil the balance of the assumption change is then taken to profit.