30 November 1010

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

Via "Open to comment" page on www.iasb.org and ifric@ifrs.org

Dear Sir David

Comments on ED/2018/8 Insurance Contracts

Thank you for the opportunity to comment on the IASB Exposure Draft ED/2010/8 Insurance Contracts. CPA Australia, The Institute of Chartered Accountants (The Institute) and the National Institute of Accountants (the Joint Accounting Bodies) have considered this exposure draft (ED) and our comments follow.

The Joint Accounting Bodies represent over 190,000 professional accountants in Australia. Our members work in diverse roles across public practice, commerce, industry, government and academia throughout Australia and internationally.

The Joint Accounting Bodies support the proposals in the ED, although changes will be required to the transitional provisions in order to ensure the proposals are acceptable to the insurance industry in Australia. Our support is based on the principles outlined in the ED which apply the three building blocks approach to the measurement of insurance liabilities. Divergent accounting practices across the world are not sustainable and therefore we support the issue of a comprehensive accounting standard based on the proposed model.

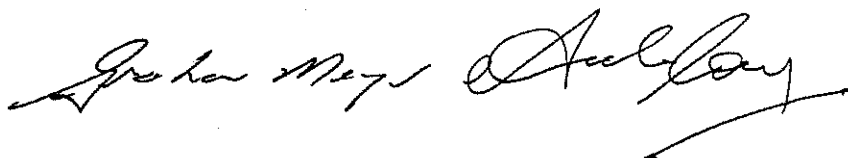
We understand, through our discussion with industry representatives that a number of practical application problems exist with the proposed model. We therefore support the submission made by the Accountants' and Actuaries' Liaison Committee (AALC) in identifying and analysing these application issues. We request that further analysis be done on these areas in order to achieve a practical solution for entities holding insurance contracts. We have attached the AALC submission as an appendix to this letter.

The areas of particular concern to industry participants include:

- Residual margin – a strong preference has been expressed for the residual margin to be remeasured for the impact of changes in assumptions based on up-to-date information. It is considered that allowing for remeasurement would reflect the economic substance of the arrangements and would allow insurers less scope for manipulation of profits.
- Contract boundary principle – whilst the principle is supported by many industry participants we consider that this area needs to further explored amongst insurers that offer health insurance, comprehensive third party insurance, lender mortgage insurance and builders' warranty insurance. Some clarification may be needed to the principle once these different types of insurance contracts are considered.
- Acquisition costs – this area reflects diversity amongst participants. On balance, the Joint Accounting bodies would prefer this area is dealt with consistently with other IFRS as we do not feel this industry is sufficiently different to warrant a different treatment to other products in the financial services sector.
- Transitional provisions – there is strong opposition in Australia to the current proposals. Support has been expressed by the insurance industry for at least permitting retrospective application in addition to the current proposals.
- Presentation and Disclosures – the summarised margin approach to presentation in the statement of comprehensive income is likely to pose difficulties where insurers have both an insurance and non-insurance business. Further, the disclosure of reconciliations on a portfolio-by-portfolio basis is likely to pose a greater cost to organisations than any benefits to users of financial statements.

If you have any questions regarding this submission, please do not hesitate to contact either Mark Shying (CPA Australia) at mark.shying@cpaaustralia.com.au, Kerry Hicks (The Institute) at kerry.hicks@charteredaccountants.com.au or Tom Ravlic (NIA) at tom.ravlic@nia.org.au.

Yours sincerely



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ACCOUNTANTS' AND ACTUARIES' LIAISON COMMITTEE

30 November 2010

The Chairman,
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UNITED KINGDOM

Dear Sir

Response to Request for Comment on IASB Exposure Draft *Insurance Contracts*

The Accountants' and Actuaries' Liaison Committee ("AALC") is pleased to provide its response to the Request for Comment on the IASB Discussion Paper Preliminary Views on Insurance Contracts ('the Discussion Paper"). This response represents the views of the members of the AALC (and not necessarily their employing organisations or professional association).

The AALC is supported by The Institute of Chartered Accountants in Australia and the Institute of Actuaries of Australia. The AALC is primarily concerned with matters affecting both professions, including the development and implementation of accounting standards for the insurance industry. The AALC takes a practical approach to problems, as its members are all practitioners in insurance and related fields.
We have provided responses to the questions where we consider it of practical relevance to the industry.

While we support the majority of the key themes in the Exposure Draft, we have significant concerns regarding the application of some of the proposed concepts.

In particular we believe the proposed transitional arrangements represent a significant backward step relative to the current Australian standards and have the potential to damage the value of financial statements to users.

We also have concerns relating to the locking of the residual margin and resulting potential impact on profit from assumption changes. Further, we consider that the current accounting framework within Australia has some positive aspects that we would not want to see discontinued when the new insurance contract standard is developed as a result of the Exposure Draft

We have provided responses to some of the specific questions as set out below:

Question 1 – Relevant information for users (paragraphs BC13-BC50)

Do you think that the proposed measurement model will produce relevant information for users of an insurer's financial statements to make economic decisions? Why or why not? If not, what changes do you recommend and why?

Response

Overall we are supportive of the proposed measurement model and believe that its key aspects assist in providing relevant information. We also note that the basic model proposed – expected present value plus a suitable margin – has been in operation in Australia since the mid-1990s and has generally been considered to provide relevant and useful information in conjunction with the measurement of assets at fair value.

In particular we believe the following key high-level aspects of the model support this:

- Three building blocks approach – the three building blocks approach including a present value of fulfilment cashflows based on assumptions as to future cashflows and an allowance for the cost of risk.

  We consider it appropriate that the best estimate unbiased cashflows be determined taking into account internal and any other available external information for non-market variables such as claims, expenses and lapses, while ensuring market variables are market-consistent where relevant and observable market based data is available.

  We support the application of the residual margin which results in the expected profit being recognised over the life of the contract. We believe that this promotes profit recognition consistent with the accounting principle of recognising income only after the provision of service.

- Asset valuation – support the proposal to address inconsistencies and profit anomalies for certain assets supporting policy liabilities.

However, we believe the following aspects make the information provided less useful and more complex to understand.

- Transitional arrangements discussed further in response to question 17.

- Impact of changes to assumptions discussed further in response to question 6.

- Application of boundary principle for contracts where an insurer's ability to underwrite contracts is subject to external constraints discussed further in question 9.

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?

(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?

Response

(a) Overall we are supportive of the calculation of the present value of fulfillment cashflows based on an explicit projection of unbiased and probability-weighted estimate of future cashflows.

We are supportive of the principle that the discount rate for determining the present value of the cashflows should be independent of the supporting assets where those cashflows are not related to the performance of those assets.

We support the inclusion of a risk margin which takes into account the uncertainty about the amount and timing of those future cashflows.

For insurance contracts where there are limited generally market observable values, we support the proposed measurement approach which provides a liability estimate for insurance contracts which is broadly consistent with fair value principles. The proposed approach is similar to that currently used and well understood by the preparers and users of financial reports for Australian entities under the requirements of AASB 1023 *General Insurance Contracts*.

(b) While overall we consider the level of guidance in Appendix B reasonable and appropriate, our response to question 5 (e) below sets out concerns we have in relation to the approach to setting the risk adjustment.

We support the IASB's intention to apply a principles based approach rather than a prescriptive or overly detailed approach. We consider the guidance to be sufficiently detailed and that it provides a clear enunciation of the high level objectives of determining cash flows.

With regards to the determination of risk margins, we would note that this is a complex area which is presently evolving due to significant debate by actuarial bodies around the world. We consider that it is beyond the scope of the proposed accounting standard to provide detailed guidance on actuarial calculations. However, further liaison with the various actuarial bodies would be worthwhile to ensure that the high level objectives are clear and can be translated into meaningful calculation methodologies that can be clearly communicated to preparer and users of financial statements.

Question 3 – Discount rate (paragraphs 30-34, 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?

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

(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?

Response

(a) We are supportive of the principle that the discount rate for determining the present value of the cashflows should be independent of the supporting assets where those cashflows are not related to the performance of those assets.

Logically, the fair value (or present value of fulfillment cashflows) of an insurance liability is independent of the characteristics of the supporting assets if its cashflows do not vary with the investment performance of those assets.

Therefore, the discount rate for such liabilities should be independent of the supporting assets the insurer chooses to invest in.

Such an approach is well understood and adopted in Australia for both the requirements of AASB 1023 and AASB 1038 *Life Insurance Contracts.*

(b) We recognise that there is no single correct method for measuring the liquidity premium. We also appreciate that for many insurance contracts judgement is involved in assessing the level of liquidity.

Nonetheless, the existence of a liquidity premium is well established within the finance literature. That is, research confirms that, between two otherwise identical assets investors require compensation (reflected in an increased yield) for the one which involves a greater penalty if it is realised early. Illiquid assets provide a match for an illiquid liability and therefore the value of such a liability is lower than for a liability with similar cashflows that is more liquid.

Recognition of a liquidity premium within the discount rate is material and relevant to the pricing, management and profit emergence from annuity style products. Within Australia these products include traditional lifetime guaranteed annuities and an emerging market of US-style variable annuity products.

The prudential regulator in Australia, APRA, is developing revised regulatory prudential capital standards and has indicated that it will consider a liquidity premium for guaranteed annuities. Reporting difficulties may emerge if such an allowance was made for these products for regulatory prudential calculations but not for financial statements.

We also recognise that measuring the level of liquidity of an obligation involves judgement. We recommend that further guidance be provided on the types of insurance contract and cashflow characteristics which are considered fully or partially illiquid and

where a liquidity adjustment is appropriate and what supporting evidence should be considered. For example:

- Liabilities involving income payment benefits where the insurer is not obliged to offer commuted benefits but in practice does so from time to time.
- Liabilities which involve payments where the timing is uncertain but is typically expected to be in the long-term.

Such obligations are reasonably common in Australia and we understand also arise in other jurisdictions.

(c) We recognise that an unrestricted application of the principle of recognising an entity's own credit risk in a liability valuation results does not provide useful information for users of financial statements – particularly where the creditworthiness of the issuer is falling (which results in the value of the liability also falling and "chasing" the creditworthiness down).

Nonetheless, most regulatory prudential reserving bases recognise that it is uneconomic to require insurers to provide a 100% guarantee of meeting liability obligations. Therefore valuing the obligations on the basis appropriate to a strong well regulated entity is an appropriate benchmark, for example bank bill swap rates. This is likely to provide a better estimate of the fair value of the liability.

It also promotes consistency with the valuation approach for insurance policies (such as guaranteed payment and deposit style products) which are valued under IAS 39 *Financial Instruments: Recognition and Measurement.*

We also note that in Australia a significant proportion of life insurance risk business is underwritten stepped premium where policy liabilities are typically negative. For these liabilities adopting a discount rate that is considered too "low" results in an overstatement in the valuation of this "asset".

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.

Response

We support the use of separate risk adjustment and residual margin. A risk margin is required in order that the present value of fulfillment cashflows represents a reasonable estimate of the fair value of the liability.

Under the approach favoured by the FASB profits are recognised prematurely for short duration contracts (and unprofitable long duration contracts).

In some cases, moreover, because the proposed liability adequacy test does not include a margin, the total provision for a portfolio contracts may be less than its risk-adjusted value. We believe that such a provision would present a misleading view to users.

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?

(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?

(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?

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

(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?

Response

(a) We believe that the proposed basis for the risk adjustment is appropriate, but fail to understand the inclusion of the word "maximum". In our view, the amount that the insurer would rationally pay is, conceptually, a single value, not a range. The idea of a range arises only because there is uncertainty, both as to the degree of risk and the risk appetite of the insurer. Setting the value chosen at the top end of such a range suggests conservatism.

We also have concerns with determining the risk adjustment from the insurer's perspective without attaching conditions to ensure that the risk adjustment does not reduce as the financial strength of the insurer deteriorates.

A condition could be included that the calculation should be based on the presumption that the insurer is a financially strong well regulated entity.

As the amount of capital that an insurer holds takes into account reinsurance, the risk margin should be based on the insurer's net of reinsurance risks.

(b) In relation to the methods that should be available for determining risk margins, we understand that the three proposed methods incorporate the range of widely recognised methods.

In particular we note the success of the use of the probability of adequacy basis currently employed in the determination of risk margins by Australian general insurers. If this option were to be removed the benefits would need to be carefully considered and clearly enunciated.

The analysis of risk margin calculations is a complex area which is developing and currently no particular approach appears to stand out. Nonetheless, in time insurers may tend to favour or converge to one of the three methods. However, in the meantime whether or not this the development occurs, the use of sufficient and appropriate disclosure will be an important aspect of enabling comparability of margins adopted by Insurers.

A majority of members would prefer to see a statement that these three methods are acceptable and that other methods may also be used, if they can be determined to result in a more relevant and reliable measure (rather than a prohibition of other methods).

A minority of members believe that the probability of adequacy measure should be preferred because of its simplicity, clarity and ease of comparability it provides.

They believe that cost of capital and conditional tail estimate methods could deliver different bases of measurement from year to year and create a lack of consistency which will undermine the investors' views of the reliability of the financial statements.

These disadvantages are not fully addressed by requiring in the disclosures, the sufficiency levels.

They also believe these methods may place undue focus on extreme outcomes and considerations more relevant to a solvency type measure.

Guidance should be provided that requires the adoption of a risk adjustment commensurate with reasonably adverse scenarios. It would not be necessary to mandate a specific level for the probability of adequacy; rather preparers should adopt a policy and maintain it over time.

We consider that it is beyond the scope of the proposed accounting standard to provide further detailed guidance on actuarial calculations. Ongoing liaison with the various actuarial bodies would be worthwhile to ensure that the methodologies remain current in the light of emerging developments and research.

(c) For Australian general insurers (where confidence level is used) disclosure of the confidence level is required.

For this method and the other two methods sufficient and appropriate disclosure, including disclosure of confidence levels, will be an important aspect of enabling comparability of margins adopted by Insurers. It also assists users in understanding the impact of uncertainty.

(d) While the risk margin should be included in provisions at a portfolio level, we consider that risk margins should be determined at a level that is no more detailed than is currently adopted for Australian financial statements which recognises the benefit of diversification within the insurance business.

We consider that a valuation basis that does not recognise the benefit of diversification is flawed as it is a fundamental principle of insurance and it is how insurers do business. It would not reflect economic reality to exclude the benefits of diversification and imperfect

correlation between portfolios, and such exclusion is inconsistent with the fulfillment value model, for instance the amount an insurer would rationally pay to relieve itself of the insurance risk depends upon diversification benefits with the insurer's other portfolios.

Each insurer will have a different approach to risk management and its diversification profile will be highly significant for regulators, reinsurers and investors in measuring the insurer's strength and business performance.

(e) See comments for (a) and (b). We are also concerned that the expressed preference in the guidance to methods that "fully reflect the potentially extreme losses in the tail of the distribution" may lead to an unwarranted focus on extremely remote outcomes that:

- Are difficult to determine reliably; and
- Might include events that are so catastrophic/remote that insurance is not the appropriate mechanism for dealing with it and that insurers should not be expected to withstand. Such events have low relevance to financial reporting.

The wording should be amended to provide appropriate emphasis that the analysis should focus on experience which considers reasonable and very adverse events but that does not give undue weight to extremely unlikely events.

Question 6 – Residual / composite margin (paragraphs 17(b), 19-21, 50-53 and BC124-BC133)

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

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

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

(d) Do you agree with the proposed method(s) of releasing the residual margin? Why or why not? If not, what do you suggest and why (see paragraphs 50 and BC125-129)?

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

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

Response

(a) We agree with the proposal.

(b) A similar requirement currently applies to Australian life companies under AASB 1038 whereby profits on profitable portfolios are recognised over the lifetime while the present value of future losses on unprofitable portfolios are recognised immediately. While it can be argued that this asymmetry creates inconsistencies, we believe that this approach is well understood by users, ensures an appropriate minimum liability and is consistent with other aspects of IFRS. A similar outcome arises for general insurance through a combination of the earning or premiums and the liability adequacy test.

Furthermore disclosures related to loss making portfolios provide useful information to users of accounts.

(c) We believe that groupings of contracts across broadly similar dates of inception and coverage periods should be permitted. Adopting too fine a division is likely to result in increased effort to capture data and perform calculations with limited impact on the overall result. Any additional information is also likely to be of limited value.

The economic reality of the business of Insurance is centred around the pooling of risk and as such some members felt that the underlying principles should reflect the determination of the residual margin at a broader portfolio level rather than at an individual contract level.

(d) The basis for releasing residual margin seems reasonable. However, we believe that the residual margin should (subject to not becoming negative) adjust for the impact of changes of assumptions on the present value of fulfillment cashflows. Issues with the proposal include:

- Results in profits from changes in assumptions about future outcomes which are uncertain;
- Seems inconsistent with principles and basis for at inception calculation; and
- May provide opportunities for profit management, although the potential for this to mislead users is mitigated through the disclosure requirements.

(e) We do not support the composite margin approach and have no comment on the basis for releasing it.

(f) Yes, interest should be accreted on the residual margin.

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

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

Response

There was a diversity of views on these proposals amongst committee members, However, the majority of members believe that the economics of the contract and the basis on which they are priced are best reflected by requiring all costs associated with acquisition of a contract (not just those which are incremental at the contract level) be included in the initial measurement of the contract as contract cash outflows.

An alternative, supported by some committee members, is to recognise acquisition expenses which are incremental (or direct) at the portfolio level. This would provide for consistency with the measurement of maintenance expenses which are measured at portfolio level and include direct costs (including direct costs which are not incremental at the portfolio level). IFRS is not consistent in relation to acquisition costs. The proposal would be consistent with some IFRS and not others.

Under the proposal companies will report losses at inception equal to the acquisition expenses other than those incremental at the contract level. These expenses may be material and include underwriting and other initial establishment costs.

Question 8 – Premium allocation approach

(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?

Response

(a) We believe that the simplified approach should be permitted (but not mandatory) for insurers whose business predominantly has coverage periods of about a year or less. In particular there should be sufficient flexibility that a life insurer that sells a few one-year term life policies, or a general insurer that sells a small proportion of policies with longer coverage periods, does not have to operate parallel systems within a single portfolio. One way of achieving this would be to apply the test on a portfolio, rather than an individual contract, basis.

(b) See comment for (a) above.

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?

Response

There was a diversity of views on these proposals amongst committee members. However, the majority of members is overall supportive and notes that such an approach reflects the economic substance of the contracts for Australian life insurers where

significant upfront commissions are paid which are funded out of future premiums. The proposal where the boundary condition is based on the renewal right / inability to reprice individual contracts ensures that the future premiums designed and priced to fund those expenses are taken into account – so that the accounting reflects the economic substance of the contract, notwithstanding the point noted above that the pricing design is to fund other non-incremental acquisition costs.

However, we believe the contract boundary principle set out in paragraph 27 should be amended in relation to contracts where an insurer's ability to underwrite contracts is subject to external constraints.

Anti-discrimination and/or insurance contracts legislation in a number of jurisdictions, for example, makes it illegal to use a variety of potential rating variables, such as age, sex, race, geographical location, etc., in certain contexts. For certain types of insurance contracts, there may be mandatory policy conditions and certain policy exclusions may be illegal. In some cases, particularly where insurance (such as motor vehicle bodily injury insurance) is mandatory, insurers licensed to accept such business must accept all proposals and are subject to price limits. All of these restrict the insurer's ability to set a price that fully reflects the risk for both new and renewal business.

We believe that such restrictions, equally applicable to both new and renewal business, should not be taken into account for the purpose of determining the contract boundary.

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 would 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?

Response

(b) For traditional "bundled" type insurance contracts, such as whole of life and endowment, it is difficult to unbundle the investment and the insurance component. Therefore they should be included in the measurement of insurance contracts.

(a), (c) and (d) No particular comment.

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?

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

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

Response

(a), (b) and (c) Agree.

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?

Response

The ED requires unbundling where there is an investment component reflecting an account balance that meets specified criteria.

This appears similar to the current approach for Australian life insurers which are required to unbundle where the revenues related to the insurance and the investment component can be readily identified. We have found this approach effective and workable.

Question 13 – Presentation

(a) Will the proposed summarized margin presentation be useful to users of financial statements? Why or why not? If not, what do you recommend and why?

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

Response

(a) We believe that the Statement of Comprehensive Income should including premiums and claims disclosures. These disclosures are fundamental to a users understanding of how insurance operates, therefore should not be relegated to note disclosure only (particularly in cases where management use this information as their predominant source of information for internal decision making purposes). Further, we note the proposed summarised margin presentation would be particularly problematic for an entity that has insurance and non-insurance businesses.

(b) Yes.

Question 14 – Disclosures

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

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

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

Response

(a) Yes.

(b) Yes, except for the disclosures relating to reconciliations on a portfolio-by-portfolio basis unless the portfolios were able to be aggregated. Portfolio-by-portfolio disclosures could end up with some insurers needing to disclose hundreds of portfolios which is unlikely to add any substantive value to users of the financial statements.

We recommend that the disclosure proposals, particularly the reconciliation proposals noted above, be field-tested amongst users in the insurance industry.

(c) No comment.

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?

Response

Agree with this proposal and should consider extending it to other policies whose cashflows depend on the performance of the underlying assets.

Question 16 – Reinsurance

(a) Do you support an expected loss model for reinsurance assets? Why or why not? If not, what would you recommend and why?

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

Response

(a) Yes.

(b) No comment.

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?

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

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

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

Response

(a) We believe that the proposal to set the residual margin to zero upon transition is likely to have highly undesirable impacts where the standard approach is adopted.

This is because no residual margin will be recognised in respect of soundly written and profitable inforce business. As a result the reported profits will misrepresent the actual performance of the business.

Under the proposal the profit emergence on the inforce policies consist of:

- Experience profits (expected value of zero); plus
- Release of the risk margin; less
- Expected excess of maintenance costs (full absorption basis) over incremental maintenance portfolio costs.

In many cases these profits are likely to be offset by the losses for new business (equal to the excess of actual costs less incremental costs).

Under the proposal it is likely that profitable and mature businesses will report losses for a significant period following transition.

A further issue with this approach is that the impacts are inconsistent with the outcomes for short-duration contracts where the full premium revenue (and therefore implicitly the residual margin) is recognised over the coverage period (through the release of the pre-claims liability and on renewal). Therefore there are significant comparability issues with the proposal, particularly where products are similar but in some contexts are classified as long while in others are short duration.

Below sets out potential alternatives (from most preferred to least preferred):

- Retrospective application of new standard is the most preferred option for the transitional provisions. We do appreciate that such an approach presents implementation challenges including difficulties in establishing residual margins where

limited information is available on old cohorts of business. It was noted that the cost of applying the proposals retrospectively is unlikely to be significant relative to the total cost of adopting the entire proposals covered under the ED.

However, we consider that the application of paragraph 23 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* should overcome some of the difficulties. Where it is impractical to apply the current standard retrospectively, for example for business at least 5 years old and where detailed information is not available, a solution involving the use of approximations and estimates is likely to provide reliable results that meet the requirements of users of financial statements at reasonable cost;

- Equating to current liability (with residual margin adopted as a balancing item) – this approach was proposed by the IASB staff. While we understand the IASB's concern that this approach is that it results in a continued application of non-IFRS standards, such an outcome is preferable to the large distortions in reported profits produced under the current proposal; or
- Establishing residual margins based on those applicable to current policies.

Despite their shortcomings and implementation challenges we believe each of the above alternatives is preferrable to the current proposal. Indeed, in the absence of suitable changes we consider that retaining the existing accounting framework for insurance (at least for a period to avoid the distortions from the transition) is preferred.

(b) Refer to comments on (a) above.

(c) While this would be desirable, we do not believe that it would be desirable to substantially delay either IFRS 9 or the Insurance Contracts IFRS in order to align their effective dates.

(d) Reasonable time period depends on final Standard. We estimate, given the significance of systems and other changes a two year period would be reasonable. In any case the period should be no less than 18 months.

Question 18 – Other comments

Do you have any other comments on the proposals in the exposure draft?

Response

We do not have any other 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.

Response

No comment.

Our response to the IASB exposure draft focuses on matters affecting both the accounting and actuarial professions. We have not made comment on a number of proposals which are beyond the scope of our Committee.

This response reflects the nature and practical focus of the AALC. In this context we note that the comments and opinions set out in this response reflect the views of the members of the AALC, and may not necessarily reflect the view of The Institute of Chartered Accountants in Australia, the Institute of Actuaries of Australia, nor the members' respective employers.

The current members of the AALC are:
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Graham Duff AMP
Gareth Mitchell Challenger
Stuart Alexander Deloitte Touche Tohmatsu
Andrew Kitchen Insurance Australia Group
Kerry Hicks The Institute of Chartered Accountants
Scott Hadfield PricewaterhouseCoopers
Mark Raumer Ernst & Young
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Actuaries
Geoff Atkins Finity Consulting
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Michael Dermody KPMG Actuaries
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