IAG
Insurance Australia Group

The Chairman
Australian Accounting Standards Board
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Dear Sir

Response to Exposure Draft: Preliminary Views on Insurance Contracts

Insurance Australia Group Limited (IAG) is pleased to respond to the "invitation to comment" on the IFRS Exposure Draft on Insurance Contracts. The Group is supportive of the International Accounting Standards Board's continuing efforts to produce a standard that provides a comprehensive set of recognition and measurement criteria for insurance contracts. We also recognise the support being given by the Australian Accounting Standards Board to this process.

As an international general insurance group operating across various national boundaries we see great value in international alignment of accounting standards. Therefore, we encourage the IASB to continue to actively engage with the Financial Accounting Standards Board.

As a large underwriter of general insurance in Australia we have a presence on many industry bodies and are involved in many industry forums. For this reason IAG has provided input to a number of submissions from Australia responding to the Exposure Draft including submissions by The Insurance Council of Australia and The Accountants and Actuaries Liaison Committee.

We have provided responses from a general insurer's perspective to some of the specific questions set out below. It is important to draw attention to what is to IAG the most critical point, that is the criteria for using the modified approach. As a general insurer we are generally supportive of the modified approach. We have a strong preference to recognise all our business using the modified approach as this recognises the economic substance of the contract. However, the wording of the current draft will probably not permit this to occur. This point is covered in detail in our response to question eight, including some alternative proposals.

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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?

Overall IAG are supportive of the proposed measurement model and believe that its key aspects assist in providing relevant information. However, we believe the following aspects make the information provided less useful and more complex to understand.

- The method for determining when the modified approach should apply discussed further at question 8.
- that an insurer should measure the risk adjustment at a portfolio level of aggregation discussed further at question 5.
- that all non incremental acquisition costs should be recognised as expenses discussed further at question 7.
- the proposed transition requirements discussed further at question 17.

Question 2 **Fulfilment cash flows**

(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?**

Generally, the approach taken to measure the mean should be the decision of the actuary valuing the portfolio and the guidance should be careful not to preclude the use of any appropriate model. In particular, there are a great number of actuarial methods commonly in use in general insurance for the estimation of the central estimate of future claims liabilities which give rise to a central estimate. As such, no explicit assessment is made of the distribution of future cashflows. The guidance should ensure it does not preclude the use of such methods for valuing the central estimate of future cashflows, as the construction of a stochastic model is not always feasible or practical. In particular, where data is limited (for example in a new line of business that has only recently been written by a company), there may be insufficient data to credibly parameterise a stochastic model. A requirement to construct such a model is, therefore, undesirable, as it could lead to the use of such models in entirely inappropriate circumstances.

B50 and B58 (and elsewhere around these paragraphs) – There is a conflict with the role of the actuary, who has to make a judgment on, for example, claims inflation. The method he/she uses to form that judgment may not include a link to market inflation rates, but this section of the ED is specifically indicating that a link should exist.

There are certain forms of claims inflation that are completely removed from published market inflation rates and others that are only loosely correlated with published inflation rates. As such, it is important that the standard does not specify that a link must exist between claims inflation and published market inflation rates.

To illustrate this, consider claims inflation for a portfolio of contracts including injury claimants (e.g. workers compensation). In this case, claims inflation will include a significant element of:

- Medical inflation – cost of operations, hospital stays, and remedial medical care. Medical inflation represents about 5% of total CPI in Australia, and medical insurance premiums are the primary item used to feed into CPI. The costs to an insurer will reflect the true cost of medical care, rather than a medical insurance premium, and these costs do not generally track the overall level of CPI to any significant degree;
- Legal costs – the costs of legal fees associated with the settlement of claims. This will include tort claims as well as legal professional fees. These costs are not included in CPI in Australia, and again do not necessarily follow CPI closely;
- Wage related costs – salary costs involved in settling claims, and some periodic cash flows (e.g. disability payments) which are indexed to State specific Average Weekly Earnings (AWE) in Australia. AWE is loosely linked to CPI is some cases, but there are certainly times when the price inflation expectations and AWE expectations may be moving in different directions.

Given the loose link between claims inflation and CPI it is not appropriate in this example to specifically link claims inflation (or claims inflation volatility) to CPI (or CPI volatility). The actuary should have the right to select an appropriate long term assumption which may be different to the current value of a published market variable.

We note that whilst the example above refers to inflation rates, the ED refers to the use of a wide range of market values within valuations, many of which may be inappropriate to use in a variety of circumstances. For example, B53 (d) refers to the use of the cost of reinsurance and comparable instruments. The use of market prices for these instruments is rarely appropriate to use in the context described in the ED. The cost of these items will not necessarily be reflective of the cost to the insurer on a fulfilment value basis as there are other market forces involved in the creation of market price for these items (e.g. availability of capital, market shocks, soft/hard part of the insurance cycle). Recommending this sort of approach for valuations is not advisable, particularly if there is a lack of consideration for the relevance of the market information, as market underpricing of a certain risk type could then lead to market under-reserving for all risks of that type.

We recommend that the ED should clearly specify that the use of market values is not required; the actuary performing the valuation should have the option of using another appropriately justified value.

B54 – This may present practical difficulties. There need not be any change in experience to justify positioning the best estimate of future cashflows differently within the 'reasonable range' of best estimates. This could occur, for example, if:

- the approach to the valuation changes fundamentally;
- improvements are made to the methodology;
- new data becomes available; or
- a new actuary assumes responsibility for the valuation who has a different opinion of subjective matters.

Question 3 **Discount rate**

(b) **Do you agree with the proposal to consider the effect of liquidity and with the guidance on liquidity? Why or why not?**

IAG agrees that in theory the effect of liquidity should be considered. In practice the estimation of the liquidity premium is problematic because of the difficulty in isolating liquidity from other factors and the wide range of estimates likely. Robust guidance should be provided, something not offered in the current exposure draft. We note that there currently does not appear to be a consensus internationally on the calculation of this sort of liquidity measure, and so without specific further guidance as to its calculation a variety of interpretations will be made.

The exposure draft also concentrates on the policyholder in terms of the pre-claim liability but does not give adequate consideration to the claim liability from the perspective of the insurer. The latter should also be discussed explicitly.

From IAG's perspective, premium refunds are readily available to policyholders upon cancellation and the financial penalty is small. We would therefore conclude that pre-claims liabilities are highly liquid and would approximate the liquidity premium at nil. We expect this would be more significant in a life insurance context where surrender penalties may be significant.

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.

IAG favours the IASB approach of splitting the risk adjustment and the 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. The residual margin is the profit arising upon inception, earned over time. As such the two should not be combined as they may have different characteristics. Furthermore, one of the key purposes of the proposed standard is to improve the clarity of financial reporting; grouping unrelated items will reduce clarity.

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?**

IAG is of the view that the proposed definition is reasonable, and is not inconsistent with IASB's overriding objective of a fulfilment based approach.

We note that 'capital' needs to be more clearly defined in this context.

(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?**

Confidence level or CTE will tell you an amount to hold which will keep you solvent with a given probability (or solvent for an average of the worst percentage of events). This is related to the cost an insurer would be prepared to pay to be relieved of the risk and therefore the three techniques are generally consistent. We are of the view that allowing these three methods for estimating risk adjustments is sensible, however are concerned this could potentially result in divergent bases for determining the risk adjustment, depending on the assumptions adopted.

We do not see why other reasonable methods should be excluded.

(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?**

IAG agrees the insurer should disclose the confidence level to which the risk adjustment corresponds as this will add to the clarity of reporting. However, we believe the approach requires more clarity and should be more prescriptive.

(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?**

IAG strongly disagrees that an insurer should measure the risk adjustment at a portfolio level of aggregation. To simply ignore these diversification benefits between portfolios of contracts will result in financial reports that do not reflect a true and fair view of the insurance operations of the entity. It also should be noted that most forms of portfolio diversification appear to be permitted under the latest Solvency II guidance. Disallowing diversification between portfolios would therefore create inconsistent treatment in the regimes, which is undesirable.

Risk adjustment at a portfolio level of aggregation goes against the overriding principle that "the risk adjustment shall be the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected". A rational insurer would take in to account the risks associated with a particular block of business in the context of its entire operations when considering a sale price. For example, an insurer with a standalone portfolio would attach a lower risk adjustment to that book if they had many portfolios than if they held only that portfolio. The reason is their diverse portfolios would act to moderate the impact of the particular liabilities on its profit in total.

Requiring diversification at a portfolio level creates a significant risk that diversification will occur at different levels, for different entities, based on how the entity, its auditors and the local market define a portfolio of contracts. This would create potential inconsistencies that would not occur at a reporting entity level.

In addition, there is no definition of 'similar' in terms of date of inception and coverage period. This creates ambiguity in the portfolio of contract concept that if implemented would create inconsistent diversification between entities based on their definition of portfolio of contracts. This would create inconsistent reporting between entities that the ED is explicitly trying to eliminate.

In conclusion, IAG recommends that an insurer should measure the risk adjustment at the reporting entity level. The diversification benefit achieved by a company in bringing together particular portfolios is relevant information that will help users of that insurer's financial statements make economic decisions.

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 adjustments is less than the expected present value of the future cash inflows)? Why or why not?**

IAG agrees it is appropriate that profit should be recognised over the term of the contract. The modified approach for short duration contracts will achieve that outcome.

(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?**

IAG agrees with the basis of releasing the residual margin over the coverage period.

Question 7: Acquisition costs (paragraph 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?**

IAG believe that the costs of selling, underwriting and initiating an insurance contract should be included in the initial measurement of the insurance contract as contract cash outflows. The exposure draft as it currently stands creates the following issues:

- Lack of comparability and un-level playing field between intermediated distribution and direct distribution models. It is our view that this is inconsistent to differentiate based on whether the acquisition services are performed in house or outsourced.
- Companies will report losses at inception equal to the acquisition expenses other than those incremental at the contract level. This is due to the residual margin being released over the coverage period. IAG supports a residual margin. However, does not support recognising losses at inception, unless a contract is onerous. These expenses may be material and include underwriting and other initial establishment costs;
- The requirements for the acquisition costs to be incremental for

measurement is not in accordance with the principle for recognition. If an insurer has processes/evidence to be able to demonstrate that the costs are necessarily incurred in securing insurance contracts they should be allowed to recognise that; and

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?

It is IAG's understanding that the modified measurement approach is designed for non-life insurance (general insurance). The Group is supportive of having a modified measurement model for general insurance, similar to what occurs currently within the AASB. As a general insurer, IAG has responded from that perspective. Our response in no way is giving an opinion on other forms of insurance contracts that may also be suitable for measurement under the modified approach.

The Group is empathetic to the IASB's desire to require the modified measurement approach to ensure consistent reporting within similar businesses. However, the desire for consistency needs to be balanced to ensure that individual groups' financial statements are "user friendly" and add value to all stakeholders. It is the view of the Group that statements will lose considerable value if the financial report, or insurance segment thereof, is primarily stated on one basis of measurement, with a small portion accounted for in the other basis.

To ensure this does not occur, it is recommended that the following courses of action be considered:

- Appropriate definition of the criteria for using the modified approach to ensure it captures general insurance as is believed to be the intention of the standard (see 8b below).
- If the time based definition to define the modified approach cannot be determined the board should permit, but not require the modified approach. This will provide some allowance or tolerance where a small proportion fits into the different approach that it can be reported consistently reflecting the economic substance of the business.

(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?

Given IAG's understanding that the modified measurement approach is designed for non-life insurance (general insurance), it does not support a time based measurement approach i.e. 12 month coverage test. A time based measurement approach is not appropriate for general insurance as it will exclude many types of business from this approach. Some examples of business that would be excluded are:

- Construction contract insurance,
- Warranty insurance,
- Consumer credit insurance,
- Certain Professional Risks contracts, for example, cover to retiring professionals.

In many instances these contracts can be from a few weeks in duration to several years, yet have the same contract wording. Despite having the same economic substance certain contracts will be required to be reported in two different approaches solely due to the contract duration.

In addition, there is a lack of clarity around whether several other forms of insurance would fit the short duration definition, these include:

- Risk attaching reinsurance that is written over a 12 month period, but is recognised over 24 months.
- Reinsurance contracts that are accounted on a 'clean cut' basis, where the liabilities are settled between the parties at the end of each year, then the remaining liabilities are covered in a new contract in the new year (with a corresponding premium). This new contract accepts risks for another year, before the 'clean cutting' is performed again, and the contract renewed.

If the current time based definition is to remain, this would force the Group to report a portion of its result in the standard approach, while the majority was in the modified approach. In our opinion, this would considerably reduce the value of IAG's external statutory reporting to users of the reports as it would not reflect the economic substance of our business.

As the above list are standard types of contracts the same issue would occur for most diversified general insurers. This would detract considerably from the readability of accounts for all insurers who unfortunately fell into this category, due to the varying lengths of contracts.

In addition, at IAG a large portion of the contract with terms longer than 12 months are held by one subsidiary. This may create the situation that this entity will account for its business on the standard approach at the entity, but on the modified approach upon consolidation. It is currently unclear how this would be treated in our systems.

Proposed solution

To avoid this scenario arising it is our strong view that a definition of life and non life insurance be included in the new standard. This would be similar to the approach used by the AASB, that has three methods; for life insurance, general insurance and other forms of insurance, that is predominantly health. The AASB defines life insurance by reference to the Australian Life Insurance Act. This method works at a national level, however, will encounter issues if trying to reach global consistency. Therefore, an alternative needs to be considered. An example of an alternative is provided by the OECD. The OECD defines life insurance as any form of insurance whose payment is contingent upon whether the insured is dead (or alive). The OECD adds in a broader sense, it extends to any form of insurance whose payment is contingent on the insured's health.

The AASB defines general insurance contracts as insurance contracts that are not life insurance contracts. Assuming that life insurance is appropriately defined as above or similar the definition of non-life insurance is acceptable.

Conclusion

In summary it is the Group's firm view that the use of a time based measurement is inappropriate to delineate between the two measurement models. Instead a clear definition, of life and non-life insurance is required.

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?**

IAG do not agree with the proposed transition requirements. It is our view that the residual margin should not be derecognised on transition. This will create a different basis of reporting of contracts currently in force and new insurance contracts, despite both having the same substance ie only vary by inception date.

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

Some of the proposals are very onerous on General Insurers – such as the requirement to compile a distribution of all possible cash flows rather than a single 'best estimate' of the cash flows. In some cases this may not be practical, as discussed in question 2.

Without a finalised standard it is impossible to reasonably estimate the time required to implement the standard. However, it may take insurers in excess of two years to implement the requirements of the ED in its current form.