27 September 2013

The Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West Victoria 8007
Australia

Dear Sir

Response to AASB Exposure Draft ED 244 *Insurance Contracts* ("the ED")

AMP is pleased to provide its response to the ED. AMP is supportive of the AASB's efforts to develop an accounting standard that will promote a consistent approach to accounting for insurance contracts and is capable of being adopted across all jurisdictions that have adopted IFRS.

Executive summary

In general we are supportive of the improvements made from the 2010 exposure draft, especially the changes to the transition rules and the unlocking of the contractual service margin.

However, we believe that the model currently proposed in the ED has issues that need to be addressed. These issues are presented below and are discussed in more detail in the body of our letter.

Overall, the ED proposals will give rise to a significant increase in the complexity of accounting for long term life insurance products relative to current practice in Australia and other jurisdictions. We believe that the complexity resulting from the proposals will decrease the understandability of financial statements and result in insurers increasing the use of non-IFRS reporting in order to interpret the IFRS result for users of the financial statements.

"Mirroring" of linked assets

The "mirroring" proposal related to contracts that require the entity to hold underlying items and specify a link to returns on those items is overly complex to apply in practice and we do not expect that it will provide a meaningful result to users of the financial statements.

Conceptually, we agree with the aim of eliminating accounting mismatches but we do not believe that the proposal in the ED succeeds in effectively eliminating accounting mismatches due to its complexity and also because it will not apply to contracts that are linked to underlying assets if the contracts are not classified as insurance contracts.

We recommend that the IASB require (or at least allow) a policy liability measurement that reflects a fair value through profit or loss measurement for both the asset and linked component of the liability in order to achieve a current valuation of insurance contracts. We further recommend that, for participating products, an adjustment to the contractual service margin be allowed for differences between actual and expected investment returns on underlying assets.

Use of Other Comprehensive Income (OCI)

The proposal to recognise interest expense in profit or loss based on discount rates that applied at the inception of the policy and the impact of current market discount rates through other comprehensive income (OCI) introduces significant and unnecessary complexity into the calculation of insurance liabilities and we do not expect that it will achieve its objective of eliminating the impact of current market rates from profit or loss.

We recommend that all changes in policy liabilities be recognised in profit or loss. If the IASB allows the use of OCI, it should be as an irrevocable election made on adoption of the standard, with profit or loss treatment being the default approach.

If the IASB decides to retain the use of OCI, we recommend as a simplification to the current proposal that the interest rate to be recognised in profit or loss should be determined using discount rates at the start of the reporting period rather than the inception of the contract.

Responses to the questions specified in the ED

IASB Question 1 – Adjusting the contractual service margin

Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial position and performance if differences between the current and previous estimates of the present value of future cash flows if:

(a) differences between the current and previous estimates of the present value of future cash flows related to future coverage and other future services are added to, or deducted from, the contractual service margin, subject to the condition that the contractual service margin should not be negative; and

(b) differences between the current and previous estimates of the present value of future cash flows that do not relate to future coverage and other future services are recognised immediately in profit or loss?

Why or why not? If not, what would you recommend and why?

AMP broadly supports this proposal, which is a significant improvement from the approach proposed in the 2010 exposure draft.

We believe that excluding the impact of changes in expected cash flows relating to future coverage from current year profit or loss provides more useful and relevant information as current year performance is not obscured by the impact of changes in expected future profitability. The proposal is also conceptually consistent with the approach in the IASB's exposure draft for revenue from contracts with customers.

AMP recommends, however, that the proposal be modified as follows:

- Require that the contractual service margin be adjusted for changes in the risk margin that relate to future coverage, rather than requiring these changes to be recognised in current period profit or loss. In our view, changes in the risk margin relating to future coverage are similar to changes in the contractual service margin relating to future coverage in that they represent changes in expected future profitability and should result in a change in the profit margin to be released in future periods rather than being taken to current period profit or loss.

- When a portfolio has exhausted its contractual service margin, require that subsequent improvements in expected cash flows related to future coverage be recognised in current period profit or loss to the extent of previously recognised losses in order to achieve accounting symmetry. As the proposal stands now, the insurer is required to recognise unfavourable changes to assumptions for such products in the current period profit or loss but not favourable changes.

Question 2 – Contracts that require the entity to hold underlying items and specify a link to returns on those underlying items
If a contract requires an entity to hold underlying items and specifies a link between the payments to the policyholder and the returns on those underlying items, do you agree that financial statements would provide relevant information that faithfully represents the entity's financial position and performance if the entity: *(a) measures the fulfilment cash flows that are expected to vary directly with returns on underlying items by reference to the carrying amount of the underlying items?* *(b) measures the fulfilment cash flows that are not expected to vary directly with returns on underlying items, for example, fixed payments specified by the contract, options embedded in the insurance contract that are not separated and guarantees of minimum payments that are embedded in the contract and that are not separated, in accordance with the other requirements of the [draft] Standard (ie using the expected value of the full range of possible outcomes to measure insurance contracts and taking into account risk and the time value of money)?* *(c) recognises changes in the fulfilment cash flows as follows:* *(i) changes in the fulfilment cash flows that are expected to vary directly with returns on the underlying items would be recognised in profit or loss or other comprehensive income on the same basis as the recognition of changes in the value of those underlying items;* *(ii) changes in the fulfilment cash flows that are expected to vary indirectly with the returns on the underlying items would be recognised in profit or loss; and* *(iii) changes in the fulfilment cash flows that are not expected to vary with the returns on the underlying items, including those that are expected to vary with other factors (for example, with mortality rates) and those that are fixed (for example, fixed death benefits), would be recognised in profit or loss and in other comprehensive income in accordance with the general requirements of the [draft] Standard?* *Why or why not? If not, what would you recommend and why?*

AMP does not support this proposal.

While AMP agrees that the accounting basis should be consistent for both the contract and linked underlying items, the proposed solution is unnecessarily complex to apply in practice and is not expected to achieve a sensible outcome in respect of participating products or situations where the underlying item is an equity or debt instrument issued by an entity within the same consolidated group.

Part of this complexity arises from the diversity of accounting treatments required for supporting assets, particularly due to the proposal to introduce a “fair value through other comprehensive income” category into IFRS 9, which for some portfolios results in some of the underlying assets being accounted for at fair value through profit or loss and other assets at fair value through OCI.

Under the ED’s proposal, a single portfolio of insurance contracts could have various different accounting treatments used to measure its insurance contract liability balance as follows:

- Linked component backed by derivatives, complex debt instruments or investment properties measured at fair value through profit or loss;
- Linked component backed by simple debt instruments measured at fair value through other comprehensive income using the effective interest rate on the backing assets;
- Linked component backed by assets held at cost (such as controlled private equity investments) measured at the accounting bases applying to individual assets;
- Other components, such as surrender options, measured at expected values with changes offset against the contractual service margin;
- Unwind of discount on components not linked to underlying assets at the discount rate on inception of the contracts.

Accounting mismatches for life insurers also arise on investment contracts that are outside the scope of insurance contracts as defined in the ED and are therefore treated as financial instruments. As the “mirroring” concept is not included in IFRS 9, the proposal to implement it for insurance contracts will result in an inconsistent approach between these two standards and accounting mismatches that arise on investment contracts will continue to exist.

Further complications with mirroring arise on consolidation. In the AMP Limited group, there are contracts written by the life insurers that require the insurer to hold underlying assets and pass the returns from these assets on to the policyholder. The underlying assets include investments in investment funds operated by AMP’s asset management business that are consolidated by AMP Limited in accordance with IFRS 10 and deposits with AMP Bank. For these assets, AMP Life Limited (the insurer) will be eligible to use mirroring in its stand-alone accounts, but the consolidated AMP Limited group will not be eligible to use the same accounting treatment.

Recommendation

AMP recommends that, as a principal, accounting mismatches are best addressed by achieving consistency between the measurement approaches of standards rather than by exceptions within the standards. For the purposes of this standard, minimisation of accounting mismatches is more effectively achieved by requiring (or at least allowing) measurement of the linked component of the liability at fair value through profit or loss. Where the underlying item is a financial asset, AASB 9 would then require the asset to also be measured at fair value through profit or loss as this reduces an accounting mismatch.

If the IASB decides to retain the use of "mirroring", AMP recommends that:

- an exception be introduced such that if mirroring is achieved for the insurer on a stand-alone basis, this treatment continue on consolidation, even where the underlying asset is consolidated; and
- "mirroring" should also be introduced for financial liabilities within the scope of IFRS 9 that have a similar link to underlying items.

With respect to participating products, AMP supports the proposal put forward by the IASB staff to the December 2012 meeting of the IASB that the contractual service margin for participating contracts is adjusted for changes in the value of the premiums by adjusting the margin for changes in the value of the underlying items as measured using IFRS.

Question 3 – Presentation of insurance contract revenue and expenses

Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial performance if, for all insurance contracts, an entity presents, in profit or loss, insurance contract revenue and expenses, rather than information about the changes in the components of the insurance contracts?

Why or why not? If not, what would you recommend and why?

AMP supports the proposal. In our view the presentation of an entity's insurance contract revenue and expenses in profit or loss provides relevant information that faithfully represents the entity's financial performance and the economic reality of the underlying products.

Question 4 – Interest expense in profit or loss

Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial performance if an entity is required to segregate the effects of the underwriting performance from the effects of the changes in the discount rates by:

(a) recognising, in profit or loss, the interest expense determined using the discount rates that applied at the date that the contract was initially recognised. For cash flows that are expected to vary directly with returns on underlying items, the entity shall update those discount rates when the entity expects any changes in those returns to affect the amount of those cash flows; and

(b) recognising, in other comprehensive income, the difference between:

(i) the carrying amount of the insurance contract measured using the discount rates that applied at the reporting date; and

(ii) the carrying amount of the insurance contract measured using the discount rates that applied at the date that the contract was initially recognised. For cash flows that are expected to vary directly with returns on underlying items, the entity shall update those discount rates when the entity expects any changes in those returns to affect the amount of those cash flows?

Why or why not? If not, what would you recommend and why?

AMP does not support this proposal as is introduces significant and unnecessary complexity into the calculation of insurance liabilities and we do not expect that it will achieve its objective of eliminating the impact of current market rates from profit or loss.

We understand that the aim of the IASB's proposal to present changes in the carrying amount of insurance contracts through other comprehensive income (OCI) is to disaggregate and separately present components of the entity's performance that have arisen as a result of changes to market variables during the period.

Whilst the removal of the impact of current discount rate movements from reported profit is conceptually appealing, it is unlikely to be fully achieved by these proposals as:

- some assets commonly used to back insurance contracts (such as investment properties, complex debt securities and interest rate derivatives) are not eligible to be measured at fair value through OCI under the proposed amendments to AASB 9;
- the durations of assets and liabilities may not always match;
- reported profit will be impacted by the entity's decisions to dispose of assets prior to their maturity; and
- liabilities will be measured using a yield curve whereas the backing assets will be measured using an effective (straight-line) discount rate.

In addition, the proposed approach is expected to add significant complexity for preparers of the financial statements. We believe that the cost of this complexity exceeds any benefits. In particular we highlight the following key concerns:

- The IASB proposes to require the use of 'locked-in' interest rates to accrete interest on insurance liabilities for presentation in the profit or loss statement, whereas the yield curve is locked in at initial recognition. This will likely require entities to record successive yield curves and associate them with the related insurance contracts, which will require significant modification to existing systems and processes in order to identify and maintain the required records. We believe that the information on discount rates that existed at the date of writing a contract is irrelevant to the users of the financial statements. In our view, interest should be accreted on insurance liabilities at current interest rates, consistent with the IASB's current value model.

- On transition, the requirement to ascertain and apply discount rates applicable at initial recognition for each insurance contract is likely to be impracticable, particularly for older contracts. For conglomerate groups that have acquired insurers, the date of initial recognition will be the date of policy inception for the insurance entity and date of acquisition for the financial statements of the consolidated group, which will result in different performance outcomes (between entity and consolidated group) over the remaining life of the policies.

In our view, the discount rate at inception is not a relevant consideration for users of the financial statements and therefore there is no benefit to support the cost of tracking and reporting information based on these discount rates.

We further note that the IASB has not yet developed a conceptual framework for the use of OCI. In our view it would be imprudent for the IASB to mandate the use of OCI for new purposes until such time as this framework is developed.

Recommendation

AMP proposes that all changes in insurance liabilities be taken through profit or loss. In our view this is more consistent with the current measurement approach adopted by the IASB and eliminates the unnecessary complexity which arises from the proposal set out in the ED.

Notwithstanding the issues discussed above, we are aware that there is strong support from some European insurers for the use of OCI (although this support is far from universal). We encourage the IASB to be global in its thinking and work towards a model that will provide a sensible accounting outcome across different jurisdictions and business models.

If the IASB decides to retain the use of OCI in the final standard, then we propose that:

- changes to the carrying amount of insurance liabilities be recognised through profit or loss as the primary approach, with an option to recognise these changes through OCI where:
  - all assets supporting the liabilities are recognised at fair value through OCI;
  - the insurer has a business model where assets supporting the liabilities are not normally purchased or sold after initial recognition of the liability; and
  - there is no link between the liabilities and underlying rates of inflation;
- amounts recognised in OCI be based on the difference between current interest rates at the start of the reporting period rather than the interest rate at inception of the contract.

Question 5 – Effective date and transition
Do you agree that the proposed approach to transition appropriately balances comparability with verifiability? *Why or why not? If not, what do you suggest and why?*

AMP is supportive of the fully retrospective approach, which is expected to allow meaningful consistent information to be reported post transition and addresses the concerns raised with respect to the proposal in the previous exposure draft to set the residual margins to zero at transition.

AMP also supports the explicit allowance for the use of a practical expedient where the full retrospective application is impracticable.

The three year transition period from the standard's publication appears to be a reasonable length of time to prepare for the adoption of the standard. We recommend that the IASB align the dates of application of IFRS 9 and IFRS 4. If alignment is not possible, we recommend that the IASB allow insurers to delay the application of IFRS 9 until the insurance contracts standard can be applied simultaneously.

Question 6 – The likely effects of a Standard for insurance contracts
Considering the proposed Standard as a whole, do you think that the costs of complying with the proposed requirements are justified by the benefits that the information will provide? How are those costs and benefits affected by the proposals in Questions 1–5? How do the costs and benefits compare with any alternative approach that you propose and with the proposals in the 2010 Exposure Draft? *Please describe the likely effect of the proposed Standard as a whole on:* *(a) the transparency in the financial statements of the effects of insurance contracts and the comparability between financial statements of different entities that issue insurance contracts; and* *(b) the compliance costs for preparers and the costs for users of financial statements to understand the information produced, both on initial application and on an ongoing basis.*

AMP is concerned about both the cost and unnecessary complexity that arise from the proposals for "mirroring" and the use of OCI. Our concerns in respect of these proposals are detailed in our responses to Questions 2 and 4 respectively.

In our view the costs of implementing these proposals is not supported by the benefits achieved.

Question 7 – Clarity of drafting
Do you agree that the proposals are drafted clearly and reflect the decisions made by the IASB? *If not, please describe any proposal that is not clear. How would you clarify it?*

AMP believes that the following areas could be drafted more clearly as suggested below:

- paragraph B32 states that an investment and insurance contract are highly interrelated if the lapsing or maturity of one product causes the lapsing or maturity of the other. In our view, this will not always be the case, as this relationship may exist for operational purposes rather than represent an economic interdependence. We recommend that this paragraph is modified so that the simultaneous lapsing is an indicator or gives rise to a rebuttable presumption.
- paragraph B66(i) – the use of the phrase "fiduciary capacity" could be open to interpretation and result in tax payments levied on the insurer to not be included in fulfilment cash flows.

  We recommend that this paragraph is modified to "payments by the insurer to meet tax obligations arising from insurance contracts in a fiduciary capacity or as a proxy for taxing policyholders".
- paragraph 68 – if there are foreign insurance operations with a different functional currency than the parent's presentation currency, exchange differences are to be recognised in other comprehensive income. The additional wording in paragraph 68 does not appear to allow for this scenario.

  We recommend that this paragraph is modified to read "Paragraph 20 requires an entity to treat an insurance contract as a monetary item under IAS 21 for the purpose of recognising foreign exchange gains and losses."

AASB Specific Matters for Comment

Question 1 – Regulatory or Australian specific considerations
Whether there are any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the proposals, particularly any issues relating to: *(a) not-for-profit entities; and* *(b) public sector entities, including any GAAP/GFS implication*

AMP has not identified any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the proposals.

Question 2 – Usefulness of financial statements
Whether, overall, the proposals would result in financial statements that would be useful to users

As noted above, AMP has concerns that some aspects of the ED will decrease the understandability of the financial statements, specifically:

- the mandatory use of other comprehensive income to recognise some, but not all, of the impacts of interest rates on insurance contracts and their supporting assets is likely to result in new accounting mismatches in reported profit; and
- the application of "mirroring", particularly with respect to participating life insurance and investment contracts appears to be unnecessarily complex and may not result in the reporting of useful information.

Further discussion on these matters, together with other detailed comments are provided in our responses to IASB questions 2 and 4 set out above.

Question 3 – Australian economy considerations
Whether the proposals are in the best interests of the Australian economy

AMP has concerns with respect to some aspects of the ED, as noted in our responses to the earlier questions. In the event that these are not resolved, however, it is still likely to be in the interest of the Australian economy to adopt the final IASB standard.

Question 4 – Costs and benefits of proposals relative to the current requirements
Unless already provided in response to specific matters for comment 1 – 3 above, the costs and benefits of the proposals relative to the current requirements, whether quantitative (financial or non-financial) or qualitative.

In the view of AMP, although there are significant improvements that may be made to the proposals set out in the ED, it is imperative that this project be brought to a close, a final standard issued and insurers move from local standards to an a consistent international approach.

Thank you for the opportunity to comment on these proposals. If you would like to discuss these matters further, please contact me on (02) 9257 6784.

Yours faithfully

Graham Duff
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