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

27 September 2013

Dear Sir

Response to the International Accounting Board (IASB) Exposure Draft ED/2013/7 *Insurance Contracts* (the ED)

Insurance Australia Group Limited (IAG) is pleased to provide its response to the Request for Comment on the IASB Insurance Contracts Exposure Draft. IAG is supportive of the IASB's continued 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 a large underwriter of general insurance, IAG operates in numerous jurisdictions, including Australia, New Zealand, Thailand and Malaysia. We have more than 16 million policies in force and have about 13,000 employees. IAG is listed on the Australian stock exchange.

IAG has responded to each of the question in detail, except for question 2. In addition the Group wanted to highlight some key areas.

We observe positively that the ED maintains the fulfilment value measurement model together with a simplified Premium Allocation Approach (PAA) for certain contracts. We also observe that in response to the comments arising from the 2010 ED, a number of significant improvements have been made. We appreciate the IASB's efforts in considering our feedback and welcome these changes, in particular:

1. **Eligibility for using the Premium Allocation Approach (PAA)**

   IAG strongly agrees with the proposal that expands the criteria for using the simplified PAA to measure the liability. The addition of paragraph 35(a) should enable the majority of general insurance contracts to be recognised under PAA when using the PAA would produce a measurement that is a 'reasonable approximation' to those that would be produced when applying the Building Block Approach. It would ensure consistent reporting within similar businesses and improve usefulness and comparability of financial reporting.

2. **Risk adjustment**

IAG strongly agrees with the proposal for measuring the risk adjustment at the level of aggregation that reflects the degree of diversification benefit, rather than the portfolio level. This will allow insurance entities to recognise diversification across portfolios. The current proposal more faithfully represents insurance business, the overall risk management and pricing practices. We do have some additional comments regarding the risk adjustment. Please refer to our response to question 7.

IAG also welcomes the proposal in the ED to remove the previously prescribed three techniques to determine the risk adjustment, being the confidence level, conditional tail expectation and cost of capital techniques.

3. **Unlocking the contractual service margin**

IAG agrees with the proposal that the contractual service margin would be unlocked and adjusted for changes in estimates of the cash flow related to future coverage. Please refer to our response to question 1.

It is important to express IAG's concerns about the proposal that the impact of discount rate changes on insurance liabilities between inception and the reporting date is to be presented in other comprehensive income (OCI). We observe that:

- The proposal creates accounting mismatches;
- The proposal creates a disconnect with the underlying economic substance;
- The use of OCI in this manner does not appear to provide useful information and adds significant complexity; and
- Current disclosure practices provide adequate information on the effect of changes in discount rates to users of the accounts.

Whilst we are supportive of the IASB's aim to bring this project to a close, we encourage the IASB to reconsider alternative options. It is our view that a more suitable option would be to permit, but not require, changes that arise from movements in discount rates to be recognised in other comprehensive income. This point is covered in detail in our response to question 4.

If you require any additional information, please contact myself or Andrew Kitchen, Group Financial Controller on +61 2 9292 3012.

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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?

IAG supports the proposal to unlock and remeasure the contractual service margin (CSM) at each reporting date to reflect differences between the current and previous estimates of the cash flows related to future coverage and other future service.

We believe the proposal for adjustment of the CSM is consistent with its determination at initial recognition and is also reasonably consistent with the IASB's revenue recognition proposal. It would provide a faithful representation of the remaining unearned profit in the contract after inception. It would also avoid some counter-intuitive effects that may arise from 'locking' the CSM.

It is also noted that the current ED does not include changes in risk adjustment relating to future coverage as part of re-measurement of the CSM. We believe this is inconsistent with the definition and overall purpose of the CSM. The CSM is defined via paragraph 28 as being inclusive of the risk adjustment (RA) at initial recognition (as a RA is included as part of the fulfilment cash flows). Holistically, the CSM exists in order that no profit is taken to the bottom line on commencement of a contract, and to ensure that this expected profit is appropriately spread over the life of the contract. As such, it appears inconsistent to allow re-measurement of the CSM due to changes in one component of the fulfilment cash flows (the present value of future cash flows) and not another (the RA). This may create accounting volatility that is not a fair representation of the economic substance of a contract at the point of re-measurement. This will hinder users of the accounts in assessing the performance of an insurer.

We recommend the IASB to broaden the ability of re-measurement to include the risk adjustment.

Question 2: Contracts that require the entity to hold underlying items and specify a link to returns on those underlying items

No comments

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?

IAG is supportive of the proposed presentation of gross performance, which is referred to as 'insurance contract revenue'. This approach has been widely used in the general insurance industry and a consistent measure of gross performance would also increase comparability between entities that issue insurance contracts, which would enhance the usefulness of the financial statements.

However, we do not agree with the proposal to present the effect of changes in the discount rates in other comprehensive income (OCI). A detailed explanation of our position and proposed alternative presentation is covered in our response to question 4.

We also think the proposed presentation and disclosure for the PAA can be further improved in the following areas:

- Under the proposal, insurance contract revenue would be an allocation of revenue across periods, rather than a metric that provides information on business written and bound in the current period. We note the omission of Gross Written Premium (GWP) information from the profit and loss statement and related disclosures. GWP is a key metric in the general insurance industry providing users of the accounts with a view of the contractual obligations entered into using current pricing approaches. GWP is also a point of reference for investors and other stakeholders looking to future performance. We recommend that GWP be required to be disclosed in the financial statements.

- The intention of paragraph 38 may present a backward step from the general accepted accrual accounting concept.

  Under the premium allocation model, the measurement of the liability is made with reference to the premium received but excluding premium written but not yet received. This approach results in insurance liabilities for future coverage to be driven by the pattern of premium receipt and acquisition cost paid. This is a cash accounting rather than accrual accounting and will result in different accounting outcomes for policies which are economically identical but with different payment terms.

  The current, and generally accepted, approach is to determine an unearned premium based on the total gross written premium, including business for which the entity has accepted risk but where final terms and conditions are being negotiated or business is simply not yet processed and the business has therefore not yet closed i.e. unclosed business. The unclosed business is currently recorded in 'premium receivable' to recognise the counterparty risks to which an insurer is exposed. This amount is also recognised in 'unearned premium'.

Although estimation of unclosed business is highly judgemental, we believe there is significant value to users of financial statements to identify a liability for future coverage which includes all expected premium within the contract boundary rather than a volatile balance sheet amount that fluctuates based on a pattern of premium receipts.

We propose that paragraph 38 be reworded to refer to expected premiums rather than premium receipts and disclose the unearned premium and premium receivable separately.

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?

IAG does not agree with the proposal in the ED for recognising certain gains and losses on insurance contracts in other comprehensive income (OCI) and recognising in profit or loss an interest expense to reflect the time value at inception of the contract. In our view it would be most appropriate to recognise the changes that arise from movements in discount rates in profit or loss for the following reasons:

1. The proposed disaggregation creates accounting mismatches

The proposal does not appear to be adequately justified, in particular, when considered alongside the accounting for assets backing liabilities under the proposed changes to

IFRS 9 *Financial Instruments.*

An accounting mismatch would arise if the assets are not categorised as FVOCI, i.e. if the assets do not satisfy the 'business model' test and 'solely payments of principal and interest' test.

An accounting mismatch would arise even when an insurance liability is perfectly matched by related asset and the asset is sold and replaced with an equivalent asset to maintain duration match for assets and liabilities. Evidently, there is no change in the entity's economic position arising from this transaction. However, accounting mismatches would arise when the accumulative gain or loss on the asset is presented in profit or loss at that time in accordance with IFRS 9, whereas there is no equivalent reclassification in respect of the insurance liability.

An accounting mismatch would also arise where cash outflows under an insurance contract are affected by inflation because changes in inflationary expectations in society are generally correlated with changes in nominal discount rates. It would be misleading to users of the accounts to report the changes in insurance liabilities due to inflation in profit or loss with the offsetting effect to be recognised in OCI.

An accounting mismatch could also arise in a more subtle way. Under the proposal, the amount included in OCI would only reflect changes in the discount rates. Any changes in liability cash flows influenced by changes in assumptions about market interest rates are excluded from OCI when the fair value change in asset would include such components.

2. The proposal creates a disconnection with the underlying economic substance.

   Under the proposal, the amount reported in OCI includes two components. One is the effect on the insurance contract liability of changes in discount rates in the period. The other is the difference between interest accretion at inception using a locked-in rate and interest accretion in the period using a current rate.

   When the discount rate changes in a particular period, any gain or loss arising from this change is meaningful. However, if in the following period the insurance liability discount rate remains the same, there would still be a gain or loss reported in OCI because of the continued use of a locked-in rate at inception, even though no real economic changes occurred.

   Hence it is our view to present the effect of changes in discount rates in OCI creates a disconnection with the underlying economic substance.

3. The use of OCI in this manner does not appear to provide any additional information and adds significant complexity.

   The proposal requires measurement of the interest expense to be recognised in profit or loss, using a historical locked-in discount rate. IAG is of the view that such historical rates have no relevance to the business at the following reporting dates. In addition, the requirement of accounting for the effect of changes in discount rate in OCI would make it more complex for users of financial statements to understand performance.

The recognition of the effect of changes in discount rates in profit or loss has been widely understood and accepted by users of the accounts. Based on feedback from users of the IAG accounts, the segregation of discount rates in both profit or loss and OCI is likely to be reversed by users of the accounts when assessing insurance performance.

The proposal is also likely to increase operational complexities. That is, the need to track discount rates over the life of a contract, to apply different historical rates to different cash flows, and to identify investment components backing liabilities would likely introduce significant costs for the preparation of financial reports. It is our view that the additional costs anticipated in compliance with the Standard should be justified by identifiable benefits, and as noted above we do not consider this proposal to be beneficial to users of the accounts.

4. Current disclosure provides adequate information on the effect of change in discount rates to users of the accounts.

   There are a number of disclosure requirements either proposed in the ED and/or in the Australia jurisdiction in respect of the effect of change in the discount rate. We consider it adequate for users to quantify the effect of change in discount rates, if required. The current disclosure requirements include:

   - Discount component in the claim expense;
   - Discount component in the outstanding claim liability;
   - Movement in discount as part of reconciliation of movement in outstanding claims liability;
   - Actuarial assumptions, normally including discount rate;
   - Sensitivity of changes in actuarial assumptions, normally including discount rate; and
   - Sensitivity of change in interest rate applied to financial asset.

We recommend that the Standard should permit, rather than require, the effect of discount rate changes to be presented in OCI. This is in line with the 2010 ED proposals that changes in insurance contract liabilities should be recognised in profit or loss. We suggest that this accounting policy choice should be made on an entire entity basis, not at a portfolio or disaggregated level.

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?

IAG agrees that the proposed approach to transition appropriately balances comparability with verifiability. Compared to the 2010 ED, the current proposal seems quite workable and represents a vast improvement in terms of complexity of implementation, as pre and post transition contracts would be treated more consistently.

We also support the proposed modified retrospective approach. The approach is not only consistent with IAS 8 *Accounting Policies, Change in Accounting Estimates and Errors,* but also provides a reasonable and practicable method when establishing the contractual service margin on transition.

Despite these improvements, it would still be a complex exercise to establish contractual service margins on transition. In particular, under the ED appendix C3(e), the requirement to recognise a separate component of equity for the cumulative effect of the difference in discount rate, will be quite challenging for many insurers. Changing the approach as per our response to question 4, will significantly reduce the cost of transition and will improve the usability of the accounts.

In addition, we strongly recommend that the IASB should align the effective dates of IFRS 9 *Financial Instruments* with the proposed insurance contract standard. This would allow entities to manage the transitions simultaneously to minimise business disruption, operational complexity and implementation costs.

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.

Refer to our response to question 3 in respect to financial statement presentation in achieving comparability between different insurance entities.

Some of the proposals may be costly for general insurers, such as the requirement to recognise the effect of change in discount rate in OCI. This would mean that most insurers will have to record additional data, track changes and model a range of business scenarios to satisfy the reporting requirement, as we have discussed above as part of our response to question 4.

In relation to the PAA eligibility criteria, we acknowledge the IFRS's improvement to expand the criteria for using the simplified approach. It will mitigate the arbitrary distinction between contracts purely based on time when these contracts could share similar economic substance. It will also help most general insurers to implement the ED so that a separate data system can be avoided for certain contracts with the coverage period longer than 12 months, if assessment indicates that the PAA is appropriate. This will lead to a lower cost of implementation.

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?

IAG considers that particular aspects of the ED in relation to the risk adjustment are unclear. Specifically, we believe that paragraph B81 will create confusion.

Paragraph B81 lists a series of characteristics that the risk adjustment shall have. The use of the word 'shall' appears that compliance is compulsory – there are no circumstances in which the risk adjustment can fail to comply with the list of sub-points. This is reinforced by the repeated use of the word 'will' within the sub-points.

However, there are examples of insurance contracts where a risk adjustment based on a probability of adequacy approach in line with the ED would fail the requirements of the sub-points. For example, consider the following (simplistic) scenario:

- Consider a policy that pays $100 with a 80% probability and $200 with a 20% probability. Then the central estimate of the cost is $120. The worst case scenario is $200. A risk adjustment at a 90% probability of adequacy is $80.

- Consider a second policy that pays $100 with a 77.5% probability, $180 with a 21.5% probability and $380 with a 1% probability. Then the central estimate is, again, $120. There is a greater range of outcomes, but a much smaller chance of the most severe outcome. A risk adjustment at a 90% probability of adequacy is $60.

B81 (a) states: 'risks with low frequency and high severity will result in higher risk adjustments than risks with high frequency and low severity'. In the simple example outlined above, the risk adjustment is lower for the second contract, yet it has risks that are of lower frequency and higher severity than the first contract. It will lead to non-compliance to B81 (a).

This example illustrates several characteristics of skewed distributions, and demonstrates, albeit simplistically, areas in which this skewness could leads to lack of compliance with B81. IAG notes that virtually all general insurance contracts exhibit skewness in their risk distributions, and as such this is likely to be an issue for a large number of general insurance contracts.

IAG proposes that B81 should be removed in its entirety – its existence is not critical to the requirements of the Standard; it serves to illustrate the correct operation of the Standard, and as noted above there are circumstances where this will lead to inappropriate outcomes. Alternatively, IAG proposes that within this paragraph, the word ‘shall’ is to be replaced by ‘should normally’, and ‘will’ is to be replaced by ‘will normally’, to allow for exceptions to occur in legitimate circumstances.