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Tasmania

DEPARTMENT *of*
TREASURY *and* FINANCE

Contact: Tara Woods
Phone: 03 6233 3846
Our Ref: D/001261 TW/CJ

Mr David Boymal
Chairman
Australian Accounting Standards Board
PO Box 204
COLLINS STREET WEST VIC 8007

Dear Mr ~~Boymal~~ David

INVITATION TO COMMENT 13 – REQUEST FOR COMMENT ON IASB DISCUSSION PAPER *PRELIMINARY VIEWS ON INSURANCE CONTRACTS*

The Heads of Treasuries Accounting and Reporting Advisory Committee (HoTARAC) welcomes the opportunity to respond to the Australian Accounting Standards Board's Invitation to Comment 13, Request for Comment on IASB Discussion Paper *Preliminary Views on Insurance Contracts* (ITC 13).

HoTARAC supports the effort to address accounting for insurance contracts. However, HoTARAC has concerns about the insurance liability measurement model proposed by ITC 13, relating to the practical application of the proposed model by government insurance entities. Detailed comments by HoTARAC on the ITC 13 proposals are attached.

HoTARAC also has concerns with the implications this Project may have on other IASB projects, such as the Fair Value Measurement Project, the Conceptual Framework Project and the Revenue Recognition Project.

If you have any queries regarding the HoTARAC response, please contact Peter Batten from the Victorian Department of Treasury and Finance on 03 9651 2395.

Yours sincerely

D W Challen
CHAIRMAN
HEADS OF TREASURIES ACCOUNTING AND REPORTING ADVISORY COMMITTEE

2 November 2007

Encl

The Treasury Building, 21 Murray Street, Hobart 7000 GPO Box 147, Hobart, 7001, Tasmania, Australia
Telephone: (03) 6233 3100 *Facsimile:* (03) 6223 2755
Email: secretary@treasury.tas.gov.au *Internet:* http://www.treasury.tas.gov.au

Comments on IASB Discussion Paper *Preliminary Views on Insurance Contracts.*

Introduction

The Heads of Treasury Accounting and Reporting Advisory Committee (HoTARAC) represents the Australian, State and Territory governments and advises the treasuries of these jurisdictions on financial reporting matters. All of these governments have entities that undertake insurance business.

General Comments

HoTARAC supports the effort to develop an International Accounting Standard (IAS) for insurance contracts. However, the following list of issues could have a significant impact on public sector insurers and are of major concern to HoTARAC:

- the implementation of the Current Exit Value Model by insurers, where no other market participants exist;
- the application of the discount rate to non-life and short-term insurance contracts;
- the estimation of market-based risk margins by insurers where no other market participants exist;
- the lack of clarification on scope and actuarial guidance for risk margins and service margins;
- the determination of risk margins without including diversification benefits between portfolios of insurance contracts; and
- the credit characteristics of insurance liabilities.

In addition to the issues identified above, HoTARAC would also like to provide general comments on the potential impact of this Project's outcome on other IASB Projects, such as the Fair Value Measurement Project, the Conceptual Framework Project and the Revenue Recognition Project.

Issues relevant to the proposals in the IASB Discussion Paper (DP) as highlighted above, are discussed in more details in the Specific Comments section (see page 2). Comments regarding the potential impact of the proposals on other IASB projects are discussed in Other Comments – Proposals in the DP setting precedence for other IASB projects (see page 14).

Specific Comments

Question 1:

Should the recognition and derecognition requirements for insurance contracts be consistent with those in IAS 39 for financial instruments? Why or why not?

No comment.

Question 2:

Should an insurer measure all its insurance liabilities using the following three building blocks:

- **explicit, unbiased, market-consistent, probability-weighted and current estimates of the contractual cash flows,**
- **current market discount rates that adjust the estimated future cash flows for the time value of money, and**
- **an explicit and unbiased estimate of the margin that market participants require for bearing risk (a risk margin) and for providing other services, if any (service margin)?**

If not, what approach do you propose, and why?

HoTARAC is concerned that it is potentially very difficult to construct reliable and objective hypothetical transactions between hypothetical market participants for government insurers. This is because government insurers often stand as the only insurer or insurer of last-resort in high-risk markets, where few or no other market participants exist. Examples of such markets include workers' compensation insurance, public liability insurance, asbestos insurance, indemnities for borrowed international fine art collections, etc. Government insurers may also be restricted by legislation from transferring their liabilities. Consequently, there will be insufficient data on transactions about other participants on which to base reliable hypothetical exit transactions. Given some of the risks involved, a hypothetical non-government backed insurer would be expected to seek a very high risk margin.

Hence, measuring insurance liabilities for such entities using the Current Exit Value Model may increase subjectivity and volatility, resulting in an unfaithful representation of entities' financial position.

HoTARAC recommends that the Board considers alternative approaches to be implemented by entities such as government insurers. Possible approaches include estimating the insurance liability at the 75 per cent confidence level or using the required rate of return. Whilst these approaches differ from the proposed Current Exit Value Model, in practice the final values are not expected to be substantially different.

With regard to each of the three building blocks , the following issues are of concern and HoTARAC urges the Board to take them into consideration:

- *Estimation of cash flows for certain types of insurance*

The DP requires future premiums to be included in the estimation of future cash flows, provided they meet any one of the three recognition criteria stated in the DP. HoTARAC notes that there are government insurance contracts that are non-life, but may have the characteristics of life insurance contracts. For example, certain government health insurance contracts may fit one of the criteria for recognising future premiums. Did the DP intend for such non-life contracts to be captured by the three criteria?

Further, the DP acknowledges that future premiums are akin to a customer relationship and notes the prohibition in IAS 38 *Intangible Assets* on recognising such assets if they are generated internally. Yet the DP's preliminary view is to include customer relationships in the estimation of insurance liabilities. The DP rejects reporting customer relationships separately as an asset on cost benefit grounds, without considering the more fundamental principle as to whether a customer relationship is an asset. HoTARAC believes that there is nothing in insurance contracts that justifies treating customer relationships inconsistently from IAS 38.

HoTARAC also notes that the prospective approach of using current estimates relating to future events raises the issue that the definition of a constructive obligation needs clarification. Additionally, the prospective approach is inconsistent with the current Framework's definitions of assets and liabilities. Consequently, HoTARAC queries whether the decision to adopt a prospective approach to measure insurance liabilities should be addressed prior to the outcome of projects including the Conceptual Framework Project and the IAS 37 Project.

- *Discount rate*

HoTARAC is concerned by the application of discounting to all life and non-life insurance contracts, regardless of the remaining terms of the cash flows, which would include short-term liabilities. This is inconsistent with current practice for other short-term liabilities and may potentially increase the volatility of those short-term contracts unnecessarily due to changes in the discount rate and in the estimated settlement pattern of the expected cash flows.

- *Estimation of risk margins and service margins*

Concern over the application of the Current Exit Value Model to risk margins is discussed in more detail in Question 4 below.

Question 3:

Is the draft guidance on cash flows (Appendix E) and risk margins (Appendix F) at the right level of detail? Should any of that guidance be modified, deleted or extended? Why or why not?

HoTARAC believes that the draft guidance provided in Appendices E and F should be significantly extended. The proposals in the DP are very complex; hence more guidance should be given to ensure that a reliable and robust outcome can be achieved during the implementation stage. Guidance particularly needs to be provided in the estimation of risk margins using the Current Exit Value Model for entities such as government insurers where potentially no other market participants exist.

Question 4:

What role should the actual premium charged by the insurer play in the calibration of margins, and why?

a) The insurer should calibrate the margin directly to the actual premium (less relevant acquisition costs), subject to a liability adequacy test. As a result, an insurer should never recognise a profit at the inception of an insurance contract;

b) There should be a rebuttable presumption that the margin implied by the actual premium (less relevant acquisition costs) is consistent with the margin that market participants require. If you prefer this approach, what evidence should be needed to rebut the presumption?

c) The premium (less relevant acquisition costs) may provide evidence of the margin that market participants would require, but has no higher status than other possible evidence. In most cases, insurance contracts are expected to provide a margin consistent with the requirements of market participants. Therefore, if a significant profit or loss appears to arise at inception, further investigation is needed. Nevertheless, if the insurer concludes, after further investigation, that the estimated market price for risk and service differs from the price implied by the premiums that it charges, the insurer would recognise a profit or loss at inception;

d) Other (please specify).

HoTARAC supports in-principle Implementation B as proposed by the DP. Therefore, HoTARAC supports in-principle 4(c) above, which may lead to the recognition of day-one profits and losses for insurance contracts.

However, HoTARAC urges the Board not to rule out the application of 4(a) above (Implementation A as per the DP) to entities where there are no active and liquid markets, such as government insurers, for the following reasons:

- it is difficult to measure the risk margins that hypothetical market participants would require for bearing risks where there are neither other market participants nor enough available data to estimate the price of a hypothetical transfer to other market participants. It is likely that such entities would use their own data on pricing and risk, which may be entry price information. In addition, the DP does not adequately demonstrate how to reliably estimate hypothetical market exit prices in the absence of market evidence. Requiring such entities to apply the proposed Current Exit Value Model would potentially introduce more subjectivity and volatility that may lead to unfaithful representations of the financial positions of these entities. The use of current entry value or entity specific measurements in this situation may be preferable to hypothetical and subjective assumptions about unobservable markets;
- imposition of a Current Exit Value Model on these entities would also result in significant implementation costs as insurers would be required to introduce and implement new accounting and actuarial systems and techniques. The benefit of this approach may be out-weighed by associated costs; and
- profit at inception should only be recognised if a reliable and robust risk margin has been incorporated into the valuation of the insurance liability. In the case of entities with no active and liquid markets, it is doubtful whether the Current Exit Value Model will result in reliable and robust risk margins for the reason explained above. Therefore, HoTARAC questions the propriety in recognising profit or loss at inception for such entities.

In addition, further clarification on the scope and more detailed guidance needs to be provided for risk margins and especially for service margins, as a number of constituents found the concept of service margin confusing. Once again, HoTARAC strongly urges the Board to provide substantial guidance for the estimation of risk margins and service margins to ensure a more reliable and robust outcome if and when the Current Exit Value Model has to be applied.

Question 5:

This Paper proposes that the measurement attribute for insurance liabilities should be 'the amount the insurer would expect to pay at the reporting date to transfer its remaining contractual rights and obligations immediately to another entity. The paper labels that measurement attribute 'current exit value'.

Is that measurement attribute appropriate for insurance liabilities? Why or why not? If not, which measurement attribute do you favour, and why?

HoTARAC has the following concerns on the measurement attribute:

- HoTARAC is of the view that it is inappropriate to apply this attribute to insurers that operate in a business environment where there is no active and liquid exit market. As mentioned above, it is difficult if not impossible to apply the Current Exit Value Model to such entities because there are neither other market participants nor enough data to measure the current exit value of insurance liabilities. For example, regarding Australian Government terrorism risk insurance, in estimating the cost of hypothetically transferring the terrorism risk to another market participant, the insurer would have to rely on its own data on pricing and risk and would expect to pay a much higher price to transfer its remaining rights and obligations under such contracts.

  In any event, the insurer is likely to be restricted legislatively from transferring its liabilities to another insurer. Such an approach can potentially introduce more subjectivity and volatility, while not necessarily resulting in a faithful representation of the entity's financial position.

- The cost of implementation of a Current Exit Value Model for government insurers could be significant, because the adoption of the model would necessitate significant change to the way insurance liabilities are valued at present. New accounting and actuarial systems and techniques would be required to estimate the current exit value of insurance contracts in the public sector.

The impact of addressing specific measurement issues relating to insurance contracts on the Conceptual Framework and Fair Value Measurement Projects is addressed under Other Comments – Proposals in the DP setting precedence for other IASB Projects on page 14.

(a) Is 'current exit value' the best label for that measurement attribute? Why or why not?

HoTARAC agrees that current exit value is the best label for the proposed measurement attribute.

Question 6:

In this paper, the beneficial policyholder behaviour refers to a policyholder's exercise of a contractual option in a way that generates net economic benefits for the insurer. For expected future cash flows resulting from beneficial policyholder behaviour, should an insurer:

- **Incorporate them in the current exit value of a separately recognised customer relationship asset? Why or why not?**
- **Incorporate them, as a reduction, in the current exit value of insurance liabilities? Why or why not?**
- **Not recognise them? Why or why not?**

HoTARAC does not express a preference for any of the above options. However, HoTARAC is concerned about the inconsistency between recognising internally generated customer relationships and the requirements of IAS 38. HoTARAC also considers that such recognition may be inconsistent with non-insurance accounting in the United Kingdom (UK), as identified by its Accounting Standards Board.

Question 7:

A list follows of possible criteria to determine which cash flows an insurer should recognise relating to beneficial policyholder behaviour. Which criterion should the Board adopt, and why?

- **Cash flows resulting from payments that policyholders must make to retain a right to guaranteed insurability (less additional benefit payments that result from those premiums). The Board favours this criterion, and defines guaranteed insurability as a right that permits continued coverage without reconfirmation of the policyholder's risk profile and at a price that is contractually constrained;**
- **All cash flows that arise from existing contracts, regardless of whether the insurer can enforce those cash flows. If you favour this criterion, how would you distinguish existing contracts from new contracts?**
- **All cash flows that arise from those terms of existing contracts that have commercial substance (ie have a discernible effect on the economics of the contract by modifying significantly the risk, amount or timing of the cash flows);**
- **Cash flows resulting from payments that policyholders must make to retain a right to any guarantee that compels the insurer to stand ready, at a price that is contractually constrained, (i) to bear insurance risk or financial risk, or (ii) to provide other services. This criterion relates to all contractual guarantees, whereas the criterion described in (a) relates only to insurance risk;**
- **No cash flows that result from beneficial policyholder behaviour; or**
- **Other (please specify).**

No comment.

Question 8:

Should an insurer recognise acquisition costs as an expense when incurred? Why or why not?

No comment.

Question 9:

Do you have any comments on the treatment of insurance contracts acquired in a business combination or portfolio transfer?

No comment.

Question 10:

Do you have any comments on the measurement of assets held to back insurance liabilities?

No comment.

Question 11: Should risk margins:

- **Be determined for a portfolio of insurance contracts? Why or why not? If yes, should the portfolio be defined as in IFRS 4 (a portfolio of contracts that are subject to broadly similar risks and managed together as a single portfolio)? Why or why not?**
- **Reflect the benefits of diversification between (and negative correlation between) portfolios? Why or why not?**

HoTARAC believes that the measurement of risk margins should be on a portfolio basis and reflect diversification benefits. If a multi-line insurer were to ignore the diversification benefits between portfolios, it would result in overestimated risk margins and place the entity at a relative disadvantage to a mono-line insurer. Such measurement of risk margins would not reflect the reality of insurance businesses and their strategies.

Question 12:

Should a cedant measure reinsurance assets at current exit value? Why or why not?

Do you agree that the consequences of measuring reinsurance assets at current exit value include the following? Why or why not?

A risk margin typically increases the measurement of the reinsurance asset, and equals the risk margin for the corresponding part of the underlying insurance contract.

An expected loss model would be used for defaults and disputes, not the incurred loss model required by IFRS 4 and IAS 39.

If the cedant has a contractual right to obtain reinsurance for contracts that it has not yet issued, the current exit value of the cedant's reinsurance asset includes the current exit value of that right. However, the current exit value of that contractual right is not likely to be material if it relates to insurance contracts that will be priced at current exit value.

No comment.

Question 13:

If an insurance contract contains deposit or service components, should the insurer unbundle them? Why or why not?

No comment.

Question 14:

a) Is the current exit value of a liability the price for a transfer that neither improves nor impairs its credit characteristics? Why or why not?

b) Should the measurement of an insurance liability reflect (i) its credit characteristics at inception and (ii) subsequent changes in their effect? Why or why not?

HoTARAC is of the view that an insurer should not include credit quality in the valuation of insurance liability for the following reasons:

- measuring insurance liabilities to reflect their credit characteristics would not be consistent with the requirements of the insurance industry regulators. There are substantial safeguards in place to protect policyholders rights. This ensures that all valid claims are met in full by a solvent insurer; and
- movements in credit standing do not affect the liability. If credit standing is incorporated into the calculation of an insurance liability, a decrease in an insurer's credit rating would impact on the accounting profit, which is misleading.

However, if an insurance liability must reflect its credit characteristics, government insurers usually have explicit or implicit guarantees attached to their insurance liabilities. Clarification is needed on how such guarantees would impact the measurement of insurance liabilities.

Question 15:

Appendix B identifies some inconsistencies between the proposed treatment of insurance liabilities and the existing treatment under IAS 39 of financial liabilities. Should the Board consider changing the treatment of some or all financial liabilities to avoid those inconsistencies? If so, what changes should the Board consider, and why?

Yes. HoTARAC believes that the inconsistency between the proposed treatment of insurance liabilities and the existing treatment under IAS 39 needs to be addressed.

However, the Board should pay close attention to the implications that an exercise of harmonising the treatment of insurance liabilities may have on existing accounting Standards and on the outcome of current IASB projects. These implications are discussed further under the section Other Comments –Proposals in the DP setting precedence for other IASB projects (see page 14).

Question 16:

For participating contracts, should the cash flows for each scenario incorporate an unbiased estimate of the policyholder dividends payable in that scenario to satisfy a legal or constructive obligation that exists at the reporting date? Why or why not?

An exposure draft of June 2005 proposed amendments to IAS 37 (see paragraphs 247-253 of this paper). Do those proposals give enough guidance for an insurer to determine when a participating contract gives rise to a legal or constructive obligation to pay policyholder dividends?

No comment.

Question 17:

Should the Board do some or all of the following to eliminate accounting mismatches that could arise for unit-linked contracts? Why or why not?

- **Permit or require insurers to recognise treasury shares as an asset if they are held to back a unit-linked liability (even though they do not meet the Framework's definition of an asset);**
- **Permit or require insurers to recognise internally generated goodwill of a subsidiary if the investment in that subsidiary is held to back a unit-linked liability (even though IFRSs prohibit the recognition of internally generated goodwill in all other cases);**
- **Permit or require insurers to measure assets at fair value through profit or loss if they are held to back a unit-linked liability (even if IFRSs do not permit that treatment for identical assets held for another purpose); and/or**
- **Exclude from the current exit value of a unit-linked liability any difference between the carrying amount of the assets held to back that liability and their fair value (even though some view this as conflicting with the definition of current exit value).**

No comment.

Question 18:

Should an insurer present premiums as revenue or as deposits? Why or why not?

HoTARAC concurs with the acknowledgment in the DP that premiums stand as an important measure to the industry and users of financial statements. Therefore, premiums should be recognised as revenue. Any presentation of a general insurer's financial statements that does not use premiums as the basis of revenue loses useful information on the insurer's activities, size, growth, etc from prior periods. While there are some premiums that do have the characteristics of deposits, mostly in the reinsurance market and hence must be recognised as such, the vast majority of general insurance premiums should remain as revenue.

Question 19:

Which items of income and expense should an insurer present separately on the face of its income statement? Why?

No comment.

Question 20:

Should the income statement include all income and expense arising from changes in insurance liabilities? Why or why not?

No comment.

Question 21:

Do you have other comments on this paper?

HoTARAC notes that the DP presupposes the outcome of other IASB projects, including the Project to revise the Framework for the Preparation of Financial Statements (Conceptual Framework), the Fair Value Measurement Project and the Revenue Recognition Project. Please see Other Comments –Proposals in the DP setting precedence for other IASB projects, on page 14.

Other Comments –Proposals in the DP setting precedence for other IASB projects

Fair value Measurement Project

Some HoTARAC constituents believe that the IASB Project on insurance contracts should not move ahead independently of the Fair Value Measurement Project. Their view is that the notion of fair value measurement for insurance contracts needs to be better explored as the DP did not provide a strong argument for the preferred use of an exit model over other measures of fair value. This was especially the case for risks where realistically an exit market does not exist. Fair value measurement is not necessarily limited to the notion of current exit value and other fair value measures, including entry price and settlement price, may be more appropriate for entities that operate in a business environment where an exit market does not exist. In addition, there is a view that insurance liabilities are not significantly different from other financial and non-financial liabilities and therefore do not necessarily warrant a different accounting treatment.

Conceptual Framework Project

General concern was expressed by HoTARAC that many of the proposals under the DP are addressed in a broader context as part of the IASB's Conceptual Framework Project. For example, the DP requires the recognition of all expected future cash flows when measuring an insurance liability, which includes not yet incurred and stand-ready obligations. This is inconsistent with the current accounting Framework's definition of a liability and presupposes the outcome of the Conceptual Framework Project.

Similar concerns were expressed in considering the other proposals in the DP, such as the proposal on the recognition of customer relationships when measuring an insurance liability, the recognition of acquisition costs and diversification benefits when determining risk margins, etc. It may be better to address the recognition and measurement of insurance contracts following the outcome of the Conceptual Framework Project. This would ensure that the accounting treatment of insurance contracts is consistent with the Conceptual Framework.

Revenue Recognition project

As proposed by the DP, Implementation B allows recognition of day-one profit or loss when calibrating the risk margin. This means that revenue may arise due to different assumptions being adopted when measuring an insurance liability, from those used to earn income by providing services to a customer. The latter transaction price seems to be a more relevant and reliable measure. This issue is perhaps more appropriately addressed in a broader context under the Revenue Recognition Project, which considers what constitutes revenue and how performance should be reported.

Conclusion

Some HoTARAC members are concerned that the Board is addressing fundamental accounting issues and may be setting precedents in advance of significant Conceptual Project developments.