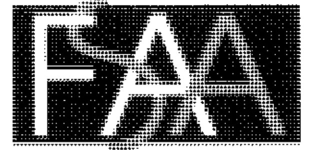


Financial Services Accountants Association Limited
PO Box 141 Brookvale Business Centre 2100
Phone: (02) 9451 3223
Facsimile: (02) 9451 3234
E-mail: administration@fsaa.com.au
ABN: 92 001 582 065

26 October 2007

Professor David Boymal
Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West Victoria 8007

Dear Professor Boymal,

IASB DISCUSSION PAPER - *PRELIMINARY VIEWS ON INSURANCE CONTRACTS*

The Financial Services Accountants Association (FSAA) welcomes the opportunity to comment on the IASB's Discussion Paper '*Preliminary Views on Insurance Contracts*'.

The FSAA is the peak industry body for individuals in Australasia involved in the financial services industry, particularly professionals from the fields of accounting, finance, regulation and taxation. The FSAA is committed to providing formal activities and opportunities for the ongoing professional development of members and fostering and encouraging networking between members through involvement in FSAA activities.

Enclosed for your information is a copy of our letter to Mr Peter Clark and our submission, which may assist the AASB in formulating its own response to the IASB.

The FSAA supports the development by the IASB of an IFRS for insurance contracts, particularly in view of the diversity of practice internationally, and considers that the Discussion Paper represents excellent progress towards this aim.

The FSAA supports a prospective measurement of insurance contracts, and generally supports the current exit value model and the three basic building blocks for determining that value.

The FSAA's main concerns with the IASB's preliminary views are:

- the emphasis on using market estimates of cash flows;
- limiting the extent to which diversification can be factored into the risk margin based on a portfolio unit of account; and
- the need for greater clarity in relation to service margins.

These concerns are discussed in detail in the attached submission.

......../2

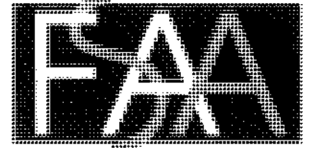
The FSAA submission focuses on those areas of greatest interest to our members and does not address the questions in Chapters 6 and 7 of the Discussion Paper.

Should you require clarification on any or our comments, then please contact me.

Yours faithfully,

RICHARD SANZIN
FSAA Federal President

Encl. IASB letter and submission



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PO Box 141 Brookvale Business Centre 2100
Phone: (02) 9451 3223
Facsimile: (02) 9451 3234
E-mail: administration@fsaa.com.au
ABN: 92 001 582 065

26 October 2007

Mr Peter Clark
Senior Project Manager
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

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RICHARD SANZIN
FSAA Federal President

Encl.

FSAA Submission to the AASB and the IASB
IASB Discussion Paper Preliminary views on Insurance Contracts

Responses to Discussion Paper Questions

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?

A key outcome of consistency with IAS 39 would appear to be that an insurer would need to recognise an insurance liability once there is a contract between the insurer and the policyholder. This is generally in line with practice in Australia, however, at the Exposure Draft stage there probably needs to be more clarity about the timing of premium recognition and the date from which an insurance liability may need to be recognised in view of the multiple events that often take place in securing an insurance contract. These events may include:

* making an offer to a policyholder subject to assessing the information received from the policyholder;
* assessing the information from the policyholder;
* both parties accepting the terms; and
* premium being paid.

Further complications may arise when insurers use intermediaries that have the authority to accept business on an insurer's behalf and when premiums received in advance are subject to 'cooling off' periods.

The derecognition requirements of IAS 39 have not necessarily been designed with insurance contracts in mind. The IAS 39 derecognition requirements have probably faced their greatest test so far with securitisation arrangements, however, other issues may arise in an insurance context because claim liabilities are only extinguished when all possible claims under a policy are finally settled. This may not be clearly determinable for some lines of business, for example, those involving third party liability.

Given the inherent complexity of IAS 39, the impacts of its application to insurance contracts need to be well explained in the Exposure Draft.

Question 2

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

(a) explicit, unbiased, market-consistent, probability-weighted and current estimates of the contractual cash flows,

(b) current market discount rates that adjust the estimated future cash flows for the time value of money, and

(c) 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 (a service margin)?

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

This question is considered in conjunction with question 3.

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?

At the principles level, the FSAA supports the IASB's preliminary views.

At the practical level, FSAA members have found the proposals in relation to entity-specific cash flows to be difficult to understand because the extent to which entities are expected to seek out market-related cash flows is not clear. We would prefer that future proposals be framed around the idea that it would need to be clearly evident that the entity's cash flows are materially different from those of other insurers with a similar spread of business before an entity needs to substitute its own cash flows estimate for those of the market. In reality, little market-based information is available in any case.

The FSAA particularly supports discounting of cash flows in measuring the insurance liability because to do otherwise would misrepresent the magnitude of the liability. We appreciate that some insurers in some jurisdictions argue that the absence of discounting helps to create the margin that they believe should be included in the liability. However, the FSAA considers that this could only rarely be a margin that reliably represents the market value margin. In all cases, disclosure of the explicit margin and discount rate would enhance comparability and better inform users of the financial statements.

The FSAA supports an explicit margin being included in the insurance liability to represent the amount a buyer would need to be compensated for taking on the relevant insurance risks and, accordingly, the discount rate should reflect only the time value of money in most cases. The measurement of the liability is generally considered to be independent of the assets that support the liabilities. Only in cases where the liability measurement is dependent upon the value of the assets backing the liabilities, would it be relevant to use a discount rate based upon returns on the actual assets held.

The FSAA considers that a market value margin is likely to be difficult to determine. For prudential regulation purposes, the Australian Prudential Regulation Authority has required a fair value model for some years for general insurers. That model benchmarks to a 75% level of sufficiency such that the amount of the liability is expected to be greater than or equal to the actual liability three times out of four. Provided they meet particular criteria, general insurers are free to choose to develop and apply their own fair value models instead of using the 75% benchmark. Developing a substitute model would generally involve the types of steps that would be involved in determining a risk margin, as proposed in the Discussion Paper. To date, no general insurer has chosen to apply its own model for prudential reporting purposes, which may be viewed as an indication of the extent to which guidance would be required on determining the risk margin if this were to become a financial reporting requirement. Accordingly, the FSAA consider that more guidance than that included in the Discussion paper is needed on risk margins. What is not clear is who is best placed to provide that guidance. The FSAA considers it likely that the IASB would need to refine its guidance, but that the industry itself would also need to establish some of the detail probably through cooperation between accountants and actuaries.

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).

On balance, the FSAA supports option (b), although in concept, the FSAA supports option (c) because it is consistent with the current exit value model proposed.

Likelihood of profits at inception

In general, over the long run, there are unlikely to be profits at inception because insurance markets are generally competitive. However, in the general insurance business in particular, there is a concern that profits would emerge at inception based simply on the stage of the pricing cycle that pervades the insurance market at both the direct and reinsurance levels. Each time the market goes through an up cycle there are likely to be profits at inception, and it is not clear whether this would provide useful information when the cycle is bound to subsequently turn down in a soft market.

Concerns with option (a)

The FSAA also has a concerns with option (a) above, because calibrating the risk margin to the actual premium charged (less acquisition costs) would seem to ignore any margin in the pricing for services expected to be provided under the contract. The FSAA considers that there needs to be more clarity about the treatment of the service elements of insurance contracts generally under the proposed current exit value model.

Another concern with option (a) is that it seems to imply that the estimates made at inception will not be changed over the life of the contract, which seems inconsistent with a current exit value model. The FSAA supports a model in which the estimates can be changed and the impacts of changes are reflected in insurance liabilities.

Option (b) – the reasonable compromise

Option (b) seems a reasonable compromise, particularly for general insurance. The premium could be regarded as the best evidence available in determining the insurance liability unless

there is strong evidence that the liability should be different based on extensive information about historical experience. Accordingly, for example, the presumption that the risk margin is other than that indicated by the premium may be capable of being rebutted for high volume personal lines of general insurance business. However, as the risks become greater and more case-specific, such as with many commercial risks, the presumption would be less likely to be rebutted because the information about historical experience would become sparser.

Some specialised commercial lines of business in which one or two insurers have entrenched positions could also give rise to a rebuttal under approach (b) even when the business volumes are not large.

Another possible basis for rebutting the presumption that the premium best reflects the risk margin is the impact of an insurer's brand, which is likely to be more significant in the life insurance market. Many insurers invest heavily in their brands and sales force infrastructure over many years and the payback for this investment can be relatively higher premiums. In such cases, it may be reasonable to recognise profits at inception, which are effectively a return on the earlier investment. However, in respect of brand and infrastructure, care would need to be taken to not recognise profit at inception in relation to all expected premiums under a regular premium product because there are likely to be future costs associated with the maintenance of that brand and infrastructure over the period those future premiums are expected to be received.

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 as 'current exit value'.

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

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

This question is considered in conjunction with questions 6 and 7.

Question 6

In this paper, 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:

(a) incorporate them in the current exit value of a separately recognised customer relationship? Why or why not?

(b) incorporate them, as a reduction, in the current exit value of insurance liabilities? Why or why not?

(c) not recognise them? Why or why not?

This question is considered in conjunction with questions 5 and 7.

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?

(a) 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, at a price that is contractually constrained.

(b) 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?

(c) All cash flows that arise from those terms of existing contracts that have commercial substance (i.e. have a discernible effect on the economics of the contract by modifying significantly the risk, amount or timiug of the cash flows).

(d) 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, to (i) bear insurance risk or financial risk, or (ii) provide other services. This criterion relates to all contractual guarantees, whereas the criterion described in (a) relates only to insurance risk.

(e) No cash flows that result from beneficial policyholder behaviour.

(f) Other (please specify).

The FSAA supports the proposed measurement attribute, as indicated by the comments under Questions 2 and 3, however, the FSAA considers that the IASB has not consistently applied its proposed model throughout the Discussion Paper.

The IASB appears to have overlaid the current exit value model with constraints based on the definitions of assets and liabilities in the IASB Framework, which has a biased impact on the extent to which renewal premiums can be factored into the insurance liability calculation.

Under the Discussion Paper model, cash inflows and outflows under an insurance contract are used to determine the amount of the insurance liability – so netting off is implicit in the model. However, when the net result is an asset, additional constraints are applied, based on guaranteed insurability that will tend to lead to the overstatement of insurance liabilities.

The FSAA consider that the relevant focus is the insurance contract and the cash inflows and outflows under the contract should be the basis for insurance liability measurement. Under the Discussion paper proposals, it would appear that when an assessment of all the expected cash flows results in a net liability, then all those expected contractual cash flows are factored into the liability calculation. Cash inflows from all expected future renewals are incorporated as they are seen as assets arising from a customer relationship that are closely related to the contract. However, when an assessment of all the expected cash flows results in a net asset, only the cash inflows from renewal premiums that meet the guaranteed insurability test or that the insurer can compel the policyholder to pay are factored into the liability calculation.

The FSAA is concerned that the IASB's proposed biased approach to incorporating cash flows in the measurement model will lead to rigidities that do not allow a proper representation of economic substance, particularly in respect of long-tail business. As conditions change, the estimates about future cash flows can also change and a net asset position can change to a net liability position and vice versa. Accordingly, the scope of the cash flows included in the liability calculation may vary for some contracts during their lifecycle.

If the guaranteed insurability test is a worthy filter in respect of cash flows, it would be applicable even when an assessment of all the expected cash flows results in a net liability.

The FSAA also has concerns about applying the guaranteed insurability test itself, particularly in respect of some life insurance business and health insurance business in Australia, and specifically with respect to the notion of price constraint.

A common form of life insurance in Australia is yearly-renewable term life cover. Under that cover, in theory, the insurer can increase the premium greatly (in many cases by an infinite amount) against all those policyholders with the same kind of contract. The insurer cannot select against an individual policyholder. It may not be clear whether the insurer is price constrained in these circumstances because it can raise the premium, but would normally be 'constrained' commercially by not wanting to lose a whole cohort of business.

Health insurers in Australia are required by law to accept business and, while they can increase premiums (this is generally done once each year), increases must be approved by government. Most policyholders pay their premiums monthly and can move between insurers at the same level of cover with few if any penalties. The difficulty here is knowing the length of the contract period. Under the IASB's proposals, it could potentially be monthly, yearly (up to the price review date), or longer.

If the IASB wishes to retain the guaranteed insurability test, its application and impact would need to be made clear in a variety of circumstances.

Question 8

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

In line with the earlier comments, the FSAA supports this proposal.

Question 9

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

The FSAA considers that, in a business combination, the constraints on the 'recognition' of renewal premiums proposed in the Discussion Paper would be irrelevant. An acquirer would factor in all the expected cash inflows and outflows associated with in-force insurance contracts in assessing the worth of the insurance portfolios. In addition, there may be goodwill associated with an insurance business that would relate to expected future insurance contracts. If the in-force contracts were to be measured using the proposals (including the constraints) in the

Discussion Paper, in some cases an element of value associated with the existing insurance portfolios would be inappropriately included with goodwill.

Question 10

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

The FSAA supports requiring assets backing insurance liabilities being measured at fair value with changes in fair value taken through profit and loss on the basis that this provides the most relevant information for users and largely removes the potential for accounting mismatches that do not reflect economic substance.

Australian insurers have not experienced great difficulties in identifying assets backing insurance liabilities and the practice has been well-accepted by financial statement users in the Australian market.

Prior to adopting IFRSs, Australian general insurers were required to fair value through profit and loss all investments 'integral to the entity's general insurance activities', which meant all those investments controlled by the entity in the conduct of its general insurance activities. Life insurers were required to fair value through profit and loss all their assets. Since adopting IFRSs, insurers are required to fair value through profit and loss all those assets that can be fair valued through profit and loss in accordance with IFRSs. This approach has led to financial reporting that fairly shows the matches (and mismatches) between insurance liabilities and assets held against those liabilities.

The FSAA's main concern is that different insurers will choose different measurement options available under IFRSs at different times and comparability will be lost across entities and over time.

The IASB notes that it would have difficulty defining assets held to back insurance liabilities without ambiguity. The FSAA appreciates that it may be difficult to define assets held to back insurance liabilities, particularly to suit a range of jurisdictions, but hope that assistance could be sought and received from the International Association of Insurance Regulators in doing so. Regulators commonly require insurers to identify the assets backing insurance contracts in assessing the prudential soundness.

Question 11

Should risk margins:

(a) 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?

(b) reflect the benefits of diversification between (and negative correlation between) portfolios? Why or why not?

The FSAA considers that risk margins should allow for diversification across the entity because this reflects the manner in which insurance businesses are managed and the way users view an insurance business. In Australia, with the exception of statutory funds used in the life insurance sector, all the assets of each registered insurer are available to meet the liabilities of that insurer.

Entity-wide diversification is also reflected in market transactions as evidenced in premium pricing, and would be taken into account in a business combination. In this context, the IASB proposed portfolio unit of account seems inconsistent with the focus on exit value.

The FSAA appreciates that the IASB is concerned about the same portfolio having a different value depending on the insurer that controls it. A compromise solution may be to permit diversification across the entity to the extent that this is relevant to an 'average' insurer in that market, which may be a domestic or international market. In concept this would be consistent with the notion of a current exit value for insurance liabilities because the amount at which a portfolio would be traded would reflect the diversification benefits that market participants would achieve across their whole business.

Question 12(a)

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

In concept, the FSAA considers that reinsurance assets should be measured consistently with the measurement of the underlying insurance contract.

A concern not addressed in the Discussion Paper relates to non-coterminous reinsurance – that is, where the term of reinsurance cover differs from the term of the related direct business. It is common at the reporting date for an insurer's direct exposures not to be covered by reinsurance for the entirety of the terms relating to that direct business. In Australia an assumption is usually made that reinsurance cover can be obtained on terms similar to the existing reinsurance cover for the uncovered remainder of the terms of the direct policies. There is a need for the IASB to address the financial reporting implications of a change in reinsurance market conditions that may make reinsurance on similar terms difficult to obtain.

Question 12(b)

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

(a) 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.

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

(c) 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.

The FSAA agrees that the above are the consequences of applying an exit value model to reinsurance assets.

Question 13

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

We note that most of insurance products sold in Australia are not bundled, so the issue relates primarily to legacy life insurance business.

The FSAA considers that, in concept, deposit components should be unbundled. Under AASB 1038 *Life Insurance Contracts* (and its predecessor Standard), life insurers have split premiums into income and deposit components for presentation purposes, where this split is practical, for many years. The FSAA considers that this approach best reflects the substance of the cash flows, but acknowledges that some products are unable to be unbundled.

The FSAA also considers that, in concept, service components should be unbundled, however, we are not entirely sure what constitutes a service under the Discussion Paper proposals. We presume that services include investment management, and this would be the most common service bundled into insurance contracts in Australia. However, unless those services are particularly significant to the contract, the FSAA doubts that it would be worthwhile unbundling them.

The FSAA has a concern about the manner in which the Discussion Paper outlines the unbundling process that may give counter-intuitive results. The Discussion Paper proposes that when the deposit component and insurance component are interdependent, but can be measured on a basis that is not arbitrary, the deposit component is measured under IAS 39; the whole contract is measured under the insurance standard; and the insurance component is the difference. This would seem appropriate if the deposit component is valued using the fair value option under IAS 39, but it may not be. If other measurement options available under IAS 39 are used, the difference between the fair value of the deposit and the amount measured using that other option becomes part of the value of the insurance component. This has the potential to make the amount attributable to the insurance component meaningless to users.

Even if the fair value option under IAS 39 were applied, the deposit floor in IAS 39 may mean that any impact of beneficial policyholder behaviour would not be recognised in the overall value of the bundled contract.

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?

The FSAA agrees that the current exit value of a liability is the price for a transfer that neither improves nor impairs its credit characteristics in most circumstances. In a regulated insurance market (such as Australia's), there may, on occasions, be insurers that fall below the benchmark capital adequacy and would be prohibited from trading insurance portfolios between them. The regulator may permit a transfer to an insurer with better (above the benchmark) credit characteristics, but not to an insurer with similarly 'low' credit characteristics.

Question 14(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?

The FSAA considers that, in a regulated insurance market (such as in Australia), the impact of credit characteristics is unlikely to be material because all insurers that are 'going concerns' will not be permitted to fall below particular capital adequacy thresholds.

Contracts held by non-insurers that meet the definition of insurance contracts may be more of a concern. Given the counterintuitive impact of credit risk on the measurement of liabilities, disclosure of the dollar impact of credit risk on any insurance liability should be required when that impact is considered to be material.

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?

The FSAA considers that no further IAS 39 treatments should be imported into the insurance project. Although we acknowledged the benefits of consistent accounting treatments, IAS 39 is a rule-based Standard in need of revision and should not be used as a precedent for impeding desirable accounting developments in other areas.

* * * * * * * * *

As noted in the cover letter, the FSAA has not commented on Questions 16 to 20 in Chapters 6 and 7 of the Discussion Paper.