ACCOUNTANTS' AND ACTUARIES' LIAISON COMMITTEE

29 October 2007

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

Dear Sir

Response to Request for Comment on IASB Discussion Paper *Preliminary Views on Insurance Contracts*

The Accountants' and Actuaries' Liaison Committee ("AALC") is pleased to provide its response to the Request for Comment on the IASB Discussion Paper Preliminary Views on Insurance Contracts ('the Discussion Paper"). This response represents the views of the members of the AALC (and not necessarily their employing organisations or professional association).

The AALC is supported by The Institute of Chartered Accountants in Australia and the Institute of Actuaries of Australia. The AALC is primarily concerned with matters affecting both professions, including the development and implementation of accounting standards for the insurance industry. The AALC takes a practical approach to problems, as its members are all practitioners in insurance and related fields. We have provided responses to the questions where we consider it of practical relevance to the industry.

Overall, we support the majority of the key themes in the discussion paper, however we do note some concerns regarding the application of some of the proposed concepts, in particular the determination and definition of Current Exit Value. Further we consider that the current accounting framework within Australia has some positive aspects that we would not want to see discontinued when the new insurance contract standard is developed as a result of the Discussion Paper.

We have provided responses to some of the specific questions as set out below:

Chapter 2

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?

We support the principle of consistent recognition requirements. We recommend that the IASB provide detailed guidance in this area given the complexity and nuances associated with insurance contracts.

Chapter 3

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?

Response

Overall we consider that the three building blocks approach is appropriate.

Whilst we agree with the theoretical notion that liabilities should be measured at observed market prices, we question whether this is ever achievable in practice. The risk is that, due to the inherent difficulties of determining such a valuation, the market may default to a generally accepted approach which may be both overly prescriptive and result in a meaningless outcome. Our view is that liabilities should be valued on their own merits including taking into account their own operational efficiencies, on a portfolio by portfolio basis.

A valuation at observed market prices is not generally a practical proposition and in the absence of a genuine or deep secondary market for insurance liabilities we consider that it would be inappropriate for the accounting framework to use such an approach. Consequently the three building block approach provides a suitable alternative basis for measurement. The proposed approach is very similar to the approach currently used and well understood by the preparers and users of financial reports for Australian entities under the requirements of AASB 1023 General Insurance Contracts.

We would however, make the following specific comments:

We have found the drafting of the Discussion Paper to be confusing around references to "market-consistent" and "entity-specific" cash flows. Our concern is that the proposed model, by requiring the use of market-consistent assumptions, may not correctly reflect the exit value of liabilities of companies that operate more or less efficiently than the market. In addition, we consider that there would be significant practical difficulties inherent in accessing meaningful market-consistent information. Our view is that valuations should be based on entity-specific data which is more meaningful and more readily available, and should be supplemented with disclosure where considered appropriate. The entity specific cash flows will, by their nature take account of market conditions.

Therefore we consider that the use of market consistent cash-flows should be limited to situations where there is clear evidence of the existence of a genuine secondary market for insurance liabilities and that such data should not equate to following the market pricing cycle.

Service Margins

It is unclear from the Discussion Paper what the IASB mean by a service margin, for which types of insurance contract they would expect to see such a margin and what that margin represents.

The Discussion Paper states that a service margin in relation to an insurance contract is one that compensates the insurer for services other than the bearing of risk.

The example given of such services is investment management. However, investment management services are not seen as applicable to insurance risk contracts or to the risk element of an unbundled contract. This is because pure risk insurance contract holders would not generally perceive investment management as part of what they are purchasing. Investments in this context are managed for the benefit of the insurer such that they can pay claims as and when they fall due.

As unbundling is a regulatory requirement in Australia, the only potential for there to be an investment management element in the service margin for an insurance contract would be in respect of discretionary participating business. This is not expected to have a significant impact in isolation.

Apart from investment management, which we consider inappropriate to consider for the reasons noted above. It is unclear what additional services to the policyholder would need to be provided for in a service margin for insurance contracts. The consistent usage of the terminology 'if any' in the context of service margins throughout the Discussion Paper would appear to indicate that the IASB are not expecting there to be a high instance of such services.

Also, current terminology in use in the Australian 'margin on services' methodology for valuing life insurance contracts and references made in paragraph 88(h) to embedded value appear to have introduced an element of confusion as to what the service margin is intended to achieve.

We agree that when an obligation to perform services other than the bearing of risk exists as part of an insurance contract, then these other services should be recognised as part of the liability to the insurance contract holder, for example claims handling. However, it is recommended that the IASB more clearly define the purpose of the service margin and the nature of the other services they expect to be included. Overall we consider that the important aspect of this is to ensure that overall reflects all obligation under the insurance contract.

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?

Response

We support the IASB's intention to apply a principles based approach rather than a prescriptive or overly detailed approach. We consider the draft guidance to be sufficiently detailed and that it provides a clear enunciation of the high level objectives of determining cash flows.

With regards to the determination of risk margins, we would note that this is a complex area which is presently evolving due to significant debate by actuarial bodies around the world. We consider that it is beyond the scope of the proposed accounting standard to provide detailed guidance on actuarial calculations. However, further liaison with the various actuarial bodies would be worthwhile to ensure that the high level objectives are clear and can be translated into meaningful calculation methodologies that can be clearly communicated to preparer and users of financial statements.

We also note the success of the use of the probability of adequacy basis currently employed in the determination of risk margins by Australian insurers and consider that the benefits of a move away from such a basis would need to be carefully considered and clearly enunciated. The use of sufficient and appropriate disclosure will be an important aspect of enabling comparability of margins adopted by Insurers.

We also note that the guidance on cash flows should reflect any proposed changes concerning entity specific versus market based cash flows in reference to the response to questions 2 and 5.

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 reputable 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).

Response

Summary

The majority of the Committee favour option c, and believe that the recognition of day one profits is consistent with the aims of the exit value model and is conceptually valid albeit the extent to which these materialise in practice may be limited. Whilst it is for each entity to determine its own liability valuation and profit releases, appropriate disclosure should ensure transparency of financial information produced.

We note however, certain committee members views in relation to Insurance contracts whereby they consider that option (a) is more appropriate where there is a significant service margin component of the contract.

Specific matters

The question refers to the calibration of 'margins', which we take to mean both risk and service margins. As risk and service margins are conceptually different we consider they should be valued independently of each other.

Risk Margins

We consider that preference should be given to objective experience data with pricing data used or taken heed of which such experience data is not sufficiently credible.

Service Margins

As noted above we consider that service margins should be valued independently of the premiums charged as we consider that this is consistent with the exit value concept. We note that there are differing views on this Committee regarding the ability to recognise day one profits associated with service margins and that such approach would lead to an inconsistency between the way in which certain insurance contracts, which have the same characteristics as investment contracts, are accounted for compared to the required treatment for financial instruments under IAS18 and IAS39.

In terms of the other options, most committee members consider:

(a) To be invalid as it does not take account of the situation as at the time the liability is being measured – unless there is a deterioration such that completion of a liability adequacy test will result in recognition of additional liabilities; and

(b) Should get the correct result but provides an increased risk that current conditions and anticipated developments prior to settlement of the liability will not be adequately considered. To be effective, the guidance on evidence to rebut the position would need to be so broadly worded that option (c) would be reached or, written as rule which may be interpreted only in a narrow or literal sense and thus lead to issues not being addressed.

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'.

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

Response
As noted previously, we agree with the theoretical notion that liabilities should be measured at observed market prices; however, we question whether this is ever achievable in practice given the lack of a genuine secondary market for insurance liabilities. This leads to difficulties in translating such a notion into a meaningful measurement tool in the real world in terms of some of the components of the three specific building blocks. In particular, we query the existence of sufficiently timely, reliable and freely available information to enable 'market consistent' cash flows to be modelled by insurers. In practically all cases it will be necessary and more accurate to have regard to the entity's own cash flows as a proxy for the market. Consequently we consider that it would not be appropriate within the accounting framework to base the valuation of insurance liabilities on market transactions where there may be inherent uncertainty in the information.

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

Response
Once again, this is reasonable as a theoretical label but the distinction between 'current exit value' and 'current entry value' or 'settlement value' can be a fine one as the IASB have outlined in the Discussion Paper. What we call the model is probably not a significant issue provided that there is clarity and agreement on the components of the three building blocks.

Chapter 4

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 asset? 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?

Response

See responses to Question 7 below for a discussion of which future cash flows we consider should be incorporated into the valuation of the insurance contract liability.

Future cash flows arising from beneficial policy holder behaviours should be incorporated into the insurance contract liability regardless of whether they are an asset or a liability as such cash flows arise from obligations in relation to the contract. We consider that they **not** be recognised as a separately identifiable customer relationship and should be included in the valuation of the insurance contract liability. We therefore support option (b).

As future renewals of general insurance contracts would normally not meet the recognition criteria, this is only likely to be applicable to multi-year life insurance policies, participating investment contracts, health insurance policies and reinsurance treaties.

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 and 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 timing 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,

    (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.

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

(f) Other (please specify).

Response

We favour the adoption of option (c) being the inclusion of all contracted cash flows arising from existing insurance contracts, regardless of whether the scenario is beneficial or detrimental to the insurer. In this context, contracted means required or established under the terms of the contract, whether or not the insurer has a practical means of enforcing the contractual requirement.

This then raises the issue of how to determine existing from new contracts.

The rebuttal presumption should be that, as in the case of most general insurance products, each premium receipt or renewal would define a new contract. The insurer may expect that the majority of policyholders will renew, there is no contractual requirement or presumption either that the policyholder renew or that the insurer accept renewal.

The determination of existing contracts as opposed to new contracts would be based on the actual contractual position, that is whether a new contract is issued. Typically this would be the case for annual general insurance contracts. Other types of insurance contracts, such as Life Insurance or Health Insurance, contain features that indicate that future premiums are contracted and the insurer is bound to accept them and pay claims arising in the period covered by those premiums.

For reinsurance treaties the reinsurer would recognise future premiums (and the resulting claims) for all direct insurances within the scope of an existing treaty and a probability weighted estimate in respect of direct business not yet written. This is because the reinsurer is obliged under the treaty to reinsure this new business.

In summary, option (c) is preferred to the recommended option (a) as placing 'guaranteed insurability' restrictions on upside cash flows and no restrictions on the downside cash flows is considered to be at odds with the current exit value concept i.e. a market participant would certainly not place these restrictions on future cash flows when considering purchasing a portfolio of insurance contracts.

Also for many multi-year life insurance portfolios in Australia, the insurer has the ability under the contract to increase the premium but only at the portfolio level, not at the level of the individual policyholder. Under the current definition of 'guaranteed insurability' it is not clear whether the insurer is price constrained in this scenario because contractually it can be altered but commercially there is a limit to the extent 'healthy' policyholders would accept price rises to accommodate deterioration of 'unhealthy' policyholders.

If the notion of guaranteed insurability was incorporated into the insurance contracts standard, we would recommend the definition be amended to incorporate such a scenario.

Question 8

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

Response

Acquisition costs should be expensed as incurred as this is implicit within the exit value model.

Question 9

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

No comments provided.

Chapter 5

Question 10

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

Response

Conceptually we are supportive of the current Australian concept of fair value treatment through the Income Statement, for both assets and liabilities associated with insurance contracts and thereby eliminating accounting mismatches. That said we are concerned about the AASB mandating an approach that is not mandated elsewhere in the world.

One of the stated aims of the Discussion Paper is to enable comparability of performance across borders and across insurance entities. We do not consider it to be appropriate for some jurisdictions to mandate the use of fair value through profit and loss whilst other jurisdictions have a range of valuation options available to them. We therefore do not support Australian accounting standard setters mandating a fair value through profit and loss valuation of assets backing insurance liabilities if preparers of financial statements elsewhere have other options available to them. In these circumstances we consider that transparency and comparability of performance can be achieved through appropriate levels of disclosure.

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?

Response

We consider that risk margins should be determined at a level that is no more detailed than is currently used for IFRS 4 purposes. We note that certain committee members consider that Risk Margins should be measured for the whole reporting entity only.

We consider that a valuation basis that does not recognise the benefit of diversification is flawed as it is a fundamental principle of insurance and it is how insurers do business. It would not reflect economic reality to exclude the benefits of diversification and imperfect correlation between portfolios and such exclusion is inconsistent with the exit value model. Each insurer will have a different approach to risk management and its diversification profile will be highly significant for regulators, reinsurers and investors in measuring the insurer's strength and business performance.

Question 12

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

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

 (i) 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

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

 (iii) 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.

Response

We consider that the treatment of reinsurance assets should be consistent with the treatment of the associated gross insurance liabilities.

Question 13

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

Response

The unbundling concept has been required in Australia for some time. We consider it is consistent with the IASB framework.

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?

Response

We consider that the credit characteristics of an insurance liability are of limited relevance for the purpose of the determining the current exit value of a liability and should not be explicitly included in the valuation. Regulatory restrictions and actual market transactions do not support the assertion that the natural transferee of an insurance portfolio is a party of similar credit standing as the transferor.

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?

Response

While consistency of application of the principles is to be lauded, we have restricted our responses to how we believe insurance contracts should be measured within the IASB principles and the economic reality of insurance operations and do not comment on the measurement of other financial liabilities.

Chapter 6

Question 16

(a) 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?

(b) 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 provided

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?

(a) 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).

(b) 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).

(c) 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).

(d) Exclude from the current exit value of a unit-linked liability any differences 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).

Response

We note that there are issues associated with the various options put forward and highlighted in the Discussion Paper. We consider that the Board should consider other potential options as described in other submissions on the Discussion Paper that we are aware of such as the Institute of Actuaries of Australia, in order to try to further eliminate accounting mismatches.

Chapter 7
Question 18
Should an insurer present premiums as revenue or as deposits? Why or why not?

Response

The majority of the committee consider that the presentation of premiums as revenue remains appropriate unless there was specific circumstances such as deposits on participating business that clearly preclude this. That said, we do not consider that the presentation as revenue or deposits makes a significant difference provided there is adequate and appropriate disclosure around the value and volume of business underwritten by the insurer.

Question 19
Which items of income and expense should an insurer present separately on the face of its income statement? Why?

No comment provided.

Question 20
Should the income statement include all income and expense arising from changes in insurance liabilities? Why or why not?

No comment provided.

Other matters
Question 21
Do you have other comments on this paper?

We have no further comments on the paper.

Our response to the AASB discussion paper focuses on matters affecting both the accounting and actuarial professions. We have not made comment on a number of proposals which are beyond the scope of our Committee.

This response reflects the nature and practical focus of the AALC. In this context we note that the comments and opinions set out in this response reflect the views of the members of the AALC, and may not necessarily reflect the view of The Institute of Chartered Accountants in Australia, the Institute of Actuaries of Australia, nor the members' respective employers.

The current members of the AALC are:
Accountants:
Gareth Mitchell AMP
Stuart Alexander Deloitte Touche Tohmatsu
Anne O'Driscoll Insurance Australia Group
Andrew Stringer The Institute of Chartered Accountants
Scott Hadfield PricewaterhouseCoopers
Mark Raumer Ernst & Young
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David Hotchkies Independent Consultant
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We would be pleased to discuss any aspect of this response with you. I can be contacted on (02) 9335 7547.

Yours sincerely

Ian Moyser
Chairman