Life Insurance
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Dear Sirs

Submission in response to request for comments on ED 122

Thank you for the opportunity for the Life Insurance Actuarial Standards Board (LIASB) to comment on the draft of the Preface (ED122) that the Australian Accounting Standards Board (AASB) intends to use to describe the means by which AASB 1023 and AASB 1038 will be brought into line with the draft requirements of the International Accounting Standards Board (IASB) contained in IASB ED 5 and other relevant standards.

The LIASB is a statutory body established under the Life Insurance Act (1995) to make actuarial standards in respect of life insurers (including friendly societies) in the form of subordinate legislation, principally in the areas of

- realistic measurement of policy liabilities (within a framework where assets are measured at net market value) for the purpose of
    - monitoring of profitability by the Australian Prudential Regulation Authority (APRA), and
    - tracking of the separate entitlements of participating policyowners and shareholders by APRA
- solvency capital requirements, and capital adequacy requirements generally. These have as their starting point, and then build upon, a realistic measurement of policy liabilities.

In this submission, therefore, we have confined our comments to matters that affect life insurers and AASB 1038. We have also confined our comments to matters that may have the capacity to distort economic substance and render general purpose financial reports unsuitable for the supervisory and prudential purposes outlined above.

In making the comments that follow we first paraphrase each aspect of the proposed approach that causes us concern and then summarise our concern (or question):

1. *Proposal:* The requirement to recognise the excess of net market value over net assets of subsidiaries is to be removed from AASB 1038. Acquired goodwill will continue to be recognised (subject to impairment testing), but internally generated goodwill can no longer be recognised.

   Concern: This change is sensible for assets held in the Shareholder Fund of a life insurer, but when it comes to measuring the entitlements of participating policyowners in non investment-linked funds and all policyowners in investment-linked funds it is necessary for assets in policyowner funds (Statutory Funds) to be at fair value. Also, this needs to be the case for all such assets, but it is unclear what is intended in the case of assets that might be excluded under IAS 39 from being treated as traded by limits or by definitions such as 'private equity' and 'non-traded equity'.

2. *Proposal:* Assets backing insurance liabilities must be measured at fair value.

   Question: This requirement is important in maintaining consistency of measurement between assets and liabilities. Are we correct in assuming, therefore, that in the case of assets the requirement will be achieved by treating them as trading, but not as 'available for sale', given that the latter would call consistency into question?

3. *Proposal:* Current indications are that fair value measurement of liabilities of investment contracts under IAS39 will:
   (i) not permit recognition of profits at point of sale
   (ii) implicitly allow for deferral and amortisation of acquisition costs, but on a narrower definition of acquisition costs than under AASB 1038
   (iii) be subject to limitations owing to the minimum of the surrender value applying to liabilities, and to possible renewal revenue recognition limits.

   Concern: We consider (i) to be appropriate. On the other hand, (ii) will to some extent lead to reporting which does not reflect the economic substance on which the business is written, and will introduce an inconsistency between investment and insurance contracts. Of greater concern, however, is (iii), namely that the fair value of liabilities will be subject to a minimum of the surrender value, and possibly to limits on the recognition of renewal revenue. For many investment contracts this requirement would prevent the deferral of some or all of the acquisition costs allowed for in their design and pricing, leading to losses being reported at the time of writing the business even though the costs are recoverable.

   In particular, we consider that the surrender value and renewal recognition limitations in (iii) may undermine the usefulness of general purpose financial reports for these contracts not only as far as APRA is concerned, but also more generally.

4. *Proposal:* Insurers will have the option to measure assets in excess of insurance liabilities on any relevant basis allowed under IAS39, IAS40, IAS16 etc (fair value, cost, amortised cost, available for sale etc).

   Concern: While this option may be appropriate for the Shareholder Fund, it will lead to confusion to have different bases within Statutory Funds for the measurement of assets backing liabilities and of excess assets respectively. We consider that all Statutory Fund assets should be measured at fair value.

5. *Proposal:* Under AASB 1038 deferred tax assets and liabilities are discounted, but from 2005 deferred tax assets and liabilities will fall under IAS12, which presently does not permit discounting.

   Concern: Such a change will cause a discontinuity not only in financial reports, but potentially also in policyowner entitlements, leading to possible inequity.

6. *Proposal:* It is proposed to amend liability measurement under AASB 1038 to require a discount rate that is based on a risk free rate in situations where the value of insurance liabilities is independent of the value of the assets backing them.

   Question: We believe that it is sensible in these situations to move to a discount rate that is relatively risk free. However, it is not clear exactly what is intended. For example, will the class of obligor and term of investment that is considered to lead to a discount rate 'based on a risk free rate' be indicated? We would welcome the opportunity to provide input on this matter as the specific detail of the basis is developed.

Finally, we would like to express our support for the AASB in its work to relate the IASB standards to the Australian environment. In particular, we will do everything that is consistent with our responsibility under the Life Insurance Act to minimize any differences between the AASB financial reporting and the LIASB prudential standards. In this regard, and subject to the small number of matters raised in this submission, we are most encouraged by ED 122 and we wish the AASB every success in finding the best way forward.

Yours sincerely

Tim Jenkins
Chairman