ACCOUNTANTS AND ACTUARIES
LIAISON COMMITTEE

31 October 2003

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

Dear Mr Clark

Request for Comment on IASB ED 5 Insurance Contracts

The Accountants and Actuaries Liaison Committee (AALC) is pleased to make this submission on the above exposure draft issued by the International Accounting Standards Board (IASB) dated July 2003.

The AALC is sponsored jointly 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 reporting standards. The AALC takes a practical approach to problems, as its members are all practitioners in insurance and related fields.

This submission reflects the nature and practical focus of the AALC. It this context we note that the comments and opinions set out in this submission 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:	Lesley Mamelok	AMP
	Caithlin McCabe	Deloitte Touche Tohmatsu
	Anne O'Driscoll	Insurance Australia Group
	Keith Reilly	The Institute of Chartered Accountants
	Jann Skinner	PricewaterhouseCoopers
	Kim Smith	Ernst & Young
	Andries Terblanché	KPMG

Actuaries:	Tim Furlan	Towers Perrin
	David Hotchkies	Ernst & Young ABC
	Greg Martin	KPMG Actuaries
	Blair Nicholls	QBE Insurance
	Bruce Watson	Deloitte Trowbridge

Approach to submission

The AALC supports the development of an international accounting standard on insurance. As you are aware, Australia has had a standard for each of general and life insurance for some years, ie AASB 1023 and AASB 1038, respectively. A number of the concepts being developed by the IASB in respect of accounting for insurance contracts are similar to the existing Australian practice.

We look forward to being in a position to review the further development of how "fair value" will be determined for insurance contracts. The absence of such a fundamental "piece of the jigsaw", and the consequent need to allow for considerable variation in practice during the development of Phase II, significantly limits the value of Phase I for international harmonisation of accounting standards.

We have restricted our comments to the two areas of major concern to us, being the measurement of liabilities associated with investment contracts and disclosure, and one concern about the definition of an insurance contract. We have also made an additional comment on the scope exclusions.

Measurement of liabilities associated with investment contracts

We have a number of significant concerns regarding the intended basis for determining the fair value of liabilities under investment contracts. Based on the requirements of IAS 39 and various pronouncements of the IASB, we understand that the "fair value" measure of liabilities under investment contracts as currently defined:

(i) Generally will not permit recognition of profits at point of sale;
(ii) Will implicitly allow deferral and amortisation of transaction costs, being "incremental costs that are directly attributable to the acquisition or disposal of a financial asset or financial liability"; and
(iii) Will be subject to a minimum of the surrender value under the contract.

None of these are consistent with the concept of fair value, as defined, in IAS 39 and elsewhere, by the IASB. While we can accept the requirement not to permit recognition of profits at point of sale, we have significant concerns regarding the latter two requirements. These represent a significant change from the current basis of measurement under AASB 1038 and, in our view, represent a significant step backwards, both in terms of the usefulness of the resulting measures, and in terms of progress towards implementation of true fair value.

The requirement to defer and amortise transaction costs means that there will be other elements of an insurer’s acquisition costs that are not deferred. Such amounts will effectively be reported as a loss at point of sale, even in cases where the investment contract is priced on profitable terms.

Similarly, the imposition of a minimum of surrender value is likely to result in material losses being reported at point of sale for inherently profitable contracts.

These requirements may lead to outcomes that are at odds with the fundamental economics of the business, and hence may produce financial statements that are not meaningful, and may even mislead users. The faster a company’s business grows, the greater the potential distortion in results, ie the greater the potential reported loss. This could have the effect of acting as a barrier to entry for new companies, which could adversely affect the competitiveness of the industry.

In Australia, the introduction of AASB 1038 represented a significant step forward for the life insurance industry, to a position amongst world’s best practice in terms of realistic financial reporting. In the opinion of a number of Australian practitioners, adopting fair value, as currently implemented under IAS 39, will represent a significant step backwards for the Australian industry.

In our view, the ideal outcome for investment contracts would be:

(i) The removal of the surrender value minimum (deposit floor); and
(ii) Broadening of the definition of transaction costs to be equivalent to the definition of acquisition costs currently applicable under AASB 1038.

In the absence of any consideration by IASB to alter IAS 39 to remove the deposit floor and change the definition of transaction costs, we will be seeking that the Australian Accounting Standards Board develop an alternative treatment of investment contracts. This could entail, for example, splitting investment contracts into two components:

- A “wholesale” component which would fall under IAS 39; and
- A “retail” component, which represents the service contract element of the investment contract, and which could fall under IAS 18 “Revenue” (or IAS 38 “Intangibles”).

Disclosure (Questions 10 and 11)

We support the intention of the IASB in enhancing the disclosures which insurers are required to make in their financial statements. The provision of more detailed information as to the material subjective or judgemental areas of insurers' financial statements will greatly assist users to make informed views on the information presented therein.

Whilst supporting the concept of enhanced disclosure, we believe that clarification is required on the implementation of the requirements, which in their current form present broad principles of information requiring disclosure. Based on a literal interpretation of the EDs many of the requirements may be extremely onerous to comply with and go beyond what would be reasonably expected in a set of general purpose financial statements.

We have outlined in Appendix A more detailed comments on the various proposals within ED 5 but summarise our comments as follows:

- We believe the extent of disclosure currently proposed may make it more difficult for financial statement users to be able to discern key information that would allow them to make informed decisions. The AASB should consider the benefits of more specific disclosure requirements that focus on key areas rather than providing more extensive disclosure that appears to be of questionable value or appropriateness in general purpose financial statements. Specifically, we consider this should include disclosures in the following key areas:
    a. Analysis of profit;
    b. Key financial assumptions;
    c. Analysis of the sensitivity of assumptions;
    d. Solvency information; and
    e. Current year impact of changes to past assumptions.
- The proposed framework, which focuses on high-level principles and concepts, is contrary to the current Australian GAAP approach that is largely prescriptive with respect to disclosure requirements. We believe that further guidance regarding disclosure requirements is required to ensure consistency of presentation and disclosure. Similarly, many of our comments on the proposals have been restricted by a lack of guidance on the extent and form of disclosure required as while the Draft Implementation Guidance provides a very extensive list of matters to be disclosed, we foresee considerable practical difficulties in producing the information in a meaningful and practical fashion for large insurers operating in a wide range of products and geographies.

- Certain disclosures are significantly more onerous than the current requirements under Australian GAAP (subject to the further guidance suggested above), which, as noted previously, has had specific insurance accounting standards and disclosure requirements for some years. Whilst supporting many of the enhanced disclosures there is a risk that, in the absence of further guidance, the proposals could result in an onerous burden on preparers of financial statements, or requiring the disclosure of commercially sensitive information.

We are also concerned about the practical implications of requiring disclosures by 31 December 2006 given that guidance for the measurement of insurance liabilities has not been released. We note that BC 140 states that the *"Board must resolve several significant issues about fair value, both conceptual and practical in phase II"* and we therefore question whether it is either realistic or "fair" to the insurance industry to require such experimentation prior to gaining general acceptance from the financial institutions community on the practicality of requiring such disclosure.

Definition of an insurance contract (Question 2)

We believe that the definition of an insurance contract as contained in appendix A to ED 5 is appropriate. However, we have concerns about the guidance contained in Appendix B to ED 5. These concerns are around the definition of "significant insurance risk".

Paragraph B21 states *"insurance risk is significant if, and only if, it is plausible that an insured event will cause a significant adverse change in the present value of the insurer's net cash flows arising from that contract (before considering possible reinsurance recoveries, because the insurer accounts for these separately). This condition is met even if the insured event is extremely unlikely or if the present value of contingent cash flows is a small proportion of the expected (ie probability-weighted) present value of all contractual cash flows"*.

B22 states *"insurance risk is not significant if the occurrence of the insured event would cause a trivial change in the present value of the insurer's contractual cash flows in all plausible scenarios".*

The definition of plausible is "*having an appearance of truth or reason*". Given this definition it would appear that as long as an insured event has an appearance of truth or reason that it will meet the definition of an insurance contract even though it is not probable that the event will eventuate. We further note that paragraph B21 does state that a contract will meet the definition of an insurance contract even if it is extremely unlikely. We believe that this definition will be difficult to apply in practice. We understand the IASB decision not to include quantitative guidance in the ED5 as it does create an arbitrary dividing line but are of the opinion that the board needs to revisit the definition of "significant insurance risk" and how the definition will apply in practice.

Changes in accounting policy (Question 5)

We consider that, in addition to the restrictions noted in paragraph 16 of ED5, the IASB should require that entities accounting for liabilities under insurance contracts should strive to ensure that their assets backing insurance contracts are stated on an equivalent basis so that mismatches are minimised.

Conclusion

We would be pleased to discuss any aspect of this submission with you. I can be contacted by e-mail on anne.o'driscoll@iag.com.au or by phone on +61 2 9292 3169.

Yours sincerely

Anne O'Driscoll

Anne O'Driscoll
Chairman

Cc The Chairman, Australian Accounting Standards Board

ED 5 disclosure requirement	Selected draft implementation guidance/ other information	Comments
Explanation of reported amounts		
• ED 5 requires insurers to disclose information that identifies and explains the amounts in its balance sheet and income statement that arise from insurance contracts. To comply with this requirement, an insurer is required to disclose:		
a. Its accounting policies for insurance contracts and related assets, liabilities, income and expense.	a. The Draft Implementation Guidance on ED 5 recommends disclosure of those judgements made in the application of accounting policies which have the most significant effect on the amounts recognised in the financial statements	a. Further guidance is required to fully understand the disclosures being proposed. Should the proposal be referring to more detailed aspects of accounting policies (for example the basis on which market value is determined), we do not perceive that this requirement would pose a significant change from current Australian GAAP.
b. The material amounts of assets, liabilities, income and expense (and, if it presents its cash flow statement using the direct method), cash flows arising from insurance contracts.	b. The Draft Implementation Guidance recommends the disclosure of material sub-classifications of insurance liabilities, including case estimates and IBNR.	b. We support this recommendation, however guidance as to the appropriate level of sub-classification may assist in the preparation of financial statements.

ED 5 disclosure requirement	Selected draft implementation guidance/ other information	Comments
c. The process used to determine the assumptions that have the greatest effect on the measurement of these amounts and, when practicable, give quantified disclosure of those assumptions.	c. ED 5 states that some constituents have expressed concerns that disclosing information about assumptions and changes in assumptions may be costly to produce, commercially sensitive and of limited usefulness. In response to these concerns, the draft IFRS proposes that disclosures about assumptions should focus on the process used to derive those assumptions, rather than the assumptions themselves. The Guidance recommends that an insurer disclose the process they undertake to identify correlations between different assumptions. This would also include disclosure of changes in assumptions and the resultant interdependent changes.	c. We do not believe that disclosure of 'the process used to determine' certain key assumptions will provide additional benefit to users of the financial statements. Rather, the disclosure of key financial assumptions will allow users to make an informed view about relevant items in the financial statements. We believe that the ED should specify which financial assumptions are required to be disclosed by insurers. Whilst we acknowledge that the disclosure of sensitivity of items to changes in assumptions will greatly enhance the quality of disclosure in financial statements, we remain concerned that this requirement would be both onerous to comply with and potentially require the disclosure of commercially sensitive information. We believe that the ED

ED 5 disclosure requirement	Selected draft implementation guidance/ other information	Comments
		should specify the extent to which it will require sensitivity analysis in insurers' financial statements. We believe that disclosure of the correlation of significant assumptions would be useful, rather than disclosure of the process undertaken to identify and assess such correlations. We believe, however, that further guidance is required on the appropriate level to which disclosure of correlations should be made.
• The effect of changes in assumptions used to measure insurance assets and insurance liabilities, showing separately the effect of each change that has a material effect on the financial statements.		• We support enhanced disclosure of the impact of changes to assumptions since past financial statements. • However, in their current form, the EDs does not provide sufficiently detailed guidance as to the level of disclosure required. The proposals would appear sensible if limited in scope to changes in economic assumptions. The current EDs could, however, be interpreted to require significantly greater

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		disclosure, and could, for instance, extend to require disclosure of re-assessments to case estimates.
• Material changes in insurance liabilities, reinsurance assets, and, if any deferred acquisition costs.	• Paragraph 27 of the draft IFRS requires an insurer to disclose movements in aggregate insurance liabilities. The Guidance states that the movements would typically include: a. The carrying amount at the beginning and end of the period b. Additional insurance liabilities incurred during the period, including increases in existing insurance liabilities. c. Amounts used (ie, incurred and charged against the insurance liabilities) during the period. d. Unused amounts reversed during the period. e. Income and expense included in profit and loss f. Liabilities acquired from, or transferred to, other insurers g. Foreign exchange translation differences.	• We do not believe that this disclosure would provide useful information to users of the financial statements.

ED 5 disclosure requirement	Selected draft implementation guidance/ other information	Comments
Amount, timing and certainty of cash flows		
• ED5 requires an insurer to disclose information that enables users to understand the estimated amount, timing, and uncertainty of future cash flows from insurance contracts. To comply with this requirement, an insurer is required to disclose:	• The Draft Implementation Guidance suggests that insurers provide an analysis of the recognised insurance liabilities and reinsurance assets by the periods in which the net cash inflows and outflows are expected to occur. The analysis is for the following periods after the balance sheet date: ▪ Not later than one year; ▪ Later than one year and not later than two years; ▪ Later than two years and not later than three years; ▪ Later than three years and not later than four years; ▪ Later than four years and not later than five years; and ▪ Later than five years. If material amounts are estimated to occur after more than five years, an insurer may need to give further analysis in bands of, for example, five years.	• We believe that the recommended disclosures represent spurious accuracy having regard to the uncertainty of timing of such cash flows. The uncertainty of cash flows is the fundamental of insurance. Accordingly we do not support the proposal.

ED 5 disclosure requirement	Selected draft implementation guidance/ other information	Comments
a. Its objectives in managing risks arising from insurance contracts and its policies for mitigating risk.		a. We agree that disclosure of risk management objectives would strengthen the corporate governance aspects of insurers' reporting. However, we believe that further guidance needs to be issued on the level of detailed required in the proposed disclosure, as much detailed information in this area would be commercially sensitive.
b. Those terms and conditions of insurance contracts that have a material effect on the amount, timing, and uncertainty of future cash flows.		b. We agree that disclosure of insurers' key product types would assist users of the financial statements. For many insurers with a wide range of products, however, disclosure of terms and conditions may prove unduly onerous.
c. Information about *insurance risk*, both before and after risk mitigation by reinsurance, including information about: i. The sensitivity of reported profit or loss and equity to changes in variables that have a material effect on them. ii. Material concentrations of insurance	c. The Draft Guidance Notes provide a suggested format for the claims development table	c. i. Conceptually, we agree with the requirement to disclose the sensitivity of reported results to changes in key variables, however guidance on the level of disclosure required needs to be issued. In the absence of

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risk. iii. Actual claims compared with previous estimates (claims development). The disclosure about claims development shall go back to the period in which the earliest material incurred claims still outstanding arose, but need not go back more than 10 years. It follows that an insurer need not disclose this information for claims that are typically settled within one year.		specific guidance as to the requirements these disclosures could be extremely onerous. ii. Disclosure of insurers' concentrations of insurance risk may, in detailed form, be both commercially sensitive and onerous. We believe specific guidance is required as to the level of detail with which these disclosures are required to be made. iii. We support the proposed enhancements to claims development tables. The Board should emphasise, however, the importance of including any separately-disclosed unusual claims expenses or developments in the table to allow reconciliation to the outstanding claims balance reported in the balance sheet. Similarly, we note that the guidance refers to losses by underwriting year, however we

ED 5 disclosure requirement	Selected draft implementation guidance/ other information	Comments
		believe that this should be clarified as being losses by *accident* year to ensure that the disclosures reconcile to the balance sheet.
d. The insurer is required to disclose information about interest risk and credit risk. The information is the same that would be required by IAS 32 Financial Instruments: Disclosure and Presentation	d. The Draft Implementation Guidance states the following with respect to disclosure of interest and credit risk: i. If lapse behaviour is likely to be sensitive to interest rates, an insurer discloses that fact and states whether the disclosures about risk reflect that interdependence. ii. Disclosure of information about the extent to which policyholder participation features mitigate or compound interest rate risk. iii. Disclosure of credit risk is likely to be important for reinsurance contracts held and for credit risk assumed under credit insurance contracts and financial guarantees. Balances due from insurance brokers may also be subject to credit risk.	d. More specific guidance is required to determine the level of detail required by the disclosure.

ED 5 disclosure requirement	Selected draft implementation guidance/ other information	Comments
e. Although IAS 39 Financial Instruments: Recognition and Measurement requires an insurer to measure some embedded derivatives at fair value, this requirement does not apply to an embedded derivative that itself meets the definition of an insurance contract. (for example, guaranteed annuity options and guaranteed minimum death benefits). The draft IFRS would require an insurer to disclose information about material exposures to interest risk or market risk under embedded derivatives contained in a host insurance contract if the insurer is not required to and does not measure the embedded derivative at fair value.	e. The Draft Implementation Guidance suggests that even though certain contracts meet the definition of an insurance contract because the insurance risk is significant, in some cases, interest risk or market risk may be more significant. An example of this would be long-term contracts with some form of payment guarantee. If equity markets or interest rates were to fall, these contracts would be 'in the money' and an insurer would face extremely large losses on a fair value basis. As a result, the Guidance places emphasis on this disclosure.	e. We support the proposed disclosure. Further guidance as to the nature and form of these required disclosures would assist in the preparation of the financial statements.