Institute of Actuaries of Australia

3 November 2003

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

Dear Mr Clark

SUBMISSION ON ED 5 INSURANCE CONTRACTS

The Institute of Actuaries of Australia (IAAust) has pleasure in enclosing a submission on Exposure Draft ED 5. This submission represents the views of the actuarial profession in Australia.

The Actuarial profession in Australia and globally plays a key role in financial reporting. Members of the Institute have long held major roles in the financial management and oversight of insurers in Australia. The Institute also plays an active role in international dialogue on reporting for insurers, with both the international actuarial and international accounting bodies.

The Institute strongly supports the development of a comprehensive set of high quality international accounting standards, and Australia's alignment with such standards where this would not represent a weakening of Australian financial reporting standards. In this regard, we note that the insurance industry in Australia currently has world class standards and we are concerned that some aspects of the international standards that are now emerging will represent a step backwards for the Australian insurance industry. This could lead to an unjustified adverse re-rating of Australian insurers by investors, and to an increase in their cost of capital.

We hope that our comments will be of assistance to the IASB and we would be pleased to clarify or discuss further any aspect of this submission as appropriate. Enquiries should initially be directed to Mr Clive Aaron, who can be contacted via the IAAust office, tel. no. +61 2 9239-6106.

Yours sincerely

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SUBMISSION TO IASB ON ED 5

1. Introduction

This submission sets out the views of the Institute of Actuaries of Australia (IAAust) on a number of matters relating to Exposure Draft ED 5 issued by the International Accounting Standards Board.

The IAAust strongly supports the development of a comprehensive set of high quality international accounting standards, and Australia's alignment with such standards where this would not represent a weakening of Australian financial reporting standards.

This submission comprises:

- A summary of the views of the IAAust on ED 5 (Section 2);
- Commentary on our key issues and observations (Section 3);
- Responses to the specific questions posed in ED 5 (Attachment 1);
- Commentary on principles of fair value measurement (Attachment 2).

We appreciate the opportunity to make this submission and would be pleased to clarify or discuss further any aspects of this submission as appropriate.

2. Summary of IAAust Views

2.1 Consistency of measurement of assets and liabilities

Consistent measurement of assets and liabilities in an insurer's financial statements is critical to the coherent reporting of the insurer's financial position.

We have serious concerns that consistency of measurement will not be achieved under IFRS due to the different measurement approaches which can apply to different categories of assets and liabilities. This is then compounded by the choice of measurement methods available under certain standards, most notably IAS 39. This is a significant flaw that current proposals fail to address.

We would point out that the Australian Accounting Standards Board (AASB) is proposing to address this issue for Australian insurers by requiring that assets backing insurance contracts be measured at fair value (which is consistent with the Australian liability measurement method for such contracts), and that investment contract liabilities, and the assets backing them, also be measured at fair value. We would strongly urge the IASB to similarly require a measurement basis for assets that is consistent with the measurement basis for liabilities, where this is possible.

We note a number of other instances where consistency of measurement, and associated recognition of movements through profit and loss, will not be achieved under the proposed IFRS framework:

- Where an investment that is held to back investment linked or discretionary business is classified as a subsidiary (i.e. is controlled), then there will be an inability to recognise the excess of net market value over net assets of the subsidiary. This may create a misalignment between the measurement of assets and the measurement of liabilities;

- There is a similar issue in respect of owner occupied property that is held to back investment linked or discretionary business. Movements in the fair value of such assets cannot be recognised through profit and loss, but must be taken directly to reserves. Where that same movement is reflected in liabilities to policyholders there will be an inconsistency in reported profit; and

- The inability to discount deferred tax assets and liabilities may lead to an inconsistency between the measurement of these provisions and the measurement of policy liabilities.

We recommend that changes be introduced to ED 5 to achieve alignment of measurement of assets and liabilities, and appropriate recognition of profit, both for insurance business and for investment business conducted by insurers.

2.2 Measurement of liabilities under investment contracts

Liabilities under investment contracts are to be measured under IAS 39, which provides a choice of amortised cost and fair value measurement bases. We strongly support the availability of a fair value measurement option in principle (and we note that the AASB is intending to require Australian insurers to use the fair value option for investment contracts). However we have a number of significant concerns regarding the intended basis for determining the fair value of such contracts:

- The fair value measure is to be subject to a minimum of the surrender value under the contract; and

- The intended basis will effectively permit deferral of incremental transaction costs only, not all genuine acquisition costs.

These requirements will result in companies reporting losses at point of sale for business that is inherently profitable. Conversely, destruction of value through the loss of profitable business will have no discernible profit impact. The result will be financial statements that blur the boundaries between realistic profit reporting and solvency measurement, resulting in statements that are not meaningful and may even be misleading to general purpose users. This will represent a significant step backwards for the Australian life insurance industry, since our current life insurance standard arguably represents world's best practice in terms of realistic financial reporting.

We recognise the difficulties involved in addressing these issues. However, we think that practical solutions can be found and we would be pleased to assist the IASB in developing alternative approaches.

2.3 *Disclosure of valuation assumptions*

We support the broad thrust of the disclosure requirements. We also support the broad approach of specifying high level requirements rather than prescribed details. Nevertheless, we are concerned that the Implementation Guidance could potentially be interpreted in a way that leads to excessive and impractical disclosure outcomes.

We believe it would be appropriate for the IASB to develop a statement of implementation principles and make it clear that Implementation Guidance is subordinate to the principles. This would allow entities to formulate practical and commercial disclosure outcomes that are consistent with the intended principles.

2.4 *Disclosure of fair value*

Paragraph 30 of ED 5 requires an insurer to disclose the fair value of insurance liabilities. This requirement is to become effective on 31 December 2006.

In principle, we support the disclosure of fair value of liabilities. However, we are concerned with the direction that the fair value measurement debate is taking at the current time. If the basis for determining fair values for disclosure follows this direction, then we seriously question the usefulness of the resulting measures.

In particular:

- We are concerned that the fair value of an insurance contract should not necessarily be set by reference to current premium rates (particularly in the case of general insurance business where, in the "soft" part of the market cycle, this is a really bad idea). In our view, the only valid approach to determining the fair value for insurance contracts is through valuation techniques; and
- We are strongly opposed to fair values being subject to a minimum of the surrender value under a contract.

We would be pleased to assist the IASB in the development of a suitable measurement basis.

Depending on the basis that is ultimately put forward, it may be a non-trivial task for companies to develop processes and systems to support the calculation of fair values. It will therefore be important for the industry to be given sufficient lead-time to respond to this requirement. Until the detailed requirements are known, it is inappropriate to establish an explicit deadline for disclosure.

2.5 *Embedded Derivatives in Insurance Contracts*

Paragraphs 5 and 6 of ED 5 require certain embedded derivatives in insurance contracts to be separated and measured at fair value under IAS 39.

We support the fair value measurement of embedded derivatives, options and guarantees. However, the separate measurement of such options that may be embedded in insurance contracts is potentially only a temporary requirement arising under Phase I because insurance contracts are not currently measured at fair value. We are therefore concerned with the practicality of introducing this requirement in Phase I, when the separation of these options may not be required in the longer term.

The requirement therefore contradicts the stated purpose of ED 5 not to introduce changes that may subsequently be reversed under Phase II.

On practicality grounds we therefore suggest that paragraphs 5 and 6 of ED 5 be deleted in their entirety subject to the following:

- A strengthening of the loss recognition test to include the cost of all embedded derivatives, options and guarantees;
- Addition of a condition under Paragraph 16 that a new accounting policy must at least measure any embedded derivative within insurance contracts in a manner which allows for inherent asymmetry of future outcomes;
- A requirement for companies to disclose all material exposures to interest rate or market risks under options and guarantees in insurance contracts; and
- Appropriate allowance being made for the cost of embedded derivatives, options and guarantees in Phase II.

We believe that the above proposal is a practical compromise in the circumstances: companies will not need to determine the cost of non-material embedded derivatives, but the cost of any material embedded derivatives, options and guarantees will need to be considered for loss recognition purposes.

2.6 IASB Framework

While this does not directly relate to ED 5, since ED 5 is an interim measure which does not attempt a strict application of the principles embodied in the IASB *Framework for the Preparation and Presentation of Financial Statements* (the "Framework"), we are concerned that the Framework, as it stands, does not provide a sound basis for accounting in the context of pervasive and substantial uncertainty, such as is found in insurance, particularly general insurance. As part of Phase II of the IASB Insurance Project, we will be arguing that this Framework needs to be modified to make it properly applicable in this stochastic context.

One aspect of this issue is the pervasive use of "measurement" and related terms, in accounting standards. Although this is qualified, in the Framework, and elsewhere, by comments that an appropriate estimate can be regarded as a reliable measurement, it nevertheless creates a false impression of precision and certainty. This is a particular problem in the context of general insurance, where the uncertainties can be highly material. We believe that it is generally preferable to use terms such as "estimation" and "valuation", when there is a material degree of uncertainty. In our view, "measurement" should be reserved for quantities, such as historical cost, where there is little or no uncertainty.

However, because we are commenting on an exposure draft that uses "measurement" for this concept, we have also used "measurement" in this submission.

3. Commentary on Key Issues and Observations

3.1 Consistency of measurement of assets and liabilities

Consistent measurement of assets and liabilities in an insurer's financial statements is critical to the coherent reporting of the insurer's financial position. While the IASB *Framework for the Preparation and Presentation of Financial Statements* calls for consistency of measurement over time and between comparable entities, it is silent on consistency within an entity, and this requirement is ignored in a number of IFRSs including, notably, IAS 39.

The greatest problem with inconsistent measurement arises when quantities are subtracted. "If you subtract apples from oranges, the answer is bananas." If the values of assets and liabilities are not measured consistently, then their difference, equity, is likely to be misleading. If these inconsistent measures behave differently in response to external factors that affect both, then the movement in their difference, and hence profit, is likely to be a total nonsense.

Most assets held by insurers will be measured under IAS 39, which offers a degree of choice, between amortised value and fair value. In most cases, the bulk of an insurer's investments will be at fair value, as being either held for trading, with movements going through profit and loss, or available for sale, with movements accounted for in equity. The held to maturity category, valued at amortised value, is likely to only be realistic for a subset of assets. IAS 39 provides an option to designate any assets as trading and, thus, measured at fair value with movements through profit and loss.

Liabilities in respect of investment contracts measured under IAS 39 offer a similar option, but few of these would fall naturally into the trading category and, as a result, there is substantial scope for the insurer to choose between fair value and amortised value. Under ED 5, liabilities in respect of insurance contracts may continue to be measured under existing national GAAP. Depending on jurisdiction, the valuation bases range from not far different to fair value, through a variety of amortised approaches, to undiscounted.

Perhaps the most important difference between these various asset and liability measurement bases, in terms of their behaviour over time, is their approach to discounting. There are three main approaches:

- undiscounted;
- discounted at historical rates;
- discounted at current rates.

Any mixture of these will make a nonsense of the assessment of equity and profit.

Fair value implicitly discounts at current rates, as do the Australian life insurance (Margin on Services) and general insurance accounting standards. Amortisation under IAS 39 effectively discounts at historical rates.

The Australian Accounting Standards Board (AASB) is proposing to address the consistency issue by requiring that assets backing insurance contracts be measured at fair value (which is consistent with the Australian liability measurement method for such contracts), and that investment contract liabilities, and the assets backing them, also be measured at fair value. We would strongly urge the IASB to similarly require a measurement basis for assets that is consistent with the measurement basis for liabilities, where this is possible, both for insurance business and for investment business conducted by insurers.

- Where national GAAP uses current discount rates, then the Australian solution is directly applicable.
- Where national GAAP uses historical discount rates, then consistency could be achieved by valuing assets under IAS 39 at amortised value, but this option is severely constrained by the fact that most insurer investments are clearly not intended to be held to maturity and are, therefore, ineligible for designation as such. This is an almost inevitable consequence of setting rules which work in a simple context, without considering what they imply in more complex cases. An alternative, where national GAAP uses historical discount rates, is to add another category of assets to IAS 32/39, namely "Held to Back Amortised Liabilities", under which fixed (or index-linked) interest assets could be measured at amortised value. If desired, this could be limited to assets backing insurance liabilities.
- Where national GAAP requires undiscounted provisions, neither of the IAS 39 valuation options is compatible, although spurious profit movements would be reduced by the historical discount rate approach of amortised value.

Nonetheless, under either of these "cost" based approaches, where the assets and liabilities are mismatched, the reported profit and equity amounts will be artificially "smoothed". As such we see these approaches as not consistent with fair value principles.

3.2 Excess of net market value over net assets of subsidiaries

There may be instances where companies hold subsidiaries as part of the investment assets backing unit linked or discretionary insurance business portfolios. In such instances, the value of the liabilities will reflect the full value of the backing assets. Hence the inability to recognise the excess of net market value over net assets of subsidiaries in such instances may create a misalignment between the measurement of assets and the measurement of liabilities. To avoid this distortion, we propose that insurers be permitted to recognise the excess of net market value over net assets where the value of insurance contract or investment contract liabilities is dependent on the value of such assets backing those liabilities.

3.3 Owner Occupied Property

An office building occupied by an insurance company is no different from any other office building that may be held as an investment asset. Insurance companies (and other financial service providers) will in all likelihood hold such assets in the funds supporting their insurance and investment contracts. In the interests of policyholder equity, changes in the fair value of the property will be reflected in the benefits to policyholders and hence in changes in the value of the liabilities.

However, that same movement in the fair value of the property asset cannot be recognised through profit and loss, but must be taken directly to reserves. An inconsistency in reported profit will therefore result. To avoid this distortion, we again propose that, where owner occupied property is an investment asset of a fund that supports insurance or investment contracts, insurers should be permitted to recognise the movement in the fair value of the property as investment income.

3.4 *Discounting deferred tax assets and liabilities*

Deferred tax assets and liabilities are measured under IAS 12, which does not permit the discounting of deferred tax.

In certain circumstances, it may be appropriate, on equity grounds, to allow for discounted deferred tax provisions in determining policy benefits for investment linked or discretionary insurance business. In such circumstances, if it is not permitted to discount deferred tax provisions for accounting purposes, then this will lead to an inconsistency between the measurement of these provisions and the measurement of policy liabilities.

We therefore recommend that insurance companies be permitted to discount deferred tax provisions in the situation where this is required to achieve consistent treatment of policy liabilities and the relevant tax provisions. Alternatively, if this is not achievable within the relevant IFRS, we propose that a compensating adjustment be permitted within the policy liability.

3.5 *Measurement of liabilities associated with investment contracts*

It is proposed that the measurement of liabilities under investment contracts will be in accordance with IAS 39. One option under IAS 39 is for such liabilities to be designated as held for trading, i.e. measured at fair value.

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 is 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, both in terms of the usefulness of the resulting measures, and in terms of progress towards implementation of true fair value reporting.

The requirement, to defer and amortise incremental transaction costs only, 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 many inherently profitable contracts. Conversely, the destruction of value through the loss of profitable business will have no discernible profit impact.

We believe that these requirements have arisen from unsound technical foundations. Further, both of these requirements lead to outcomes that are at odds with the fundamental economics of the business. The result will be financial statements that blur the boundaries between realistic profit reporting and solvency measurement, resulting in statements that will not be meaningful, and may even mislead general purpose users. The greater the rate of change in a company's business, the greater the potential distortion in results. This could have the effect of acting as a barrier to entry for new companies which could adversely affect the competitiveness of the industry.

We note that in Australia, we have a regulatory framework that recognises the need to separate profit reporting and solvency measurement. This has allowed the development and implementation of realistic profit reporting measures for insurers. The methods now being proposed as a basis for IFRS will therefore represent a significant step backwards for the Australian insurance industry.

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

(i) the removal of the surrender value minimum (deposit floor); and

(ii) the broadening of the definition of transaction costs to encompass all genuine acquisition costs.

We recognise that such changes may be problematic given the current construction of IAS 39. We see two ways forward:

(i) Alter IAS 39 to remove the deposit floor and change the definition of transaction costs; or

(ii) Develop an alternative treatment of investment contracts. For example, splitting investment contracts into two components:

1. A financial instrument component which would fall under IAS 39; and
2. A service component, which represents the service contract element of the investment contract, and which could fall under IAS 18 "Revenue" (or IAS 38 "Intangibles").

We would be pleased to assist the IASB in the development of such an alternative approach.

Finally, we note that there is presently a lack of clarity as to the treatment of continuation or renewal options for the purposes of measuring fair values under IAS 39. In our view, the appropriate treatment of such options is to allow for expected (i.e. probability-weighted) surrender patterns in the projection of future cashflows. We suggest that this point be clarified prior to finalising the amendments in IAS 39.

3.6 Disclosure requirements

Summary of views

We support the broad thrust of the disclosure requirements. We also support the broad approach of specifying high level requirements, rather than prescribed detail and formats. Nevertheless, we are concerned that the high level approach and the detail contained in the Implementation Guidance in the draft IFRS could potentially be interpreted in a way which leads to excessive and impractical disclosure outcomes. At various points the Implementation Guidance makes reference to principles such as disclosure at a level that is useful to users of financial statements (e.g. IG22) and practicality (e.g. IG34). We believe it would be appropriate for the IASB to develop and include a consolidated statement of implementation principles within the draft IFRS, and to make it clear that the Implementation Guidance is subordinate to those principles. This would be particularly applicable to the disclosure of assumptions and the effect of assumption changes. Such a statement would ensure that the standards are principle-based rather than detail-based and allow entities to formulate practical and commercial disclosure outcomes to meet the needs of users.

Disclosure of valuation assumptions

While we strongly support the concept of appropriate disclosure of valuation assumptions, this disclosure could be extremely voluminous, particularly for general insurance. It could also be almost unintelligible to anyone but the actuary concerned. For example, many general insurance actuarial valuations have assumptions relating to claim frequency, claim reporting pattern, average claim size and payment pattern. The reporting and payment pattern assumptions are commonly based on generalised linear models. The parameters of these models seldom relate easily to visible aspects of the claim process. Another standard approach involves assumptions that can only be expressed in the form of extensive tables of values. With the exception of mortality and perhaps morbidity, there are usually no standard tables that could be referred to by name, and even such references would not normally be meaningful to the average user of the financial statements.

We note that BC128 states that the emphasis is on the process used to derive assumptions, but IG20 has eight sub-paragraphs of things to be included in this description of process and paragraph 27(c) requires, when practicable, "quantified disclosure of those assumptions". Because the processes used can vary greatly between different classes of business, and because the assumptions vary even more widely, disclosure at this level is likely to be extremely voluminous and not very helpful.

By way of comparison, the level of disclosure appears to be rather greater than is generally considered appropriate for financial condition reporting to the Board of an insurer. In that context, it is appropriate to discuss the valuation of liabilities in terms of process, since it is important for the Board of an insurer to understand and have confidence in the valuation process. As a basis for comparison between insurers, however, it is virtually useless since there are a variety of valid approaches, all capable of giving similar answers if applied appropriately. The greater the level of detail provided, the greater the likely apparent differences and the greater the scope for confusion, rather than understanding.

A large part of the problem is that the assumptions needed will interact with each other. To use a simple example, there is a strong link between claim frequency and average claim size. This can be seen in the effect of a policy excess. Because most potential claims are small, but most of the cost comes from large claims, imposing a moderate policy excess might halve the number of claims, but only reduce the total cost of claims by a few percent, so that the average claim size nearly doubles. Similar, but less obvious, effects arise with other assumptions.

As a practical matter, we believe that, for disclosure purposes, the claim assumptions should be presented in a standardised form for each major business segment. One possibility would be, in addition to inflation, discount and expense rates, to disclose the following summary of the consequences of the claim assumptions:

- claim frequency; and
- average claim size; and either
- dollar weighted mean term from middle of year of accident; or
- a table of percentages paid by end of year of accident and yearly thereafter.

Disclosure of changes and sensitivities

The disclosure of the impact of changes in valuation assumptions is affected by the same issues. In Australia, changes in assumptions from valuation to valuation are the norm, reflecting the requirement that they be “best estimates”. Because of the interdependence between assumptions, it is not particularly meaningful to try to show separately the impact of each individual assumption. Rather, we would suggest a limited number of columns:

- discount rate
- inflation rate
- claim assumptions (as a package)
- expense rate
- one-off changes (usually zero)

Disclosure of fair value

Paragraph 30 of ED 5 requires an insurer to disclose the fair value of insurance liabilities. This requirement is to become effective on 31 December 2006.

In principle, we support the disclosure of fair value of liabilities. Fair value measures, determined on an appropriate basis, would provide valuable supplementary information for users of an insurer’s financial statements. However, we have two major concerns at this time:

(i) We are concerned with the direction that the fair value measurement debate is taking at the current time. If the basis for determining fair values for disclosure follows this direction, then we seriously question the usefulness of the resulting measures. We expand on this point in Attachment 2.

(ii) At the current time there is no definitive guidance as to how fair values are to be determined for this purpose. Depending on the basis that is ultimately put forward, it may be a non-trivial task for companies to develop processes and systems to support the calculation of fair values. It will therefore be important for the industry to be given sufficient lead-time to respond to this requirement. Until the detailed requirements are known, it is inappropriate to establish an explicit deadline for disclosure.

3.7 Financial instruments with discretionary participating features

ED 5 permits financial instruments with discretionary participating features to be accounted for under existing "insurance" accounting policies. However, in respect of investment contracts paragraph 25 in addition requires an insurer to “recognise a liability measured at no less than the measurement that IAS 39 would apply to the fixed element”. Such a measurement under IAS 39 would seem to be subject to a minimum of the surrender value.

As we interpret ED 5, the surrender value of the fixed element therefore becomes a minimum measure for the liability under the investment contract as a whole. The consequences are:

- Profit volatility during depressed markets, when prudential pressures are likely to be greatest, contrary to the economic substance of the business;
- An apparent (although not real) reduction in the future profitability of life companies (measured as the difference between the total liability and the value of the fixed element);

- Reductions in policyholder benefits as companies seek ways to restore apparent returns on capital for this business;
- A negation of the benefit to customers of smoothing of policy benefits; and
- Inconsistencies in reporting, and hence potential for inequitable treatment, between participating investment contracts and participating insurance contracts (which will not be constrained in this way).

In the Australian market, the liabilities in respect of business affected by this would, based on APRA statistics, amount to approximately $20 billion.

We propose that the requirement relating to the fixed element of such a financial instrument be deleted from paragraph 25, for the following reasons:

- The fixed element minimum introduces an inconsistency between the treatment of discretionary insurance and discretionary investment contracts, which pre-empts deliberations in relation to discretionary business under Phase II (see Paragraph 1(a) and Basis of Conclusions BC 10(a) and BC 104).
- In combination with the surrender value minimum under IAS 39 it may lead to an inconsistency between the economic substance and management of the business, and reporting in the financial statements. The inconsistency has the potential to undermine the overall concept of participation that assumes that a given tranche of participating business may share, over time, in both the profits and losses arising in respect of that tranche. Without this, participation ceases to be viable.
- The results are contrary to the general intention of ED 5 that changes should result in improvements to accounting practices that make financial statements more relevant and reliable (see Paragraph 14).

Paragraph 24 should then be applied to both insurance contracts and investment contracts.

3.8 Scope – treatment of weather derivatives

While it is not yet a matter of great practical impact in Australia, we are concerned about the way in which weather derivatives are to be excluded from ED 5. The perceived need for this exclusion arises because these contracts are tradable instruments that behave like other derivatives and have observable market values. We believe that, if they are to be excluded from the scope of the insurance standard, they should be excluded on that basis, rather on the basis of the lack of a direct link between the insured and the insured contingency.

Such an exclusion does, however, raise issues when an insurer uses catastrophe bonds or other forms of securitised risk transfer to hedge its catastrophe exposure. The existence of this hedge directly affects the net uncertainty of the hedged exposure. Depending on the approach taken in Phase II, it may be desirable to retain catastrophe bonds under the insurance standard, when they are used to hedge insurance risks or to take other steps to ensure that this hedging is properly accounted for.

If the proposed basis is used, the implementation guidance for ED 5 (IG2, examples 1.19 and 1.20) makes it clear that two very similar catastrophe bonds would be treated under different standards, according to whether they include or do not include a condition that the issuer suffers a loss. Unless the accounting treatment under the two standards is identical, this would be a case of accounting treatment dictating the substance of the contract.

ATTACHMENT 1

IASB Questions – ED 5

Question 1 – Scope

(a) The Exposure Draft proposes that the IFRS would apply to insurance contracts (including reinsurance contracts) that an entity issues and to reinsurance contracts that it holds, except for specified contracts covered by other IFRSs. The IFRS would not apply to accounting by policyholders (paragraphs 2-4 of the draft IFRS and paragraphs BC40-BC51 of the Basis for Conclusions).

The Exposure Draft proposes that the IFRS would not apply to other assets and liabilities of an entity that issues insurance contracts. In particular, it would not apply to:

(i) assets held to back insurance contracts (paragraphs BC9 and BC109-BC114). These assets are covered by existing IFRSs, for example, IAS 39 *Financial Instruments: Recognition and Measurement* and IAS 40 *Investment Property*.

(ii) financial instruments that are not insurance contracts but are issued by an entity that also issues insurance contracts (paragraphs BC115-BC117).

Is this scope appropriate? If not, what changes would you suggest, and why?

(b) The Exposure Draft proposes that weather derivatives should be brought within the scope of IAS 39 unless they meet the proposed definition of an insurance contract (paragraph C3 of Appendix C of the draft IFRS). Would this be appropriate? If not, why not?

Our response: We agree with part (a) in principle. However, we are concerned that little attention seems to have been paid to the over-riding need to value assets and liabilities on a consistent basis. On part (b), IAS 39 would appear to be the appropriate "home" for "pure" weather derivatives, but we have some concern over both the criteria used and the use of the term "weather derivative" to characterise the contracts that should be subject to IAS 39.

Question 2 – Definition of insurance contract

The draft IFRS defines an insurance contract as a 'contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder or other beneficiary if a specified uncertain future event (the insured event) adversely affects the policyholder or other beneficiary' (Appendices A and B of the draft IFRS, paragraphs BC10-BC39 of the Basis for Conclusions and IG Example 1 in the draft Implementation Guidance).

Is this definition, with the related guidance in Appendix B of the draft IFRS and IG Example 1, appropriate? If not, what changes would you suggest, and why?

Our response: Clauses BC21-BC24 give some guidance around the definition of "significant insurance risk". However, any form of numerical guidance has been deliberately avoided. Therefore, the guidance is couched via the use of two examples (and in terms of "significant adverse change"). Whilst we understand (and agree) that numerical rules will encourage the wrong behaviour in the design of contracts, it should be acknowledged that the guidance as currently provided will still be subject to a range of interpretations, and could quite possibly be open to manipulation if desired. We believe that a broader range of examples is needed to minimise this potential misinterpretation.

We are also concerned that, in the absence of guidance to the contrary, and following examples 1.19 and 1.20 in IG2, the definition of insurance contract may have gone from being too inclusive to being too restrictive. If the definition requires, as seems to be implied, a **contractual** condition that the insured event adversely affects the policyholder or other beneficiary, this would exclude, for example, third party life insurance policies, since the test of insurable interest is applied at the time the policy is written and not recited in the contract.

Question 3 – Embedded derivatives

(a) IAS 39 *Financial Instruments: Recognition and Measurement* requires an entity to separate some embedded derivatives from their host contract, measure them at fair value and include changes in their fair value in profit or loss. This requirement would continue to apply to a derivative embedded in an insurance contract, unless the embedded derivative:
   (i) meets the definition of an insurance contract within the scope of the draft IFRS; or
   (ii) is an option to surrender an insurance contract for a fixed amount (or for an amount based on a fixed amount and an interest rate).

   However, an insurer would still be required to separate, and measure at fair value:
   (i) a put option or cash surrender option embedded in an insurance contract if the surrender value varies in response to the change in an equity or commodity price or index; and
   (ii) an option to surrender a financial instrument that is not an insurance contract.

   (paragraphs 5 and 6 of the draft IFRS, paragraphs BC37 and BC118-BC123 of the Basis for Conclusions and IG Example 2 in the draft Implementation Guidance)

   Are the proposed exemptions from the requirements in IAS 39 for some embedded derivatives appropriate? If not, what changes should be made, and why?

(b) Among the embedded derivatives excluded by this approach from the scope of IAS 39 are items that transfer significant insurance risk but that many regard as predominantly financial (such as the guaranteed life-contingent annuity options and guaranteed minimum death benefits described in paragraph BC123 of the Basis for Conclusions). Is it appropriate to exempt these embedded derivatives from fair value measurement in phase I of this project? If not, why not? How would you define the embedded derivatives that should be subject to fair value measurement in phase I?

(c) The draft IFRS proposes specific disclosures about the embedded derivatives described in question 3(b) (paragraph 29(e) of the draft IFRS and paragraphs IG54-IG58 of the draft Implementation Guidance). Are these proposed disclosures adequate? If not, what changes would you suggest, and why?

(d) Should any other embedded derivatives be exempted from the requirements in IAS 39? If so, which ones and why?

Our response: (a) We suggest, on practicality grounds, that all embedded derivatives attaching to insurance contracts be exempt from the requirements of IAS 39 in Phase I, subject to: (i) a strengthening of the loss recognition test to include the cost of all embedded derivatives, options and guarantees; (ii) addition of a condition under paragraph 16 that a new accounting policy must at least measure any embedded derivative within insurance contracts in a manner which allows for inherent asymmetry of future outcomes; (iii) a requirement for companies to disclose all material exposures to interest rate or market risk under options and guarantees in insurance contracts; and (iv) appropriate allowance being made for the cost of embedded derivatives, options and guarantees in Phase II. This would mean that paragraphs 5 and 6 be deleted in their entirety.

(b) If fair value treatment of embedded derivatives is required, we do not agree that there should be an exemption for those that have insurance features, since some of these could currently have material cost. For the purposes of Phase I, we favour the approach outlined in our response to (a) above.

(c) We agree with the proposed disclosure requirements for exempt embedded derivatives.

(d) If our proposed approach in (a) above is not adopted, then we recommend that all non-material derivatives be exempted, but that all material embedded derivatives, options and guarantees be subject to fair value measurement.

Question 4 – Temporary exclusion from criteria in IAS 8

(a) Paragraphs 5 and 6 of [the May 2002 Exposure Draft of improvements to] IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* specify criteria for an entity to use in developing an accounting policy for an item if no IFRS applies specifically to that item. However, for accounting periods beginning before 1 January 2007, the proposals in the draft IFRS on insurance contracts would exempt an insurer from applying those criteria to most aspects of its existing accounting policies for
:

(i) insurance contracts (including reinsurance contracts) that it issues; and
(ii) reinsurance contracts that it holds.

(paragraph 9 of the draft IFRS and paragraphs BC52-BC58 of the Basis for Conclusions).

Is it appropriate to grant this exemption from the criteria in paragraphs 5 and 6 of [draft] IAS 8? If not, what changes would you suggest and why?

(b) Despite the temporary exemption from the criteria in [draft] IAS 8, the proposals in paragraphs 10-13 of the draft IFRS would:

(i) eliminate catastrophe and equalisation provisions.
(ii) require a loss recognition test if no such test exists under an insurer's existing accounting policies.
(iii) require an insurer to keep insurance liabilities in its balance sheet until they are discharged or cancelled, or expire, and to report insurance liabilities without offsetting them against related reinsurance assets (paragraphs 10-13 of the draft IFRS and paragraphs BC58-BC75 of the Basis for Conclusions).

Are these proposals appropriate? If not, what changes would you propose, and why?

Our response: No changes are suggested on a). We agree with b) (ii) and (iii). In respect of b) (i), such provisions are not currently a feature of Australian insurance accounting practice. As a general proposition, we agree that they should be classified as equity, rather than liability, but note that, in some jurisdictions, provisions going under these names may form part of what will be subsequently recognised as market value margins. We therefore believe that an absolute ban on recognising such provisions as liabilities is inappropriate. One possible approach would be to allow their recognition to the extent that they can reasonably be justified as a proxy for market value margins.

Question 5 – Changes in accounting policies

The draft IFRS:

(a) proposes requirements that an insurer must satisfy if it changes its accounting policies for insurance contracts (paragraphs 14-17 of the draft IFRS and paragraphs BC76-BC88 of the Basis for Conclusions).

(b) proposes that, when an insurer changes its accounting policies for insurance liabilities, it can reclassify some or all financial assets into the category of financial assets that are measured at fair value, with changes in fair value recognised in profit or loss (paragraph 35 of the draft IFRS).

Are these proposals appropriate? If not, what changes would you propose and why?

Our response: No comment.

Question 6 – Unbundling

The draft IFRS proposes that an insurer should unbundle (ie account separately for) deposit components of some insurance contracts, to avoid the omission of assets and liabilities from its balance sheet (paragraphs 7 and 8 of the draft IFRS, paragraphs BC30-BC37 of the Basis for Conclusions and paragraphs IG5 and IG6 of the proposed Implementation Guidance).

(a) Is unbundling appropriate and feasible in these cases? If not, what changes would you propose and why?

(b) Should unbundling be required in any other cases? If so, when and why?

(c) Is it clear when unbundling would be required? If not, what changes should be made to the description of the criteria?

Our response: Given potential difficulties associated with the application of the insurance definition it is actually helpful to be able to unbundle those products which can in practice be unbundled, regardless of the fact that there may be no omission of assets or liabilities in not unbundling. In so doing it removes any “boundary issues” as to whether the insurance risk is “significant” particularly if it changes over time. In an unbundled environment the insurance element is always insurance and the investment element is always investment.

(Note that this does not imply that unbundling should apply in all cases – there are clearly contracts, such as conventional whole-of-life or endowments, and life annuities, which it is not practical to unbundle. However, for those products, there is invariably a significant risk transfer such that the contract is insurance regardless.)

Furthermore, it is possible that the most appropriate treatment of most investment contracts will be to account for them in accordance with IAS 18 and/or IAS 38 to the extent that they do not give rise to financial assets or financial liabilities. In effect, investment contracts will in those circumstances be unbundled into separate components representing the underlying financial instrument, a service component and an intangible asset to the extent that one arises from expenditure at acquisition.

In considering the issue of unbundling, care is therefore needed to ensure that an interpretation is not applied to these requirements that might be construed as allowing unbundling ONLY in the circumstances where assets or liabilities might otherwise be omitted.

Specifically:

(a) We agree with the principles of unbundling as described in paragraph 7 of the draft IFRS, and with the comment in paragraph 8 whereby unbundling is not required if existing accounting policies mean all liabilities (including the deposit component) are recognised. To support this statement, we note that there may be instances in which the deposit components may be so interwoven with the insurance contract as to make unbundling very difficult. (An example may be provided by the combination of a weather-related derivative with an insurance risk).

(b) We do not believe unbundling should be required in any other cases.

(c) We believe that examples of the type of contract implied under (b) would be helpful. (For instance partially securitised XoL reinsurance contracts).

Question 7 – Reinsurance purchased

The proposals in the draft IFRS would limit reporting anomalies when an insurer buys reinsurance (paragraphs 18 and 19 of the draft IFRS and paragraphs BC89-BC92 of the Basis for Conclusions).

Are these proposals appropriate? Should any changes be made to these proposals? If so, what changes and why?

Our response: We believe these proposals are appropriate in an Australian context.

Question 8 – Insurance contracts acquired in a business combination or portfolio transfer

IAS 22 *Business Combinations* requires an entity to measure at fair value assets acquired and liabilities assumed in a business combination and ED 3 *Business Combinations* proposes to continue that long-standing requirement. The proposals in this draft IFRS would not exclude insurance liabilities and insurance assets (and related reinsurance) from that requirement. However, they would permit, but not require, an expanded presentation that splits the fair value of acquired insurance contracts into two components:

(a) a liability measured in accordance with the insurer's accounting policies for insurance contracts that it issues; and

(b) an intangible asset, representing the fair value of the contractual rights and obligations acquired, to the extent that the liability does not reflect that fair value. This intangible asset would be excluded from the scope of IAS 36 *Impairment of Assets* and IAS 38 *Intangible Assets*. Its subsequent measurement would need to be consistent with the measurement of the related insurance liability. However, IAS 36 and IAS 38 would apply to customer lists and customer relationships reflecting the expectation of renewals and repeat business that are not part of the contractual rights and obligations acquired.

The expanded presentation would also be available for a block of insurance contracts acquired in a portfolio transfer (paragraphs 20-23 of the draft IFRS and paragraphs BC93-BC101 of the Basis for Conclusions).

Are these proposals appropriate? If not, what changes would you suggest and why?

Our response: We believe these proposals are appropriate.

Question 9 – Discretionary participation features

The proposals address limited aspects of discretionary participation features contained in insurance contracts or financial instruments (paragraphs 24 and 25 of the draft IFRS and paragraphs BC102-BC108 of the Basis for Conclusions). The Board intends to address these features in more depth in phase II of this project.

Are these proposals appropriate? If not, what changes would you suggest for phase I of this project and why?

Our response: We agree with the proposals in relation to the treatment of unallocated surplus.
We also agree that discretionary participating features should be accounted for under existing "insurance" accounting policies. However, in respect of investment contracts, paragraph 25 imposes an additional requirement, namely that the insurer "recognise a liability measured at no less than the measurement that IAS 39 would apply to the fixed element". Such a measurement under IAS 39 would seem to be subject to a minimum of the surrender value.

As we interpret ED 5, the surrender value of the fixed element therefore becomes a minimum measure for the liability under the investment contract as a whole.

We propose that the requirement relating to the fixed element of such a financial instrument be deleted from Paragraph 25, for the following reasons:

- The fixed element minimum introduces an inconsistency between the treatment of discretionary insurance and discretionary investment contracts, which pre-empts deliberations in relation to discretionary business under Phase II (see Paragraph 1(a) and Basis of Conclusions BC 10(a) and BC 104).

- In combination with the surrender value minimum under IAS 39 it leads to an inconsistency between the economic substance and management of the business, and reporting in the financial statements. This inconsistency has the potential to undermine the overall concept of participation that assumes that a given tranche of participating business may share, over time, in both the profits and losses arising in respect of that tranche. Without this, participation ceases to be viable.

- The results are contrary to the general intention of ED 5 that changes should result in improvements to accounting practices that make financial statements more relevant and reliable (see Paragraph 14).

Paragraph 24 should then be applied to both insurance contracts and investment contracts.

Question 10 – Disclosure of the fair value of insurance assets and insurance liabilities

The proposals would require an insurer to disclose the fair value of its insurance assets and insurance liabilities from 31 December 2006 (paragraphs 30 and 33 of the draft IFRS, paragraphs BC138-BC140 of the Basis for Conclusions and paragraphs IG60 and IG61 of the draft Implementation Guidance).

Is it appropriate to require this disclosure? If so, when should it be required for the first time? If not, what changes would you suggest and why?

Our response: We agree with the disclosure of the fair value of liabilities. However, until all relevant aspects of fair value are defined clearly in a timeframe that allows for implementation (including the production of necessary historical comparisons to support meaningful disclosure) an implementation date should not be specified. We note that there appear to be several obstacles that may prevent such clear and complete definition in the time-frame currently proposed. In particular, as we indicate in the body of our submission, we have strong misgivings about the definition of fair value which appears to be emerging. In the context of both life and general insurance, some of the suggested constraints on fair value are likely to produce grossly misleading results.

Question 11 – Other disclosures

(a) The Exposure Draft proposes requirements for disclosures about the amounts in the insurer's financial statements that arise from insurance contracts and the estimated amount, timing and uncertainty of future cash flows from insurance contracts (paragraphs 26-29 of the draft IFRS, paragraphs BC124-BC137 and BC141 of the Basis for Conclusions and paragraphs IG7-IG59 of the draft Implementation Guidance).

Should any of these proposals be amended or deleted? Should any further disclosures be required? Please give reasons for any changes you suggest.

To a large extent, the proposed disclosures are applications of existing requirements in IFRSs, or relatively straightforward analogies with existing IFRS requirements. If you propose changes to the disclosures proposed for insurance contracts, please explain what specific attributes of insurance contracts justify differences from similar disclosures that IFRSs already require for other items.

(b) The proposed disclosures are framed as high level requirements, supplemented by Implementation Guidance that explains how an insurer might satisfy the high level requirements.

Is this approach appropriate? If not, what changes would you suggest, and why?

(c) As a transitional relief, an insurer would not need to disclose information about claims development that occurred earlier than five years before the end of the first financial year in which it applies the proposed IFRS (paragraphs 34, BC134 and BC135).

Should any changes be made to this transitional relief? If so, what changes and why?

Our response: (a) We support the general thrust of the disclosure requirements contained in the draft IFRS. However, we have a number of specific comments as noted below.

(b) We support the broad thrust of the disclosure requirements. We also support the broad approach of specifying high level requirements, rather than prescribed detail and formats. Nevertheless, we are concerned that the high level approach and the detail contained in the Implementation Guidance in the draft IFRS could potentially be interpreted in a way which leads to excessive and impractical disclosure outcomes. At various points the Implementation Guidance makes reference to principles such as disclosure at a level that is useful to users of financial statements (e.g. IG22) and practicality (e.g. IG34). We believe it would be appropriate for the IASB to develop and include a consolidated statement of implementation principles within the draft IFRS, and to make it clear that the Implementation Guidance is subordinate to those principles. This would be particularly applicable to the disclosure of assumptions and the effect of assumption changes. Such a statement would ensure that the Standards are principle based rather than detail based and allow entities to formulate practical and commercial disclosure outcomes to meet the needs of actual users.

There are also cases where disclosure may be inappropriate. As an example of such a case, consider levels of sufficiency, which are mentioned in several instances. Given other comments regarding diversification and similar issues, the range of methodologies used within the industry will mean that provision of the level of sufficiency could actually be misleading, and encourage insurers to take an aggressive stance on the calculation methodology – which is likely to work against the objectives of the standards.

(c) We support the transitional relief provisions proposed

Question 12 – Financial guarantees by the transferor of a non-financial asset or liability The Exposure Draft proposes that the transferor of a non-financial asset or liability should apply IAS 39 *Financial Instruments: Recognition and Measurement* to a financial guarantee that it gives to the transferee in connection with the transfer (paragraphs 4(e) of the draft IFRS, C5 of Appendix C of the draft IFRS and BC41-BC46 of the Basis for Conclusions). IAS 39 already applies to a financial guarantee given in connection with the transfer of financial assets or liabilities. Is it appropriate that IAS 39 should apply to a financial guarantee given in connection with the transfer of non-financial assets or liabilities? If not, what changes should be made and why?

Our response: We agree with the proposal, provided such financial guarantees do not meet the proposed definition of an insurance contract

Question 13 – Other comments Do you have any other comments on the draft IFRS and draft Implementation Guidance?

Our response: We have no further comments, beyond the body of our overall submission.

ATTACHMENT 2

Fair Value Measurement Basis

Fair value is defined, for example in the ED 5, Appendix A as:

> The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

In paragraph 66 of the IASB exposure draft of IAS 39 however, we have:

> When a financial asset or financial liability is recognised initially, an entity shall recognise it at its cost, which is the fair value of the consideration …

Paragraphs 99 to 100A then establish a hierarchy for the subsequent assessment of fair value:

- published prices in an active market;
- recent market transactions between knowledgeable, willing parties in an arm's length transaction, adjusted for changes in the price of similar instruments; or
- valuation techniques.

If these rules are applied to insurance contracts, as appears to be the current intention, it would follow that the premium liability for a policy at issue (prior to initial expenses) would be the premium paid, regardless of the current state of the insurance cycle. That is, recognition of profit or loss at issue would be effectively prohibited. Because it is arguable that the retail market for insurance policies is active, in the sense that there are frequent transactions, this should drive the subsequent assessment of fair value. That is, fair value of premium liabilities should be set by reference to current premium rates for similar policies.

We believe that such an approach is totally inappropriate. In the Australian context, it would make a repetition of the HIH experience far more likely and, in our view, runs completely contrary to the recommendations of the HIH Royal Commission.

While the retail insurance market is, indeed, active, it is only active in one direction. Policies are sold by insurers to insureds, but not vice versa. While both parties are, in general, willing and, in many cases, knowledgeable, they are by no means equal, a condition which should be, but is not included in the definition of fair value. In particular, the value that the policyholder places on reducing his or her individual exposure to risk is substantially greater than the cost of the capital that the insurer needs, in order to accept that exposure in the context of a large pool of similar risks.

In general insurance there is a pronounced market cycle. During a "soft market" prices for some classes of insurance can be more than 25% below what hindsight shows to have been required. Australian prices for some lines of liability insurance have risen by factors in excess of 1000%, from their levels a year or two before the collapse of HIH. If such prices are used as the basis for liability provisions, insurers would be required to set provisions for premiums, IBNR claims and some reported claims, well below the probable cost in a soft market. It is exactly this approach to valuation that enabled HIH to continue to appear solvent, long after it should have ceased trading. This is a sort of vicious circle where, because premiums are "known" to be profitable, provisions are set at levels that show a profit and, because the accounts show a profit on the basis of those provisions, the premiums are “known” to be profitable.

We believe that the only valid approach to fair value for insurance contracts is through professional valuation techniques. While the central estimate of the expected present value of future cash flows is technically challenging, it is conceptually straightforward. The conceptual problem in estimating fair value for insurance contracts lies in the derivation of Market Value Margins. There does not yet appear to be any practical way of calibrating these to observable market transactions. Nor does there appear to be any market mechanism for rating the insurance risk embodied in different classes of insurance. Further work is needed to develop an explicitly market based approach. We therefore believe that it is necessary to adopt a practical expedient for Phase I.

General Insurance

Because Australia has the experience of using discounted provisions for general insurance, for the most part with risk margins, for over twenty years, and more than ten years of mandatory discounting under our local general insurance accounting standard, we believe that we are well placed to suggest such a practical approach.

For the most part, Australian actuarial practice for general insurance has been to add a risk margin intended to give a designated probability that the resulting provisions will prove adequate. This appears to have been accepted by the market as a reasonable approach. The target levels adopted have ranged from 60% to 95%, with acceptance of 75% to 80% as being middle-of-the-road.

When the Australian Prudential Regulation Authority (APRA) wanted to adopt a practical proxy for fair value, for regulatory purposes, they followed this practice and specified a target level of adequacy of 75% in their Prudential Standard, GPS 210. (Because, for certain extreme cases, the 75th percentile can be below the mean of a skew distribution, there is an alternative of the mean plus half a standard deviation, which is a little below the 75th percentile in almost all cases.) This has met with general acceptance as being a sensible and appropriate basis.

We therefore propose that, until a better basis, more directly calibrated tomarket data, can be derived, a practical basis such as that embodied in GPS210 be adopted as a workable proxy for fair value for Phase I.

It is instructive to compare the GPS 210 approach with the criteria for fair value in BC 6(c).

(i) *An undiscounted measure is inconsistent with fair value.* GPS 210 requires discounting at current rates.

(ii) *Expectations about the performance of assets should not be incorporated into the measurement of an insurance contract, directly or indirectly (unless the amounts payable to a policyholder depend on the performance of specific assets).* GPS 210 does not incorporate such expectations.

(iii) *The measurement of fair value should include an adjustment for the premium that marketplace participants would demand for risks and mark-up in addition to the expected cash flows.* GPS 210 requires a margin, over the expected value, intended to achieve a 75% probability of adequacy (but not less than half a standard deviation for extremely skew distributions where the 75^{th} percentile might otherwise be below the mean). While this margin is not directly calibrated to the market, there is some evidence, based on the acceptance of similar margins as being reasonable, that it is not too far wide of the mark. In

the absence of a more explicitly market based approach, the GPS 210 approach would seem to be a reasonable proxy for the required market value margin for Phase I.

(iv) *Fair value measurement of an insurance contract should reflect the credit characteristics of that contract, including the effect of policyholder protections and insurance provided by governmental bodies and other guarantors.* This is a highly contentious issue, but the adjustment is only material, in the general insurance context, for insurers close to statutory insolvency. The problem is that, for such insurers, such an adjustment would help to conceal their weakness. If there is a material adjustment, this is vital information for policyholders and potential policyholders, who should be seeking alternative cover as a matter of urgency, and for claimants, as well as shareholders, regulators, etc. The GPS 210 approach does not explicitly incorporate such adjustments. The future claim payments valued are, however, typically estimated on the basis of historical experience, which does incorporate whatever impact concern over the insurer's ability to pay may have had on negotiated claim settlements. If there is any market perception that the insurer may not be able to make claim payments, this could be expected to result in both lower and earlier settlement amounts.

Life Insurance

Similarly, while the Margin on Services (MoS) approach under the Australian life insurance accounting standard is conceptually a deferral and matching approach, it can also be a reasonable proxy for fair value.

It is instructive to compare the MoS approach with the criteria for fair value in BC 6(c).

(i) *An undiscounted measure is inconsistent with fair value.* MoS requires discounting at current rates.

(ii) *Expectations about the performance of assets should not be incorporated into the measurement of an insurance contract, directly or indirectly (unless the amounts payable to a policyholder depend on the performance of specific assets).* MoS incorporates such expectations for performance-linked policies but not otherwise (given the changes proposed under the Australian Accounting Standards Board ED 122).

(iii) *The measurement of fair value should include an adjustment for the premium that marketplace participants would demand for risks and mark-up in addition to the expected cash flows.* MoS requires a margin, over the expected value, based on the profit margin implied by the premium rates charged. It is recognised that this margin is not necessarily equivalent to the risk margin that would be demanded by the market. However, in the absence of a clear methodology for determining market risk margins, this approach has the advantage of being practical and objective.

(iv) *Fair value measurement of an insurance contract should reflect the credit characteristics of that contract, including the effect of policyholder protections and insurance provided by governmental bodies and other guarantors.* This is a highly contentious issue, but the adjustment is only material, in the life insurance context, for insurers close to statutory insolvency.

Finally, we are strongly opposed to such a measure of fair value being subject to a minimum of the surrender value (demand deposit floor) under the contract.

We would be pleased to assist the IASB in the development of suitable measurement bases.