INSURANCE COUNCIL OF AUSTRALIA

25 October 2013

IFRS Foundation
International Accounting Standards Board
30 Cannon Street
London, EC4M 6XH
United Kingdom

Dear Sir/Madam

RESPONSE TO IASB EXPOSURE DRAFT ED/2013/7 INSURANCE CONTRACTS

The Insurance Council of Australia (Insurance Council) welcomes the opportunity to comment on the International Accounting Standards Board's (IASB) Exposure Draft on Accounting Standards for Insurance Contracts (ED). The Insurance Council is the representative body of the general insurance industry in Australia. Our membership, which includes both insurers and reinsurers, represents more than 90 percent of total premium income written in Australia by private sector general insurers.[1]

The Insurance Council supports many of the proposed changes

The Insurance Council supports the IASB's objective to improve the transparency of the financial health of insurance businesses and recognises the importance of creating a comprehensive International Financial Reporting Standard (IFRS) to harmonise the treatment of insurance contracts across different products and jurisdictions. The Insurance Council hopes that ultimately there can be one accounting standard used for general insurance contracts in all countries.

We endorse many of the changes in the latest ED and in particular support the following:

Increased contract boundary

The Insurance Council supports the increased boundary level to allow for repricing at the portfolio level instead of the contract level. This clarifies the boundary for measurement purposes.

[1] Insurance Council members are a significant part of the Australian financial services system. March 2013 Australian Prudential Regulation Authority statistics show that the private sector insurance industry generates gross written premium of $39.2 billion per annum and has total assets of $116.1 billion. The industry employs approximately 60,000 people and on average pays out about $101 million in claims each working day.

Insurance Council members provide insurance products ranging from those usually purchased by individuals (such as home and contents insurance, travel insurance, motor vehicle insurance) to those purchased by small businesses and larger organisations (such as product and public liability insurance, professional indemnity insurance, commercial property, and directors and officers insurance).

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Eligibility for premium allocation approach
We support the changes to determining eligibility for the premium allocation approach (PAA) through the introduction of the reasonable approximation test. This should allow the application of PAA to a greater proportion of general insurance contracts.

One format Profit and Loss (P&L) and Balance Sheet disclosure requirements
We support the harmonisation of the PAA and BBA reporting approaches, which reduces the unnecessary requirement for multiple P&Ls and Balance Sheets. This facilitates the reporting for general insurers which use both PAA and BAA when presenting combined results.

Unit of account for determining risk adjustment
We consider that the proposal not to specify the unit of account for determining the risk margin enables recognition of the diversification benefit across portfolios. This is a positive change and consolidates the approach used in the Australian market.

Unlocking of contractual service margin (CSM)
The Insurance Council strongly supports the IASB's proposal to unlock the CSM. This will reduce volatility, particularly for insurers that have longer tail business.

Concern with the proposal to recognise the discount rate in the OCI
Notwithstanding the positive elements in the ED, the Insurance Council continues to have serious reservations about a number of proposed requirements. We would therefore appreciate the IASB taking these issues into account when further developing the standard. Insurance Council members are particularly concerned by the proposal to present the discount unwind at an inception date rate in the Profit and Loss (P&L) and the remainder of the discount movement in Other Comprehensive Income (OCI).

The Insurance Council considers that this will introduce more volatility into the reported results of many general insurers. The proposal and examples provided in the ED do not take into account the correlation between inflation and interest rates and assume a level of asset and liability matching that is unlikely to exist in practice for many general insurers. This aspect of the proposals will also significantly increase the costs of applying the proposed requirements compared with the 2010 ED due to the data requirements required to capture and unwind historical discount rates.

The Insurance Council urges the IASB to provide for optionality. This would allow adoption of a split approach for discounting (either through the P&L or OCI). Movements in the current discount rate should be recognised in the P&L with an option to use movements in the current discount rate in OCI if that reflects the insurer's business model. In other words, the standard should permit rather than require the effect of discount rate changes to be presented in OCI. This is in line with the 2010 ED proposals that changes in insurance contract liabilities should be recognised in the P&L. We suggest that this accounting policy choice should be made on an entire entity basis, not at a portfolio or disaggregated level.

The inclusion of an option for discounting should be worded to ensure that it does not inappropriately interact with the Fair Value Option (FVO) proposed in IFRS 9, which can be applied to reduce accounting mismatch.

To ensure a sensible application of both options, the Insurance Council proposes that the discount rate option should be elected first. We consider the FVO in IFRS 9 to be compatible with a discount option provided there is clear guidance on application. IFRS 9 adopts a business model led approach in determining the classification of assets to accounting categories. The FVO for assets in the Fair Value Other Comprehensive Income (FVOCI) category is applied to specific assets and can only be elected in the case of accounting mismatch. Therefore, it is necessary to elect the discount option first (either on transition, first adoption of a business combination) allowing entities to then determine whether the FVO in IFRS 9 should be applied.

The Insurance Council submits that allowing for optionality is supported by the following considerations:

Duration mismatch

A key concern of the IASB Board has been how to explain duration mismatch. Life insurance businesses have many products requiring an alignment of the duration of assets and liabilities. General insurance, however, does not have such a compelling need to match duration.

We understand that some IASB Board members are concerned that an amortised basis of discounting is essential to allow users to understand duration mismatch. However, the Insurance Council does not believe this approach is necessary for general insurance. Depending on the risk tolerance of the general insurance entity, maintaining a level of duration mismatch may be a preferred approach to reduce risk. Such a mismatch is usually decided by management and therefore part of the current business performance and current year's P&L account.

P&L exposure to inflation mismatch

General insurance claims are significantly impacted by changes in inflation. The recognition of discount movements in the P&L provides a natural offset between explicit and implicit inflation movements in the claims incurred. This relationship is much less apparent for life insurance business where only a few isolated classes tend to respond to inflation. It is common for Australian actuaries to specifically model inflationary factors, whereas member experience globally indicates this is not as prevalent elsewhere. When claims are discounted, as practiced in the Australian market, correlations between inflation and discount rates can be observed.

The proposal put forward by the IASB does not recognise the natural offset between inflation and discount rates relevant to most general insurance classes of business. In particular, for many long tail claims there may be specific links between discount rates and the inflation rates used to drive claims values. Long tail claims concern those that have an extended period between recognition of the claim and final determination of the payment amount and settlement. Long tail claims may include latent claims but may have other elements. Where there is a significant period between recognition and settlement, the impact of discounting is particularly marked. There may also be a defined link between the discount rate and the inflation rates used to determine the net loss, as found in the Australian experience of dust disease claims.

High cost of implementation
Implementation of the ED would require collection of inception data which would be costly, particularly if it were not already part of the insurers' business model. Significant resources would also be needed to separate discount movement into two components. Adopting the concept of a cohort as an underwriting year requires entities to develop significant systems and collect previously unused data in order to track discount rate unwind. If this cohort is intended to be more granular then the level of data collected and the system complexity escalates accordingly. This amounts to a serious increase in costs, which would ultimately be passed to consumers.

Demand from users
The Insurance Council has serious doubts that investment analysts will use the additional information. This is despite claims that analysts have an appetite for the introduction of the proposed discount rate treatment. Our members have reported that the Australian investment analysts have shown little interest.

Other issues
While the discount rate treatment in the OCI and P&L remains the greatest concern for our members, the Insurance Council submits that a number of additional issues need to be reconsidered as follows:

Calculation of discount rate
The Insurance Council notes that the ED left open the approach to be used in calculating the discount rate. However, insurers require further guidance on how the Liquidity Premium is calculated so that there is a uniform approach in the sector.

In addition, there is no clear definition of the cohort required to measure inception discount rates. The requirement in paragraph 60 (h) to include in the P&L the interest expense on insurance contract liabilities determined using the discount rates specified in paragraph 25 which applied at "the date the contract was initially recognised" requires application to a cohort of contracts or portfolios.

As interest and therefore discount rates move daily, this could imply that the inception discount rate should vary daily. Alternatively, a clear and unambiguous cohort already commonly used in general insurance is the underwriting year (the calendar year the policy incepts).

Recognition of unearned premium revenue
The Insurance Council considers that unearned premium revenue should continue to be recognised for businesses modelled under the PAA. In considering the PAA accounting requirements, we recognise that paragraph 38 is worded to suggest that entities may measure the liability for the remaining coverage using premium received at initial recognition.

The Insurance Council considers that unearned premium is an appropriate proxy for the liability for remaining coverage in the PAA method. This method is preferred to a cash based approach where the receipt of premium drives the balance sheet amount.

The Insurance Council recommends that paragraph 38 be reworded to refer to expected premiums. Wording used elsewhere in the ED, such as that used in Appendix B91, better reflects the actual mechanics and economics of general insurance contracts. This approach

will also better align the BBA and PAA methodologies in respect of the balance sheet presentation and disclosure.

Adjustment of CSM

The Insurance Council is concerned that the CSM adjusts for the changes in expected cash flows but not for changes in risk margin and discount rate. Our members consider that changes in estimates of future cash flows are likely to result in changes to the related risk adjustment. Discount rate changes are affected by both time and changing estimates of cash flows. As a result, cash flows from future coverage and the resulting discount rate are dependent on each other, and should be treated consistently. We therefore consider it problematic to treat components of the liability for future coverage in different ways.

It is also noted that the current ED does not include changes in risk adjustment relating to future coverage as part of re-measurement of the CSM. We believe this is inconsistent with the definition and overall purpose of the CSM. The CSM is defined via paragraph 28 as being inclusive of the risk adjustment (RA) at initial recognition (an RA is included as part of the fulfilment cash flows).

Holistically, the CSM exists in order that no profit is taken to the bottom line on commencement of a contract and to ensure that this expected profit is appropriately spread over the life of the contract. Therefore, it appears inconsistent to allow re-measurement of the CSM due to changes in one component of the fulfilment cash flows (the present value of future cash flows) and not another (the RA). This may create accounting volatility that is not a fair representation of the economic substance of a contract at the point of re-measurement. This will hinder users of the accounts in assessing the performance of an insurer.

We recommend the IASB broaden the ability to re-measure to include the RA. The RA and discount rate for future coverage should be permitted to be adjusted against the CSM. This would enable a more consistent approach, while also reducing volatility. The change would also lead to a better accounting match and reduce the level of complexity in financial statements.

Implementation Period

The Insurance Council is concerned by the lack of alignment between the commencement dates for IFRS 9 relating to financial assets and financial liabilities and the insurance contracts standard which is expected to become operative later. This could lead to a disorderly implementation period and increased costs as a result of further potential changes to accounting for financial instruments on transition to the insurance contracts standard.

Consequently, the Insurance Council submits that the implementation of the Insurance Contracts Standard needs to be aligned with the implementation of IFRS 9.

Characters of RA

The Insurance Council considers that there are particular aspects of the draft standard in relation to the RA that are unclear. Specifically, we believe that paragraph B81 will create confusion.

Paragraph B81 lists a series of characteristics that the RA shall have. The use of the word ‘shall’ suggests that compliance is compulsory. There are no circumstances in which the RA

can fail to comply with the list of sub-points. This is reinforced by the repeated use of the word 'will' within the sub-points.

However, there are examples of insurance contracts where a RA based on a probability of adequacy approach in line with the rest of the Standard would fail the requirements of the sub-points. For example, consider the following (simplistic) scenario:

- Consider a policy that pays $100 with an 80% probability and $200 with a 20% probability. Then the central estimate of the cost is $120. The worst case scenario is $200. A RA at a 90% probability of adequacy is $80.
- Consider a second policy that pays $100 with a 77.5% probability, $180 with a 21.5% probability and $380 with a 1% probability. Then the central estimate is, again, $120. There is a greater range of outcomes, but a much smaller chance of the most severe outcome. A RA at a 90% probability of adequacy is $60.

B81 (a) states: 'risks with low frequency and high severity will result in higher RAs than risks with high frequency and low severity'. In the simple example outlined above, the RA is lower for the second contract, yet it has risks that are of lower frequency and higher severity than the first contract. It is therefore not possible to comply with B81 (a) in this situation and other examples can also be envisaged.

This example illustrates several characteristics of skewed distributions, and identifies areas in which this could lead to lack of compliance with B81. The Insurance Council notes that virtually all general insurance contracts are skewed in their risk distributions, and as such this is likely to be an issue for a large number of general insurance contracts.

The Insurance Council proposes that B81 should be removed in its entirety. Its existence is not critical to the requirements of the Standard. It serves to illustrate the correct operation of the Standard, and as noted above there are circumstances where this will lead to inappropriate outcomes. Alternatively, the Insurance Council proposes that within this paragraph, the word 'shall' could be replaced by 'should normally', and 'will' by 'will normally', to allow for exceptions to occur in legitimate circumstances.

Further, and notwithstanding the recommendation made above, the Insurance Council proposes that B81(c) should be removed in its entirety. B81(c) states 'risks with a wide probability distribution will result in higher risk adjustments than risks with a narrower distribution'. The words 'wide' and 'narrow' have no statistical meaning, and as such this entire phrase has no statistical meaning and it is likely to lead to confusion and should be removed.

If you require further information in relation to this submission, please contact Mr John Anning, Insurance Council's General Manager Policy – Regulation Directorate at janning@insurancecouncil.com.au or telephone (612) 9253 5121.

Yours sincerely

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