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

31 July 2015

Dear Sir/Madam

IASB TENTATIVE DECISIONS UNDER IFRS 4: INSURANCE CONTRACTS

The Insurance Council of Australia[1] (Insurance Council) wishes to raise several issues regarding the tentative decisions of the International Accounting Standards Board (IASB) concerning the Insurance Contracts Exposure Draft (ED/2013/7). We recognise that the IASB has been undertaking further internal debate and outreach on the Insurance Contracts Exposure Draft and is seeking to determine a final Standard for implementation. The concerns we raise affect the general insurance industry, particularly those such as Lenders Mortgage Insurance (LMI) providers, which have contracts of a long-term nature.

Our key issue relates to the requirement to recognise the contractual service margin (CSM) based on coverage period and number of contracts in force. We believe this requirement will not accurately portray the insurance protection being provided as a result of the stand-ready obligation when insurance protection varies over time or when the protection provided covers risks that occur earlier in the contract's life.

This issue is further compounded when the contractual term of the insurance protection being provided is not a stipulated date but instead relates to an underlying item, such as a loan in the case of LMI. Recognition of CSM over time in periods where there is minimal service being provided due to the remote expectation of a claim results in the reporting of insurance contracts revenue that will no longer reflect the economic performance of the insurance product.

The Insurance Council also wishes to raise concerns regarding the requirement to disclose the unwind of discount based on the inception date discount rate, which is likely to impose an unnecessary compliance burden on insurers due to the cost of preparation of the information. We further have issue with the requirement to discount the CSM using a locked-in rate at inception date that is likely to adversely impact long-dated contracts. This submission will address these issues in detail below.

IFRS 4 Tentative Guidance on IFRS 4 Insurance Contract

The Insurance Council is concerned that the accounting standard being developed for insurance contracts may adversely affect the LMI industry through the distortion of reported performance figures.

[1] The Insurance Council of Australia is the representative body of the general insurance industry in Australia. Our members represent more than 90 percent of total premium income written by private sector general insurers. Insurance Council members, both insurers and reinsurers, are a significant part of the financial services system. September 2013 Australian Prudential Regulation Authority statistics show that the private sector insurance industry generates gross written premium of $40.4 billion per annum and has total assets of $112.6 billion. The industry employs approximately 60,000 people and on average pays out about $92.5 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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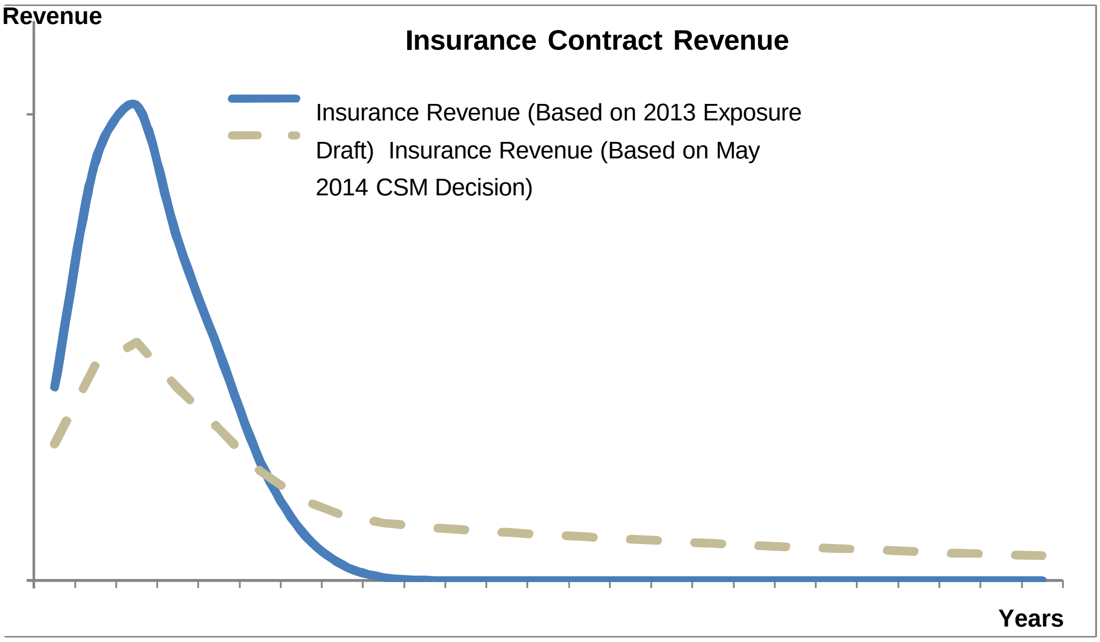
The IFRS 4 Tentative Guidance, paragraph 32 of the Exposure Draft, states that an entity shall recognise the remaining CSM in profit or loss over the coverage period in a systematic way that best reflects the remaining transfer of services under the insurance contract. The clarification added at the May 2014 IASB meeting states that for non-participating contracts, the service represented by the CSM would be insurance coverage that:

- is provided on the basis of the passage of time; and
- reflects the expected number of contracts in force.

Based on the clarification, instead of using expected timing of claims or another systemic measure of the service being performed, revenue recognition would follow an approach based on the number of contracts and contractual period.

In Australia, along with many other jurisdictions, the entire LMI premium is required to be paid at the beginning of the contract and coverage applies to the entire life of the underlying item for which insurance protection is provided. The risks associated with these products are significantly different from risks such as mortality in life insurance products where the risk of a mortality event increases over time (i.e. the risk is linear in relation to the passage of time). While the coverage period can be 25 to 30 years, the effective risk of loss on the mortgage insurance coverage is more heavily weighted to the first few years after origination, with minimal risk in the remaining years of the contract.

For certain products, the CSM typically could represent a significant proportion of the insurance liability and would be a significant component of the revenue recognised on the product. The clarification concerning the CSM will result in certain insurance contract revenue being recognised over a longer period of time and will impact the indicators used to measure the performance of the insurance business. This will have a material impact on how premium is recognised and ultimately the new treatment will not reflect the performance of the certain insurance businesses, as illustrated below.



We understand that that one of the arguments presented as a rebuttal to the issue raised during the July Accounting Standards Advisory Forum (ASAF) meeting regarding the recognition pattern of CSM is that the risk adjustment should encompass the potential variability in expected claims such that the CSM should be relatively small for most products. If the CSM is relatively small for most products, then we do not understand why a rebuttable presumption could not be added to enable the recognition of CSM in a manner that reflects the timing of expected claims when the passage of time is not an appropriate measure of the service being provided. It would seem that the concerns about diversity in practice would be minimised and comparability would not be jeopardised if the CSM was indeed a small component of the overall insurance liability.

However, if the CSM is a significant component of the insurance liability, including a rebuttable presumption would ensure the revenue recognition pattern for such products would be similar to other insurance products that have a more significant risk adjustment and minimal amount of CSM. In those circumstances, including a rebuttable presumption would result in both types of insurance products recognising revenue in a similar manner. One would be based on the release of the risk adjustment, while the other product with a large CSM recognising revenue in relation to expected claims, would follow a similar pattern to the risk adjustment.

We understand that another view expressed during the July ASAF meeting was that the risk adjustment could be established to consider aspects such as the capital requirements that may be one of the primary reasons a premium would be large in relation to an entity's expected claims. This is the case with LMI.

While we recognise the theory surrounding this argument, we do not believe the guidance from the Exposure Draft would support those conclusions. The guidance related to the risk adjustment starting in paragraph B76 of the Exposure Draft is focused on variability in cash flows and does not necessarily reference the amount of capital that would be required for an insurer. As a result, we believe it would be difficult to increase the risk adjustment beyond what was referenced in the LMI example without effectively creating a risk adjustment that was nearly two times or more than the expected cash flows.

If the Board's intent is to permit consideration of other factors outside of the expected cash flows and variation in those cash flows, the Insurance Council recommends that the Board ensure appropriate clarification is made within the accounting guidance to ensure that aspect is well understood. As currently written, the definition of the risk adjustment does not reference considerations other than variability in cash flows:

> *Risk Adjustment – the compensation that an entity requires for bearing the uncertainty about the amount and timing of cash flows that arise as the entity fulfills the insurance contract*

We note that the IASB confirmed in March 2014 that "differences between the current and previous estimates of the risk adjustment that relate to future coverage and other services should be added to, or deducted from, the contractual service margin, subject to the condition that the contractual service margin should not be negative."

The Insurance Council considers the above decision a positive step to avoid the adverse consequences of having changes in the risk adjustment related to future coverage being reflected in profit and loss. However, the application of this change from the Exposure Draft means that the CSM would increase if risk adjustments relating to future coverage are reduced. For example, the risk adjustment could be determined using a formula based on an entity's expected claims where a factor is multiplied against the projected claims by year using a compounding factor to reflect the greater amount of uncertainty in each year of the projection.

As a result of utilising this approach, an entity would be able to assert the risk adjustment would effectively compensate for the uncertainty related to the amount and timing of expected future claims. As time passes and the compounding effect for each year of the projection is reduced, there would be a corresponding reduction in the risk adjustment. This decrease in risk adjustment would appear to related to the future period's cash flows that are now less uncertain (or less subject to variability) as time elapses.

Based on the March 2014 tentative decision, it appears that such a reduction in the risk adjustment would be added to the CSM since the risk adjustment related to the future year's cash flows (i.e. future coverage and other services). When overlaid with the changes noted above from the May 2014 decision to recognise CSM based on the passage of time, this would result in an even larger proportion of premium being earned based on the passage of time and number of contracts. Therefore, the impact of both changes together does not produce the desired outcomes.

The Insurance Council would urge that the Board undertake further field testing to ensure the application of the accounting guidance aligns with the Board's expectations.

The interplay of the risk adjustment and the CSM also impacts the validity of the conclusion that a higher risk adjustment should be used for products such as LMI in order to minimise the amount recognised within the CSM. Our concern regarding the recognition of CSM based on the passage of time would only be exacerbated if the interaction between the risk adjustment and CSM results in a higher risk adjustment ultimately being added to the CSM.

The Insurance Council recommends that the IASB reconsider the tentative clarification concerning the CSM. We suggest that the IASB consider a rebuttable presumption, similar to the premium allocation approach revenue recognition model, be inserted for CSM recognition for non-participating contracts which would enable an insurer to recognise CSM based on expected timing of claims and benefits under certain circumstances.

Disclosure of the unwind of discount applied

The Insurance Council is concerned that the requirement to disclose the unwind of discount based on the inception date discount rate is likely to impose an unnecessary compliance burden on insurers due to the cost of information preparation. ED 2013 required insurers to discount the balance sheet liabilities using current discount rates and to split the discount movement between a P&L component, which is calculated as the unwind of discount using inception date discount rates, and other comprehensive income (OCI) that is the residual amount.

Due to industry concerns, this was changed in March 2014 to allow an option to use the method above or to elect to report all discount movement in the P&L as currently permitted under Australian Accounting Standards Board (AASB) 1023. However, the IASB retained the requirement for all insurance portfolios to disclose:

- the amount of interest accretion determined using current discount rates;
- the effect on the measurement of the insurance contract of changes in discount rates in the period; and
- the difference between the present value of changes in expected cash flows that adjust the CSM in a reporting period when measured using discount rates that applied on initial recognition of insurance contracts, and the present value of changes in expected cash flows that adjust the CSM when measured at current rates.

This will require all insurers using the main measurement model (which would be all LMI insurers) to maintain discount rate data using inception date discount rates. Due to the cost of this for a result which is irrelevant for meaningful disclosure and unnecessary for any other purpose, the Insurance Council submits that it should not be a requirement for any insurer that elects to record all discount movement through the P&L.

CSM discounted using a locked in rate at inception date

The Insurance Council has concerns regarding the compliance costs associated with the requirement to discount the CSM using a locked-in rate at inception date. IFRS 4 Tentative Guidance, paragraph 30 of the Exposure Draft states:

“At its meeting on 22 July 2014 the IASB tentatively decided that, for contracts without participating features, an entity should use the locked-in rate at the inception of the contract for accrediting interest on the contractual service margin”

The AASB and some industry members have highlighted this as an issue for general insurers with long dated contracts. Discounting the CSM for the time value of money is required to be calculated using the “locked-in” discount rate based on the inception of the contract. LMI businesses currently do not use the inception date discount rate in their business model and this requirement would result in an unnecessary compliance cost. The Insurance Council supports the AASB’s position that the IASB should allow use of the current discount rate in accreting interest.

If you have any questions or comments in relation to our submission please contact John Anning, the Insurance Council's General Manager Policy, Regulation Directorate, on tel: 02 9253 5121 or email: janning@insurancecouncil.com.au.

Yours sincerely

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