INSURANCE COUNCIL OF AUSTRALIA

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By email: insurancetax@treasury.gov.au

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Dear Sir/Madam

Taxation of insurance companies: Consultation paper on the tax impacts of AASB 17, recognition of outstanding claims and tax provisions for health insurers

The Insurance Council of Australia[1] (Insurance Council) appreciates the opportunity to comment on Treasury's consultation paper on the tax impacts of AASB 17, *recognition of outstanding claims and tax provisions for health insurers* (the Consultation Paper).

As the representative body of the general insurance industry, the Insurance Council addresses in this submission only the general insurance-related questions in Sections 1 and 3 of the Consultation Paper. As Insurance Council members differ for example in the range of products offered and business model, on some issues there will be a number of perspectives.

Following discussion with our members about the Consultation Paper questions, the Insurance Council can make a number of observations:

- General insurers have commenced assessment of the financial implications of adopting AASB 17. However, they are unable to finalise assessments or fully quantify the impact of AASB 17 adoption due to fundamental interpretation issues yet to be resolved by standard setters.

- The major tax implications for general insurers adopting AASB 17 will occur during the transition or in the first year following the Standard's adoption.

[1] The Insurance Council of Australia is the representative body of the general insurance industry in Australia. Our members represent approximately 95 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 2018 Australian Prudential Regulation Authority statistics show that the private sector insurance industry generates gross written premium of $47.2 billion per annum and has total assets of $121.2 billion. The industry employs approximately 60,000 people and on average pays out about $124.8 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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- Tax and financial reporting should be aligned to enable efficient, cost-effective reporting and to minimise costs to the industry and consumers and increase the transparency and reliability of financial reports for regulators.

The responses to the specific questions posed in the Consultation Paper set out in the Attachment explore these points in more detail.

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 (02) 9253 5121 or janning@insurancecouncil.com.au.

Yours sincerely

Robert Whelan
Executive Director and CEO

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ATTACHMENT

RESPONSES TO QUESTIONS IN THE CONSULTATION PAPER

Stage of implementation

Question 1.1
Insurance Council members have commenced their assessments of the financial implications of implementing AASB 17. However, progress in quantifying the financial impact of adopting the Standard has been impeded by the need to resolve critical questions about the interpretation of AASB 17. These issues are of both a general and technical nature and require a final determination at the IASB standard-setting level to allow for complete assessment of AASB 17's financial impact. The key matters for Australian general insurers are:

- clarity over whether the generally accepted practice of determining the level of aggregation within portfolios to identify 'portfolios' and 'groups of contracts can continue'; and
- confirmation of the extent to which general insurance products are affected by specific AASB 17 accounting approaches which impact both accounting for ongoing business and acquired portfolios.
- The need for a final determination that AASB 17 can be amended to extend the subsequent measurement requirement set out in AASB 17.66(c)(ii) where those underlying losses are recognised at initial recognition of the reinsurance contracts held, or subsequently.

Question 1.2
The Insurance Council has been advised by its members that their assessments of the financial implications of adopting AASB 17 will be completed over the next eighteen months, with all insurers expecting to have them finalised before 30 June 2020.

Question 1.3
Information received from the Insurance Council's members indicates that general insurers intend to adopt the Standard on the relevant mandatory application date (either 1 January 2022 or 1 July 2022). Two insurers have informed the Insurance Council that they are considering earlier adoption.

Financial impacts for accounting and tax purposes

Questions 1.4; 1.5; 1.8
There are numerous issues with AASB 17 interpretation, as discussed in our response to question 1.1, which prevent general insurers from being able to accurately quantify the financial impact and transitional adjustments required to adopt the Standard.

General Insurers have kept abreast of developments with the interpretation of AASB 17 since the Standard's release. In addition, to better understand the financial impact of AASB 17, members have also conducted qualitative assessments of the key differences from core principles of AASB 1023 and the immediate implications of adopting AASB 17.

Deferred Acquisition Costs and unearned premium reserves
(Affecting the balance sheet and profit and loss statement in the first year of adoption.)

Several insurers have informed the Insurance Council that they intend to apply the AASB 17 option to expense on transition all acquisition costs for contracts with coverage periods of a year or less. If the AASB 17 accounting policy is adopted, there will be a potential de-recognition of opening deferred acquisition costs and unearned premium reserves as new expenses will not be deferred going forward. In this scenario, the impact would carry across from the balance sheet to profit and loss, reducing opening retained earnings.

The alternative approach favoured by some other insurers would be to reclassify certain expenses under AASB 17. For example, the classification of acquisition costs under AASB 1023 as overheads may change under AASB 17.

Illiquidity component
(Affecting the balance sheet in the first year of adoption.)

Insurers will apply one of several AASB 17 methods to derive the discount rate depending on the complexities of assessing an illiquidity premium and comparing reference portfolios and insurance contracts. The inclusion of an illiquidity premium when deriving the discount rate may result in slightly higher rates when measuring the liability for incurred claims. This in turn, may reduce the value of claim liabilities relative to the AASB 1023 value.

Contractual service margin and reinsurance
(Affecting the profit and loss statement in the first year of adoption.)

On adoption of AASB 17, profit may be impacted by the discounting and timing of recognition of the contractual service margin (CSM) within the reinsurance result. There are complex requirements around the recalculation of the CSM at each balance date, which in practice may lead to material differences from AASB 1023 values. However, this is limited to the potential impact of adopting the AASB 17 Building Block Approach (BBA) measurement model for specific long -term reinsurance contracts held, and the resulting in year on year timing differences.

Reinsurance contracts held: Onerous contracts
(Affecting the profit and loss statement in the first and subsequent years of adoption.)

A loss on onerous contracts issued is recognised immediately in the profit and loss, but a corresponding benefit on the related reinsurance held must be recognised over the coverage period of the reinsurance contract. This results in an accounting mismatch that does not reflect the economics of the reinsurance transaction as a risk mitigation tool.

This AASB 17 requirement is also inconsistent with the subsequent measurement requirement in AASB 17.66(c)(ii) and the principles applied in other accounting standards to similar transactions. The prevalence of onerous underlying contracts which have the potential to give rise to reinsurance gains is greater than previously contemplated by the IASB due to the introduction of ‘groups of insurance contracts’ as a unit of account late in the drafting of the standard.

Question 1.6
The Insurance Council represents general insurers and cannot comment on whether alignment would be appropriate for some or all life insurance and/or health insurance business.

Question 1.7
Due to the similar treatment of risk adjustment under AASB 1023, members advise that in most cases they do not anticipate a material change for risk adjustment in the financial statements under AASB 17.

However, if a new AASB 17 estimation methodology is adopted, there may potentially be a refinement to the estimation basis for deriving the risk adjustment (risk margin) associated with the liability for incurred claims. This could occur if, for example, the Cost of Capital approach is applied in place of the existing AASB 1023 probability of adequacy (PoA) approach to calculate the risk adjustment.

Linking tax to accounting standards

Questions 1.9(a); 1.9(b)
AASB 17 provides a highly transparent accounting model, which should be leveraged to improve the administration of taxation. The same level of transparency is unlikely if tax law were to deviate from accounting. The Insurance Council therefore submits that tax and financial reporting should be aligned to minimise costs and to enable the efficient preparation of reports. Alignment of tax and financial reporting would also increase transparency and reliability of financial reports for regulators such as APRA and the ATO.

However, inconsistencies between financial and tax reporting would have the opposite effect, resulting in reduced transparency, additional reporting complexity and higher compliance costs. A duplication of tax and financial record keeping obligations for insurers will require additional expenditure on unproductive administrative activities and, in turn, higher costs to consumers.

At present, tax law aligns with accounting, except for indirect claims settlement costs. Section 321-20 of the *Income Tax Assessment Act 1997* (Cth) currently excludes indirect claims settlement costs and requires a separate adjustment when calculating taxable income. The Insurance Council suggests that the tax law should be amended to achieve consistency of treatment between direct and indirect claims settlement costs and to align with the AASB 17 accounting model.

Question 1.10
The financial effects of implementing AASB 17, discussed above in responses to questions 1.4 and 1.5, will have significant accounting impacts mostly on transition or the first year of adoption; with only some insurers expecting to see a minor, ongoing impact on profit recognition.

Consequently, the Insurance Council does not consider there to be a compelling basis for differences between financial and tax reporting, but notes that consideration should be given to transitional arrangements. Transition Rules will be required for any material transitional adjustments arising for example, if there is a material de-recognition of DAC as explained in our response to question 1.6 above. Material transitional adjustments which arise should be

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recognised for taxation purposes within a reasonable timeframe to prevent any undue current effects on tax reporting.

Recognition of outstanding claims

Questions 3.1; 3.2

Insurance Council members presently determine the outstanding claims liability (OCL) for accounting purposes through a rigorous actuarial process based on factors relevant to each insurer. The OCL is typically subject to review by independent consulting actuaries, external auditors and company executives. This process is unique for each insurer and the introduction of uniform criteria for the industry to determine the OCL would inevitably result in differences between financial and tax calculations. This would entail adverse consequences as discussed in the response to question 1.9 above.

Accordingly, the Insurance Council submits that there is no need for the ATO to specify other adjustments if tax is aligned to accounting as recommended.