APRA

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CONFIDENTIAL SUBMISSION

20th October 2003

Ms Ruth Picker, Chairman
Australian Accounting Standards Board
PO Box 204, Collins Street West Vic 8807
AUSTRALIA

RE: Submission on ED 122 *"Insurance Contracts" (IASB ED 5)*

Dear Ms Picker,

The Australian Prudential Regulatory Authority (APRA) has reviewed the proposals in ED 122/ED5 *"Insurance Contracts"*. Our general and specific comments in relation to these proposals are set out below. APRA recognises that the AASB/IASB is still in the process of amending and exposing a number of their standards and our comments are made in this context. We also recognise that the consequential amendments to AASB 1023 *"Financial Reporting of General Insurance Activities*" and AASB 1038 *"Life Insurance Business"* are presently being exposed in Australia as ED 122A and ED 122B. The views expressed in this submission are primarily directed to the ED 122/ED 5 *"Insurance Contracts"* document but may also have an impact on ED 122A and ED 122B documents that are presently being exposed.

General Comments

1. Structure of the Exposure Draft(s)

The AASB Preface to the ED 122 Exposure Draft (p.10) suggests that, to determine the appropriate reporting requirements, in future readers would need to consider the requirements in ED 122 *"Insurance Contracts" (*for insurance business), Improvements *ED/IAS 32 "Financial Instruments: Disclosure and Presentation"*, and Improvements ED/IAS 39 *"Financial Instruments: Recognition and Measurement"* (for investment linked business), in addition to the amended insurance standards AASB 1023 *"Financial Reporting of General Insurance Activities"* and AASB 1038 *"Life Insurance Business"*. Presently, readers predominantly consider the requirements in AASB 1023 and AASB 1038.

In this context, it would be useful for the AASB to clarify the hierarchy in relation to the application of these standards to reporting entities once these standards are approved for issuance in Australia. Furthermore, consideration of the adequacy of the implementation guidance of ED 5 and appendices in AASB 1023 and 1038 may also be necessary to enable consistent application of the principles in the proposed standards and the transition to international financial reporting standards for affected reporting entities in Australia.

2. Fair Value Measurement

APRA supports the AuASB decision to adopt a fair value measurement basis with respect to financial assets and liabilities. However, careful consideration needs to be given to the issue of consistency of measurement so as to avoid the potential for mismatch between the valuation of assets and liabilities under the proposed framework. The proposed framework creates the potential for asset liability mismatch in specific circumstances and we have included some comments in that regard below.

2.1 General Insurance

APRA is strongly supportive of the AASB approach to adopt the proposals with respect to prudential reporting and capital requirements in General Prudential Standard 210 *Liability Valuation for General Insurers*. GPS 210 provides a workable proxy for Fair Value measurement of general insurance liabilities in the Australian market until such time as the IASB progresses with Phase II of the insurance project.

GPS 210 requires the use of market value of assets in conjunction with a prospective discounted liability valuation based on best estimate assumptions but with prudential or risk margin to bring the probability of sufficiency of the liabilities up to 75%. This is viewed as providing a reasonable proxy for a market value margin for business which is essentially volatile. Prudential capital requirements additional to this are required to cover both liability and asset risks such that the provisions plus capital are designed to provide a high (about 99.5%) probability of sufficiency that the liabilities will be honoured. Again this allows profitability on a 'market value' basis to be reported but profits withheld to ensure prudential capital requirements are met.

Reporting of underlying profitability based on a market value or economic substance approach, but tightly integrated with a prudential solvency calculation and reporting approach can provide both effective market discipline and incentives along with reconcilable prudential strength reporting.

2.2 Life Insurance

The general purpose financial reporting and prudential reporting requirements in Australia for life insurance have been developed so that while market values of assets are required, the liability valuations for general purpose financial reporting are calculated with a prospective methodology using best estimate assumptions so that it is 'market value related'. Thus asset and liability valuations have a considerable degree of symmetry resulting in less volatility in profits for closely matched life operations, but high profit volatility for significantly mismatched life operations. For prudential solvency purposes the same liability calculation methodology is used as for profit reporting purposes, but using prudentially conservative assumptions. The difference between the prudentially conservative liability calculations and the best estimate liability valuation is a significant component of the regulatory minimum solvency requirements. These requirements and the form of financial reporting have been deliberately developed to be an integrated package so users can easily see the underlying profitability of the business, but also the level of retained profits which must be held back from distribution in order to meet prudential solvency requirements.

However, an asset liability mismatch could arise as a result of the inability to recognise the excess of net market value over net assets of the subsidiary in the case of life insurance. The current AASB 1038 (Para 5.3) requires that:

> "**Any excess of the *net market values* of an interest in a subsidiary over the net amount of that subsidiary's assets and liabilities recognised in the consolidated financial report must be recognised in the consolidated financial report of a life insurer as a separate asset".**

APRA recommends that this requirement be removed from AASB 1038.

APRA is supportive of the AASB proposal (p.15) to retain the ability to discount deferred tax assets and liabilities for life insurance assets and liabilities on the basis that this form of discounting reflects the substance of the underlying contracts. This approach avoids the potential for any inconsistency between the measurement of these provisions and the measurement of policy liabilities.

APRA is also supportive of the proposed requirement that investment contract assets and liabilities both be measured at fair value and that assets backing insurance contracts be measured at fair value. However, while the IASB/AASB may find it necessary to make the distinction between the two, it is desirable that the same principles – particularly in relation to fair value measurement (paragraphs 95-106 of Improvements ED/IAS 39) be consistently applied between ED5, and the Improvements ED/IAS32 and 39, for life insurance and general insurance business. The consistent application will require clarification of the fair value measurement approach within IAS 39 as it applies to financial instruments issued by insurance companies.

3. Life insurance issues

3.1 Impact on the quality of financial reporting for life insurance entities in Australia

APRA has general concerns about the quality of financial reporting arising from applying the requirements of ED 5 *"Insurance Contracts"* and the financial instruments standards (IAS 32 & 39) to life insurance entities in Australia. The underlying substance of inherently similar transactions could be treated differently under the insurance and financial instruments standards, and could be presented in a manner that does not enhance the comparability and understandability of financial information (as defined in the Statement of Accounting Concepts) for life insurance entities.

Accounting and reporting for the insurance contracts and financial instruments of insurers using different methods is likely to be confusing for users of financial statements, and will produce misleading results for some products and business structures. This is because the current Australian accounting standards and legislative requirements do not distinguish an insurance contract from a financial instrument. However, under the new proposals, insurance contracts in life insurance businesses would be treated under ED 122 whereas investment linked products would be treated under the financial instruments standard. Over 80% of the business of Australian life insurers will be classified as financial instruments under the new standards. APRA has identified some of the fair value issues arising with respect to IAS 39 in the section above, and these issues are also relevant here.

In addition, there is also a risk that accounting/reporting for the insurance and investment business of life insurers using different methods may be confusing for users of financial statements, and will produce misleading results for some products and business structures. These demographic characteristics of the Australian market may lead to significant differences in profit reporting and even capital requirements between contracts that meet the definitions of insurance contracts and those that do not. It may also lead to artificial changes in product design and pricing that has the potential to distort the market, and may in turn necessitate extensive additional disclosures to help users understand reported results and the underlying economic reality of the business.

3.2 Discount Rate

IAS39 requires the fair value of liabilities to be determined with reference to the "prevailing rate of return for financial instruments having substantially the same terms and characteristics" (paragraph 100C). The LIASB standard requires the use of the return on the "assets backing the liabilities". APRA prefers the IAS 39 standard, and we note that the

LIASB also acknowledges that it is sensible in these situations to move to a discount rate that is relatively risk free.

3.3 Profit Deferral

Referring to the IASB's Insurance Contracts (phase I) project summary[1] in relation to ED 122/ED 5, there are 4 issues arising from the interaction with suggested changes to the Improvements ED/IAS 39 that could lead to a significant reduction in the reported profits of life insurers in Australia and some other jurisdictions. These are:

- A narrower basis for acquisition costs (paragraph 25 (a)) We note that the AASB proposes that the deferred amortisation cost choice be removed from the Australian equivalent to IAS 39 in Australia as it represents a backward step for Australian financial reporting practice. In APRA's view, a specific exception needs to be created for life insurance. Acquisition costs (as presently defined in AASB 1038), on the basis that the current proposals in the exposure draft currently may not reflect the economic substance on which the business is written, and may introduce an inconsistency between investment and insurance contracts.
- Deposit (surrender value or amount payable on demand) floor (paragraph 29 (c) and (e)),
- Recognition of profits at inception (paragraph 29 (e) and (f))
- The recognition of renewal premiums (to be addressed in phase II – see paragraph 31)

They are interrelated. The central question is whether the value of a liability can be reduced by the expected value of future premiums even if (under fair value assumptions) they exceed the value of future benefits. (The effect is to treat the future cash flows under the policy as an asset.). This question is the recognition of "renewal premiums" which is ostensibly deferred until phase II of the project.

There are effectively three views on this question.

1 The profits have not been "earned" until the premiums have been paid.
2 It would be imprudent to recognise profits that may not arise if the policy is lapsed or surrendered.
3 The policies have a positive expected (fair) value and so contribute to profit, even though capital reserves are required to cover possible losses from future discontinuances.

The Insurance Contracts (phase I) Draft Statement of Principles (DSOP, 2001) discusses the issue and takes the 3rd view in favour of recognition of the premiums if policyholders have "uncancellable renewal options that are potentially valuable to them" (paragraph 4.50). We believe the DSOP approach to be consistent with a fair value approach although it has not been endorsed by the IASB. The DSOP explicitly recognises that this may lead to the policy being an asset (4.56). It also makes the connection with the deposit floor and the recognition of profits at inception (4.62). The connection is as follows. The net present value of future expected cash flows can be an asset. If it is an asset it may be deducted from the liability associated with the policy (i.e. cash surrender value). In circumstances when the surrender value is zero, the policy as a whole may be an asset, which in turn gives rise to profits at inception.

The project summary proposes that the new IAS 39 draft will include deposit floors and exclude profits at inception which is inconsistent with ED5/ ED 122. This approach is also in conflict with actuarial standards in many countries. U.S. and Australian standards do not permit profits at inception, but Canadian and UK standards do. The Australian standards do not apply a full surrender value minimum except for capital reserves.

APRA believes that rapid growth companies need to set realistic directors and actuarial assumptions about future profit. The setting of realistic assumptions is particularly important

[1] The latest (July 2003) version can be found at http://www.iasb.org.uk/docs/projects/insurance1-ps.pdf

for rapidly growing companies report accurately on their expected profitability. However, if rapid growth always leads to reported losses, then investors have no means of evaluating real profitability, and this approach would undermine the usefulness of general purpose financial reports. This would contribute to difficulties of rapidly growing companies. to raise the capital that should provide a buffer against the risks they face. Established companies, on the other hand, have an interest in reporting the much smoother profits that arise if new business profits are spread over the lifetime of contracts.

Given that further consideration of the above issues is required and will be undertaken in Phase II, APRA would recommend that existing national standards (MoS in the case of Australia) be retained in the interim. Movements towards a fair value approach should not however be discouraged. From APRAs perspective the ideal outcome for investment contracts would be:

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

APRA encourages the AASB in its attempts to persuade the IASB in achieving this outcome.

4. Credit risks

ED5 (paragraph BC6) requires that the value of a liability requires consideration of the "credit characteristics of that contract, including the effect of policyholder protections".

This could give rise to differences of opinion between management, regulator and auditor regarding the appropriate credit assessment for liability valuation purposes, and may lead to unnecessary and/or undesirable disclosure of potential company weaknesses in circumstances that are subsequently adequately addressed. The liabilities of a company operating under confidential regulatory oversight might be exposed to higher credit risks using normal criteria, however the oversight may reduce the risks to acceptable levels.

APRA suggests that this concern could be addressed by ensuring that additional allowance for credit risk be based on publicly available information.

5. Specific Comments

Our specific comments in relation to the ED 122 exposure draft are included as a separate attachment (***Attachment A***).

6. Concluding Comments

The new international standards could potentially represent a backward step from a prudential reporting perspective. The AASB/IASB needs to further consider how the new IAS39/ED 122/ED5 *"Insurance Contracts"* accommodates the provisions within the actuarial and prudential standards without creating the potential for conflict. As noted above, it may be useful for the AASB/IASB to consider deferring the treatment of profit deferral in the Insurance ED to be part of Phase II. National jurisdictions would essentially determine the appropriate treatment in the interim in accordance with legislative and regulatory requirements. This approach will also allow the AASB/IASB sufficient time to resolve most of the matters arising with the financial instruments standards that are still subject to considerable debate.

The AASB also needs to recognise that our comments above are made in the context that APRA generally seeks to ensure that our prudential reporting requirements are broadly consistent with accounting standards. However, protecting the interests of policyholders may require prudential rules and reporting that may differ from rules designed for shareholder disclosure.

Should you have any questions in relation to this submission please contact me directly on (02) 9210 3408.

Yours sincerely

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Senior Accounting Advisor, APRA
Cc: Peter Clark, IASB (Confidential)

Attachment A: Specific Comments

Comments are made in relation to the specific matters that the AASB is seeking feedback on below:

1. APRA supports the AASB's proposal to adopt Option 2 for loss recognition (p.11) in AASB 1023. Under the proposed AASB approach, premium revenue would be recognised on the commencement of a contract of insurance on a fully prospective basis. It is APRAs understanding that AASB 1023 would also be amended to require recognition of premium liabilities on a basis that is consistent with APRA's General Prudential Standard 210 *Liability Valuation for General Insurers*. This approach is also consistent with the reporting requirements of APRA's regulated entities. *[AASB reference (a)]*

2. APRA supports the proposal to retain the requirements of section 6 of AASB 1038 in relation to the splitting of premiums and claims, and to cross-reference AASB 1023 and AASB 1038 to the unbundling requirements proposed in AASB ED 122. APRA recognises that the significance of the unbundling decision rests on whether the contract is treated under IAS 39 or ED 5/ED 122. Under the current proposals in ED 5, identical contracts may be accounted for differently as a company can choose (but is not required) to unbundle. This could have an impact on the usefulness of general purpose financial reports. *[AASB reference (b)]*

3. APRA is supportive of the proposal that AASB 1023 require the disclosure of insurance liabilities measured at a central estimate, at the greater of a 75% sufficiency level and half the coefficient of variation, and at the margin ultimately adopted by the entity. This is consistent with APRA's General Prudential Standard 210 *Liability Valuation for General Insurers*. *[AASB reference (c)]*

4. APRA is supportive of a fair value measurement basis for assets and liabilities backing insurance and investment contracts, although it recognizes that there is not yet consensus on its precise determination. The general comments in relation to the consistent treatment of fair values between ED122/ED 5 and IAS 39/Improvements ED also applies. Please also see general comments above. *[AASB reference (d) & (e)]*

5. APRA is supportive that a risk free discount rate be applied to insurance liabilities under AASB 1023 and AASB 1038. *[AASB reference (f) and (g)]*

6. APRA is supportive that a risk margin be introduced under AASB 1023 in the form described in (3) above. APRA suggests that AASB 1038 permit, but not require the use of risk margins – subject to full disclosure of the basis and impact of such margins. *[AASB reference (h) and (i)]*

7. APRA believes that AASB 1038 should retain the requirement to discount deferred tax assets and liabilities for insurance contracts and for certain investment contracts. Please see general comments above. *[AASB reference (j)]*

8. APRA recommends the inclusion of Medical Benefits Institutions under AASB 1023 and Friendly Societies under AASB 1038. *[AASB reference (k) and (l)]*

9. APRA is supportive of the disclosure proposals in AASB ED 122. In many respects, adequate disclosure is critical to understanding. In this respect, paragraph 27 of ED122/5 should be expanded to require that the entities report the impact of differences between the key (material) assumptions made in the previous balance sheet and actual experience over the past reporting period. Disclosure on an aggregated basis with only key items separated as

necessary for the purposes of enhancing understandability, would be essential information. This form of disclosure provides an indication of the impact of key assumptions on the results, and discourages the use of unrealistic assumptions.

Moreover, this approach would provide a more complete analysis of the contribution of items in the reporting period in question. In this context, the requirements relating to changes in assumptions in *ED/IAS 32 "Financial Instruments: Disclosure and Presentation"*, may need to be revised in paragraphs 77B or 79. It is suggested that deviation from assumptions should also be included here. However, APRA recognises that there is a need for further cost/benefit analysis and subsequent guidance in relation to the proposed requirements for detailed disclosure of information. Detailed disclosure is onerous and also needs to be carefully developed and presented to ensure that it is not to be misleading. *[AASB reference (m)]*

10. In relation to any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the proposals *[AASB reference (n)]* and whether the proposals are in the best interests of the Australian economy *[AASB reference (o)]*, please refer to general comments section above.