6 November 2013

GROUP OF 100

The Group of 100 Incorporated

Level 20, 28 Freshwater Place
Southbank VIC 3006 AUSTRALIA
www.group100.com.au

Telephone: +61 3 9606 9661
Facsimile: +61 3 9670 8901
Email: g100@group100.com.au

ABN: 83 398 391 246

Mr H. Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
London EC 4M 6XH
UNITED KINGDOM

Dear Mr Hoogervorst

ED/2013/7 "Insurance Contracts"

The Group of 100 (G100) is an organization of chief financial officers from Australia's largest business enterprises with the purpose of advancing Australia's financial competitiveness. We are pleased to comment on the Exposure Draft.

The G100 believes that achieving international consistency in accounting for insurance contracts will improve comparability and provide better and more reliable information to users. However, in seeking to achieve this outcome it is important that the focus is on achieving a model which provides sensible accounting outcomes across different jurisdictions and business models.

The G100 is broadly supportive of the proposals made in this ED when compared with those in ED/2010/8 particularly in respect of the transitional requirements and the unlocking of the contractual service margin. However, we remain concerned about the costs of implementation and compliance with the proposals, such as that relating to the use of discount rates at inception of a contract which would require significant investment in systems and processes with minimal benefits to users of financial statements, and the mirroring requirements.

Q1 ADJUSTING THE CONTRACTUAL SERVICE MARGIN*: Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial position and performance if differences between the current and previous estimates of the present value of future cash flows if:*

a. differences between the current and previous estimates of the present value of future cash flows related to future coverage and other future services are added to, or deducted from, the contractual service margin, subject to the condition that the contractual service margin should not be negative; and
b. differences between the current and previous estimates of the present value of future cash flows that do not related to future coverage and other future services are recognised immediately in profit or loss?

Why or why not? If not, what would you recommend and why?

The G100 supports this proposal for unlocking the contractual service margin, which is a significant improvement from the approach proposed in the 2010 ED. We believe that excluding the impact of changes in expected cash flows relating

to future coverage from current year profit or loss provides more useful and relevant information as current year performance is not obscured by the impact of changes in expected future profitability. The proposal is also conceptually consistent with the proposed approach to recognising revenue from contracts with customers.

The G100 suggests that the proposal be modified to require that:

- **the contractual service margin be adjusted for changes in the risk margin that relates to future coverage, rather than requiring these changes to be recognised in current period profit or loss. We believe that changes in the risk margin relating to future coverage are similar in nature to changes in the contractual service margin relating to future coverage in that they represent changes in expected future profitability. Consequently, such changes should result in a change in the profit margin to be released in future periods rather than being taken to current period profit or loss. Disaggregation of the overall change in risk in each period into the expiry of risk as coverage is provided and changes in the estimates of risk associated with future coverage is not necessarily a major concern for insurers in Australia as this forms part of the disclosures required under prudential standards for general insurance; and**

- **when the contractual service margin of a portfolio is exhausted subsequent improvements in expected cash flows related to future coverage be recognised in current period profit or loss to the extent of previously recognised losses in order to achieve accounting symmetry. The current proposals require an insurer to recognise unfavourable changes to assumptions for such products in the current period profit or loss but not favourable changes.**

Q2 CONTRACTS THAT REQUIRE THE ENTITY TO HOLD UNDERLYING ITEMS AND SPECIFY A LINK TO RETURNS ON THOSE UNDERLYING ITEMS*: If a contract requires an entity to hold underlying items and specifies a link between the payments to the policyholder and the returns on those underlying items, do you agree that financial statements would provide relevant information that faithfully represents the entity's financial position and performance if the entity:*

a. *measures the fulfilment cash flows that are expected to vary directly with returns on underlying items by reference to the carrying amount of the underlying item?*
b. *measures the fulfilment cash flows that are not expected to vary directly with returns on underlying items, for example, fixed payments specified by the contract, options embedded in the insurance contract that are not separated and guarantees of minimum payments that are embedded in the contract and that are not separated, in accordance with the other requirements of the (draft) Standard (ie using the expected value of the full range of possible outcomes to measure insurance contracts and taking into account risk and the time value of money)?*
c. *Recognises changes in the fulfilment cash flows as follows:*

   i. *changes in the fulfilment cash flows that are expected to vary directly with returns on the underlying items would be recognised in profit or loss or other comprehensive income on the same basis as the recognition of changes in the value of those underlying items;*
   ii. *changes in the fulfilment cash flows that are expected to vary indirectly with the returns on the underlying items would be recognised in profit or loss; and*

iii. changes in the fulfilment cash flows that are not expected to vary with the returns on the underlying items, including those that are expected to vary with other factors (for example, with mortality rates) and those that are fixed (for example, fixed death benefits), would be recognised in profit or loss and in other comprehensive income in accordance with the general requirements of the (draft) Standard?

Why or why not? If not, what would you recommend and why?

The G100 does not support this proposal.

We believe that the accounting basis should be consistent for both the contract and linked underlying items, the proposed solution is unnecessarily complex to apply in practice and is not expected to achieve a sensible outcome in respect of participating products or situations where the underlying item is an equity or debt instrument issued by an entity within the same consolidated group.

Part of this complexity arises from the diversity of accounting treatments required for supporting assets, particularly due to the proposal to introduce a "fair value through other comprehensive income" category into IFRS 9, which for some portfolios results in some of the underlying assets being accounted for at fair value through profit or loss and other assets at fair value through OCI.

Under the proposals, a single portfolio of insurance contracts could have various different accounting treatments used to measure its insurance contract liability balance as follows:

- **Linked component backed by derivatives, complex debt instruments or investment properties measured at fair value through profit or loss;**
- **Linked component backed by simple debt instruments measured at fair value through other comprehensive income using the effective interest rate on the backing assets;**
- **Linked component backed by assets held at cost (such as controlled private equity investments) measured at the accounting bases applying to individual assets;**
- **Other components, such as surrender options, measured at expected values with changes offset against the contractual service margin;**
- **Unwinding of the discount on components not linked to underlying assets at the discount rate on inception of the contracts.**

Accounting mismatches for life insurers also arise on investment contracts that are outside the scope of insurance contracts as defined in the ED and are therefore treated as financial instruments. As the "mirroring" concept is not included in IFRS 9, the proposal to implement it for insurance contracts will result in an inconsistent approach between these two standards and accounting mismatches that arise on investment contracts will continue to exist.

Further complications with mirroring arise on consolidation. For example, for some groups, there are contracts written by the life insurers that require the insurer to hold underlying assets and pass the returns from these assets on to the policyholder. The underlying assets include investments in investment funds operated by a group's asset management business that are consolidated in accordance with IFRS 10 and deposits with a banking entity. For these

assets, the insurer will be eligible to use mirroring in its separate accounts, but the consolidated group will not be eligible to use the same accounting treatment.

The G100 recommends that, as a principle, accounting mismatches are best addressed by achieving consistency between the measurement approaches of standards rather than by exceptions within the standards. For the purposes of this standard, minimization of accounting mismatches is more effectively achieved by requiring (or at least allowing) measurement of the linked component of the liability at fair value through profit or loss. Where the underlying item is a financial asset, IFRS 9 should require the asset to also be measured at fair value through profit or loss as this reduces an accounting mismatch.

If the use of "mirroring" is retained the G100 believes that:

- **an exception be introduced such that if mirroring is achieved for the insurer in its separate accounts, this treatment continue on consolidation, even where the underlying asset is consolidated; and**
- **"mirroring" should also be introduced for financial liabilities within the scope of IFRS 9 that have a similar link to underlying items.**

Q3 PRESENTATION OF INSURANCE CONTRACT REVENUE AND EXPENSES*: Do you agree that financial statements would provide information that faithfully represents the entity's performance if, for all insurance contracts, and entity presents, n profit or loss, insurance contract revenue and expenses, rather than information about the changes in the components of the insurance contracts?*
Why or why not? If not, what would you recommend and why?

The G100 supports the proposal because we believe that the presentation of an entity's insurance contract revenue and expenses in profit or loss provides relevant information that faithfully represents the entity's financial performance and the economic reality of the underlying products. This information is more relevant to users of financial statements than information about the changes in components of insurance contracts.

Q4 INTEREST EXPENSE IN PROFIT OR LOSS*: Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial performance if an entity is required to segregate the effects of the underwriting performance from the effects of the change in the discount rates by:*

a. *recognising, in profit or loss, the interest expense determined using the discount rates that applied at the date that the contract was initially recognised. For cash flows that are expected to vary directly with returns on underlying items, the entity shall update those discount rates when the entity expects any changes in those returns to affect the amount of those cash flows; and*
b. *recognising, in other comprehensive income, the difference between:*
   i. *the carrying amount of the insurance contract measured using the discount rates that applied at the reporting date; and*
   ii. *the carrying amount of the insurance contract measured using the discount rates that applied at the date that the contract was initially recognised. For cash flows that are expected to vary directly with returns on underlying items, the entity*

shall update those discount rates when the entity expects any changes in those returns to affect the amount of those cash flows?

Why or why not? If not, what would you recommend and why?

The G100 does not support this proposal as it introduces significant and unnecessary complexity into the calculation of insurance liabilities and we do not believe that it will achieve its objective of eliminating the impact of changes in current market rates from profit or loss.

We consider that the aim of the IASB's proposal to present changes in the carrying amount of insurance contracts through other comprehensive income (OCI) is to disaggregate and separately present components of the entity's performance that have arisen as a result of changes to market variables during the period. However, we understand that the proposed approach is likely to add significant complexity for preparers of the financial statements and believe that the cost of this complexity will exceed any benefits. In particular, we have the following concerns:

- **the proposal requires the use of 'locked-in' interest rates to accrete interest on insurance liabilities for presentation in the profit or loss statement, whereas the yield curve is locked in at initial recognition. This will likely require entities to record successive yield curves and associate them with the related insurance contracts, which will require significant modification to existing systems and processes in order to identify and maintain the required records. We believe that the information on discount rates that existed at the date of writing a contract is irrelevant to the users of the financial statements. In our view, interest should be accreted on insurance liabilities at current interest rates, consistent with the IASB's current value model; and**

- **on transition, the requirement to ascertain and apply discount rates applicable at initial recognition for each insurance contract is likely to be impracticable, particularly for older contracts. For conglomerate groups that have acquired insurers, the date of initial recognition will be the date of policy inception for the insurance entity and date of acquisition for the financial statements of the consolidated group, which will result in different performance outcomes (between entity and consolidated group) over the remaining life of the policies.**

The G100 believes that the discount rate at inception is not a relevant consideration for users of the financial statements and, therefore, there is no benefit to support the cost of tracking and reporting information based on these discount rates.

The IASB has not yet developed a conceptual framework for the use of OCI. We believe that it would be premature for the IASB to mandate the use of OCI for new purposes until such time as this framework is developed.

The G100 believes that all changes in insurance liabilities should be taken through profit or loss. In our view this is more consistent with the current measurement approach adopted by the IASB and eliminates the unnecessary complexity which arises from the proposal set out in the ED.

However, if the IASB decides to retain the use of OCI in the final standard, we recommend that:

- **changes to the carrying amount of insurance liabilities be recognised through profit or loss as the primary approach, with an option to recognise these changes through OCI where:**
  - **all assets supporting the liabilities are recognised at fair value through OCI;**
  - **the insurer has a business model where assets supporting the liabilities are not normally purchased or sold after initial recognition of the liability; and**
  - **there is no link between the liabilities and underlying rates of inflation; and**
- **amounts recognised in OCI be based on the difference between current interest rates at the start of the reporting period rather than the interest rate at inception of the contract.**

Q5 EFFECTIVE DATE AND TRANSITION*: Do you agree that the proposed approach to transition appropriately balances comparability with verifiability?*
Why or why not? If not, what do you suggest and why?

The G100 supports the fully retrospective approach, which is expected to allow meaningful consistent information to be reported post transition and addresses the concerns raised with respect to the proposal in the previous exposure draft to set the residual margins to zero at transition. This approach achieves an appropriate balance between comparability and verifiability.

We also support the explicit allowance for the use of a practical expedient where the full retrospective application is impracticable.

The three year transition period from the standard's publication appears to be a reasonable length of time to prepare for the adoption of the standard. We recommend that the IASB align the dates of application of IFRS 9 and IFRS 4. However, if alignment is not possible, we recommend that the IASB allow insurers to delay the application of IFRS 9 until the insurance contracts standard can be applied simultaneously.

Q6 THE LIKELY EFFECTS OF A STANDARD FOR INSURANCE CONTRACTS*: Considering the proposed Standard as a whole, do you think that the costs of complying with the proposed requirements are justified by the benefits that the information will provide? How are those costs and benefits affected by the proposals in Q1-5?*

How do the costs and benefits compare with any alternative approach that you propose and with the proposals in the 2010 Exposure Draft?

Please describe the likely effect of the proposed Standard as a whole on:
a. the transparency in the financial statements of the effects of insurance contracts and the comparability between financial statements of different entities that issue insurance contracts; and
b. the compliance costs for preparers and the costs for users of financial statements to understand the information produced, both on initial application and on an ongoing basis.

The G100 welcomes the practical improvements included in the ED. However, we are concerned about both the cost and unnecessary complexity that arise from the proposals for "mirroring", the use of OCI and the current proposal to require interest amounts to be calculated on the basis of discount rates at inception which, as explained above, would require substantial investment in systems and processes with minimal benefits.

In our view the costs of implementing these proposals is not supported by the benefits achieved.

Q7 CLARITY OF DRAFTING*: Do you agree that the proposals are drafted and reflect the decisions made by the IASB?*
If not, please describe any proposal that is not clear. How would you clarify it?

The G100 believes that the following areas could be drafted more clearly as suggested below:

- **paragraph B32 states that an investment and insurance contract are highly interrelated if the lapsing or maturity of one product causes the lapsing or maturity of the other. In our view, this will not always be the case, as this relationship may exist for operational purposes rather than represent an economic interdependence. We recommend that this paragraph is modified so that the simultaneous lapsing is an indicator or gives rise to a rebuttable presumption; and**
- **Paragraph 38(a) of the ED dealing with the premium allocation model requirements states that the measurement of the liability for remaining coverage is made on the basis of premium 'received' at initial recognition. The wording of the proposal appears to be driven by cash rather than accruals accounting when measuring the liability for the remaining coverage. Our expectation would be the basis of measurement is on premium received as well as premium written but yet received, in line with the principles of accrual accounting.**
- **paragraph 68 – if there are foreign insurance operations with a different functional currency than the parent's presentation currency, exchange differences are to be recognised in other comprehensive income. The additional wording in paragraph 68 does not appear to allow for this scenario.**

  We recommend that this paragraph is modified to read "Paragraph 20 requires an entity to treat an insurance contract as a monetary item under IAS 21 for the purpose of recognising foreign exchange gains and losses."

Yours sincerely
Group of 100 Inc

Terry Bowen
President