



Institute of Actuaries of Australia

# **Discussion Paper**

## **Application of IAS 39 to Insurers**

**IAS 39 Taskforce**

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## **Discussion Paper – Application of IAS 39 to Insurers**

### **Executive Summary**

From 2005, contracts issued by Australian insurers which do not satisfy the specified definition of an insurance contract under International Financial Reporting Standards (“IFRS”) will need to be accounted for in accordance with IFRS including, in particular, IAS 39 *Financial Instruments: Recognition and Measurement* (“IAS 39”).

The IAAust’s IAS Committee has established a taskforce (the IAS 39 Taskforce) to develop guidance for IAAust members on how IAS 39 might be applied to contracts issued by insurers that are not insurance contracts.

This discussion paper has been developed and issued by the IAS 39 Taskforce for the following purposes:

- To provide members with an update on developments in relation to international accounting standards as they affect Australian insurers, and in particular those changes which are expected to be implemented from 2005.
- As the first step towards the development of specific guidance for the actuarial profession in Australia and those that look to it for support on this subject.
- As a vehicle for promoting to the wider international community the views of the Australian actuarial profession on some of the technical issues surrounding the application of IFRS’s to contracts issued by insurers.

The paper is being made available for membership comment at IAAust Horizon meetings in April 2003, and will also be distributed to the broader international (actuarial and accounting) communities. A revised paper, allowing for feedback received, will be presented at the IAAust May 2003 Convention.

Section 1 of the paper provides some historical background on the development of an international accounting standard for insurance contracts and on the standards for financial instruments.

Section 2 provides a high level summary of the provisions of IAS 39 which will be relevant to Australian insurers, noting the circumstances where assets or liabilities may be measured at amortised cost and those where they may be measured at fair value.

Section 3 examines the classification of contracts as being subject to IAS 39 or not, and recommends the unbundling of certain products to ensure the consistent and stable application of the relevant accounting standards to particular product groupings.

Section 4 looks at the technical issues associated with the measurement of liabilities at amortised cost, and noting its similarity to Margin on Services (MoS) (albeit with some assumptions locked in), and differences in the extent to which acquisition costs are potentially deferrable.

Section 5 similarly looks at the technical issues associated with the measurement of liabilities at fair value, again noting the similarities with MoS but with discount rates based on the returns on replicating asset portfolios, and potential differences in the treatment of minimum profit margins, changes in assumptions and allowance for future renewals.

Section 6 examines a more generalised fair value measurement model in the context of the IASB's accounting model. This model considers both insurance contracts and financial instruments in terms of their separate "wholesale" and "retail" components. The wholesale component represents the "pure" financial instrument or insurance process which is measured at fair value (or possibly at amortised cost, for some financial instruments). The retail component is then treated as a service contract under IAS 18 *Revenue* and /or as an amortised acquisition expense recovery under IAS 38 *Intangibles*. The conclusions reached in this section are supportive of the preliminary views provided in sections 4 and 5.

Section 7 proposes some basic criteria for method selection (amortised cost or fair value) to ensure that assets and liabilities are treated consistently and that financial reports are understandable, useful and meaningful.

Section 8 briefly examines other related issues: deferred tax liabilities, taxation bases and the provisions of the Life Insurance Act and associated actuarial standards.

The tentative recommendations and conclusions of the IAS 39 Taskforce, from which future guidance might be developed, are then outlined in Section 9. The taskforce particularly seeks feedback from the IAAust membership on the suitability and practicality of these recommendations. **The task force welcomes the views of members which will enable it to put more definitive recommendations to bodies such as the IASB, AASB and LIASB.**

It should be noted that the position in relation to many of the issues raised in this paper is still quite fluid, with new decisions being made every month by the IASB. The status of issues described in this paper therefore represents the best understanding of the IAS 39 Taskforce as at the time of writing.

Readers who wish to maintain an up to date picture in relation to the development of IFRS should refer to the list of further reading in Section 10, which includes a list of relevant web links.

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## CONTENTS

1.	Introduction	6
1.1	Background & History	6
1.2	The IAS 39 Taskforce, Interaction with Key Players and This Paper	7
1.3	Relevant Phase I Issues	9
1.4	Reinsurance	10
2.	Summary of Relevant IAS 39 (IAS 32) provisions	11
2.1	Overview and Scope	11
2.2	Key IAS 39 (IAS 32) Requirements	12
2.3	Valuation of Derivatives	14
2.4	Guidance on Application of IAS 39 to Investment Contracts	15
3.	Classification Of Business	16
3.1	Issues arising from the definition of insurance contract	16
3.2	Issues arising from the unbundling and embedded derivative requirements	17
3.3	Solution - Unbundling revisited	17
3.4	Alignment with current practice	18
4.	Amortised Cost Method Under IAS 39	19
4.1	Overview of Requirements	19
4.2	Full Acquisition Costs v Transaction Costs	19
4.3	Amortisation: Effective Interest Method	20
4.4	Assumption Changes - Impairment / Loss Recognition	21
4.5	Embedded Derivatives	22
4.6	Projection v Accumulation	22
5.	Fair Value Issues	24
5.1	Background & Accounting Issues	24
5.2	Application to IAS 39	25
5.3	Renewals	25
5.4	Economic Assumptions (Future Earning Rate and Discount Rate)	26
5.5	Best Estimate Assumptions	26
5.6	Stochastic Methods / Option Pricing	26
5.7	Own Credit Risk	27
5.8	Assumption Changes	27
5.9	Projection v Accumulation	28
6.	ALTERNATIVE ACCOUNTING Model	29
6.1	Wholesale v Retail	29
6.2	Justification of Disaggregation	30
6.3	Wholesale Component	30
6.4	Treatment of Acquisition Costs	31
6.5	Risk Margins	32
6.6	Renewals (Wholesale Component)	32
6.7	Overall Theoretical Framework Summary	32
6.8	Implementation - Amortised Cost Under IAS 39	33
6.9	Implementation - Fair Value Under IAS 39 or Phase II	33
7.	Criteria for Method selection under IAS 39	34

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7.1	Consistency Between Measurement of Assets and Liabilities	34
7.2	Choices Available	34
7.3	Assets Backing Equity	35
7.4	Expected Approach for Australian Insurers	35
8.	Other Issues	36
8.1	Discounting Deferred Tax Liabilities	36
8.2	Taxation Basis	36
8.3	Life Act Issues	36
8.4	Owner Occupied Property	36
9.	Conclusions	37
9.1	Classification of Business	37
9.2	Criteria for Method Selection under IAS 39	37
9.3	Amortisation Methodology	37
9.4	Fair Value Methodology	37
9.5	Acquisition Costs	38
9.6	Other Issues	38
10.	Further Reading	40

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## 1. INTRODUCTION

### 1.1 Background & History

#### 1.1.1 *International Accounting Standards affecting Financial Services*

The Financial Reporting Council ("FRC") has directed the Australian Accounting Standards Board ("AASB") to work towards the adoption of International Financial Reporting Standards ("IFRS") in Australia by 2005. This followed a similar decree by the European Union ("EU") in relation to European listed companies.

Of relevance to insurers is that the International Accounting Standards Board ("IASB") currently has a project underway to develop an IFRS for insurance contracts. This standard will cover accounting for liabilities under both life insurance and general insurance contracts. Implementation of IFRS's by financial services organisations, and particularly life and general insurers, is likely to involve significant change from existing measurement and recognition approaches.

The current target is that these new standards will apply to companies for financial years commencing on or after 1 January 2005. This is now less than two years away for many businesses. Indeed, to provide comparatives in respect of 2004, values of assets and liabilities will need to be determined in accordance with these new standards as at 31 December 2003 for companies with 31 December balance dates.

#### 1.1.2 *Insurance IFRS Progress*

Until recently, the objective of the IASB was to have the Insurance IFRS in place for reporting from 2005, which would have fitted with the timetables of the FRC and the EU. However, in May 2002 the IASB recognised that this timeframe was too ambitious, and decided to split the project into two phases:

- Phase I: The development of an interim insurance standard to be effective from 1 January 2005 until a permanent insurance standard becomes available; and
- Phase II: The development of a permanent IFRS to be implemented from 1 January 2007 at the earliest. A detailed document, canvassing alternative accounting and measurement approaches for insurance contracts, entitled Draft Statement of Principles ("DSOP") was issued during 2001/02.

At its October 2002 meeting the IASB took a number of tentative decisions in relation to Phase I of the project. The key decisions were as follows:

- The Board tentatively agreed on the definition of an insurance contract and on a number of exclusions from this definition for the purposes of Phase I. Under the proposed definition, an insurance contract is essentially a contract under which the insurer accepts significant "insurance" risk.
- The Board agreed that Phase I should temporarily exempt insurers from the criteria applicable under IFRS's for determining their accounting policy for insurance contracts where no IFRS specifically applies. This decision will effectively permit insurers to continue to use their current GAAP standards for insurance contracts during Phase I.

#### 1.1.3 *Contract v Entity Focus*

The Insurance IFRS will address accounting for insurance **contracts** only. It will **not** address other aspects of accounting for insurance **entities**. All other aspects of accounting for insurance companies will be dealt with under other IFRS's - one of the most important of these is IAS 39, which is the subject of this paper.

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For example, accounting for investment assets held by insurers will be covered by IAS 39, and so investment assets need not necessarily be measured at market value as currently applies under AASB 1038 and AASB 1023.

This will affect Australian insurers in areas such as the valuation of subsidiaries and the treatment of Excess of Market Value Over Net Assets ("EMVONA").

Scope exclusions in existing IFRSs will similarly be changed to refer to insurance contracts rather than insurance entities.

#### 1.1.4 *Relevance of IAS 39*

A consequence of the above decisions is that contracts issued by insurers that do not satisfy the agreed definition of insurance will be accounted for as financial instruments under existing IFRS's, namely:

- IAS 32 *Financial Instruments: Disclosure and Presentation*; and
- IAS 39 *Financial Instruments: Recognition and Measurement*.

The majority of investment based contracts issued by Australian life insurers are likely to fall into this category, as well as some general insurance contracts.

Historically, contracts issued by insurers have been exempt from the provisions of IAS 39. Hence, there is no practical experience as to how to apply the measurement bases under this or similar standards to such contracts.

#### 1.1.5 *IASB, AASB and IAA Timetable*

The IASB is aiming to issue an exposure draft relating to Phase I of the Insurance Accounting project towards the end of Q2 2003, with the IFRS to follow in the first half of 2004. The aim is also that revisions to IAS 39 should be finalised by the third quarter of 2003.

The International Actuarial Association (IAA) is supporting the IASB in the development of the Insurance IFRS through the development of related international actuarial standards and guidance. Discussion papers relating to this are being prepared for the next meeting of the IAA in Sydney in May 2003.

By the middle of 2003 the AASB aims to have exposure drafts of revised standards to grandfather elements of the existing standards AASB 1023 *General Insurance* and AASB 1038 *Life Insurance* in accordance with Phase I of the IASB Insurance Accounting project. In relation to financial instruments, the AASB is aiming to have a standard on disclosure developed in Q2 2003 and a standard on recognition and measurement in Q3 2003, following the finalisation of IAS 39.

Australian businesses will need to keep abreast of developments, if they are to be well placed for implementation in 2005.

## 1.2 **The IAS 39 Taskforce, Interaction with Key Players and This Paper**

In light of these developments the IAS Committee of the Institute of Actuaries of Australia established a taskforce (the IAS 39 Taskforce) to develop guidance as to how IAS 39 might be applied to contracts issued by Australian insurers that do not satisfy the definition of an insurance contract.

The terms of references of the IAS 39 Taskforce are:

- To identify the typical contract-types issued by Australian insurers that will be accounted for as financial instruments under IAS 32 and IAS 39.
  - To develop guidance as to the measurement of liabilities under such contracts in terms of IAS 39, covering separately the amortised cost and the fair value bases of measurement.
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- To consider the practical implications for insurers of having to implement and utilise the measurement bases under IAS 39 as an interim standard for contracts that do not satisfy the definition of an insurance contract (in conjunction with a Margin on Services (“MoS”) measurement basis for life insurance contracts).
  - To identify ways that the measurement bases might be simplified to minimise implementation effort and ensure maximum consistency with a MoS measurement basis for life insurance contracts.
  - To consider whether the guidance developed for Australian insurers can be extended to the measurement of obligations under similar financial instruments issued by other entities e.g. obligations under trust-based investment contracts.
  - Engage in dialogue on the development of this guidance with key internal and external audiences.

In relation to this final point the IAS 39 Taskforce is also:

- Working closely with representatives from the AASB as they strive to implement the FRC’s directive.
- Planning to advise the Life Insurance Actuarial Standards Board (“LIASB”) on changes to actuarial standards, particularly AS 1.03, which may be necessary to avoid unnecessary inconsistency between regulatory reporting and financial reporting.
- Providing input to discussions within the IAA on the development of international accounting standards and associated actuarial standards.
- Liaising with individual members of the IASB and others on the application of IAS 39.

In the context of these terms of reference, this discussion paper has been developed and issued as the first stage towards the development of specific guidance for the actuarial profession in Australia and those that look to it for support on this subject. The overall project plan of the IAS 39 Taskforce is briefly:

- Issue a preliminary discussion paper (this paper) for membership comment at IAAust Horizon meetings in April 2003 as well as preliminary distribution to the broader international (actuarial and accounting) communities.
- Based on feedback from those meetings make appropriate amendments to the paper for representation and update at the IAAust May 2003 Convention (noting that the next IAA meeting is in Sydney immediately prior to the convention, and many international guests directly involved in the IASB matters will be there).
- Work with the AASB and accounting profession representatives during the remainder of 2003 to revise existing standards and develop new standards and guidance on IAS 39 and “insurance entity” liabilities.

### 1.2.1 IAS 39 Taskforce Membership and Acknowledgements

The IAS 39 Taskforce is comprised of IAAust members and AASB representatives as follows:

David Rush (C)	IAAust
Clive Aaron	IAAust
Kevin Allport	IAAust
Christine Brownfield	IAAust
Christina Habal	AASB
Greg Martin	IAAust
Angus Thomson	AASB
Mike Thornton	IAAust

While this paper represents the consensus view of the members of the IAS 39 Taskforce at the time the paper was finalised, it should not be regarded as representative of the official views of the IAAust, the AASB, any of the above members in isolation, nor their respective employers.

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The IAS 39 Taskforce members would like to acknowledge the support provided to them by their respective employers and their professional colleagues (both actuaries and accountants) who reviewed early drafts of the paper and provided valuable feedback.

### 1.3 Relevant Phase I Issues

Notwithstanding that this paper is concerned with IAS 39, there are some specific issues arising in the context of Phase I of the Insurance Accounting project that are relevant background.

#### 1.3.1 *Recognition and Measurement – Continuation of Existing Practices*

To avoid requiring changes in Phase I that might be reversed or altered in Phase II, the IASB does not intend to develop specific recognition and measurement requirements in Phase I. Rather, Phase I will provide for the temporary continuation of the provisions of local accounting standards and generally accepted accounting principles ("GAAP") relating to the accounting for insurance contracts. In the case of Australia this means the insurance liability measurement elements of AASB 1038 and AASB 1023.

However, there is nothing to prevent local GAAP being "improved" by local accounting standard setters during this period, having regard to the direction of developments under Phase II.

Furthermore, the following exceptions would apply to this "grandfathering" under Phase I (mostly general insurance focused and unlikely to be materially relevant in Australia):

- The use of catastrophe provisions and equalisation provisions will be prohibited.
- Loss recognition tests will be introduced where they currently do not apply.
- Reinsurance assets will not be allowed to be netted against gross liabilities.
- Changes in the liability measurement basis on buying reinsurance will not be allowed. This may have some implications for life insurance reporting in Australia (for example, there is concern about the application of this requirement to quota share reinsurance).
- Embedded derivatives which are incorporated in a contract not otherwise measured at fair value, and where the characteristics and risks of the embedded derivative are not closely related to the those of the host contract, must be separated from the host contract and measured at fair value. (This requirement has been clarified such that embedded derivatives in a host insurance contract which are themselves insurance contracts, such as guaranteed annuity options, or guaranteed minimum death benefits, do not need to be separated.)

#### 1.3.2 *Unbundling*

The IASB has tentatively agreed that for Phase I, where a contract contains both an insurance component and a deposit component the two components should be unbundled if the cash flows from the insurance component do not affect the cash flows from the deposit component.

However, the proposal is not intended to require an insurer to unbundle the surrender value in a traditional life insurance contract.

#### 1.3.3 *Temporary exemption from IAS 39 for Participating Business*

The IASB has investigated the provision of a temporary exemption from IAS 39 for investment contracts with discretionary participation features.

At its March 2003 meeting the IASB confirmed that existing accounting policies for such contracts should generally continue. However, the liability in respect of such contracts will be subject to a minimum equal to the measurement that would apply under IAS 39 to the fixed (i.e. guaranteed) element of the contract. The fixed element may also be reported separately from the discretionary participation feature if so desired.

The minimum amount would be similar to (although not identical to) the Best Estimate Liability

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("BEL") under MoS. As such, the minimum only becomes an issue if the contract is in, or close to, loss recognition and so should generally not represent a practical imposition.

However, it is likely that to satisfy IAS 39 the minimum would have to be determined at a lower discount rate than currently applies under MoS and so may produce a higher result than the existing BEL. This poses a potential inconsistency in that a contract might still have positive profit margins under MoS and yet the IAS 39 minimum might still be imposed resulting in an effective capitalised loss. Some changes might be required to MoS to resolve this inconsistency.

The IASB also confirmed that any unallocated surplus relating to the discretionary participation feature would have to be treated as either a liability or as equity (an intermediate categorisation will not be permitted).

#### **1.4 Reinsurance**

This paper does not specifically address issues in relation to reinsurance on the basis that reinsurance is to be regarded as an insurance contract between the cedant and the reinsurer. As such, issues relating to direct insurance will similarly apply to reinsurance.

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## 2. SUMMARY OF RELEVANT IAS 39 (IAS 32) PROVISIONS

### 2.1 Overview and Scope

As noted, IAS 32 and IAS 39 are existing IFRS's.

However, these are currently under review, with an Exposure Draft having been issued in mid 2002. The IASB is currently anticipating that these will be reissued in final form in the third quarter of 2003.

#### 2.1.1 Definition of Financial Instrument

A financial instrument is defined in the Exposure Draft as any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity.

A financial asset is any asset that is:

- cash;
- a contractual right to receive cash or another financial asset from another entity;
- a contractual right to exchange financial instruments with another entity under conditions that are potentially favourable; or
- an equity instrument of another entity (excluding controlled and associated entities, joint ventures, etc. which are dealt with under other IFRS).

A financial liability is any liability that is a contractual obligation:

- to deliver cash or another financial asset to another entity; or
- to exchange financial instruments with another entity under conditions that are potentially unfavourable.

All financial assets and financial liabilities are recognised on the balance sheet, including the value of derivatives.

#### 2.1.2 Definition of Insurance Contract

The definition of insurance contract to be adopted under IAS 32 and IAS 39 is to be the same as that finally adopted under Phase I of the Insurance Accounting project. This definition will apply consistently across all IFRSs. The following definition of an insurance contract is currently proposed for Phase I:

“A contract under which one party (the insurer) accepts significant insurance risk by agreeing with another party (the policyholder) to compensate the policyholder or other beneficiary if a specified uncertain future event (the insured event) adversely affects the policyholder or other beneficiary.”

There are some exclusions relating to contracts which would satisfy the definition but which are adequately covered by existing IFRSs, but they are not material for the purposes of this paper.

Uncertainty is the essence of an insurance contract. Insurance risk therefore exists if at least one of the following is uncertain at the inception of the contract:

- Whether a future event specified in the contract will occur,
- When the specified future event will occur, or
- How much the insurer will need to pay if the specified future event occurs.

Insurance risk does not include financial risk, which is defined as:

“The risk of a possible change in one or more of a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index or similar variable.”

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Nor does insurance risk include lapse risk, persistency risk or expense risk, as these events do not adversely affect the policyholder or beneficiary.

Insurance risk is deemed to be significant if, and only if, there is a reasonable possibility that the insured event will cause a significant change in the present value of the insurer's net cash flows arising from the contract. In making this assessment it is necessary to consider both the probability of the event and the magnitude of its effect. This assessment of whether insurance risk is significant is to be made contract by contract, and so is separate from the concept of materiality for the purpose of preparing the accounts.

A contract satisfies the definition of an insurance contract if the issuer can foresee that significant insurance risk will exist at some time, even if it doesn't exist at present. Once a contract satisfies the definition of an insurance contract it remains an insurance contract, even if the insurance risk subsequently becomes insignificant.

Essentially, then, if a contract has the potential to pay a benefit (e.g. a death or indemnity benefit) exceeding the amount payable on contract discontinuance (e.g. surrender or premium / experience refund) then the contract is an insurance contract, unless the additional benefit is trivial or insignificant. Similarly, an annuity that may pay out regular sums for the rest of a policyholder's life is an insurance contract, unless the aggregate life-contingent payments are insignificant.

If contracts do not involve the transfer of insurance risk then they are not to be accounted for as insurance contracts. Instead:

- If the contracts create financial assets or financial liabilities they are subject to IAS 39.
- Otherwise, IAS 18 *Revenue* applies.

## 2.2 Key IAS 39 (IAS 32) Requirements

### 2.2.1 Assets

Financial assets are to be classified under **IAS 39** into the following categories:

Classification	Detail
Held to Maturity ("HTM").	Assets with fixed or determinable payments and fixed maturity that an enterprise has the positive intent and ability to hold to maturity.
Entity Originated Loans	Loans and receivables originated by the enterprise by providing money, goods or service directly to a debtor.
Available for sale ("AFS")	All other assets not otherwise classified. In particular, equities can only be classified as AFS or Trading.
Held for trading ("Trading")	Assets acquired for the purpose of generating profit from price fluctuations.

The Exposure Draft extends the definition of "held for trading" to any asset so designated at its initial recognition. However, an asset cannot be reclassified out of this category subsequent to its initial recognition.

Three significant rules on these clarification categories are:

- The classification rules technically apply on an asset by asset basis.
- The order of classification in the above table indicates a general test and reclassification hierarchy. While an asset can generally be reclassified down the list, it cannot be reclassified upwards. Furthermore, any actual reclassification of HTM to AFS or Trading

is likely to cast serious doubt over the continued and future classification of assets as HTM by the entity.

- Derivatives (other than those designated as hedging instruments) are classified as Trading.

The classification of existing assets will need to be made at the time that IFRS are first applied, although in some cases – such as hedging instruments – supporting documentation may need to be in place earlier.

The measurement and reporting treatment of each of these classifications is as follows:

<b>Classification</b>	<b>Balance Sheet Measurement</b>	<b>P&amp;L Impact</b>
HTM	Amortised cost, less any provision for impairment.	Change in balance sheet value (amortised cost).
Originated Loans	Amortised cost, less any provision for impairment.	Change in balance sheet value (amortised cost).
AFS	Fair value (market value).	Fixed Interest: Change in amortised cost less impairment. Other (equity): Change in cost less impairment.
Trading	Fair value (market value).	Change in balance sheet value (fair value).

For AFS assets, the difference between the balance sheet value movement and that recognised in the P&L is reported through movement in equity. Convergence between these two occurs only on sale or maturity of the asset.

### 2.2.2 *Liabilities*

Whereas assets have three main classification possibilities (treating Entity Originated Loans and HTM as essentially the same), only two possible classifications exist for liabilities, namely:

- Trading; and
- Other.

The Trading category includes those financial liabilities which are held for trading (or designated as “held for trading”) and non-hedging derivatives that are financial liabilities. These liabilities are treated in the same way as assets which are categorised as Trading, i.e. measured at fair value for the balance sheet, with fair value gains and losses taken in full to the P&L statement.

All other financial liabilities are measured at amortised cost, with change in amortised cost taken in to the P&L statement.

### 2.2.3 *Measurement*

Initial measurement of all financial liabilities is at cost (net of directly attributable transaction costs), which is deemed to be the fair value when the liability is acquired. For this purpose, only incremental external costs would appear to be included in the definition of transaction costs.

Amortised cost is then to be measured using the “effective interest method”. While it is clear how this method would apply in the case of a simple fixed interest debt, it is less clear how this method might apply to investment contracts issued by life insurers or general insurance contracts that fall within IAS 39.

Indeed, there would seem to be similar questions in respect of even basic banking assets such as variable rate retail home mortgage loans, with redraw facilities etc, that incur acquisition costs

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to be funded from the loan margin.

There is similarly little guidance or even principles in IAS 39 as to how fair value should be determined. Principles and guidance therefore need to be construed from other sources e.g. the Insurance DSOP.

#### 2.2.4 IAS 32 Requirements

IAS 32 imposes detailed reporting requirements in relation to financial assets and liabilities.

Possibly the most significant requirement is the need to disclose the fair value of all financial instruments (assets and liabilities) in the notes to the financial statements, irrespective of which classification and measurement basis is selected under IAS 39.

### 2.3 Valuation of Derivatives

IAS 39 requires the identification of derivatives in both the asset and liability portfolios and explicit accounting, at fair value, of each derivative. Changes in the fair value of derivatives are taken through the P&L statement unless strict 'hedge accounting' rules can be satisfied, in which case the change in fair value is recognised in 'other comprehensive income' and only affects the P&L when the hedged item is realised.

Hedge accounting rules under IAS 39 are likely to be onerous, being closely aligned to the requirements applying under US GAAP. Under these rules, companies must regularly demonstrate that the hedge is fully effective. Whilst not specifically covered in this paper, it is possible that this will have a material impact on companies that currently record some derivatives off balance sheet.

Derivatives that are embedded in another contract must, under IAS 39, be split or 'bifurcated', from the host contract and accounted for separately if three conditions are met:

- The economic characteristics and risks of the embedded derivatives are not closely related to the economic characteristics and risks of the main contract;
- A separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and
- The hybrid (combined) instrument is not measured at fair value with changes in fair value reported in the P&L statement.

Where the split cannot meaningfully be made, the whole contract must be valued using fair value techniques.

However, the IASB has agreed that an insurer need not separate an embedded derivative if the embedded derivative itself meets the definition of an insurance contract. Hence, payments or benefits that result from an identifiable and insurable event (other than a change in price) are deliberately excluded. Examples of this nature include payments on death, sickness, fire, theft, etc.

In particular, by virtue of this amendment, guaranteed annuity options and guaranteed minimum death benefits do not need to be separated. The IASB has also tentatively agreed that an insurer need not separate an option to surrender an insurance contract for a fixed amount, even if the surrender value differs from the carrying amount of the host insurance liability.

Inevitably, whether or not an embedded derivative exists, will hinge on interpretation of the phrase 'closely related'. Features requiring investigation in detail include:

- Business insurance policies are sometimes used as collateral for policy loans. Although only a proportion of the base cash value can be used to support the loan, this could be regarded as a 'floor' in adverse conditions.
  - Participation arrangements on group schemes where profit distribution rules may be complex.
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- Capital guarantees on investment products such as the return of premiums in certain circumstances.
  - Policy debts can exist at early durations where policy charges exceed premiums paid. Like negative asset shares, zero could be regarded as a 'floor'

## **2.4 Guidance on Application of IAS 39 to Investment Contracts**

The IASB does not consider it necessary to include further application guidance in IAS 39 on the treatment of contracts issued by an insurer which do not satisfy the definition of an insurance contract. However, some implementation guidance is being considered for publication with the exposure draft for Phase I of the Insurance Accounting project relating to the following which may be of relevance:

- The definition and treatment of transaction costs.
- Modifications of financial liabilities (which under IAS 39 requires extinguishment of the original liability).
- Whether administration costs are to be included in the computation of amortised cost or fair value.
- The extent to which future cash flows from assets should be considered in determining the amortised cost or fair value of liabilities.
- The treatment of insignificant (but positive) insurance risk.
- The impact on amortised cost measurement of changes in assumptions or experience.
- Profit at inception.

Any such guidance will be welcome.

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### 3. CLASSIFICATION OF BUSINESS

In general, the assessment of which business will fall under IAS 39 (32) and which will fall under the Insurance IFRS (and continue under current GAAP during Phase I) is reasonably clear in most cases. However, a number of issues need to be considered in relation to some specific types of contract, primarily contemporary investment products with insurance riders written under the one legal contract.

The fundamental issue is ultimately one of certainty. Insurers need to know that a particular group of like products will be accounted for one way, and one way only, for all the contracts in that group and over their entire lifetime. The alternative of having systems which potentially switch between different accounting treatments at individual contract level is not practical.

Furthermore, the categorisation should ideally be applied consistently by all entities in the market.

#### 3.1 Issues arising from the definition of insurance contract

##### 3.1.1 *Level of differentiation – individual contract v product groups*

From the IASB's current pronouncements it is clear that the assessment of whether a contract is an insurance contract or not is to be made at the individual contract level, albeit that it may be on qualitative rather than strictly quantitative terms. It is thus conceivable that two contracts having the same legal form and administered on the same system could be categorised differently because at the specific point in time one is deemed to have significant insurance risk while the other is deemed not to.

##### 3.1.2 *Assessing "Significant Risk"*

In respect of traditional business the element of risk transfer is integral to the contract and is generally significant at some point in its lifetime. As such, traditional endowment, whole of life and life annuity products should all be classified as insurance contracts over the life of the contract.

However, for some products there are still likely to be "grey areas" where the amount of insurance risk is marginal, even though the assessment should be based on qualitative, rather than quantitative, terms. In the absence of explicit limits being mandated individual insurers will be left to make their own assessments.

##### 3.1.3 *Changes in materiality of risk transfer over time*

Compounding the above is that the categorisation of an individual contract, and hence its accounting treatment, could change over time as the level of insurance risk associated with the contract varies. Recent changes to the IASB's interpretation of the definition – in particular the inclusion of the concept that a contract satisfies the definition of an insurance contract now if the issuer can foresee that significant insurance risk will exist at some time in the future – help to provide some certainty in this regard.

However, for a contemporary, flexible contract with the facility to add riders in the future, the potential for a rider to be added may be insufficient to claim that the increase in insurance risk was "foreseen". If that is the case then the addition of the rider could change the contract from being an investment contract into an insurance contract. And yet the basic contract, and its administration, would not have changed.

Similarly, if a rider were removed from an insurance contract the contract would still remain as an insurance contract even though it is then to all intents and purposes an investment contract.

Further complicating this issue is that where the addition of riders has to be agreed by both parties (e.g. if it is subject to underwriting), then the rider arguably represents a "new contractual relationship" which could be accounted for separately. However, where the addition is an option, then the contract technically always had significant risk, and so was entirely insurance from

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inception.

### 3.2 Issues arising from the unbundling and embedded derivative requirements

The requirements to separately value embedded derivatives and to unbundle deposit elements from insurance elements have caused concern in the past due to the fear that it would require the separate identification and measurement of elements of contracts when it was not practical or even feasible to do so.

Recent clarifications by the IASB have eased, but not entirely eliminated, these concerns. In particular, the clarification of the unbundling requirement does not specifically address cases where an insurance rider is “interactive” – i.e. the rider benefit depends on the prevailing value of the base contract. It is therefore conceivable that interactive and non-interactive riders (and their associated base contracts) may be treated differently even though the underlying substance of the contracts is the same.

### 3.3 Solution - Unbundling revisited

The concept of unbundling was initially rejected when raised in the Insurance Issues Paper, largely because of concerns over the impracticality of unbundling traditional business. Such practical concerns should not be as material for contemporary products.

Furthermore, although unbundling is specifically required in relation to non-interactive riders, it would still be permissible under the IASB Framework to unbundle interactive riders where doing so would ensure that the accounting treatment is in accordance with the underlying substance and economic reality.

Unbundling of all risk riders, even if legally part of the same “contract”, and treating them for accounting purposes as a separate product group, would seem to largely achieve the certainty and consistency of treatment that the industry desires. In particular it is worth noting that:

- The practice of unbundling interactive riders already exists under Australian life insurance regulations where the rider is administered in a separate statutory fund from the base contract.
- Insurability options can themselves be regarded as riders and so unbundled in this way.

If a practical application of the definition along these lines can be achieved then the business of a typical Australian or UK insurer would seem to broadly fall into the following permanent groupings (assuming participating business is wholly exempted from IAS 39):

#### 3.3.1 *Insurance contracts:*

- Most general insurance and health insurance products, including consumer credit insurance (but see exclusions noted below).
- Stand alone life and disability risk business - both retail and group life.
- All risk riders on unbundled life products.
- Life time annuities - where the insurance of longevity risk is integral to the operation of the contract and cannot be separated from the investment element.
- Conventional life business - where the insurance of mortality risk is integral to the operation of the contract and cannot be separated from the investment element.
- Genuine “insurance” risk transferring reinsurance.

#### 3.3.2 *Financial instruments:*

- All investment linked life business, net of riders.
  - All investment account or unitised with profits life business, net of riders.
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- Fixed rate, fixed term investment products and annuities.
  - Other financial markets and investment based products.
  - Trade credit and mortgage insurance products – whilst these contracts may satisfy the definition of an insurance contract, they are expected to be excluded from the scope of Phase I and will therefore fall within the scope of IAS 39, to be consistent with the accounting for financial guarantees.
  - Financing reinsurance (with little or no risk transfer), other results “smoothing” reinsurance arrangements, or reinsurance that involves financial instrument risk transfer rather than insurance risk (e.g. investment risk rather than claims risk).

Such an approach would provide the greatest likelihood of consistent and stable treatment between investment related life insurance business and non-life business while confining the insurance standard to a readily identified subset of the business which is primarily focused on significant risk transfer.

### **3.4 Alignment with current practice**

There are strong parallels between this issue and the issue of separating the deposit element of premium / claim under AASB 1038 and US GAAP reporting. In this context it is interesting to note that the possible categorisation described above is along similar lines to those on which most Australian companies divide their business for deposit separation (“splitting”) purposes - between those that are not, or cannot be, split, and those that can.

Furthermore, it is noted that the requirements of AS 1.03 to properly allow for asymmetrical outcomes effectively requires embedded options to be separately dealt with, although not necessarily fair valued. As such, Australian life insurers should already be addressing the practical aspects associated with the separate identification and measurement of embedded options.

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## 4. AMORTISED COST METHOD UNDER IAS 39

As noted in section 2, financial instrument liabilities under IAS 39 must be valued on either an amortised cost basis or a fair value basis. This section considers the first of these approaches. Section 5 considers fair value issues.

### 4.1 Overview of Requirements

The two key elements of an amortised cost approach are:

- The initial value determination (including what acquisition costs may be deferred).
- What the method of amortisation is to be.

The requirements of IAS 39 on these two points are as follows.

#### 4.1.1 Initial Value

IAS 39 (section 66) (with proposed amendments) states:

“When a financial asset or financial liability is recognised initially, an entity shall measure it at its cost, which is the fair value of the consideration given (in the case of an asset) or received (in the case of a liability.) Transaction costs that are directly attributable to the acquisition or issue are included in the initial measurement of the financial asset or financial liability.”

IAS 39 (section 67) states

“The fair value of the consideration given or received for a financial instrument is normally determinable by reference to the transaction price or other market prices. If such market prices are not available, or part of the consideration is for something other than the financial instrument, the fair value of the consideration is estimated as the sum of all future cash payments or receipts, discounted using the prevailing market rate(s) of interest for a similar instrument [of an issuer with similar credit rating.]”

#### 4.1.2 Amortisation Method

IAS 39 (section 10) contains the following definition of amortised cost:

“Amortised cost of a financial asset or financial liability is the amount at which the financial asset or financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amounts, and minus any write-down (directly or through the use of an allowance account) for impairment or uncollectability.”

## 4.2 Full Acquisition Costs v Transaction Costs

Under MoS, acquisition costs are not explicitly deferred and amortised. In the determination of the policy liability, all acquisition costs (direct and indirect) are allowed for in the determination of the initial planned profit margin. Hence, provided a contract is profitable, there is no acquisition cost strain reported at policy issue.

Under amortised cost, acquisition costs are explicitly deferred and amortised but only to the extent of transaction costs.

From the above definition it is possible that direct transaction costs might be taken to be only commission or similar costs which are directly attributable to the acquisition of the business and paid to an external party. If this is the case, then there will be an acquisition cost strain. In this respect it is noted:

- Section 66 explicitly limits the effective deferral of acquisition costs to transaction costs. However, the second half of Section 67 would imply the deferral of all acquisition costs, on the basis that it describes the prospective valuation of **all** future cash flows.

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- The first half of Section 67 would imply no profit at inception. Furthermore, Section 66 would imply a strain at inception equal to the excess of full acquisition costs over transaction costs. However, the second half of Section 67 could be interpreted as resulting in a profit or loss at issue to the extent that the resulting prospective valuation differed from the cost of the liability net of acquisition costs.

Current indications from the IASB are that front end fees would be added to the initial carrying amount of the contract liability, to the extent that they do not exceed origination costs deducted in determining that initial carrying amount. Taken at face value, this would be consistent with the treatment of establishment fees under MoS in that if establishment fees exceed the amount of acquisition expenses which can be deferred then the excess would have to emerge as an allowable profit at inception.

However, such a result may be contrary to the desired “no profit at inception” outcome. Furthermore, it is not clear as to whether surrender charges count as “fees”. Nor is it clear whether the requirement applies only to fees that are guaranteed receivable (matched by equivalent explicit charges over time) or whether it also applies to those that are temporary and can potentially be avoided (as under a number of more recent nil entry fee products).

The IASB has directed its staff to draft guidance on the treatment of front end fees for inclusion as an appendix to IAS 18.

Note that as Phase I of the Insurance Accounting project will not address issues relating to acquisition costs under insurance contracts a potential accounting arbitrage may exist between any limited deferral of acquisition costs as implied above under IAS 39 and the fuller deferral of acquisition costs implicitly available under existing MoS treatment (and potentially under the Phase II Insurance IFRS, depending on how fair value measurement is interpreted).

Potential accounting inconsistencies / arbitrage might also arise between companies depending on:

- The extent to which sales staff are salaried or paid by commission, and any differences in the identification and definition of quantities such as “salary” or “commission”.
- The extent to which costs are incurred directly / internally or outsourced via a service company or IFA, and whether the service company or distribution channel is associated or “at arms length”.

The IAS 39 Taskforce acknowledges that the limited deferral of acquisition costs could be detrimental to the financial results of Australian insurers in the short term. Longer term however, for a mature business, the impact at contract inception will be offset by higher profit margins in subsequent years.

**In any case, the taskforce believes that the primary objective should be to achieve consistent reporting without any opportunity for arbitrage.**

### 4.3 Amortisation: Effective Interest Method

A key issue in measuring liabilities at amortised cost is the way in which the “effective interest method” should be applied for various products.

The “effective interest method” implies a fixed amortisation schedule. As a practical matter it should be reasonably straightforward as to its application to fixed dollar liabilities such as corporate fixed interest debt and fixed rate, fixed term investment bond and annuity products. However the position is far from clear for products such as:

- Investment account products with unknown future interest rate credits, and even more so for investment linked products with completely dynamic investment performance credits.
- The general insurance products that are deemed to be financial instruments (credit and mortgage insurance).

Some recent discussions at an international level on the application of the effective interest method to a single premium investment contract give rise to the following observations:

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- The run-off of the deferred acquisition costs could be determined to be equal to a fixed percentage of the nominal account balance (sufficient to amortise the costs over the life of the contract) less the unwinding of the discount rate assumed.
  - The use of the effective interest method to amortise acquisition costs on contracts where the benefit is not defined in monetary terms (e.g. investment linked business) is potentially problematic, since there is not a constant effective interest rate applicable over the life of the contract.

A suggested solution to the second point is to regard the unit liability as an embedded option, which is then separated and valued at fair value. The amortised cost method is then simply applied to the “host” contract which is merely a Deferred Acquisition Cost asset (“DAC”) with a pre-defined run-off.

Another alternative would be to adopt an approach similar to the Acquisition Expense Recovery Component (“AERC”) process under MoS where the AERC is also assumed to be effectively unitised, consistent with the unit liability. The amortisation is then effectively expressed in terms of units rather than monetary terms.

Furthermore, at its March 2003 meeting the IASB considered the issue of cancellation and renewal rights, and concluded that the amortised cost method should be applied on the basis of expected (i.e. probability-weighted) surrender patterns.

There is a clear similarity between these observations and conclusions and the existing Australian MoS methodology for unit linked investment products. This is perhaps not surprising given that MoS was specifically designed as a “deferral-and-matching” reporting basis (particularly in respect of acquisition cost recovery) that deals appropriately with investment products providing an underlying dynamic market value based return.

In particular, it is noted that under the single premium investment contract example described above the amortisation pattern is consistent with the use of asset management charges as the AERC carrier under MoS. The key difference is that under the effective interest method the discount rate assumption is, in principle, locked in, albeit subject to an impairment test.

It follows that the typical amortisation pattern under MoS, whether implicit in the projection method or explicit in the accumulation method, may well be acceptable for use in the amortised cost method, and that MoS methodology may well be an appropriate basis on which to undertake the calculations, subject to changes (such as tranching the business into separate cohorts) to achieve the required lock-in of assumptions. (But see Section 4.6 below.)

#### 4.4 Assumption Changes - Impairment / Loss Recognition

Amortised cost is subject to an impairment test. This means that some consideration must be given to adverse changes in the expected future experience. This was reinforced by the IASB at its March 2003 meeting where it confirmed that:

“The issuer should treat changes in estimated surrender patterns in the same way that a lender treats impairments of loans, and reversals of impairments under paragraphs 111-114 of IAS 39.”

Under paragraph 111 of IAS 39 impairment occurs when:

“it is probable that an entity will not be able to collect all amounts due (principal and interest) according to the contractual terms of loans, receivables, or held-to-maturity investments carried at amortised cost.”

It follows that changes in assumptions do not immediately result in impairment if there are sufficient margins within the liability such that it can still support **all** amounts due under the contract.

Essentially this is an equivalent test to loss recognition under MoS. The differences under IAS 39 are:

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- Under MoS a change in assumption would alter the pattern of future amortisation, whereas under IAS 39 amortisation remains at the level established at inception until such time as margins are exhausted and impairment occurs.
  - In neither case does a change in investment earning assumptions give rise to impairment / loss recognition (except potentially for participating business under MoS). Under MoS a change in investment earning assumption results in immediate adjustment to the liability, consistent with the valuation of assets. Under IAS 39 the investment earning assumption remains locked in, even when assessing subsequent impairment.
 

(Under IAS 39 there may be an issue where a liability measured at amortised cost is backed by assets categorised as AFS. While changes in expected future investment earnings would have no P&L impact, the value of the AFS asset would be altered in the balance sheet without any corresponding change to the value of the liabilities. This is addressed under US GAAP by the use of "shadow adjustments" to the liability value. However, in its November 2002 update the IASB agreed that shadow accounting should not be introduced under IAS 39 as the measurement of liabilities is supposed to be independent of the measurement of assets.)
  - Under MoS the test is at product group level. Under IAS 39 (Section 112) the test may be at the individual contract level if the contract is individually significant or at a collective level for contracts of similar credit risk.

Therefore, a liability determined at amortised cost would require a parallel "best estimate" liability to be calculated on current assumptions (except discount rate) for the purpose of assessing impairment. In theory this is no different to MoS where liabilities calculated using an accumulation method are still subject to loss recognition. In practice, such assessment will only be required in particular circumstances where impairment / loss recognition is reasonably expected.

Again this suggests that the practical requirements under IAS 39 are similar to those under MoS with only slight variation. However, this assumes that contracts can be appropriately grouped for loss recognition purposes. If not, there will be a serious issue of practicality, as individual product records would need to carry their own individual profit margin details.

The IAS 39 Taskforce believes that it would be appropriate to group business for loss recognition purposes, although it is acknowledged that the grouping may not necessarily correspond to existing MoS product groups.

#### 4.5 Embedded Derivatives

As noted elsewhere in this paper, the IASB has tentatively agreed that an insurer need not separate an option to surrender an insurance contract for a fixed amount, even if the surrender value differs from the carrying amount of the host insurance liability.

While that may simplify matters for contracts which are ultimately deemed to be insurance contracts (including, for the time being, participating investment contracts) the same does not necessarily apply to surrender options under investment contracts.

At its March 2003 meeting the IASB confirmed that:

"If the amortised cost of the liability is less than its surrender value, the issuer should measure the investor's option to surrender at fair value, unless the surrender value is approximately the same as the carrying amount at each date."

This would require the separation of surrender guarantees under investment contracts **unless** the whole contract is measured at fair value.

#### 4.6 Projection v Accumulation

For business currently valued using a projection approach, the merits of moving to an accumulation approach for calculating amortised cost (probably with a projection based AERC) would need to be considered.

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In theory, a projection approach should still be acceptable on the grounds that it meets the same principles as an accumulation approach, and hence gives a similar pattern of amortisation, albeit implicit in the release of profit margins.

However, recent indications from the IASB indicate that implicit fees for services, such as investment management, should be separated from the cash flows used to determine the amortised cost of a related financial liability, so that IAS 18 Revenue can be applied.

Under a MoS accumulation method, where the profit emergence is effectively fees less expenses less AERC run-off, this requirement would not cause problems as the fees would be recognised as they are incurred.

However, under a MoS projection method **all** of the fees expected in the future are present valued and then respread in accordance with the chosen profit carrier. As a result, they do not necessarily emerge as they are incurred, unless the pattern of the profit carrier matches the pattern of the fees. Hence, this requirement would not necessarily be satisfied under a MoS projection method. For the projection method to be acceptable the emergence of profit in accordance with the chosen profit carrier would therefore need to be deemed acceptable for the purposes of IAS 18.

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## 5. FAIR VALUE ISSUES

### 5.1 Background & Accounting Issues

Most Australian insurance actuaries will have a general sense of what is meant by a fair value measure and will believe they have a reasonable idea of the type of realistic assumptions and cash-flow projections that would underpin a fair value assessment. While there may be some issues around the edges concerning discount rate selection, etc, realistic policy valuations and BEL calculations under AASB 1038 or AASB 1023 are things that Australian actuaries are very familiar with.

However, there are two very key issues that need to be acknowledged and which underly much of the following discussion in this section:

- What exactly is it that is being fair valued? What is it that the IASB will allow the actuary to “recognise”? These questions are reflected in the issue of whether or not to include future contract renewal revenue in the fair value assessment.
- What practical (or “arbitrary”) restrictions will the IASB want to apply in meeting their objectives? This question is reflected in the debate over whether to use an “entry” or “exit” value and the extent to which profit should be recognised inception.

These issues have been heavily canvassed to date within the context of the Insurance Accounting project. The discussion set out in the DSOP, together with subsequent pronouncements by the IASB, provide the best guidance available on the determination of fair value for IFRS’s, in the absence of more detailed guidance in IAS 39.

#### 5.1.1 *Overview of Fair Value as Defined for Phase II of the Insurance Accounting Project*

The current IASB proposals relating to the determination of fair value, for the purposes of Phase II of the Insurance Accounting project, are summarised here.

Under Phase II, assets and liabilities arising from insurance contracts would be measured at their fair value. This is a departure from the approach originally advocated in the DSOP which was for liabilities to be measured at entity-specific value. The IASB decided that entity-specific measurement was indistinguishable from fair value as used in other IFRSs and that common terminology should be adopted for essentially the same measurement. However, entity-specific assumptions and information could be used when market-based information is not readily available.

Further in the absence of market evidence to the contrary, estimated fair value should not be less than the amount the insurer would charge to accept new contracts with identical terms and remaining term to maturity.

The IASB Project Update for Phase II identifies the following characteristics of fair value:

- It involves discounting in some form to obtain a present value.
- It is independent of the assets backing the liabilities (unless the liability cash flows depend on the performance of specific assets).
- It includes an allowance for the premium that market participants demand for risks in addition to the best estimate cash flows.
- It should reflect the creditworthiness of the issuer, including the effect of policyholder protections and insurance provided by governmental bodies or other guarantors.
- Future premiums (and associated cash flows) in respect of in force business would be included in the calculation of fair value only if:
  - policyholders hold uncancellable continuation or renewal rights that constrain the insurer’s ability to reprice the contract to rates that would apply for new policyholders, and

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- those rights will lapse if the policyholders stop paying premiums.
  - Assuming that margins for risk are allowed for by adjusting the projected cash flows, discounting is to be at a “risk free rate”.
  - It is envisaged that to properly allow for the various guarantees and options available in a typical insurance contract some form of stochastic valuation or option pricing methodology may be required.

## 5.2 Application to IAS 39

Sections 66 and 67 of IAS 39 were quoted in Section 4.1.1 in terms of initial (day 1) fair value measurement.

However, in terms of ongoing fair value measurement, Section 66 would seem to refer to an entry value basis whereas Section 67 seems to refer more to an exit value. The latter is perhaps more akin to the familiar concept of fair value as being in the nature of an economic value reflecting all future cash flows associated with the asset or liability. This is not necessarily the same as the market price or cost of the asset or liability (refer to the IAAust Position Statement on Economic Valuation Concepts).

Drawing on the above requirements, the DSOP discussion on fair values and recent pronouncements by the IASB, our current expectation is that fair values under IAS 39 for non-insurance contracts would be determined as follows:

- It will be based on a discounted cashflow valuation.
- The discount rate will be the return on a replicating portfolio (i.e. a riskless portfolio of matching assets).
- It will include a margin in the cash flows to ensure no profit recognition at issue. Such margins will have a minimum of the level the market requires to compensate for the risks being taken on.
- Ordinarily, as a fair value is usually based on a prospective assessment, acquisition costs are not relevant. However, the “nil profit at inception” requirement immediately brings them into consideration. In this case, the acquisition costs allowed would be consistent with the discussion in Section 4.2 of this paper.
- It should reflect the creditworthiness of the issuer.
- It may allow for future renewals.

A number of these aspects are expanded on below.

## 5.3 Renewals

IAS 39 itself is silent on the treatment of cancellation and renewal rights in the calculation of fair value.

The IASB’s position in relation to Phase II appears to be that renewals (including continuation of inforce single premium contracts) should only be allowed for if there is a reasonable possibility that continuation of the contract will significantly constrain the insurer’s ability to reprice the contract at rates that would apply for new policyholders who have similar characteristics to the existing policyholder.

This issue affects both the assumptions relating to receipt of future premiums under a regular premium contract, and the assumption relating to non-cancellation of a paid-up contract. Within accounting frameworks, this is not a “measurement” issue. Rather, it is a “recognition” issue, i.e. the question being addressed is whether or not future net inflows to an insurer under an existing contract satisfy the recognition test to be classified as an asset.

In the context of IAS 39 the issue primarily affects single premium investment contracts with no initial fee or surrender penalty, or where these fees are insufficient to recover the acquisition costs incurred. Where renewals cannot be included, it would be necessary to adopt an

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accumulation-type valuation approach, as opposed to a prospective approach.

There is uncertainty over whether acquisition cost deferral or acquisition cost recovery could be allowed for in such circumstances. Where acquisition cost deferral occurs as part of the liability calculation, this is based on a prospective calculation process. Hence, if it is not permitted to recognise future renewals, it does not make sense to recognise the value of future margins that are required to recoup acquisition costs. In such circumstances, the liability would essentially be equivalent to the surrender value.

However, at its March 2003 meeting, the IASB confirmed that:

“fair value of the liability should be based on the expected (i.e. probability-weighted) surrender patterns.”

By allowing for such cancellations the valuation implicitly assumes a certain level of renewal. Indeed the IASB goes on to confirm that the resulting measurement of fair value should include:

“all associated cash flows such as deposits, repayments, future front-end fees and surrender charges.”

In this regard, the calculation process would be similar to that with which Australian actuaries are more familiar (being similar to MoS for both projection and accumulation approaches) where best estimate lapse assumptions are taken into account.

#### **5.4 Economic Assumptions (Future Earning Rate and Discount Rate)**

The fair value liability calculation requires the use of a replicating portfolio discount rate.

Relative to existing Australian practice, this issue is likely to be most significant for annuity products. Under a fair value basis, the underlying cash flows of annuity payments and management expenses would be discounted at a rate reflecting the market rate for similar instruments from institutions of similar credit rating. Assuming that the financial institution seeks a gilt reputation then the discount rate is likely to be quite close to the risk free rate.

Therefore a fair value basis may recognise losses up-front when assets supporting the policy liabilities increase in risk as higher yields are sought and passed onto policyholders. Under MoS, this may not happen, as the discount rate used in assessing policy liabilities is the fund earning rate.

This issue may be resolved by a more considered determination of what constitutes “risk free” for such business. The IAAust Discount Rates Taskforce has produced some valuable work in this regard.

Essentially if what is deemed to be a “risk free” rate is carefully chosen having regard to the nature of the liability cash flows and the associated risks, then inappropriate losses at inception should be avoided.

#### **5.5 Best Estimate Assumptions**

In the context of Phase II the IASB has concluded that, in practice, fair values would use the insurer's own assumptions unless:

- there is evidence that market assumptions would be different; or
- the insurer's own data is insufficient, and industry data would be more credible.

This is broadly consistent with the position under MoS where a company's own set of best estimate assumptions is generally used in determining the policy liability.

#### **5.6 Stochastic Methods / Option Pricing**

There is a potential requirement to use stochastic valuations or option pricing techniques to properly determine fair value where a contract contains asymmetrical liability outcomes.

Recent changes to AS1.03 implicitly require stochastic valuation or option pricing to deal with

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any potential asymmetry in the distribution of liability outcomes. So the issue is not new for Australian life insurers.

Where asymmetry does not exist a deterministic valuation should give an equivalent result to a stochastic valuation. Hence it is only where material asymmetries exist that any form of stochastic valuation should generally be required.

## 5.7 Own Credit Risk

Under IAS 39, fair value needs to include the impact of the issuing entity's own credit standing. This is akin to viewing the value of a liability as being the same as what its value would be as an asset to someone else. This requirement has caused much international debate. However, it must be noted that:

- The terms upon which an entity issues a contract should logically reflect its credit standing at the time. Indeed, the use of amortised cost measurement, along the lines already applying in many jurisdictions, effectively includes full credit rating effects at the level applying when the contract was issued. Hence, it is not as if allowance for own credit standing is a new thing. What is new is the potential allowance for any **changes** in that credit standing after issue.
- All entity-specific assumptions used are underpinned by market perceptions of the entity's credit worthiness. This includes everything from lapse and surrender rates to claims settlement and dispute rates, success and patterns.
- As a practical matter in Australia (even if not elsewhere), the overlay of statutory capital requirements would seem to largely mitigate against the most extreme and nonsense results that this requirement can give rise to.

In making allowance for own credit risk, it is the view of the IAS 39 Taskforce that in most cases it will be automatically addressed via:

- The adoption of entity specific best estimate valuation assumptions as per existing life insurance and general insurance practice in Australia.
- Linking minimum profit margins, etc, to current new business issue terms (that will reflect existing market credit view of the entity).
- Allowing "risk free" discount rates to include high grade fixed interest investment liquidity spreads as would be common current product pricing practice.

This approach would also be largely consistent with the view expressed in the IAAust Discount Rates Taskforce Paper on the allowance for own credit risk. The paper noted that it was reasonable to allow for own credit rating for financial reporting, but that in practice the discounting allowed for valuing the liability should not exceed that which could actually be obtained when issuing new instruments to the market. (i.e. It is not appropriate to continue to discount an entity's liabilities for credit worthiness below a reasonable ongoing concern "solvency" basis).

The IAS 39 Taskforce believes that this provides a more practical and generally acceptable outcome than the literal application of the IAS 39 requirements relating to own credit risk. The Taskforce acknowledges that this would mean that a major "shock" reduction in credit standing would not be fully reflected in the value of liabilities, but believes that such is in fact the appropriate result.

## 5.8 Assumption Changes

The definitions in IAS 39 are silent on the treatment of assumption changes. Under a generic fair value concept it would be expected that all assumption changes would be immediately reflected in the fair valuation. This represents a key departure from MoS where the effect of assumption changes is generally absorbed in the margins within the liability valuation.

However, the January 2003 IASB Update states that the estimated fair value of an insurance liability under Phase II should not be less, but may be more, than the entity would charge to

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accept new contracts with identical terms and remaining term from new policyholders.

In other words, at any point in time the fair value should not be less than the initial fair value that would be determined for a new contract on equivalent terms. If new business is charged the same price (premium rates or charges) as existing business, then for in-force business, this might be interpreted as requiring that the minimum margins be reset at each valuation date to absorb the effect of assumption changes, subject to a minimum margin as implied by prevailing market prices.

If that is the case then this process is quite close to that under MoS except that the minimum margin may be greater than zero and variable over time.

## **5.9 Projection v Accumulation**

For business currently valued using an accumulation approach, a move to fair value may appear incompatible, as retrospective methods would appear to be more consistent with amortised cost.

However, given the caveats that are being placed on the calculation of fair value by the IASB, then such may not necessarily be the case. As indicated above there are now significant similarities between the IASB fair value accounting model and the calculations applying under MoS principles. To the extent that a MoS accumulation approach represents an approximation to a MoS projection approach it is conceivable that, for certain products, a “fair value” accumulation approach could be developed as a practical approximation in these cases.

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## 6. ALTERNATIVE ACCOUNTING MODEL

The discussion of the preceding section outlined a number of issues with the determination of fair values under IAS 39, canvassed various IASB and other views and proposed some possible approaches, a number of which appear to be significantly consistent with existing MoS methodology.

However, it appears to the IAS 39 Taskforce that:

- There remain a number of issues around entry/exit value difference, profit at inception and recognition of renewals that have been dealt with by the IASB on mostly arbitrary and/or weak theoretical bases.
- The treatment of these items and related items such as acquisition cost measurement and deferral, involve inconsistencies between amortised cost and fair value methodologies and conclusions.
- There is a lack of logical consistency of some aspects of the proposals relative to other common financial reporting recognition and measurement bases. At this stage, it is not clear that there will be material consistency between what may be an acceptable approach to fair value under IAS 39 and what may be acceptable under Phase II of the Insurance Accounting project.

The IAS 39 Taskforce has therefore investigated whether there are alternative approaches within the wider international accounting standards framework, which would appropriately address the above noted issues.

The IAS 39 Taskforce believes that there is an alternative fair value model, the adoption of which would provide a sounder framework within which to resolve these issues. Furthermore, the conclusions under the model would also seem to be applicable to amortised cost valuations (where relevant), as well as asset valuations (particularly retail asset valuations such as retail home mortgages).

### 6.1 Wholesale v Retail

As noted above, the valuations that emerge under many fair value models often give rise to results that cause general unease and disquiet in areas such as large profits or losses at contract issue, or a need to recognise future revenue in a manner not typically considered under other accounting standards. This has resulted in various "restrictions" or "adjustments" being proposed to the valuation process to avoid the issues. However, many of these approaches, while addressing some of the symptoms, rest on unsatisfactorily weak technical foundations.

It would appear that the principal area where the greatest issues arise is in the context of retail product liabilities, i.e. retail financial instrument products and retail insurance products.

The issues would seem to be immaterial, if not insignificant, in the case of wholesale product liabilities.

In the context of this paper the following key definitions are adopted:

- A wholesale financial instrument or insurance arrangement refers to such an arrangement entered into between two substantial institutional peers (e.g.: between two large banks, between large life insurers, or between two large P&C insurers).
- A retail financial instrument or insurance arrangement is defined as other than a wholesale arrangement. In normal usage this would refer to an arrangement between a financial institution and its day-to-day operating customers.

In terms of the wholesale financial instrument process or insurance instrument function, an entry/exit value gap, or profit at inception issue, should not exist (see 6.3 below). The apparent measurement gaps and issues which are giving rise to current debate only arise in terms of the retail product overlay, which:

- Involve cost allowances and profit margins concerned with retail administration expenses, distribution channel remuneration, "return on brand", "return on infrastructure investment" and unequal bargaining power margins etc; but
- Have nothing to do with the underlying (wholesale) financial instrument or insurance process operation.

The IAS 39 Taskforce therefore proposes that the issues causing concern only arise because what is actually a service contract relationship between an institution and its retail customers is being confused and treated as part of a "financial instrument" or an "insurance process", with, as a consequence, the future value of the customer relationship (and return on brand etc) being present valued up front.

An alternative treatment for any financial instrument liability or insurance liability (or asset for that matter) might therefore be:

- To disaggregate (if only conceptually) the liability into its underlying wholesale component and its retail overlay component.
- To treat the wholesale component under IAS 39 or Phase I / Phase II as appropriate.
- To treat the retail overlay under IAS 18 *Revenue* (including service contracts) and/or IAS 38 *Intangibles*.

If this disaggregation approach is accepted, then the entry/exit value disparity overall, the related profit at inception issues and the renewals issue for the wholesale component of the product, largely disappear.

## 6.2 Justification of Disaggregation

The disaggregation suggested above (either conceptually or actually) is supported by the IASB framework and standards:

- Para 35 of the Framework requires transactions to be accounted for in accordance with their substance and economic reality, and not merely their legal form.
- Para 39 of the Framework reinforces this by requiring a consistency of treatment of "like arrangements". The treatment of an investment-linked life insurance policy compared with a mutual fund with separate funds manager is a clear case in point.
- Para 13 of IAS 18 instructs that it is appropriate to apply the recognition (and by implication measurement) criteria to the separately identifiable components of a single transaction in order to reflect its substance.
- While IAS 32 and IAS 39 refer to financial instrument contracts, implying dealing with a total arrangement, it is not necessary that a "contract" needs to extend to the whole of an actual legal document's terms or a legal relationship between two parties. To interpret the standard in this way would leave open a very large loop-hole.

## 6.3 Wholesale Component

The "wholesale" concept should not be confused with a "bulk transaction" or a sale of block of retail business. Rather it relates conceptually to a wholesale, peer to peer, exchange of specific liabilities and risks (for example, bank money on deposit via the inter-bank market or a pure risk reinsurance arrangement).

It is suggested in the case of wholesale arrangements, which can generally be assumed to be entered into on a closely negotiated, fair value basis, that:

- The fair value profit at inception would, by definition, be nil.
- Similarly, the difference between entry and exit values should be nil (or otherwise only to cover specific incurred deal implementation costs).
- As a consequence of the above, any future non-contracted terms (non-contracted renewal revenues) must, net of associated expected outgoings, also have a nil net fair

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value at inception. Consequently, whether or not any non-contractual renewal revenue is recognised (valued) at inception, it has no net liability / asset value impact. The issue of non-contracted renewals after inceptions is considered further in 6.6 below.

### 6.3.1 *Reinsurance Not Wholesale*

Although reinsurance is used as an example in defining the wholesale component above, in practice it is not intended that the terms of any actual or potential reinsurance contract can simply be adopted as indicating a wholesale fair value base for insurance without further consideration. The wholesale concept is intended to relate a "closely negotiated, fair value (an arms length, non-anxious) deal between large institutional peers". In this context it is envisaged that:

- While having regard to general fair value parameters, the value of the wholesale component will be based on a professional actuarial assessment of the underlying financial instrument's or insurance process's value based on analysis of relevant experience etc.
- Actual volatile reinsurance market prices, which often involve somewhat anxious and erratic behaviour and reflect other than equal bargaining power, would not be the first point of reference. In practice, the reinsurance market itself should be treated as a "retail" market, no different from the direct insurance market.

## 6.4 **Treatment of Acquisition Costs**

A key issue that then remains to be addressed is the ability to either:

- Amortise the "retail" acquisition costs incurred in generating the future service revenue under IAS 18 or IAS 38. That is, holding an intangible deferred acquisition cost asset (or similar); and/or
- Recognise that the expenditure of acquisition costs involves the purchase of a specific anticipated future income stream - similar to the purchase of a securitised income stream - which may actually be classified as a financial asset. In this case, the "purchase price" would be amortised over the expected life of the asset under IAS 39 (or IAS 38), or alternatively the remaining future recovery revenue could be fair valued under IAS 39. The revenue stream recognised as "bought" should only relate to that which directly recovers the upfront expenditure, and not other incidental revenue under the contract related to future administrative service or other profit margin components.

In either case, the "deferred acquisition costs" or "acquisition expense recovery asset" would seem to have to be treated as an asset in the financial statements (not a liability offset), and would, either directly or indirectly, be subject to recoverability testing (i.e. loss recognition).

Assuming some DAC (or acquisition expense recovery asset) is able to be recognised, the amount of expenses that could be treated in this way needs to be defined. Given the overall IAS framework, these may be limited as discussed in Section 4.2. This would imply a loss at inception equal to the internally sourced / fixed acquisition expenses, less the amount of any establishment fees not offset against recoverable acquisition expenses.

It is acknowledged that various IASB (and DSOP etc) discussions have previously concluded that DAC has no relevance under the IASB's preferred asset-and-liability accounting model, and particularly under a fair value based model. Conceptually this is a sound and logical conclusion.

However, the existing IAS 18 and IAS 38 are clearly "deferral-and-matching" based standards, and the exposure draft of IAS 39 permits significant non-fair value and non-asset-and-liability accounting options.

To the extent that the retail overlay component properly falls under an IAS based on a deferral-and-matching framework, then the use of a DAC, notwithstanding previous asset-and-liability model conclusions, is an appropriate mechanism to adopt. This will continue to be the case until such time as the IASB develops a sound basis for dealing with service contracts and other similar processes under an asset-and-liability framework.

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## 6.5 Risk Margins

For many wholesale financial instrument component values it is likely that the additional risk margin will be small, if not zero, after allowing for market value parameters and hedging/derivative costs. For example:

- A term certain annuity valued at high grade corporate bond rate would not seem to need a further risk margin.
- A bank account at face value or an investment linked unit holding at current unit value would not require a further risk margin.
- An investment account contract, valued at account balance plus investment fluctuation reserve plus a put option value for any guarantees, would not require a further risk margin.

Nonetheless, unhedgable financial instruments and many uncertain insurance liabilities may require the inclusion of some material risk margins.

Likewise, where it is not possible to identify an appropriate or reliable risk margin from available market data it may be appropriate for a prescribed margin to be mandated (akin to the 75% adequacy margin applied to the valuation of Australian general insurance liabilities), or for an industry consensus to be adopted, thus reducing the potential degree of subjectivity involved.

In this context, it is noted that one of the conclusions from the above valuation model is that retail financial instrument and insurance prices, being dominated by distribution control, brand strength and other retail service issues, do not provide meaningful "market value" information relevant to the underlying financial instruments or insurance processes. Consequently, it is largely futile to set valuation risk margins etc based on actual/observed retail prices.

## 6.6 Renewals (Wholesale Component)

Where there is contractually bound renewal revenue (and outgoings) these should be fully included in the wholesale component valuation.

In the case of non-contractual renewals:

- These will have a net nil value at commencement, as noted in 6.3 above.
- Thereafter, it would seem intuitive that they should be included if they increase the liability, or excluded otherwise.

If the wholesale renewals are to be excluded, this potentially adds a level of complexity to the overall (wholesale plus retail) valuation approach. However, in terms of simple calculation mechanics the process would seem to reduce in many cases to a "termination value - DAC" approach.

## 6.7 Overall Theoretical Framework Summary

The above discussion suggests a theoretical fair valuation framework for complex, non-traded financial instruments and insurance contracts that may be briefly summarised as follows:

- Determine, at inception, the component of the future gross revenue anticipated under the financial instrument or insurance contract that would cover the actuarially assessed value of the future benefits to be provided, including any option values and/or risk margins, plus any expenses directly associated with the management/provision of those benefits (e.g. claims management costs).
  - The balance of the gross revenue is taken to comprise the retail component. This provides for the acquisition costs incurred and the retail service costs anticipated to be incurred, with any remaining profit margin to be amortised over the anticipated revenue earning/recognition period. This residual component would be subject to impairment (i.e. loss recognition) testing at inception.
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- The effect of a change of assumptions on the wholesale component (principally interest, benefits, claims, claims expenses) would be immediately present valued and brought to account.
  - The effect of a change of assumptions on the retail component would be re-amortised, subject to impairment testing.

### **6.8 Implementation - Amortised Cost Under IAS 39**

Where the amortised cost approach is appropriate for adoption under IAS 39 for the wholesale instrument component, then it would seem that the practical (mechanical) outworking of splitting a retail contract between:

- Its wholesale component valued on amortised cost, and
- Its retail component which is necessarily treated on an amortised (deferral and matching) recognition basis,

is the same as valuing the total product on one combined simple amortised cost basis.

This would produce a result consistent with the common amortisation approach discussed in Section 4 of this paper. As previously noted, such an approach is largely equivalent to the application of MoS with limited acquisition expenses and locked in assumptions.

### **6.9 Implementation - Fair Value Under IAS 39 or Phase II**

Where the fair value basis is adopted for the financial instrument or insurance contract, it would seem that the practical (mechanical) outworking of splitting a retail contract into its two parts would be the same as a modified form of MoS, where:

- Appropriate “risk free” discount rates are used and a minimum allowance (“profit margin”) for the value of risk and uncertainty on the wholesale component is included (based on a CAPM or similar market calibrated approach). Note that this minimum might conceivably be zero for many products if valued with appropriate assumptions (see 6.5 above).
- Any changes in the valuation assumptions in relation to the wholesale component (interest rates, claims rates, claims amounts, claims delays, economic margins for value of risk/uncertainty etc) should be present valued immediately to profit/loss and not amortised.
- The effect of other retail related assumption changes related to acquisition cost recovery (voluntary lapses, expense levels, interest rate effects on DAC etc) should be respread subject to loss recognition testing. To the extent that the minimum “profit margin” above is non-zero, loss recognition would potentially cut in earlier than it currently does under MoS.

Again, these conclusions are consistent with those discussed in section 5 of this report, albeit now based on a more robust logic.

Note that there is nothing in the proposed approach that is intended to negate proper loss recognition (or impairment) testing. When (notionally) splitting any contract into its wholesale and retail overlay elements, neither would be permitted to have a negative value at inception – i.e. profit margins must at least be equal to the minimum risk allowance on the wholesale component.

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## 7. CRITERIA FOR METHOD SELECTION UNDER IAS 39

The IAS 39 Taskforce does not believe it is appropriate for the flexibility available under IAS 39 to be constrained by guidance by the IAAust prescribing particular methods for particular products or circumstances.

However it does believe that there are important criteria that should be considered in considering the selection of approaches. In particular, companies will probably want to ensure that:

- Their application of IAS 39 is understandable by users of their reports; and
- The results emerging are useful and meaningful, including:
  - Avoidance of inappropriate volatility in the results, and
  - Ensuring consistency of results over time.

### 7.1 Consistency Between Measurement of Assets and Liabilities

If the above objective applies, then it will be paramount that the method adopted for valuing assets is consistent with the method adopted for valuing the liabilities, and vice-a-versa.

Not only will inconsistent methods result in spurious volatility but depending on which way the inconsistency is the volatility could be in entirely different directions. For example, in certain circumstances the use of amortised cost to measure liabilities and fair value to measure assets could produce a spurious profit. In those same circumstances, the use of fair value to measure liabilities and amortised cost to measure assets could produce a corresponding loss.

An initial report has recently been published on a Joint American Council of Life Insurers (ACLI) / International Actuarial Association (IAA) Research Project into the interaction of methods of asset measurement under IAS 39 with various liability measurement methods. The results of this research give strong support for this criteria.

### 7.2 Choices Available

In simple terms, it is suggested that:

- If liabilities are measured at amortised cost, then assets should be similarly measured at amortised cost.
- If liabilities are measured at fair value then assets should be similarly measured at fair (i.e. market) value.

The IAS 39 Taskforce envisage two options:

		<b>Assets</b>	<b>Liabilities</b>
Option 1	Designation Valuation basis	Held for trading Fair value	Held for trading Fair value
Option 2	Designation Valuation basis	Held to maturity Amortised cost	Other than held for trading Amortised cost

In light of the discussion in the previous sections it should be noted that in applying these choices:

- The required consistency needs to apply separately to the separate components of the assets and liabilities, where relevant; and
- Consideration needs to be given to the unit of measurement adopted. For example, if an amortised cost approach is being applied to the liabilities such that the amortisation is expressed in terms of units, rather than monetary amounts, then it would still be appropriate to value assets at market value, representing the amortised cost of the assets expressed in terms of equivalent units.

### 7.3 Assets Backing Equity

The one area not covered by the above choices is the measurement of assets backing equity rather than liabilities.

If those assets could be specifically identified, separate from the assets backing liabilities, then the potential flexibility in measurement choices could result in substantial differences in reporting outcomes.

- Classification of such assets as Trading would produce results similar to those under ASSB 1023 / 1038 where volatile market value movements are fully reflected in the P&L as investment earnings on capital and retained profits.
- Classification of such assets as AFS would still result in market value movements being reflected on the balance sheet as movements in equity, but the P&L would only reflect the change in cost or amortised cost plus any realised gains and less any impairment. The apparent accounting result may therefore be much more "stable", albeit subject to the effects of asset turnover and the possibility of "cherry picking" of realised gains to enhance the P&L.

This issue is of particular relevance given the concern over the volatility of profits for insurers who hold substantial quantities of equities as assets backing retained profits and shareholder capital.

### 7.4 Expected Approach for Australian Insurers

In the case of Australian life and general insurers the factors which are likely to affect the choice between these two options include:

- Current market value of assets and dynamic liability valuation practice under AASB 1023 and AASB 1038;
- Existing regulatory APRA reporting requirements, and the very considerable likelihood that capital requirements of insurers will continue to be measured against the market value of the assets; and
- The disclosure requirements of IAS 32 which will still require fair value of financial assets and liabilities to be shown in the notes to the accounts.

On this basis the IAS 39 Taskforce anticipates that a trading definition of assets and liabilities will generally be adopted by Australian life and general insurers.

The set of products where the use of full amortised cost methods is most likely to be feasible are matched annuity portfolios. It should be noted that if the portfolio is not matched then the earnings impact of that mismatch arising from yield movements will not be immediately recognised, but will be spread in accordance with the amortisation process. The appropriateness of this would require careful consideration before this approach was adopted.

Furthermore, if the assets are to be measured at amortised cost (for both P&L and balance sheet) then, with the exception of loans issued by the insurer, they need to be classified as "held to maturity". The requirements to do so are quite onerous. Even for the average matched annuity portfolio it might be difficult to argue that there was no intention to ever trade the matching portfolio of assets. To do so might potentially require a degree of asset segmentation which does not necessarily exist in the typical statutory fund of Australian life insurers.

A less likely, though still possible, choice is that amortised cost might be applied to investment linked products. In such circumstances the additional considerations at the end of Section 7.2 become relevant. Either:

- The product is split into its wholesale and retail components as proposed in Section 6.9 with the wholesale component (the unit liability) being fair valued and backed by assets at market value, leaving only the retail element to be measured at amortised cost; or
  - The entire product is measured at amortised cost but with the amortisation expressed in terms of units corresponding to the market value of the supporting assets.
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## 8. OTHER ISSUES

There are several other issues which will need to be considered by both insurers and regulators in the Australian context.

In relation to all these issues a key consideration for the industry will be to avoid duplicate calculation and reporting.

### 8.1 Discounting Deferred Tax Liabilities

IAS 39, Phase I (i.e. AASB 1038) and Phase II all require cash flows to be discounted when determining the value of liabilities for insurance contracts and financial instruments.

However, IAS 12 prohibits discounting of deferred tax and the IASB have explicitly noted that changes to that standard are not a priority for them.

There is an obvious inconsistency in this, not only in terms of the standards themselves, but also in terms of current industry practice.

It is not clear at present how this inconsistency will be resolved.

### 8.2 Taxation Basis

The basis of taxation for Australian life insurance was changed in 2000 to reflect liabilities calculated in accordance with MoS.

To the extent that liabilities calculated in accordance with IAS 39, and ultimately Phase II, differ from the basis stipulated in the tax acts then there is potential duplication of processing effort, which will be exacerbated if the two bases drift apart. Greater variance between tax and accounting outcomes could also result in the need to recognise deferred tax assets and liabilities (as was the case prior to the recent tax changes).

### 8.3 Life Act Issues

The Australian Life Insurance Act includes concepts of policy liabilities, operating profit and retained profits, primarily for the purposes of establishing equity between the interests of shareholders and policyholders.

These Life Act quantities rest upon the requirements of Actuarial Standard AS 1.03. Consistency between the Life Act and Australian GAAP reporting is achieved by the valuation of liabilities under AASB 1038 being aligned with AS 1.03.

This consistency will be maintained if AS 1.03 is amended to align initially with the requirements of IAS 39 in respect of contracts not deemed to be insurance. A further change would then be required when Phase II is implemented.

While inconsistency between Life Act reporting and GAAP reporting would result if AS 1.03 were not changed, it would not immediately result in a change in the relative interest of policyholders and shareholders, if participating business is temporarily exempted from IAS 39.

### 8.4 Owner Occupied Property

Although property assets which constitute financial instruments under IAS 39 will be valued at fair value (market value), IAS 16 *Property, Plant and Equipment* requires owner occupied property to be valued in accordance with a cost model or a revaluation model.

This would seem to be the case, even when the asset is held as part of a statutory fund backing policyholder benefits and where notional rents at market levels are charged as an expense to the organisation.

It is possible that this could be partly remedied under Phase II of the Insurance Accounting project by an exemption for assets backing policyholder benefits. However, this would not address the issue in relation to non-insurance investment products.

## 9. CONCLUSIONS

Based on the discussion in the preceding sections, the IAS 39 Taskforce propose the following tentative recommendations and conclusions as the basis for any future guidance. In some instances the conclusions indicate that some uncertainty remains.

**The task force welcomes the views of members which will enable it to put more definitive recommendations to bodies such as the IASB, AASB and LIASB.**

### 9.1 Classification of Business

- There is a need for companies, actuaries and accountants to undertake a careful audit of their in-force product set to allocate them under the most appropriate IFRS.
- Unbundling of all riders should enable the business to be appropriately grouped such that the relevant accounting standards can be applied with certainty and consistency. The effective separation of business between insurance contracts and investment contracts is likely to be similar to that already applied under AASB 1038 for premium and claim splitting.
- Further guidance will be required relating to the identification of embedded options which need to be split from their host contract, although the practical consequences should be similar to those already required to deal with asymmetrical outcomes under AS 1.03.

### 9.2 Criteria for Method Selection under IAS 39

- If liabilities are measured at amortised cost, then assets should be similarly measured at amortised cost.
- If liabilities are measured at fair value then assets should be similarly measured at fair (i.e. market) value.
- The required consistency needs to apply separately to the separate components of the assets and liabilities, where relevant.
- In seeking the required consistency, consideration needs to be given to the unit of measurement adopted.

### 9.3 Amortisation Methodology

- For liabilities expressed in fixed monetary terms (e.g. fixed rate, fixed term bonds and annuities) application of the Effective Interest Method will be materially consistent with existing MoS methodology with all assumptions locked-in at inception and a profit carrier based on interest credits or asset management charges.
- For investment contracts with interest or investment return credits based on unknown future performance, the required approach would be consistent with existing MoS methodology, as follows:
  - Where an accumulation method is used, the AERC is amortised relative to actual in-force numbers of units but with the future earning assumption locked in at inception and with an AERC carrier based on interest credits or asset management charges.
  - Where the projection method is used, normal MoS methodology would apply but with assumptions locked in at inception and a profit carrier based on interest credits or asset management charges.
- All results would be subject to a BEL minimum as per existing practice.

### 9.4 Fair Value Methodology

- If the IASB position on fair values as summarised in the most recent March 2003 update remains unaltered (as described in Section 5), then the practical outworking would seem

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to be a methodology consistent with existing Australian MoS methodology, with the following exceptions:

- Appropriate “risk free” discount rates should be used reflecting the issuer’s creditworthiness (i.e. generally high grade corporate debt rates or replicating portfolio rates as appropriate).
  - The level and nature of acquisition costs allowed for when setting profit margins at inception would be different (see 9.5 below).
  - The minimum profit margin (for loss recognition purposes) would be based on prevailing market prices, and may be greater than zero.
- Alternatively, if the model in Section 6 can be adopted, and a contract is considered in terms of separate wholesale and retail components, the practical (mechanical) outworking is that the approach would also be a modified form of MoS, as follows:
- Appropriate “risk free” discount rates should be used (as above).
  - The level and nature of acquisition costs allowed for when setting profit margins at inception would be different (as above).
  - A minimum profit margin should be included to allow for the value of risk and uncertainty on the wholesale component, based on a CAPM or similar market calibrated approach.
  - Where it is not possible to identify an appropriate or reliable minimum margin from available market data it may be appropriate for a prescribed margin to be mandated.
  - Any changes in the valuation assumptions relating to the wholesale component (interest rates, claims rates, claims amounts, claims delays, economic margins for value of risk/uncertainty etc) are reflected immediately in the value of the liability.
  - Changes in other valuation assumptions (voluntary lapses, expense levels, interest rate effects on DAC etc) are not reflected in the value of the liability, but are absorbed in the value of the profit margins, subject to loss recognition (i.e. profit margins being no less than the minimum above).

## 9.5 Acquisition Costs

- The amount of acquisition costs which can be implicitly or explicitly deferred is likely to be more restrictive than the current AASB 1038 interpretation and there is a considerable risk they could be limited to externally incurred costs only.
- If such a restrictive basis is adopted, there would be the potential for accounting arbitrage where the amount of deferrable acquisition costs is interpreted differently under different accounting standards, different corporate structures or different “employee” remuneration / employment structures.
- Limited deferral of acquisition costs could be detrimental to the financial results of Australian insurers in the short term. However, for a mature insurer, the negative impact in respect of new business could be offset by higher profit margins on in-force business.
- To the extent that the definition of transaction costs is well established internationally then to avoid arbitrage it may be appropriate for the LIASB to amend the extent to which acquisition costs are deferred under MoS.

## 9.6 Other Issues

- Changes to AS 1.03 should be made to accommodate the treatment of business which is subject to IAS 39.
  - Application of such changes to insurance contracts (i.e. not subject to IAS 39) should also be considered to minimise inconsistencies of treatment, subject to a reasonable
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certainty that Phase II of the Insurance Accounting project will develop in a similar direction.

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## 10. FURTHER READING

- Updates of monthly IASB Board meeting available at  
<http://www.iasc.org.uk/cmt/0001.asp?s=6890629&sc={2CECE8FB-1479-4CE0-8F6B-DDB355B4CDA2}&n=4012>
- The Exposure Draft of improvements to IAS 39 available at  
[http://www.iasc.org.uk/docs/ias32-39/02-32\\_39-ed.pdf](http://www.iasc.org.uk/docs/ias32-39/02-32_39-ed.pdf)
- The Insurance Accounting project DSOP available at  
<http://www.iasc.org.uk/cmt/0001.asp?s=6890819&sc={4A3E3ECE-1402-496E-AEBB-CE603641309D}&n=4124>
- The Insurance Accounting project Phase I status update available at  
<http://www.iasc.org.uk/docs/projects/insurance1-ps.pdf>
- The Insurance Accounting project Phase II status update available at  
<http://www.iasc.org.uk/docs/projects/insurance2-ps.pdf>
- The IAAust Position Statement on Economic Valuation Concepts available at  
<http://www.actuaries.asn.au/PublicSite/pdf/econvalnposition.pdf>
- The IAAust Discount Rates Taskforce Report available at  
[http://www.actuaries.asn.au/PublicSite/pdf/sessionals/sessional\\_06\\_2001\\_DiscountRateTaskForce.PDF](http://www.actuaries.asn.au/PublicSite/pdf/sessionals/sessional_06_2001_DiscountRateTaskForce.PDF)
- LIASB Actuarial Standard AS 1.03 (Valuation of Policy Liabilities) – i.e. MoS – available at  
<http://www.apra.gov.au/Friendly/loader.cfm?url=/commonspot/security/getfile.cfm&PageID=4480>
- APRA Prudential Standard GPS 210 (Liability Valuation for General Insurers) available at  
<http://www.apra.gov.au/Policy/loader.cfm?url=/commonspot/security/getfile.cfm&PageID=3831>
- Australian Accounting Standard AASB 1038 (Life Insurance Business) available at  
[http://www.aasb.com.au/public\\_docs/aasb\\_standards/AASB1038\\_11-98.pdf](http://www.aasb.com.au/public_docs/aasb_standards/AASB1038_11-98.pdf)
- Australian Accounting Standard AASB 1023 (Financial Reporting of General Insurance Activities) available at  
[http://www.aasb.com.au/public\\_docs/aasb\\_standards/AASB1023\\_11-96.pdf](http://www.aasb.com.au/public_docs/aasb_standards/AASB1023_11-96.pdf)
- Various publications by major accounting firms such as:
  - Ernst & Young:  
[http://www.ey.com/global/download.nsf/Australia/FS\\_-\\_Monitor\\_-\\_December\\_2002/\\$file/DecSpecialMonitor.pdf](http://www.ey.com/global/download.nsf/Australia/FS_-_Monitor_-_December_2002/$file/DecSpecialMonitor.pdf)
  - KPMG:  
[http://www.kpmg.com/Rut2000\\_prod/Documents/9/alrt%2002-40%20attachment.pdf](http://www.kpmg.com/Rut2000_prod/Documents/9/alrt%2002-40%20attachment.pdf)
  - PricewaterhouseCoopers:  
<http://www.pwcglobal.com/extweb/pwcpublishations.nsf/docid/B77DE02E9F71B886CA256CCD0011576A?OpenDocument>