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Mr David Boymal
The Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West VIC 8007

Dear Mr Boymal,

Re: RESPONSE TO IASB "DISCUSSION PAPER: PRELIMINARY VIEWS ON INSURANCE CONTRACTS"

QBE Insurance Group is an Australian listed general insurance and reinsurance group which is one of the world's top 25 largest insurers and reinsurers. QBE currently operates in 45 countries and most major insurance markets and, as such, must comply with many regulatory and financial reporting regimes.

We would like to congratulate the IASB on the quality of the DP, and support the aim of developing an international accounting standard on insurance contracts in order to attain comparability of financial position and financial performance across many jurisdictions. The consultative approach of the AASB in seeking industry comment on the development of the standard has also been welcome.

Australia has, for many years, applied AASB 1023, an accounting standard which embodies many of the features of the IASB's current exit value model. QBE's experience both with the original introduction of AASB 1023 and the amendments made on transition to IFRS phase I, has been that the need for a technically sound theoretical model must be balanced by a sufficiently flexible, principles based approach which allows for the diverse nature of insurance businesses in the market. We consider that AASB 1023 has been tested in the Australian market and that this standard and the associated guidelines produced by the Australian actuarial bodies may be a useful reference in drafting the final international standard in terms of measurement principles as well as disclosure.

Whilst it is a worthy aim to create a single accounting standard that covers both life and general insurance, the reality is that the two industries operate in quite different ways and that there are fundamental differences between both types of business. The DP in its current form introduces uncertainties for general insurers, who are struggling to determine if or how life insurance type concepts such as service margins may apply to their business. We suggest that either two separate standards are produced, each based on the same fundamental building blocks but with specific regard to the nature of the business, or that there are specific 'life' and 'general' sections identified in the final standard.

We agree with the theoretical principle of measuring liabilities at observed market prices, however we question whether this will ever really be possible in practice. The three building blocks approach, which is very similar to the approach currently applied to financial reporting by Australian insurers, is a suitable practical basis for determining such valuations. However, we question the IASB's approach in two main areas:

- In the absence of a true market for insurance liabilities, we believe that entity specific cash flows should be applied in the valuation process rather than "market-consistent" cash flows, the former being more readily available and producing more meaningful information.

- Diversification of risk is fundamental to how insurance businesses operate. It does not reflect economic reality to disallow diversification benefits in the determination of risk margins.

We believe that any country specific divergences from the IASB's final standard will undermine the goal of achieving comparability and that all jurisdictions should therefore be subject to the same standard. For example, we would not support any proposal by the AASB to mandate fair value through profit and loss as the basis of valuation of assets backing insurance liabilities as has been suggested.

Ultimately, disclosure will be crucial to enabling transparency and useability of financial statements. The final standard should focus on establishing a principles based approach rather than being overly prescriptive. The appropriate level of disclosure will ensure that users of financial statements are given relevant information about important areas such as, for example, the valuation of assets to support insurance liabilities and the recognition of day one profits. Such disclosure, pitched at the right level, should avoid the IASB having to mandate outcomes that may not be conceptually consistent with the exit model, e.g. limits around the recognition of day one profits, or should avoid the need for amendments in the application of the standard in certain jurisdictions e.g. due to mandating a valuation basis for assets backing insurance liabilities.

In summary, we are supportive of the IASB's exit value model as a theoretical framework for establishing a new international insurance accounting standard. Our experience in Australia has been that whilst not intentional, accounting standards can influence commercial practice, and this can be detrimental to financial performance. It is our view that to be successful, an international standard must be principles based and that guidelines and agreed practice in the implementation thereof must evolve in line with commercial reality. We see effective disclosure as a key component in producing a standard which allows companies to operate without artificial constraints whilst ensuring that users of financial statements are fully informed.

We would be happy to share our views and experience in person, by of way of senior management attendance at meetings of the AASB as the international standard develops.

Yours sincerely

Neil Drabsch
Chief Financial Officer

Question 1

Should the recognition and de-recognition requirements for insurance contracts be consistent with those in IAS 39 for financial instruments? Why or why not?

In principle we believe that there should be consistency of approach where possible between the requirements of IAS 39 and the Discussion Paper ("DP"). That said, in this case this would have practical implications for insurers that would need to be considered in detail before any such change is effected e.g. consistency of approach would appear to result in recognition of premium at the date of contractual commitment, which could be before the inception of the contract. This would have implications on the timing of the recognition of day one profits, if relevant. This needs to be further considered before any change to current practice is mandated.

Question 2

Should an insurer measure all its insurance liabilities using the following three building blocks:

a) explicit, unbiased, market-consistent, probability-weighted, and current estimates of the contractual cash flows,

b) current market discount rates that adjust the estimated future cash flows for the time value of money, and

c) an explicit and unbiased estimate of the margin that market participants require for bearing risk (a risk margin) and for providing other services, if any (a service margin)?

If not, what approach do you propose and why?

Whilst we agree with the theoretical notion that liabilities should be measured at observed market prices, we question whether this is ever achievable in practice. The risk is that, due to the inherent difficulties of determining such a valuation, the market may default to a generally accepted approach which may be both overly prescriptive and result in a meaningless outcome. Our view is that liabilities should be valued on their own merits, on a portfolio by portfolio basis.

As valuation at observed market prices in not generally a practical proposition, the three building block approach provides a suitable alternative basis for measurement. The proposed approach is very similar to the approach currently used and well understood by the preparers and users of financial reports for Australian entities under the requirements of AASB 1023.

However, we would make the following specific comments:

We have found the drafting of the document to be confusing around references to "market-consistent" and "entity-specific" cash flows. Our concern is that the proposed model, by requiring the use of market-consistent assumptions, may not correctly reflect the value of liabilities of companies that operate more or less efficiently than the market. In addition, there may be practical difficulties inherent in accessing meaningful market-consistent information. Our view is that valuations should be based on entity-specific data which is more meaningful and more readily available, and should be supplemented with disclosure where considered appropriate. This approach need not be inconsistent with the market-consistent approach, as this can be specifically factored into the measurement of the risk margins.

We believe that the intent behind the "service margin" concept is unclear and that further clarification is required. Our concern is that the uncertainty of application may result in life insurance accounting principles being forced upon general insurance contracts, giving rise to meaningless outcomes. We do not want this concept to be interpreted as a Margin on Services ("MoS") applicable to general insurance contracts.

Question 3

Is the draft guidance on cash flows (appendix E) and risk margins (appendix F) at the right level of detail? Should any of that guidance be modified, deleted or extended? Why or why not?

We strongly support the probability of adequacy basis currently employed in the determination of risk margins by Australian insurers. We do not support the capital based risk margin approach advocated by the International Actuarial Association.

We support the IASB's intention to apply a principles based approach rather than a prescriptive or overly detailed approach. We consider the draft guidance to be sufficiently detailed and that it provides a clear enunciation of the high level objectives of determining cash flows. In regard to the determination of risk margins, we note that this is a highly complex area which is presently evolving due to significant debate by actuarial bodies around the world. We consider that it is beyond the scope of the proposed accounting standard to provide detailed guidance on actuarial calculations. However, further liaison with the various actuarial bodies is recommended to ensure that the high level objectives are clear and can be translated into meaningful calculation methodologies that can be clearly communicated to preparers and users of financial statements.

Question 4

What role should the actual premium charged by the insurer play in the calibration of margins, and why?

a) *The insurer should calibrate the margin directly to the actual premium (less relevant acquisition costs), subject to a liability adequacy test. As a result, an insurer should never recognise a profit at the inception of an insurance profit.*

b) *There should be a rebuttable presumption that the margin implied by the actual premium (less relevant acquisition costs) is consistent with the margin that market participants require. If you prefer this approach, what evidence should be needed to rebut the presumption?*

c) *The premium (less relevant acquisition costs) may provide evidence of the margin that market participants would require, but has no higher status other than possible evidence. In most cases, insurance contracts are expected to provide a margin consistent with the requirements of market participants. Therefore, if a significant profit or loss appears to arise at inception, further investigation is needed. Nevertheless, if the insurer concludes, after further investigation, that the estimated market price for risk and service differs from the price implied by the premiums that it charges, the insurer would recognise a profit or loss at inception.*

d) *Other (please specify).*

We support option c, and believe that the recognition of day one profits is consistent with the aims of the exit value model and is conceptually valid. Whilst it is for each entity to determine its own liability valuation and profit releases, appropriate disclosure should ensure transparency of financial information produced.

Question 5

This paper proposes that the measurement attribute for insurance liabilities should be "the amount the insurer would expect to pay at the reporting date to transfer its remaining contractual rights and obligations immediately to another entity. The paper labels that measurement attribute "current exit value".

a) *Is that measurement attribute appropriate for insurance liabilities? Why or why not? If not, which measurement attribute do you favour, and why?*

As noted previously, we agree with the theoretical notion that liabilities should be measured at observed market prices; however, we question whether this is ever achievable in practice. There are some difficulties in translating that into a meaningful measurement tool in the real world in terms of some of the components of the three specific building blocks. In particular, we query the existence of sufficiently timely, reliable and freely available information to enable 'market consistent' cash flows to be modelled by insurers. In practically all cases it will be necessary and more accurate to have regard to the entity's own cash flows as a proxy for the market.

b) *Is "current exit value" the best label for that measurement attribute? Why or why not?*

Once again, this is reasonable as a theoretical label but the distinction between 'current exit value' and 'current entry value' can be a fine one as the IASB have outlined in the DP. What we call the model is probably not a significant issue provided that there is clarity and agreement on the components of the three building blocks.

Question 6

In this paper, the beneficial policyholder behaviour refers to a policyholder's exercise of a contractual option in a way that generates net economic benefits for the insurer. For expected future cash flows resulting from beneficial policyholder behaviour, should an insurer:

a) *incorporate them in the current exit value of a separately recognised customer relationship asset? Why or why not?*

b) *incorporate them, as a reduction, in the current exit value of insurance liabilities? Why or why not?*

c) *not recognise them? Why or why not?*

No comment. Not applicable to general insurance.

Question 7

A list follows of possible criteria to determine which cash flows an insurer should recognise relating to beneficial policyholder behaviour. Which criterion should the Board adopt, and why?

a) *Cash flows resulting from payments that policyholders must make to retain a right to guaranteed insurability (less additional benefit payments that result from those premiums). The Board favours this criterion, and defines guaranteed insurability as a right that permits continued coverage without reconfirmation of the policyholder's risk profile and at a price that is contractually constrained.*

b) *All cash flows that arise from existing contracts, regardless of whether the insurer can enforce those cash flows. If you favour this criterion, how would you distinguish existing contracts from new contracts?*

c) *All cash flows that arise from those terms of existing contracts that have commercial substance (ie have a discernible effect on the economics of the contract by modifying significantly the risk, amount or timing of the cash flows).*

d) *Cash flows resulting from payments that policyholders must make to retain a right to any guarantee that compels the insurer to stand ready, at a price that is contractually constrained, i) to bear insurance risk or financial risk, or ii) to provide other services. This criterion relates to all contractual guarantees, whereas the criterion described in a) relates only to insurance risk.*

e) *No cash flows that result from beneficial policyholder behaviour.*

f) *Other (please specify).*

Should an insurer recognise acquisition costs as an expense when incurred? Why or why not

No comment. Not applicable to general insurance.

Question 8

Should an insurer recognise acquisition costs as an expense when incurred? Why or why not?

Yes. We support this proposal as being consistent with the exit model proposal.

Question 9

Do you have any comments on the treatment of insurance contracts acquired in a business combination or portfolio transfer?

Practically, there should not be a difference between current exit value and fair value of a portfolio of liabilities acquired in an arm's length transaction. As a result, our view is that the expanded presentation option available under IFRS 4 would not be required.

Question 10

Do you have any comments on the measurement of assets held to back insurance liabilities?

One of the stated aims of the DP is to enable comparability of performance across borders and across insurance entities. It is not appropriate for some jurisdictions to mandate the use of fair value through profit and loss whilst other jurisdictions have a range of valuation options available to them. We do not support Australian accounting standard setters mandating a fair value through profit and loss valuation of assets backing insurance liabilities when preparers of financial statements elsewhere have other options available to them. Transparency and comparability of performance can be achieved through appropriate levels of disclosure.

Question 11

Should risk margins:

a) *be determined for a portfolio of insurance contracts? Why or why not? If yes, should the portfolio be defined as in IFRS 4 (a portfolio of contracts are subject to broadly similar risks and managed together as a single portfolio)? Why or why not?*

We agree that the portfolio be defined as a portfolio of contracts subject to broadly similar risks and managed together as a single portfolio. This is a realistic representation of how insurance businesses are managed. To attempt to measure at a more granular level e.g. individual insurance contracts, would be highly misleading.

b) reflect the benefits of diversification between (and negative correlation between) portfolios? Why or why not?

A valuation basis that does not recognise the benefit of diversification is fundamentally flawed. It would not reflect economic reality to exclude the benefits of diversification and imperfect correlation between portfolios, and such exclusion is inconsistent with the exit model. Each insurer will have a different approach to risk management and its diversification profile will be highly significant for regulators, reinsurers and investors in measuring the insurer's strength and business performance.

Question 12 (a)

Should a cedant measure reinsurance assets at current exit value? Why or why not?

We believe that the measurement of the reinsurance asset should be consistent with the valuation of the related gross liability.

Question 12 (b)

Do you agree that the consequences of measuring reinsurance assets at current exit value include the following? Why or why not?

i) A risk margin typically increases the measurement of the reinsurance asset, and equals the risk margin for the corresponding part of the underlying insurance contract

ii) An expected loss model would be used for defaults and disputes, not the incurred loss model required by IFRS 4 and IAS 39.

iii) If the cedant has a contractual right to obtain reinsurance for contracts that it has not yet issued, the current exit value of the cedant's reinsurance asset includes the current exit value of that right. However, the current exit value of that contractual right is not likely to be material if it relates to insurance contracts that will be priced at current exit value.

We agree that i) and ii) are consistent with the proposed exit value model.

We believe that it is meaningless and impractical to attribute value to the asset set out in iii). Given that the amount would be immaterial, there is no added value in performing an explicit valuation.

Question 13

If an insurance contract contains deposit or service components, should the insurer unbundle them? Why or why not?

We agree with the view expressed in the DP that:

a) If the components are so interdependent that the components can only be measured on an arbitrary basis, the phase II standard on insurance contracts should apply to the whole contract; and

b) If the components are not interdependent, the phase II standard should apply to the insurance contract and IAS 39 should apply to the deposit component.

However, where unbundling is possible, the proposal that would measure the entire contract based on the phase II standard and then adjust out the deposit component based on an IAS 39 valuation would potentially produce a meaningless valuation of the insurance component of the contract.

Question 14

a) *Is the current exit value of a liability the price for a transfer that neither improves nor impairs its credit characteristics? Why or why not?*

The measurement of an insurance liability before reinsurance should <u>not</u> reflect credit characteristics. Credit standing is attributable to the insurance entity rather than each underlying contract

b) *Should the measurement of an insurance liability reflect i) its credit characteristics at inception and ii) subsequent changes in their effect? Why or why not?*

No. The liability does not have any individual credit characteristics of its own so this approach is not meaningful.

Question 15

Appendix B identifies some inconsistencies between the proposed treatment of insurance liabilities and the existing treatment under IAS 39 of financial liabilities. Should the Board consider changing the treatment of some or all financial liabilities to avoid these inconsistencies? If so, what changes should the Board consider, and why?

Whilst in principle there is merit in consistency between the standards, we feel strongly that this is not the time to address this issue. Given that both IAS 39 and accounting for insurance contracts are both currently under review, there are dangers inherent in attempting to align the standards at this time.

Question 16

a) *For participating contracts, should the cash flows for each scenario incorporate an unbiased estimate of the policyholder dividends payable in that scenario to satisfy a legal or constructive obligation that exists at the reporting date? Why or why not?*

b) *An exposure draft of June 2005 proposed amendments to IAS 37 (see paragraphs 247-253 of this paper). Do those proposals give enough guidance for an insurer to determine when a participating contract gives rise to a legal or constructive obligation to pay policyholder dividends?*

No comment. Not applicable to general insurance.

Question 17

Should the Board do some or all of the following to eliminate accounting mismatches that could arise for unit-linked contracts? Why or why not?

a) *Permit or require insurers to recognise treasury shares as an asset if they are held to back a unit-linked liability (even though they do not meet the Framework's definition of an asset).*

b) *Permit or require insurers to recognise internally generated goodwill of a subsidiary if the investment in that subsidiary is held to back a unit-linked liability (even though IFRS's prohibit the recognition of internally generated goodwill in all other cases).*

c) *Permit or require insurers to measure assets at fair value through profit or loss if they are held to back a unit-linked liability (even if IFRSs do not permit that treatment for identical assets held for another purposes).*

d) *Exclude from the current exit value of a unit-linked liability any differences between the carrying amount of the assets held to back that liability and their fair value (even though some view this as conflicting with the definition of current exit value).*

No comment. Not applicable to general insurance.

Question 18

Should an insurer present premiums as revenue or as deposits? Why or why not?

For general insurance contracts where there is a transfer of underlying risk, revenue is the only sensible approach.

Question 19

Which items of income and expense should an insurer present separately on the face of its income statement? Why?

The following items are the generally accepted key components of an insurer's performance:

- Gross written premium
- Reinsurance written premium
- Net earned premium
- Gross incurred claims
- Reinsurance and other recoveries
- Net commissions
- Net expenses
- Investment income on policyholders' funds
- Investment income on shareholders' funds

We feel that the format of the income statement should not be overly prescribed and that there should be some flexibility to permit insurers to present their financial information in a way that is most meaningful to that entity. As an example, an insurer may feel it appropriate to separately identify inwards or outwards portfolio transfers where these are material to the operations of the entity.

Question 20

Should the income statement include all income and expense arising from changes in insurance liabilities? Why or why not?

We agree that the income statement should include all income and expense due to changes in insurance liabilities. The level of disclosure needs to be carefully considered as too much detail around each specific element giving rise to a movement may be confusing to the reader rather than helpful.

Question 21

Do you have other comments on this page?