

28 January 2004

The Director – Accounting and Professional Standards  
Institute of Chartered Accountants of New Zealand  
P O Box 11342  
WELLINGTON

Dear Sir

**Exposure Draft FRS-35A: *Financial Reporting of Insurance Activities***

**Introduction**

The New Zealand Society of Actuaries (the Society) welcomes the opportunity to comment on the Exposure Draft FRS-35A.

The Society is a professional body to which all qualified actuaries practising in New Zealand belong. Actuaries have a close involvement with all aspects of the general insurance industry. Many of the large general insurance companies employ the services of actuaries in determining premium rates and in the calculation of provisions and reserves.

As you will see in general the Society supports the aims and proposals of FRS-35A. There are two major areas in which we believe some change is required. These are in respect of discount rates ( see comment 3) and risk margins (see specific matters for comment 5). We would welcome the opportunity to discuss our submission and these matters in particular further.

**Initial comments on ED5**

The Society is aware that the Institute of Chartered Accountants of New Zealand has produced the Exposure Draft FRS-35A: *Financial Reporting of Insurance Activities*, in the light of the requirements of Exposure Draft ED: 5 *Insurance Contracts* (ED 5) issued by the International Accounting Standards Board (IASB) on 31 July 2003. The proposals in ED 5 apply to all insurance contracts (including reinsurance contracts) that an entity issues and to reinsurance contracts that it holds, except for specified contracts covered by other International Financial Reporting Standards (IFRS). The wording of ED 5 includes proposals to:

- eliminate catastrophe and equalisation provisions. This has already been introduced in FRS-35,

- require a loss recognition test if no such test exists under an insurer's existing accounting policies. Under FRS-35 there was no requirement for recognition of losses expected over and above the amount of deferred acquisition costs (DAC),
- require an insurer to keep insurance liabilities in its balance sheet until they are discharged or cancelled, or expire, and to present insurance liabilities without offsetting them against related reinsurance assets, and
- only permit an insurer to change its accounting policies for insurance contracts if that would mean that its financial statements present information that is more relevant and reliable.

The Society supports these proposals.

Also, under ED 5 disclosure is required about:

- the amounts in the insurer's financial statements that arise from insurance contracts,
- the estimated amount, timing and uncertainty of future cash flows from insurance contracts. The proposals in this area address disclosures about the risks to which an insurer is exposed and they highlight material exposures to interest risk or market risk under embedded derivatives such as guaranteed annuity options, and
- the fair value of the insurer's insurance liabilities and insurance assets.

The Society supports the principals of the proposed disclosure, but has some difficulties with the nature and level of detail that may be required.

### **Society comments on FRS-35A**

1. In general we are supportive of the aims and proposals of FRS-35A.
2. The definitions of paragraph 4 are generally helpful, in particular those for 'discretionary participation feature' and 'fair value' make clear what is intended.

However, throughout ED5 and FRS-35A there are references to the words 'significant' and 'materially different'. How these words are to be interpreted is not necessarily obvious in all cases. Although there are generally accepted accounting interpretations that are applied in regard to materiality, it may be necessary to carry out detailed calculations in order to establish whether particular values or differences are 'significant' or 'material'.

For example, paragraph 2.2 states that the liabilities for outstanding claims shall be determined on a reliable basis, including a review of assumptions, and not be materially different from liabilities for outstanding claims determined by a full actuarial valuation. We note that the regulatory authorities have, on other occasions when a reliable basis has been proposed, required a full actuarial valuation to show that the liabilities are not materially different. It is of concern that this could become a virtual requirement.

3. A liability for outstanding claims is to be recognised and measured as the present value of the expected payments. Paragraph 5.20 notes that this requires estimation of the ultimate costs of settling claims and discounting to a present value.

ED5 makes no specific requirement or prohibition concerning the discount rate to be used. However, in paragraphs 5.36 to 5.39 of FRS-35A there is a lengthy discussion of

'risk free rates' to be used, including a note that the Financial Reporting Standards Board intends to revisit this matter once an international consensus is reached.

Some statement as to suitable bases for selecting rates to be used for discounting, and the need to consider the assumed pattern of future payments is necessary in order that a consistent approach be applied. However, the specification of discount rates in FRS-35A appears to be over complicated for most purposes.

We note that this is an area in which international consensus has not yet been reached. Also, there are extra difficulties in requiring reference to yields on government stock, which is more limited and subject to special factors in New Zealand when compared to larger markets. We note that whatever basis is used, all assumptions used in the estimation and calculation must be disclosed.

4. We note and support the measures that would:
  - exempt an insurer from accounting for an embedded derivative separately at fair value if the embedded derivative meets the definition of an insurance contract,
  - require an insurer to unbundle (account separately for) deposit components of some insurance contracts, to avoid the omission of assets and liabilities from its balance sheet,
  - limit reporting anomalies when an insurer buys reinsurance,
  - permit an expanded presentation for insurance contracts acquired in a business combination or portfolio transfer, and
  - address limited aspects of discretionary participation features contained in insurance contracts or financial instruments.
5. We support the requirement that any premium deficiency disclosed by a loss recognition test carried out by class of business or a contract by contract basis is to be recognised in full immediately.

We note that financial reports have to disclose the provision for premium deficiency and the loss by class of business in excess of the writedown of deferred acquisition costs (DAC) and intangible assets.

We note that paragraph 5.88 refers to separate measurement being 'necessary' if losses from an individual contract are 'individually material'.

6. In general we support the objectives of FRS-35A in requiring disclosure about:
  - the amounts in the insurer's financial statements that arise from insurance contracts,
  - the estimated amount, timing and uncertainty of future cash flows from insurance contracts. We note that the proposals in this area address disclosures about the risks to which an insurer is exposed and highlight material exposures to interest risk or market risk under embedded derivatives such as guaranteed annuity options, and
  - the fair value of the insurer's insurance liabilities and insurance assets.
7. Section 6 deals with disclosures. We are aware of the influence of the Australian Prudential Regulation Authority (APRA) reporting requirements in paragraph 6.6. We note that, although there are the disclosure requirements in Section 6, FRS-35A does not appear to require the use of any specific calculation basis for the claims liability amount that is used in the financial statements.

We submit that there should be disclosure of the actual sufficiency level that is implicit in the amount of liability for outstanding claims used in the financial statements.

8. We note that the wording of 6.6 (e) is not technically correct, as there is no reference to adding the coefficient of variation to the central estimate. As well, there would appear to be a very strict requirement to determine the minimum value by each class of business and then consider the sum over all classes to be the amount required for 75% sufficiency. In comparison, APRA allows for a diversification adjustment when the total claims liability with 75% sufficiency is disclosed. We suggest that this specific disclosure should be made at an aggregate level, and allow for diversification of risk within outstanding claims that will be sufficient with 75% probability to cover a portfolio as may be appropriate, with full disclosure of the assumptions and bases used.

We submit that paragraph 6.6(e) should be amended to:

*'the amount of liability for outstanding claims required to secure the greater of (i) a 75% sufficiency and (ii) the central estimate plus half the coefficient of variation of the outstanding claims liability.'*

9. The disclosures required by FRS-35A include all key assumptions, many of which are now prescribed. This is far more extensive than the inflation discount and expense rates in the current standard. We are concerned that the disclosures could be extremely voluminous, particularly for general insurers with many classes of business. In addition, we believe that there may be issues relating to sensitivity in a competitive market.

Assumptions may relate to claim frequency, claim reporting patterns, average claim size and payment patterns. Parameters are often based on generalised linear models or extensive tables of values. We submit that it should be acceptable for the assumptions to be stated in an abbreviated, standardised form for each major business segment.

Similar issues arise in relation to the effect of changes in assumptions. We submit that there should be a limited amount of information provided, rather than separately showing the impact of each individual assumption change. Some standardisation of scenarios considered appropriate should be expected.

10. We note the cross references to various other applicable IFRS regarding valuation of assets. We consider that the effective change from net market value to fair value of assets introduces consistency of treatment across insurance entities.

### **Specific matters for comment**

You have asked for comment on a number of specific matters. The Society is pleased to respond to that request, using the same numbering as in your Discussion Paper.

1. **Scope.** The Society agrees that FRS-35A should apply to the general purpose financial reports of entities that issue insurance contracts, other than life insurers as defined in FRS-34A.
2. **Assets.** The Society agrees with proposals to require all assets to be measured using the fair value option in the relevant standards (NZIAS16, NZIAS38 and NZIAS40). We agree with the proposals referenced as (a), (b) and (c). In terms of (d), the Society

believes that the fair value option requirement should apply to investments in subsidiaries.

3. **Liabilities.** The Society agrees that financial liabilities should be measured using only the fair value option and designated as held for trading in accordance with NZIAS39.
4. **Definition of losses.** The Society agrees that losses should be recognised when they become foreseeable for insurance contracts.
5. **Risk margins.** The Society does not consider it appropriate to value outstanding claims without the use of a risk margin. The Society agrees with the proposals in AASB ED122A which require the use of a risk margin.
6. **Disclosure requirements.** In terms of the specific questions:
  - (a) the Society agrees with the proposed disclosures of (i) central estimates and of (ii) the (proposed amended) amount required to secure the greater of a 75% sufficiency and the central estimate plus half of the co-efficient of variation of the outstanding claims liabilities,
  - (b) the information should be disclosed by class of business for (i) and be aggregated across the entire portfolio for (ii), and
  - (c) the Society has difficulty in agreeing with the proposed additional disclosures regarding actuarial assumptions unless limitations are imposed on the volumes of disclosures that might be required.
7. The Society considers that the transitional arrangements will provide sufficient guidance when taken in conjunction with the standards and guidelines that the New Zealand Society of Actuaries is likely to promote.
8. The Society knows of no reason to have any additional material in respect of public benefit entities.
9. The Society is not aware of any regulatory or other issues arising in the New Zealand environment that may affect the implementation of the proposals.
10. The Society, in the earlier sections of this response, has set out the matters of concern which we would like the FRSB to raise with the IASB.
11. The Society believes that accounting standards that are in common agreement and in common use throughout the world are the standards that best serve the interests of the users of general purpose financial reports in New Zealand.

## **Further information or consultation**

The Society would welcome the opportunity to meet and discuss our submission or provide any further information required. To arrange this please contact:

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Yours sincerely

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