25 October 2013

The International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UNITED KINGDOM

Dear Sir

IASB Exposure Draft ED/2013/7 Insurance Contracts

The New Zealand Society of Actuaries (NZSA) welcomes the opportunity to comment on Exposure Draft ED/2013/7 Insurance Contracts issued by the International Accounting Standards Board (IASB) in June 2013. Our response is attached with this letter.

The NZSA is the professional body representing actuaries practicing in New Zealand. Further information on the NZSA has been provided at the end of our submission.

The life insurance market in New Zealand consists of some 30 participants with annual premium income of approximately NZ$2.0 billion. New contracts sold are predominantly pure risk contracts with yearly renewable premiums, however there is also large existing portfolios of older style products including with-profits whole of life and endowment, investment account and unit linked contracts.

New Zealand's general insurance market has annual premium income in excess of NZ$3.5 billion, covering a wide range of personal and commercial insurance classes. In addition, the Accident Compensation Corporation is a crown entity that provides statutory personal injury cover in New Zealand and has levy income of approximately NZ$4.5 billion.

New Zealand's health insurance market has annual premium income of approximately NZ$1.1 billion. This market is progressively moving away from providing primary care benefits, and is focusing more on cover for elective surgery and specialist care. Premiums are generally reviewable each year, and vary by age in line with the underlying risk. The market is characterised by having one large dominant insurer with around a 70% market share, and at the other end of the scale some quite small insurers with a 0.2% market share or less.

A key issue for especially smaller New Zealand insurers, with respect to the Exposure Draft (ED) proposals, is the potential complexity of the resulting new standard resulting in increased systems, actuarial and audit costs, for what appears to be little benefit to users compared to current New Zealand accounting standards. Smaller companies currently operate quite viably in this market. There needs to be a balance struck so that the resulting information is useful but also cost-effective.

The New Zealand Society of Actuaries would be pleased to discuss these issues with you further. For further information regarding our submission please contact the undersigned.

Yours faithfully
for New Zealand Society of Actuaries (Inc)

Paul Rhodes
President

Catherine Johnston
Life Insurance Committee (Convenor)

IASB Exposure Draft ED/2013/7 Insurance Contracts

Submission by New Zealand Society of Actuaries

Question 1—Adjusting the contractual service margin

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

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

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

The NZSA agree with the proposal to remeasure the contractual service margin for differences between the current and previous estimates of the present value of future cashflows related to future coverage and other future services.

The contractual services margin arises through the fact that profit that would otherwise arise at outset of an insurance contract, is spread over the lifetime of the contract and emerges as services are provided under the contract. To the extent that estimates of that "profit" change, then we believe that this should be reflected in a remeasurement of the contractual services margin. To do otherwise, would be to introduce an inconsistency between the treatment of that estimated profit at inception of a contract compared to during its lifetime.

In addition, in our experience of the Margin on Services methodology of accounting for life insurance contracts, currently used in New Zealand and Australia, such an approach reduces fluctuations in profit which would otherwise arise from the timing of making assumption changes and is somewhat self-correcting.

If, for example, the mortality claims assumption is not increased at a particular balance date when it arguably should be, then the impact on the following reporting period will likely be a mortality experience loss. This compares to the situation where the assumption is updated, which would result in a reduction to the contractual services margin (under MoS, the profit margin) and then a significantly lower experience profit/loss. The actual profit reporting under the two scenarios is likely to be fairly similar.

Contrast this to the situation where there is no remeasurement of the contractual service margin, in which case a large capitalised loss would occur when the assumption change was made. We do not believe this provides the user with useful information about the ongoing profitability of the business and future profit emerging will not reflect the profitability of the business relating to the future coverage period, as a portion will already have been taken to profit and loss.

Similar comments could also be made regarding the risk margin, which could also arguably be remeasured upon a change in the entity's view of risk relating to future coverage periods. We recommend that the IASB consider this further inconsistency.

We are also concerned that the capitalisation of changes in assumptions or in the risk adjustment can lead to increased volatility and the potential for manipulation of the timing of such changes to bring about a certain profit impact in a particular period. For long term contracts, the impact of small assumption changes can be significant compared to the actual profit for a period.

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Question 2—Contracts that require the entity to hold underlying items and specify a link to returns on those underlying items

If a contract requires an entity to hold underlying items and specifies a link between the payments to the policyholder and the returns on those underlying items, do you agree that financial statements would provide relevant information that faithfully represents the entity's financial position and performance if the entity:

(a) measures the fulfilment cash flows that are expected to vary directly with returns on underlying items by reference to the carrying amount of the underlying items?

(b) measures the fulfilment cash flows that are not expected to vary directly with returns on underlying items, for example, fixed payments specified by the contract, options embedded in the insurance contract that are not separated and guarantees of minimum payments that are embedded in the contract and that are not separated, in accordance with the other requirements of the [draft] Standard (ie using the expected value of the full range of possible outcomes to measure insurance contracts and taking into account risk and the time value of money)?

(c) recognises changes in the fulfilment cash flows as follows:
   (i) changes in the fulfilment cash flows that are expected to vary directly with returns on the underlying items would be recognised in profit or loss or other comprehensive income on the same basis as the recognition of changes in the value of those underlying items;
   (ii) changes in the fulfilment cash flows that are expected to vary indirectly with the returns on the underlying items would be recognised in profit or loss; and
   (iii) changes in the fulfilment cash flows that are not expected to vary with the returns on the underlying items, including those that are expected to vary with other factors (for example, with mortality rates) and those that are fixed (for example, fixed death benefits), would be recognised in profit or loss and in other comprehensive income in accordance with the general requirements of the [draft] Standard?

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

Whilst we understand the rationale for the proposed "mirroring" approach in some circumstances (for example, unit linked business), we expect that the ED proposals will be very complex to both apply and understand in many circumstances where the ED appears to mandate its use (for example, Participating Whole of Life and Endowment contracts).

Particular complexities arise from:

- Splitting contracts into components that vary directly with underlying assets and those that do not
- Splitting out embedded derivatives
- Contracts which have profit participation features
- Contracts which provide various options to policyholders

In many cases it is not clear how contracts should be split between components that are subject to mirroring and those that are not. The example in the ED is simple and still various scenarios were produced. The case of a With-Profits Whole of Life contract will be much more complex.

It is also not clear how the mirroring proposals would be applied where the underlying link is to profits rather than investment returns.

In addition, there appears to be an inconsistency between the unbundling rules and those relating to mirroring. There are contracts which would appear to not be allowed to be unbundled on the one hand, but then appear to be required to be unbundled under the mirroring proposals. This is confusing.

We recommend that the mirroring approach is optional, such that it could be applied in more straight forward circumstances, where there are clearly separate components, but that more complex contracts could be valued as a whole under the general proposed measurement approach (the Building Block Approach).

Question 3—Presentation of insurance contract revenue and expenses

Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial performance if, for all insurance contracts, an entity presents, in profit or loss, insurance contract revenue and expenses, rather than information about the changes in the components of the insurance contracts?

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

Whilst we appreciate the IASB's reasons for the change in presentation of insurance contract revenue and expenses, we do have concerns around the calculation of such items and the interaction with the movement in the insurance contract liability for the period.

The calculation of the insurance contract liability under the BBA would effectively take into account the timing of premium receipt in the calculation of the expected present value of future premiums. It is not necessarily straight forward to isolate and separate the component relating to the gross premium paid in the period and show this component separately in the income statement.

In addition, part of the premium paid in the period may relate to coverage in the current period and part in relation to future periods. This is particularly the case for level premium contracts. It is not clear how the IASB envisage such contracts be treated with respect to the insurance revenue disclosed for the period.

The margin disclosure proposed under the previous ED did provide useful information as to the emergence of profit for the period and would be a useful disclosure item.

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Question 4—Interest expense in profit or loss

Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial performance if an entity is required to segregate the effects of the underwriting performance from the effects of the changes in the discount rates by:

(a) recognising, in profit or loss, the interest expense determined using the discount rates that applied at the date that the contract was initially recognised. For cash flows that are expected to vary directly with returns on underlying items, the entity shall update those discount rates when the entity expects any changes in those returns to affect the amount of those cash flows; and

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

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

The NZSA do not believe that the proposal with regard to interest, as outlined above, will provide users with relevant or useful information. If anything, we believe they will be confusing for users to understand.

We agree with the alternative view of Stephen Cooper as outlined in the Basis for Conclusions in the ED.

In addition, the proposals will add a large degree of complexity with respect to the need to keep track of all historical yield curves.

We recommend that the proposed use of the OCI to record changes in discount rate should be optional in certain circumstances (for example, to avoid an accounting mismatch).

Question 5—Effective date and transition

Do you agree that the proposed approach to transition appropriately balances comparability with verifiability?

Why or why not? If not, what do you suggest and why?

We agree with the proposed approach to transition.

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Question 6—The likely effects of a Standard for insurance contracts

Considering the proposed Standard as a whole, do you think that the costs of complying with the proposed requirements are justified by the benefits that the information will provide? How are those costs and benefits affected by the proposals in Questions 1–5? How do the costs and benefits compare with any alternative approach that you propose and with the proposals in the 2010 Exposure Draft?

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

In many ways the outcome of the proposed approach in the ED is relatively consistent with current accounting concepts in New Zealand (the Margin on Services methodology). As such, there is likely to be little change and therefore little benefit to New Zealand insurers and users upon adoption of the ED proposals.

However, due to the underlying complexities within the ED proposals, the cost of adoption is expected to be significant. In particular, we highlight the complexity and hence cost associated with the following aspects of the ED:

- Mirroring
- Interest expense and use of OCI
- Increased disclosures
- Calculation of the risk adjustment and disclosure of associated confidence level

For small insurers such as those that predominantly exist in the New Zealand market, such costs are amplified, particularly when there is no real benefit discernable. There is also likely to be additional cost from having to educate users to understand the added complexity.

Question 7—Clarity of drafting Do you agree that the proposals are drafted clearly and reflect the decisions made by the IASB? **If not, please describe any proposal that is not clear. How would you clarify it?**

In our view the following proposals are not clear:

- The application of the mirroring proposals, particularly for complex products such as With-Profits whole of life and endowment
- The interaction between unbundling and mirroring
- How the premium revenue earned in a period should be determined for certain long term contracts where premiums are level.

The Actuarial Profession on New Zealand

Fellows of the New Zealand Society of Actuaries adhere to standards designed to ensure competence, impartial advice and the highest standard of business ethics.

The FNZSA qualification is obtained by:

(1) passing professional exams and meeting the experience requirements of the Institute of Actuaries of Australia or Institute of Actuaries in the UK or other approved examining body recognised by the Society;

(2) being resident in New Zealand or doing work that relates to New Zealand;

(3) meeting ongoing continuing professional development requirements; and

(4) maintaining the highest standard of business ethics as set out in our code of professional conduct and adhering to mandatory practice standards.

Actuarial advice is governed by a code of conduct and relevant standards designed to protect the public interest.

The practice committees which set and review standards comprise experienced actuaries specialising in a practice area. The standards are reviewed by the professional standards committee and Council of the New Zealand Society of Actuaries. Draft standards and revisions thereto are circulated to Fellows as Discussion Drafts and Exposure Drafts before being adopted.

The process allows standards to be updated quickly if required to meet changing circumstances and provides for scrutiny and robust debate during the drafting process.

The New Zealand Society of Actuaries is a full member of the International Actuarial Association as we meet the international benchmarks for qualification, standards, disciplinary process and continuing professional development.

The Society's members are governed by its standards in all work they do whether or not they are remunerated for it. They are required to disclose any potential conflict of interest and to provide advice only if they are competent in that practice area.

Members have a collective responsibility for the maintenance of standards. If they become aware of any potential breach which is not rectified, they must bring the matter to the attention of the Society for consideration of further action.

The New Zealand Society of Actuaries contributes to debate on various matters from the perspective of the public interest rather than the commercial interests of institutions that employ or contract actuaries.

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