



17 October 2007

Technical Director – Accounting Standards
New Zealand Institute of Chartered Accountants
PO Box 11 342
WELLINGTON

Dear Sir/Madam

Request for Comment
IASB Insurance Project Phase II
Discussion Paper: Preliminary Views on Insurance Contracts

This submission is made for and on behalf of the New Zealand Society of Actuaries (NZSA) the professional body representing Actuaries practicing in New Zealand. The NZSA welcomes the opportunity to provide feedback on the IASB Discussion Paper: Preliminary Views on Insurance Contracts.

Background on New Zealand insurance market

The life insurance market in New Zealand consists of some 30 participants with annual premium income of approximately NZ\$1.3 billion. New contracts sold are predominately 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\$2.6 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\$3.3 billion.

New Zealand's health insurance market has annual premium income of approximately NZ\$760m. This market is progressively moving away from providing primary care benefits, and is focusing more on cover for elective surgery. 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.

We have chosen to comment on those issues brought up in the Discussion Paper that we consider key for New Zealand insurers. These are as follows.

Consistent Treatment across Insurance Classes

Actuaries in New Zealand work within each of the life, general (“non-life”) and health insurance classes. At a high level we are supportive of a consistent accounting treatment across each of these



classes as proposed in the discussion paper. However we do recognise that given the historical differences in their accounting treatment over time, this change may result in some unintended consequences and transitional issues will need to be carefully considered.

Volatility from “Current Exit Value” Approach

Whilst we believe that there are some theoretically attractive aspects of the proposed “current exit value” approach (such as recognising profit on inception), we believe that this will inevitably result in increased volatility in the reported profit/loss of insurance entities. This is not to say that their accounts will be open to manipulation, but rather that the range of outcomes resulting from “reasonable” assumptions could be wider than currently experienced.

In our view, the risks associated with such volatility in earnings outweigh the benefits of moving to this approach.

Renewal Premiums

The model proposed is based on a discounted future cash flow model. The Discussion Paper discusses the extent to which future premiums should be included as part of the cash flows being modelled, and in particular focuses on those future premiums which are expected but which the policyholder is not compelled to pay.

The Discussion Draft proposes in Section 154 “that future premiums (and resulting additional benefit payments to policyholders) should be included in the recognised part of the customer relationship (and hence in the overall measurement of the insurance liability) if, and only if, any of the following criteria is met:

- (a) the policyholder must pay the premiums to retain guaranteed insurability (a right that permits continued coverage without reconfirmation of the policyholder’s risk profile and at a price that is contractually constrained)
- (b) the insurer can compel the policyholder to pay the premiums
- (c) including the premiums and the resulting policyholder benefits will increase the measurement of the liability.”

In the New Zealand life insurance market, the majority of new business written has the following characteristics:

- premiums increase with the age of the life insured;
- the policyholder must pay the premiums in order to retain continued insurance cover;
- the policyholder can do so without reconfirmation of the life insured’s risk profile;
- premium rates are not guaranteed but can only be changed by the insurer (increased or reduced) as long as the rates are so changed for all similar policies and/or policyholders.

Within the New Zealand life insurance market, such premiums, and resulting policyholder benefit payments, would be taken into consideration and valued as part of a transfer of business to a third party. We believe therefore that such premiums should form part of a theoretical current exit value and hence should be included in the liability calculation for an insurance contract.



If such premiums (and additional benefit payments to policyholders) are not included in the policy liability, the consequences would be that the expected profit emerging from such contracts would be significantly negative in the first policy year due to large acquisition expenses and acquisition commission and then positive in following years. We do not believe that such a profit signature will provide users of accounts with useful information regarding the financial position of the entity. For example, a growing company, writing profitable business, would potentially show losses for many years together with policy liabilities close to zero.

We would like to see further clarification of this issue by the IASB to ensure that such premiums are included in the policy liability. We are conscious that this issue is an issue predominately for life insurers and that any definition would need to be specific enough not to capture future general insurance premiums.

We would not wish to see the manipulation of policy terms and conditions in an attempt to meet the “contractually constrained” definition. This would be an undesirable outcome of what should be a purely accounting change.

Acquisition Costs

Under the IASB proposals, acquisition costs would be recognised as incurred, and only “deferred” (implicitly) to extent that they are priced for in future premiums and future premiums are included in liability determination (refer section 165).

We have already discussed above the implications of this where future premiums, designed in part to recoup initial expenses, are not able to be included in the liability determination.

There is the potential that in distribution competitive markets, where there is pressure to pay high commissions, this could cause more volatility and lead to changes in pricing decisions, product design and distribution channel structures. Again this is an undesirable outcome of what should be a purely accounting change.

Where acquisition costs cannot be deferred even implicitly, this treatment appears to be at odds with the treatment of acquisition costs in NZ IAS 18 whereby at least some such costs can be deferred.

Treatment of Participating Business

The IASB proposals would see policyholder bonus and/or dividends included in liabilities only to the extent that they “satisfy a legal or constructive obligation that exists at the reporting date” (refer section 254).

IAS 37 defines a constructive obligation as “an obligation that derives from an entity’s actions where:

- by an established pattern of past practice, published policies or sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and
- as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.”



It is unclear whether policyholder unvested benefits (i.e. amounts earmarked for future policyholder bonus, but yet to be declared) would meet the definition of a “constructive obligation”.

If policyholder unvested benefits are not included in liabilities but instead in equity, this could give a false impression to users of accounts (both policyholders and shareholders) that such amounts are not potential liabilities with the result that they could be used in the business for other purposes. We are concerned that this result would not be fair to policyholders.

We therefore wish to see further clarification by the IASB regarding the treatment of policyholder bonuses such that amounts clearly identified by the entity as unvested policyholder benefits are included as part of policy liabilities and not equity.

Estimates of Future Cash Flows

Sections 39 and 40 of the Discussion Paper imply that a stochastic approach to the modelling of expected future cash flows will be required. For smaller entities, this degree of modelling is likely to be prohibitive from a cost point of view.

There is also an implicit assumption that probability distributions relating to each cash flow/assumption can be found and demonstrated to be robust. In our view this is most unlikely to be the case.

The NZSA would like to see this issue further addressed by the IASB with acknowledgment that the degree of modelling sophistication should be appropriate for the size of the entity.

Discounting of Non-Life Claims Liabilities

We are supportive of the view outlined in sections 66-68 that all insurance liabilities, including non-life claims liabilities, should be discounted. Non-life claims liabilities are discounted in New Zealand (where material) and we would support this continuing as we believe it is consistent with giving a “true and fair” value of these liabilities.

Market information

Under the proposed “current exit value” approach the recommendations are that market assumptions are used rather than entity-specific assumptions. Apart from financial information and some market data on mortality, no market information exists in New Zealand with regard to any other assumptions.

There is very little portfolio transfer activity in the market, if any. Where there has been, there is usually little information released to the market that would allow assumption sets to be determined.

The non-economic information that does exist is often not directly applicable to specific portfolios of business as it is not at a detailed enough level. Therefore entities will end up using entity specific information by default.

This situation is discussed in sections 59-62 in the discussion paper with reference to the costs of servicing insurance contracts. We agree with the statement in section 59 that “the measurement of an insurance liability should reflect the servicing costs that the insurer expects to incur” as opposed



to any “hypothetical cash flows that would occur only in the unlikely event that the insurer transfers the liability to another party”. It seems appropriate that an insurer should reflect any competitive advantage/disadvantage in claims handling (for example) in the measurement of its liabilities.

As acknowledged in section 62, in practice insurers are likely to use their own assumptions, particularly in light of the lack of market information, and as such we do not support the recommendation to use market assumptions.

However, should this recommendation be adopted it would be instructive for the IASB to give further guidance as to how assumption sets should be determined where no market data exists.

Risk/Service Margins

Similar comments apply to the identification of risk and service margins, which are also proposed to be “market consistent”. In reality there is no New Zealand market information from which these could be determined.

We note again the need to be able to take an approach that is relevant to the size of the entity and that is not overly costly to implement and manage.

Also, we disagree with the Board’s preliminary view in section 202 (b) that risk margins should be determined at a portfolio level, and that diversification benefits and negative correlations between portfolios should not be reflected in risk margins. Currently insurers are allowed to recognise such benefits.

We believe that risk margins should be set at a level that is consistent with the way the insurer manages their business and that in most cases this will be at an entity level rather than a portfolio level.

Diversifying an insurer’s business by entering new geographical areas, new product lines etc. can be an important part of their risk management approach and lead to more efficient use of capital. Such strategies therefore impact on capital management, reinsurance strategies, pricing etc. On that basis we believe it to be appropriate that these diversification benefits are reflected in the claims liabilities.

In addition, we would anticipate that removing diversification benefits may significantly increase the claims liabilities of some insurer’s and that this would not be a true reflection on the nature of their business.

Asset Valuation

Currently Appendix C of NZ IFRS 4 mandates that assets backing life insurance and life investment contract must be valued at “fair value through profit or loss”. The IASB proposals do not continue this requirement.

Should insurers value assets at other than “fair value through profit or loss” this could lead to a mismatch between assets and liabilities. Should different insurers use different methods, consistency between companies will be reduced.



As noted in section 176 of the Discussion Paper, it “costs time and money for insurers to explain volatility caused by accounting mismatches even to sophisticated users. Less sophisticated users may not understand these effects at all.”

Some accounting mismatches remain for certain assets backing insurance liabilities, in particular treasury shares, owner occupied property, and investments in controlled entities.

We would like to see the IASB address the issue of accounting mismatches between insurance assets and liabilities within the final accounting standard for insurance contracts.

Elimination of differences in accounting treatment of investment contracts and insurance contracts in the life insurance sector

We would welcome further work by the IASB on attempting to eliminate differences in accounting treatment of investment contracts and insurance contracts in the life insurance sector. In particular, we would wish to see the opportunities for potential accounting arbitrage severely limited.

General Comments

It is clear that the proposed methodology will increase greatly the volatility of profit reported by insurers within New Zealand and globally. In particular, the impact of a change in expected future experience will flow directly through to profit. The financial impact of such changes can be significant.

A key issue for especially smaller New Zealand insurers will be the potential complexity of the resulting new standard resulting in increased systems, actuarial and audit costs. 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 sincerely
For/New Zealand Society of Actuaries (Inc)

Handwritten signature of Peter Brown in black ink.

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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.

Typically, it takes about 7 years post-graduate study to qualify as an actuary, with the training providing a thorough grounding for the complex financial analysis that underlies the provision of actuarial advice.

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.