VALUATION STANDARD REVIEW TASK FORCE

Discussion Note: Initial and Ongoing Profit Impacts of the Transition to Risk Free Discount Rates under AASB 1038

1 DISCUSSION NOTE STATUS

1.1 This note was prepared by the Valuation Standard Review Task Force (TF) of the Institute of Actuaries of Australia ("IAAust") in February 2005. This discussion note does not represent a professional standard or a guidance note of the IAAust and it has been prepared for the purposes of generating discussion on the profit impact of the transition to Risk Free Discount Rates under AASB 1038. This note does not constitute accounting advice.

1.2 Feedback from IAAust members is encouraged and should be forwarded to the Task Force (care of the IAAust) or any member of the Task Force.

1.3 Please note that the views expressed in this note are those of the individual members of the Task Force. They do not necessarily represent the views of their respective employers or the IAAust as a body.

2 BACKGROUND

2.1 In September 2004, the Institute of Actuaries established a task force (TF) to consider the impact of changes to AASB 1038 on existing actuarial standards and guidance.

2.2 The revisions to AASB 1038 have raised a number of issues that require early public discussion. The TF will release a series of discussion notes to facilitate this discussion, accelerate the feedback process and provide market participants with an early indication of the direction of the TF's thinking.

2.3 The TF has a separate note concentrating on the choice of discount rate under the revised AASB 1038. This note considers the expected initial and ongoing profit impacts of applying risk free discount rates when valuing protection insurance, lifetime annuity and other life insurance business where policyholder benefits are not contractually linked to the performance of the assets held.

2.4 The TF's conclusions (and influencing arguments) are presented first with relevant legislation being referenced afterwards.

3 SUMMARY OF CONCLUSIONS

3.1 The impact of moving to a risk free discount rate for some insurance contracts on adoption under IFRS is, in many instances, expected to be re-spread over the remaining term of the insurance contracts through a re-calculation of profit margins.

3.2 Where the methodology adopted to determine policy liabilities has been adjusted to reduce profit volatility, as described in GN258 "Volatility of Results under Actuarial Standard 1.01" issued by the IAAust, re-spreading through profit margins may not give the true IFRS liability and adjustment to the total policy liability may be required.

3.3 Where initial adoption of a risk free discount rate results in the capitalisation of expected future losses for a related product group, this loss should be recognised as a direct adjustment to retained earnings.

3.4 Subsequent to initial adoption, it is appropriate for any change in the risk free discount rate between reporting dates to result in a change in policy liabilities for all non-participating insurance contracts.

3.5 The methods currently adopted by some members to reduce profit volatility related to discount rate changes for liabilities with small, or negative, asset support (eg. 'set and forget') are not appropriate under IFRS.

4 DISCUSSION

4.1 The TF discussed the appropriate treatment of the change to a risk free discount rate under IFRS and concluded that, in most instances, treating the change in discount rate as a change in assumptions (ie. re-spreading through profit margins) gives a result closest to the position that would have been reached if IFRS had always applied.

4.2 Adjustment of the profit margin will be consistent with the treatment of new business under IFRS, as new business profit margins will be set at inception based on the risk free discount rate. Investment mismatch profits/losses will emerge as experience items when (if) they are earned, rather than capitalised in PVPM.

4.3 Loss recognition arising due to the change in discount rate on the initial adoption of IFRS would reflect that profitability of the business is wholly dependent on future investment mismatch profits that have yet to be earned.

4.4 The TF noted that the exact IFRS policy liability position cannot be determined without complete historic data for all policies. Section 12 of AS1.03, “Valuation of Policy Liabilities”, issued by the Life Insurance Actuarial Standards Board, considered this issue with respect to initial adoption of MoS and required the actuary to determine a reasonable estimate of the policy liability based on available data and professional actuarial judgement. The TF noted that similar considerations would be appropriate to establishing the opening liabilities under IFRS.

4.5 The conclusions of the TF were supported by testing simple model point projections for common risk products to demonstrate that the derived IFRS policy liability was materially the same as the liability calculated assuming the IFRS discount rate requirements had applied from policy inception.

4.6 The TF noted that for some products, in some circumstances, this conclusion may need to be tested further. In particular, the TF considered that the conclusion may need further testing where the methodologies described in GN258, “Volatility of Results under Actuarial Standard 1.01”, issued by the IAAust, have been previously applied to reduce profit volatility for products with small, or negative asset backing.

4.7 Where these smoothing methodologies have been applied, the policy liability at any reporting date will be either above or below the policy liability that would otherwise have been derived. On initial adoption of IFRS the Actuary should estimate the current amount of this implicit smoothing adjustment (ie. the current variance from the unadjusted liability) and, if material, make an adjustment to the IFRS policy liability.

4.8 In such cases it is unlikely that complete historic information will be available relating to the entire portfolio of business to enable the true unsmoothed policy liability to be determined and approximate methods will therefore be required. The impact of smoothing (ie. the current under or overstatement of the policy liability relative to the IFRS liability) may be estimated by considering the history of:

(i) the actual discount rate applied at each annual valuation compared to the rate that would have been adopted if smoothing had not been applied; or

(ii) where the discount rate was changed in basis 2, the impact on PVFP at each annual valuation arising from the change in discount rate.

Method (i) would most likely be appropriate where a "set and forget" rate has been adopted and the information required should be readily available.

4.9 The TF was of the view that AAAB1, "First Time Adoption of Australian Equivalents to International Financial Reporting Standards" requires that any loss recognition or reversal resulting from the initial adoption of a risk free discount rate will be an opening IFRS balance sheet adjustment and will not impact profit in the first IFRS reporting period

4.10 Consideration was given to the current range of practices adopted by the industry with respect to the profit impact of changes in the discount rate for business with little or negative asset backing. The TF concluded that the methods described in GN258 are not appropriate under IFRS.

4.11 This conclusion was supported by considering a portfolio of yearly renewable term assurance business. The cash flow profile for this portfolio is not dissimilar to that arising from purchasing a portfolio of bonds. There is an initial outlay, the acquisition cost if writing the contracts from inception or the purchase price if acquiring an in force book, followed by an income stream. For a large portfolio, this income stream is relatively predictable and not subject to significant non-diversifiable risk. The profile, and risk characteristics, of this cash flow may therefore be replicated by purchasing a portfolio of bonds. The bond portfolio would be held at fair value each reporting date with any restatement resulting from investment market movements impacting reported profit for the reporting period. The TF was of the view that the liability with respect to the term assurance portfolio should similarly impact reported profit as a result of changes in the economic conditions.

APPENDIX: SELECTED REFERENCES

AASB 1 – First-time Adoption of Australian Equivalents to International Financial Reporting Standards

11 The accounting policies that an entity uses in its opening Australian-equivalents-to-IFRSs balance sheet may differ from those that it used for the same date using its previous GAAP. The resulting adjustments arise from events and transactions before the date of transition to Australian equivalents to IFRSs. Therefore, an entity shall recognise those adjustments directly in retained earnings (or, if appropriate, another category of equity) at the date of transition to Australian equivalents to IFRSs.

AASB1038 – Life Insurance Contracts

This standard has been revised to incorporate the limited improvements to accounting for insurance contracts required by AASB4 Insurance Contracts (the Australian Equivalent to IFRS4 Insurance Contracts).

8.5 (c) the effects of a change to adopted discount rates and related economic assumptions caused by changes in investment market and general economic conditions shall be recognised as income or expense of the reporting period in which the change occurs;

8.5 (d) material calculation errors and similar errors shall be treated in accordance with AASB108 Accounting Policies, Changes in Accounting Estimates and Errors.

Task Force members:

Megan Beer	megan.beer@au.towerlimited.com
Caroline Bennet	caroline.bennet@trowbridge.com.au
Rob Desoisa	rob.desoisa@amp.com.au
Daniel Longden	daniel_longden@asteron.com.au
Paul Nuttall	PNuttall@colonial.com.au
Jaimie Sach	jaimie.sach@ing.com.au
Mark Stewart	mark.stewart@towersperrin.com