FSC FINANCIAL SERVICES COUNCIL

7 June 2017

Anthony.Regan – by email at Anthony.Regan@TREASURY.GOV.AU

Dear Anthony

Expected Impact of IFRS 17 – Insurance Contracts International Accounting Standard: Request for a Joint Workshop between Treasury, Australian Accounting Standards Board (AASB), Australian Prudential Regulation Authority (APRA) and the Australian Taxation Office (ATO)

The Financial Services Council (FSC) represents Australia's retail and wholesale funds management businesses, superannuation funds, life insurers and financial advisory networks. The FSC has 130 members who are responsible for investing $2 trillion on behalf of more than 11 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Stock Exchange and is the fourth largest pool of managed funds in the world. The FSC promotes best practice for the financial services industry by setting mandatory Standards for its members and providing Guidance Notes to assist in operational efficiency.

In light of the release of the final IFRS 17 Insurance Contracts standard on 18 May 2017 (replacing AASB 1038 for life insurance contracts), we would like to take this opportunity to raise our concerns over the potential for anomalous outcomes that will arise (absent co-ordinated regulator action) due to the high degree of integration between the accounting, income tax and regulatory regimes applying to life insurance companies.

A number of concerns have already been identified with the interaction of issues governed by different regulators. We set out in Appendix A the following examples where co-ordination between regulators is needed to allow for consistent calculation and reporting of tax amounts for accounting and income tax purposes:

- **Basis of measurement of policy liabilities and their misalignment for income tax purposes** - IFRS 17 will change the way policy liabilities are measured for accounting purposes but for income tax they will continue to be valued under prudential standard LPS 340 unless that is updated to align with IFRS 17.

- **Re-bundling of investment contract policies with risk riders** – where risk riders are no longer allowed to be unbundled from an investment contract under IFRS 17 they will be accounted for as a single (investment) contract. However, unless LPS 340 is updated to align with IFRS 17 the risk rider will be separately taxed as an insurance (risk) contract.

Changes to LPS 340 should be effective from the same time that a life insurance company adopts IFRS 17, whether early adopting or not. That is, the revised LPS 340 will only apply to financial years in

which a life insurance company has adopted IFRS 17 to ensure consistency between the reporting regimes.

There are also a number of other tax and non-tax issues emerging where accounting and prudential standard concepts intersect. These will also need co-ordination between regulators. We have included a third example in Appendix A regarding the profit release from participating policies to demonstrate the breadth of interaction of these concepts.

These examples are based on our understanding of how the Australian standard will apply once IFRS 17 is adopted by the AASB.

These examples illustrate the need for Treasury, Australian Accounting Standards Board (AASB), Australian Prudential Regulation Authority (APRA) and the Australian Taxation Office (ATO) to work together in identifying and planning for all issues requiring a coherent and timely response.

Whilst the Australian standard implementing IFRS 17 is expected to have mandatory application for years ending on or after 30 September 2021, we understand that early adoption is expected to be available for the 2018-19 financial year, which could be as early as years ending on 31 December 2018 for some insurers. Life insurers are already evaluating the expected impacts of the proposed accounting standard, giving rise to an urgent need for clarity on how each regulatory regime will interact. In order to enable insurers to early adopt IFRS 17, it is recommended that clarity and alignment is achieved by 31 December 2017.

Requested approach

Given the option to adopt the standard from years ending on 31 December 2018, we urge that early action be taken and recommend a joint workshop with industry bodies by Treasury, APRA, the AASB and ATO as soon as possible, preferably in June 2017 (before 30 June financial year-ends) such that the issues are fully understood and appropriate solutions are designed.

We would appreciate the opportunity to discuss these issues further with you if necessary. Please do not hesitate to contact me on 02 9299 3022.

Yours sincerely,

Allan Hansell
Director of Policy & Global Markets

APPENDIX A

1. BASIS OF MEASUREMENT MISALIGNMENT FOR INCOME TAX PURPOSES – RISK POLICIES

We set out below two examples of anomalous outcomes that will arise under Division 320 of the *Income Tax Assessment Act 1997* once IFRS 17 is adopted because Division 320 currently relies on the APRA valuation standard (LPS 340 Valuation of Policy Liabilities).

> ***Issue:*** As outlined below, unless LPS 340 is updated to align with IFRS 17, any life insurers that early adopt IFRS 17 will be faced with a misalignment between the valuation of continuous disability policies for prudential standards, accounting & income tax purposes.
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> ***Requested approach:*** APRA to update LPS 340 to align with IFRS 17. Changes to LPS 340 should be effective from the same time that a life insurance company adopts IFRS 17, whether early adopting or not. That is, the revised LPS 340 will only apply to financial years in which a life insurance company has adopted IFRS 17 to ensure consistency between the reporting regimes.

a) Treatment of acquisition expenses

Division 320 currently refers to the value of the net risk components of certain life insurance policies (continuous disability policies) as an amount that is valued in accordance with a prudential standard (LPS 340 Valuation of Policy Liabilities) made under section 230A of the *Life Insurance Act 1995*.

Although the valuation of life insurance policies for the purpose of preparing the financial statements under existing accounting standards AASB 1023 and AASB 1038 aligns with the principles and practices of LPS 340 for valuing life insurance policy liabilities, this is not the case under the proposed new accounting standard IFRS 17.

Under LPS 340, acquisition expenses not recovered by the establishment fees must be charged against expected future profits (i.e. giving rise to DAC), provided these profits are sufficient to recover them. However, under IFRS 17, only direct attributable costs will be charged against future profits, with the remaining acquisition costs immediately expensed in the Profit and Loss Statement.

Unless LPS 340 is updated to align with IFRS 17, any life insurers that early adopt IFRS 17 will be faced with a misalignment between the valuation of continuous disability policies for income tax purposes (including DAC) and for accounting purposes (excluding DAC), with consequences including:

- Financial accounts will be prepared under IFRS 17 but include current and deferred tax amounts calculated on a different basis under LPS 340 (with life insurers also needing to prepare policy valuations on different bases for financial accounting vs APRA reporting purposes) – this would mean tax balances in IFRS 17 compliant accounts would be meaningless; and

- The deduction of acquisition costs for income tax purposes will no longer align with the accounting treatment as policy liabilities under IFRS 17 will exclude many acquisition costs but a deduction will not be available for those costs until a later time.

This issue can be resolved by updating LPS 340 to align with IFRS 17. If this occurs, it is expected that the exclusion of acquisition costs from existing policy liability values will bring forward tax deductions for those acquisition costs because Division 320 applies by reference to policy liability values (e.g. Sections 320-15(1)(h) and 320-85 of the *Income Tax Assessment Act 1997*). The availability of this deduction appropriately reflects acquisition costs.

The timing of the deduction of acquisition costs may need to be discussed between Treasury, the ATO and industry bodies to consider alternatives for dealing with this timing difference, such as allowing a life insurance company the choice between simplicity (deducting in the year of transition, which would not alter the current legislative framework in Division 320) or a discrete legislative amendment to spread the timing for the tax deduction, e.g. a number of other legislative provisions have spread income tax deductions over 4-5 year periods, such as TOFA transitional deductions over 4 years and the convertible foreign loss rules over 5 years.

b) Level of aggregration (unit of account)

As noted above, Division 320 currently refers to the value of the net risk components of certain life insurance policies as an amount that is valued in accordance with a prudential standard (LPS 340 Valuation of Policy Liabilities) made under section 230A of the *Life Insurance Act 1995*. For loss making policies, this valuation is adjusted for Division 320 purposes to exclude the sum of any cumulative losses (as defined in LPS 340, refer paragraphs 115-121) for the net risk components of the policies at that time (refer to subsection 320-85(4)).

In determining whether there are any cumulative losses under LPS 340, a comparison of the value of future profits to the "adequacy threshold" for a related product group is made.

A related product group is used as a unit of account in LPS 340 and is defined to mean a grouping of products where the products are considered by an appointed actuary to exhibit benefit characteristics and pricing structures sufficiently similar as to justify their grouping for the purposes of profit margin calculation, loss recognition or reporting.

Under the new IFRS 17, a portfolio level unit of account will instead be used. This involves identifying portfolios of insurance contracts that provide coverage for similar risks and are managed together as a single pool. Contracts within a product line would be expected to have similar risks and contracts in different product lines would be expected to be in different portfolios. Further, a portfolio is split into a group of contracts, being identified as contracts onerous at inception (identification of onerous contracts replaces the liability adequacy test), contracts with no significant risk of becoming onerous and other contracts.

Under these changes, it is expected that there will be more granularity in contract groupings for the purposes of valuing policies and identifying onerous contracts, with more contracts to be recognized as "onerous" because of the lower levels of aggregation (insurers will not always be able to offset individual loss-making contracts against profitable ones within the same product group).

Unless LPS 340 is updated to align with IFRS 17, any life insurers that early adopt IFRS 17 will be required to include current and deferred tax amounts calculated on a different basis based on cumulative losses (and related product groups) under LPS 340 - this would mean tax balances in IFRS 17 compliant accounts would be meaningless where cumulative losses exist.

This can be resolved if LPS 340 is updated to align with IFRS 17. There would continue to be an accounting to tax timing difference in respect of losses but the calculation of this amount for income tax would align with both accounting and prudential standard requirements.

2. RE-BUNDLING OF LIFE INVESTMENT CONTRACT POLICIES WITH RISK RIDERS

Issue: As outlined below, unless LPS 340 is updated in response to the expected changes under IFRS 17, any life insurers that early adopt IFRS 17 will be faced with a misalignment between the unbundling requirements under IFRS 17 and LPS 340, with flow-on consequences for income tax as different policies will be recognised under Division 320 of the *Income Tax Assessment Act 1997*.

Requested approach: APRA, the AASB, Treasury and ATO to consult with industry on an appropriate approach to achieve alignment between IFRS 17 and LPS 340 with due consideration of the income tax consequences.

Statutory Funds

Investment-linked contracts written in life insurance companies often have risk riders attached to those contracts.

The Life Insurance Act (1995) Section 31(b) requires that the investment-linked benefit be held in a different Statutory Fund to the life insurance benefit.

Re-bundling of policies

Under the existing accounting standard AASB 1038, contracts are permitted to be unbundled into separate insurance (protection) and deposit components if (and only if) the deposit component can be measured separately. To unbundle a life insurance contract, the insurance component must be treated as a life insurance contract. The deposit component must be treated as a separate life insurance contract if it includes a discretionary participation feature. Otherwise, the deposit component must be treated as a life investment contract (and AASB 139 will apply).

For the purposes of the *Life Insurance Act 1995*, prudential standard LPS 340 refers to unbundling contracts under AASB 1038, with further requirements to unbundle contracts where for example a contract contains both investment-linked and non-investment linked benefit options.

Under the new IFRS 17 standard, investment contract policies with risk riders may not be allowed to be unbundled and hence some of what are currently classified as investment contracts may be insurance contracts instead (with different profit patterns).

An example of this is an investment linked contract with a death risk rider written as a single individual contract with a policyholder. Where the termination of the investment linked component of the contract would result in the termination of the death risk rider component of the contract (even where there was a continuation option to enable a person to continue insurance cover in a different product if the contract was terminated), then we expect that under IFRS 17 the contract would not be allowed to be unbundled. Historical treatment of contracts as separate contracts under AASB 1038 / AASB 139 and LPS 340 will cease and the contracts will be re-bundled as a single insurance contract to be valued under IFRS 17.

Life insurance companies have historically recognised separate contracts for investment linked contract policies with risk riders. These are also separately recognised by life insurance companies in identifying the income tax treatment of these policies under Division 320 of the *Income Tax Assessment Act 1997*.

Unless LPS 340 is updated in response to the expected changes under IFRS 17, any life insurers that early adopt IFRS 17 will be faced with a misalignment between the unbundling requirements under IFRS 17 and LPS 340, with flow-on consequences for income tax as different policies will be recognised under Division 320 (e.g. if a risk rider is no longer separately recognised, both the investment linked contract and risk rider will need to be treated as an investment policy for income tax purposes (but this won't happen until LPS 340 is updated), with the basis of taxation for the risk rider changing substantially once aligned as premiums, claims and policy liability movements will no longer be assessable or deductible, as relevant for income tax purposes).

Furthermore, as the contract is divided between 2 statutory funds as required by the Life Insurance Act (1995) there is currently a lack of clarity regarding how the value of the combined contract should be divided between the 2 statutory funds.

3. PROFIT RELEASE OF PARTICIPATING POLICIES – EXAMPLE OF NON-TAX INTERACTION ISSUES

Link between Shareholder and Policyholder Profits

The Life Insurance Act (Section 60) states that Australian participating business must have at least 80% of profits and no more than 80% of losses (or a higher figure if specified in the company's constitution) allocated to Australian Policy Owners' Retained Profits. The remainder must be allocated to Shareholders' Retained Profits (Australian Participating).

The Life Insurance Act (Section 62(5)) states that the prudential standards may prohibit the distribution of shareholders' retained profits (Australian participating) unless the distribution is in accordance with specified requirements relating to the distribution of Australian policy owners' retained profits.

APRA Life Prudential Standard for Statutory Funds (LPS 600) Section 31 does not permit distribution of shareholder's retained profits (Australian Participating) from a statutory fund unless there is at the same time a distribution of Australian Policy Owners' Retained Profits from the Statutory Fund and immediately after the distribution, the shareholders' retained profits (Australian participating) of the statutory fund that remain undistributed are less than 25% (or such lower percentage as is specified in the company's constitution) of the Australian policy owners' retained profits of the statutory fund that remain undistributed. Essentially this means that the shareholder earns profits when the policy owner bonuses are paid and the ratio of shareholder profit to policy owner bonuses is 20%/80% (or as specified in the company's constitution).

APRA Life Prudential Standard for Valuation of Policy Liabilities (LPS 340) Section 104 makes a distinction between allocation of profit and distribution of profit. For participating policies the operating profit needs to be allocated between policy owner and shareholder and this allocation will act to increase Australian Policy Owners' Retained Profits and Shareholder's Retained Profits

(Australian Participating). The Distribution of Profit (or earning of profit) occurs when bonuses are paid.

IFRS 17 does not particularly have a concept of Australian Policy Owners' Retained Profits nor Shareholder Retained Profits (Australian participating). Profit in the form of a contractual service margin is earned in a pattern which reflects the expected duration and size of the contracts in the group, together with (if experience emerges as expected) the unwind of the risk adjustment. Thus there is now no direct link between the earning of profit by the shareholder and the payment of bonuses to the policy owner.