Australian Government
Australian Accounting Standards Board

XRB | Te Kāwai Ārahi Pūrongo Mōwaho
EXTERNAL REPORTING BOARD

Staff Paper

Project:	**Insurance Activities in the Public Sector**	**Meeting:**	AASB September 2022 (M190) NZASB October 2022 (M103)
Topic:	Risk adjustments in measuring insurance liabilities	**Agenda item:**	AASB 4.6 NZASB 7.6
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Objectives of this paper

1. The objectives of this paper are for the AASB and the NZASB to:

   (a) NOTE the Board's decisions at their August 2022 meetings on risk adjustments;

   (b) CONSIDER additional feedback received from staff liaison with actuarial stakeholders in Australia and New Zealand; and

   (c) DECIDE on the deliberations that should be included in the Basis for Conclusions to the Amending Standard.

The Boards' decisions in August

2. In AASB ED 319/NZASB ED 2022-3 *Insurance Contracts in the Public Sector* the AASB proposed no public sector modifications to the risk adjustment requirements, while the NZASB proposed a rebuttable presumption that there be a risk adjustment measured at a 75% level of confidence.

3. Based on the feedback received on AASB ED 319/NZASB ED 2022-3, both Boards decided at their August meetings not to have public sector modifications to the risk adjustment requirements.

4. Staff proposed including guidance on applying the risk adjustment requirements in a public sector context. However, at their August 2022 meetings, both Boards rejected including the guidance on the basis that:

   (a) there is relevant guidance in AASB 17/PBE IFRS 17 *Insurance Contracts* regarding risk adjustments; and

   (b) they have decided not to modify the AASB 17/PBE IFRS 17 risk adjustment requirements for public sector entities; therefore, further guidance (of itself) could be perceived as a modification.

5. The Boards agreed to incorporate in the Basis for Conclusions public sector context on applying the risk adjustment requirements in AASB 17/PBE IFRS 17 that formed part of the Boards' deliberations.

Terminology and referencing

6. AASB 17/PBE IFRS 17.37 refers to a risk adjustment reflecting "… the compensation that the entity requires for bearing the uncertainty about the amount and timing of the cash flows that arises from non-financial risk". For brevity, this Agenda Paper refers to 'compensation for bearing risk'.

7. The Basis for Conclusions paragraph numbers quoted in this Agenda paper refer to the numbering in both AASB ED 319/NZASB ED 2022-3. For example, a reference to BC101/BC113 is a reference to paragraph BC101 in AASB ED 319 which is the same as paragraph BC113 in NZASB ED 2022-3.

Additional outreach

8. During August, staff conducted outreach with stakeholders, including in particular Australian and New Zealand actuaries, who will be involved in applying the risk adjustment requirements. The key themes that emerged from that outreach are outlined below.

Compensation for bearing risk – public sector entities versus private sector not-for-profit/public benefit entities

9. Some stakeholders consider that the application of the risk adjustment requirements would be similar for: (i) public sector entities; and (ii) private sector not-for-profit (NFP) entities. They note that:
   (a) the IASB intended IFRS 17 to be applicable to mutual entities that are typically private sector NFP entities; and
   (b) NFP private sector entities with insurance contracts will be required to apply AASB 17/PBE IFRS 17 from 2023, which means that implementation experience for determining risk adjustments will be available prior to 2025 [the proposed transition date for public sector entities].

10. However, other stakeholders noted that the circumstances of public sector entities and NFP private sector entities that might affect an entity's perspectives on risk are fundamentally different. NFP private sector entities would typically need to rely on their own resources to maintain solvency, which could involve building [and, when necessary, re-building] reserves, by including compensation for bearing risk into the pricing of their services. That is, even though these entities may not seek to make a profit from their activities, they would often still need to be compensated for bearing risk and build that margin into their pricing.

11. All private sector entities that issue insurance contracts in Australia and/or New Zealand, including for-profit and NFP private sector entities, would need to be registered as insurers and would face prudential regulation and need to hold risk-weighted regulatory capital.

12. A private sector NFP entity might achieve a state of financial security that means it no longer needs to seek compensation for bearing risk. However, any such entity might also need to address issues around intergenerational equity, which means they may need to consistently, over the long term, set premiums that include compensation for bearing risk.

13. For example, a mutual entity would typically address the issues around intergenerational equity by adopting a business model that involves routinely seeking to be compensated for bearing risk and periodically returning [or at least 'crediting'] any 'excess' capital back to members. In the context of risk adjustments, a mutual entity would generally be the same as its commercial counterparts, except that its customers are also its shareholders/owners.

14. Public sector entities typically have risk mitigation measures in place in the form of implicit or explicit government backing, and often a monopoly position in underwriting particular risks. This risk mitigation differentiates public sector entities from both private sector commercial and NFP entities. That is, unlike their private sector counterparts, public sector entities would ordinarily not rely on being compensated for bearing risk in order to remain a going concern and most have no need to generate returns for distribution.

15. Accordingly, there is a conceptual underpinning for a public sector entity, depending on its circumstances, for having no need to be compensated for bearing insurance risk and, therefore, measuring its insurance contract liabilities at their central estimate, that is, with no risk adjustment.

Risk mitigation measures and capital management

16. The availability of risk mitigation measures, such as access to government guarantees, and potentially funding from general taxation, and a monopoly market position could be significant factors in determining whether an entity would seek to be compensated for bearing risk.

17. Even though they may ultimately have the backing of their controlling government and have the benefit of various external risk mitigation measures, most public sector entities will have a capital management strategy to help ensure the efficient use of capital. The existence of a capital management strategy is not necessarily indicative of an entity that would seek to be compensated for bearing risk. However, a capital management strategy could impact on the extent of an entity's risk adjustment. A capital management strategy might involve entity-based risk mitigation measures, such as a reinsurance program or achieving/maintaining a particular funding to claims ratio above 100%. In some cases, public sector entities are also subject to capital charging to help encourage the effective application of funds.

Break-even pricing

18. Most public sector entities with insurance arrangements set levies/premiums to break even – that is, to cover the costs of expected claims, claims settlement and operating costs, with no margin for bearing risk or to generate a 'profit'. In many cases, there is a legislative or regulatory requirement to underwrite for a break-even result for each accident year.

19. For various reasons, the levies/premiums in any given period may be different from the break-even price. For example, because:

    (a) the entity has included a margin in levies/premiums for capital management purposes in preparation for enhancing future benefits or to make up for previous under-reserving because claims experience has been worse than expected;

    (b) the entity faces a temporary price cap imposed by government designed to help ease cost of living pressures; and

    (c) the entity receives outside funding to help subsidise levies/premiums for all or some groups of policyholders.

20. However, none of these factors necessarily indicates that the entity is seeking to be compensated for bearing risk. Instead, they relate more to implementing the entity's risk mitigation strategy that can be viewed as avoiding the need for risk adjustments. Accordingly, a departure from actual break-even pricing in any particular period does not necessarily mean the entity has departed from the underlying intent to price at break-even levels over the long term.

21. Therefore, the broader issue is whether the intention to consistently achieve break-even pricing would be an indicator that an entity would not have a risk adjustment. The following views have been expressed by stakeholders.

    (a) The intention/requirement to achieve break-even pricing is consistent with an entity not needing to be compensated for bearing risk and, therefore, consistent with an entity not having a risk adjustment.

    (b) Break-even pricing is indicative of having no risk adjustment for the liability for remaining coverage.

    (c) There may be circumstances in which there is a risk adjustment in the liability for incurred claims even though the liability for remaining coverage has no risk adjustment. For example, an entity might find that the level of uncertainty around the amounts and timing of actual claims are greater than initially expected. Such an example is more likely to arise for major event risks, such as earthquakes and cyclones and is less likely for day-to-day events, such as motor vehicle accidents.

    (d) While there may be periods in which actual break-even pricing is not achieved, either based on unexpected claims or other cost experience, or because the entity is undertaking 'capital management' and/or 'capital repair' by intentionally pricing at below or above break-even, this should not undermine an entity's intention/requirement to consistently achieve break-even pricing.

    (e) The extent to which a public sector entity might seek to be compensated for bearing risk could vary depending on its circumstances. These circumstances could include the entity's level of capital, the extent to which the management is treated as operating independently from its controlling government and is not expected to take advantage of any government risk mitigation measures. A relatively independent entity might, for example, be responsible for entering into its own risk mitigation measures, such as a reinsurance program, and/or achieving/maintaining a particular funding to claims ratio above 100%.

Basis for Conclusions

22. The Basis for Conclusions to AASB ED 319/NZASB ED 2022-3 already alludes to some of the above thinking that emerged from recent liaison with stakeholders.

23. Since both Boards have decided not to modify AASB 17/PBE IFRS 17 in respect of risk adjustments, the following text in paragraphs BC114/BC127 and BC115/BC128 in AASB ED 319/NZASB ED 2022-3[1] remains relevant.

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1 Paragraphs BC116/BC128 to BC120/BC132 in AASB ED 319/NZASB ED 2022-3 are no longer relevant given the NZASB's August decision not to proceed with a rebuttable presumption of a risk adjustment determined at a 75% confidence level. However, the final Basis for Conclusions to the modified AASB 17/PBE IFRS 17 will include a 'history' of the Boards' decision making, including the Boards' deliberations on proposals that were not ultimately adopted.

BC114/BC126 The AASB observed that:

(a) most public sector entities do not seek to profit from bearing insurance risk;

(b) under AASB 17, public sector entities might determine a zero risk adjustment on the basis that they are monopolies and can adjust future prices to make up for higher-than-expected past claims;

(c) under AASB 17, public sector entities might determine a risk adjustment based on a particular level of adequacy based on their facts and circumstances; and

(d) providing a benchmark confidence level, even as a rebuttable presumption, is not consistent with principle-based standard setting.

BC115/BC127 Accordingly, the AASB concluded that it would support Approach 1 and propose not making public-sector-specific modifications to the requirement to include a risk adjustment in measuring liabilities for incurred claims.

24. Staff recommend retaining in the Basis for Conclusions the above messages about risk adjustments and supplementing them with factors that have emerged from additional feedback from stakeholders and during the Boards' re-deliberations.

25. In summary, staff recommend including the following factors in the Basis for Conclusions:

(a) Whether a particular public sector entity has a risk adjustment, and the amount of any risk adjustment, would depend on the circumstances of that entity. This would include clarifying, for the avoidance of doubt, that the 'compensation' approach to risk adjustments in the Standard [AASB 17/PBE IFRS 17] is different from the 'inherent variability' approach to risk margins under the superseded Standards [AASB 1023 and AASB 4/PBE IFRS 4].

(b) Clarify, for the avoidance of doubt, that some public sector entities may have no risk adjustments – that is, their liability for remaining coverage and/or their liability for incurred claims may be measured at the central estimate.

(c) The availability of risk mitigation measures, such as access to government guarantees and, potentially funding from general taxation, and a monopoly market position, could be significant factors in determining risk adjustment for public sector entities. These factors may influence whether an entity seeks to be compensated for bearing risk; and influence its level of indifference between fulfilling a liability that has a range of possible outcomes arising from insurance risk and fulfilling a liability that would generate fixed cash flows with the same expected present value.

(d) The extent to which a public sector entity might seek to be compensated for bearing risk, and the significance of the risk mitigation measures such as government guarantees, could depend on the extent to which the entity and its management is treated as operating independently from its controlling government. A relatively independent entity might, for example, be responsible for entering into its own risk mitigation measures, such as a reinsurance program, or maintaining a particular funding to ratio to its liabilities, and would not be expected to relying on measures such as government guarantees.

(e) Break-even pricing could indicate the entity does not seek to be compensated for risk and would not include a risk adjustment in its liability for remaining coverage.

(f) Clarify, for the avoidance of doubt, that some public sector entities may have circumstances in which the risk adjustment in the liability for incurred claims is different from any risk adjustment in the liability for remaining coverage.

Question for Board members

Q1: Do Board members agree with the staff recommendation noted in paragraph 25? If not, what would you suggest?