Australian Government
Australian Accounting Standards Board

AASB Transition Resource Group for AASB 17 *Insurance Contracts*

risk adjustment

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Potential implementation question

The implementation question addressed in this paper is how to practically interpret the AASB 17 requirements to include the risk adjustment for non-financial risk in the future estimate of fulfilment cash flows as required by AASB 17.37.

Paragraph of AASB 17 *Insurance Contracts*

AASB 17.32, 37. AASB 17 Appendix A. AASB 17. AASB 17.B87, B88. AASB 17.119. May 2018 IASB TRG Paper 02

Analysis of the question

The purpose of this paper is to outline **practical issues arising in the determination of the risk adjustment for entities applying AASB 17**. The risk adjustment for non-financial risk is defined in Appendix A of AASB 17 as "*The compensation an entity requires for bearing the uncertainty about the amount and timing of the cash flows that arises from non-financial risk as the entity fulfils insurance contracts".*

AASB 17.B87 states that *"The risk adjustment for non-financial risk for insurance contracts measures the compensation that the entity would require to make the entity indifferent between:*

a) fulfilling a liability that has a range of possible outcomes arising from non-financial risk; and
b) fulfilling a liability that will generate fixed cash flows with the same expected present value as the insurance contracts."

For the purposes of this paper, and to illustrate the relevant concepts, the following is assumed to apply.

a) The discussion is based on the LRC versus LIC for a group of contracts as the unit of account.
b) Although there is no explicit risk adjustment in the LRC when the Premium Allocation Approach (PAA) is applied, there is an implicit risk adjustment. In the event that there are facts and circumstances indicating the group of contracts is onerous, the PAA carrying amount would be compared with a fulfilment cash flows measure for the LRC, which would include an explicit risk adjustment. If contracts are onerous the loss component would then require an explicit risk adjustment.
c) The confidence level is assumed to be a quantile approach using a **Probability of Adequacy %** to reflect the entity required level of certainty. It is noted that even when a confidence level % is the same, the different distribution of risk underlying the LIC and LRC within a group[1] may still result in different dollar ($) risk adjustment levels between the LIC and LRC, therefore the dollar ($) amounts are not the focus of this paper.

The fact pattern and discussion questions are included in Appendix A.

Is the question pervasive?

The paper has been discussed in similar form at the PHI focus group of the AASB TRG, the Actuaries Institute Taskforce on AASB 17 and the Accountants and Actuaries Liaison Committee and determined to be pervasive.

1 For example, a group of contracts could include contracts with coverage periods ranging from one year to five years and, in subsequent periods, the LRC would relate only to the contracts with longer coverage periods while the LIC may relate to contracts with both shorter and longer coverage periods.

Appendix A

The fact patterns are included to illustrate two different approaches being considered in implementing AASB 17.

Scenario 1 - The Entity sets a confidence level of **75% on the LIC** for a group of contracts.[2] This is the percentage desired by the Board, reflecting the compensation required to bear the uncertainty in amount and timing of cash flows, but also includes their obligation to meet capital and solvency requirements which they consider when setting their risk appetite. The Entity however sets a confidence level of **60% on the LRC** (implicit for the PAA) and in the measurement of onerous contracts, which is consistent with the desired percentage either included in the Entity's pricing approach for the group of contracts, or, in any other similar compensation targets set in Board policies.

Scenario 2 - The Entity sets a confidence level of **75% on the LIC** for a group of contracts. This is the desired confidence level set by the Board, reflecting the compensation required to bear the uncertainty in amount and timing of cash flows, but also includes their obligation to meet capital and solvency requirements which they consider when setting their risk appetite. The Entity then uses a consistent confidence level of **75% for the LRC** (implicit for the PAA) and when measuring onerous contracts. This results in **recognition of onerous contracts** as the entity actually sets premium amounts based on a confidence level of 60%.

Irrespective of the basis used to determine the risk adjustment, AASB 17 requires disclosure of the confidence level % of the LIC and, for entities applying the general measurement model (GMM) also the LRC. Although the PAA doesn't have an explicit risk adjustment determined for the LRC, there is an implicit risk adjustment within the premium amount (received or earned and not received), which is the basis of measuring the LRC. And any measurement of onerous contracts or 'loss component' would also require the entity to have a view on the appropriate risk adjustment and confidence level related to the LRC under the PAA.

This paper considers the following four questions:

1. Should the confidence level % used to determine the risk adjustment for the LRC be consistent with the entity's premium setting approach?
2. Should the confidence level % be the same for the LIC and the LRC?
3. Will the risk adjustment for the LRC or LIC need to be consistent with the Regulator's Capital Requirements?
4. Are there any additional factors to consider when applying the PAA (rather than the general measurement model) for LRC?

Question 1: Should the confidence level percentage (%) used to determine the risk adjustment for the LRC be consistent with the entity's premium setting approach?

AASB 17 requires determination of a risk adjustment that reflects "*The compensation an entity requires for bearing the uncertainty about the amount and timing of the cash flows that arises from non-financial risk as the entity fulfils insurance contracts".* The reference to 'compensation' is **the amount that the entity would notionally charge**, but would not necessarily be the actual amount of premium charged. If an entity is buying or selling portfolios of business the compensation would be reflected in the risk adjustment determined in measuring the **contracts acquired or sold**.

Premium setting process

In premium setting, the entity in essence determines a **'technical price'** for a product and then adds a **'profit margin'**. The **technical price** determines the compensation for the uncertainty around the amount and timing of the cash-flows from non-financial risk of the product and, therefore implicitly, includes a component related to risk adjustment (incorporating the appropriate level of benefit of diversification) to **a confidence level of 60%.**

[2] Insurers applying the PAA are most likely to first explicitly consider risk adjustments for the LIC as the LRC does not require an explicit risk adjustment when using the PAA.

The profit margin includes compensation for other risks, such as financial risks, expense risk not attributable to insurance contracts, asset liability mismatch risk etc.

An entity may deliberately “under-price” by reducing the profit margin (i.e. CSM) to zero and sometimes further, with an expectation of increasing prices over a number of future renewals. This is particularly the case with 'long tail’ business where the actual degree of under-pricing and required level of price increase may take time to evaluate and establish. An insurer may choose to increase prices over a number of years and would therefore be willing to continue under-pricing until the desired price has been achieved.

View 1:
The confidence level % used for measurement of LRC and onerous contracts (and loss component if applicable) under AASB 17 **needs to be consistent with the premium setting approach (including any profit margin).** For example, an entity that wishes to hold 60% confidence level for technical pricing before profit margin would be expected to use the same approach for the determination of onerous contracts/loss component under AASB 17 (either implicitly under the PAA or explicitly under the GMM).

Proponents of this view argue that the IASB Staff (the staff) believe there is a link to technical pricing, based on the discussion in the May 2018 IASB TRG AP02 where the Staff added: "*the risk adjustment for non-financial risk represents the compensation that the entity **would require** if it was to charge the policyholder an explicit separate amount for bearing non-financial risk"*.

The **staff view** outlined in AP02 was based largely on the last sentence of AASB 17.B87, which states that (emphasis added): "*… , the risk adjustment for non-financial risk conveys information to users of financial statements about **the amount charged by the entity** for the uncertainty arising from non-financial risk about the amount and timing of cash flows*". The staff considered that: "*Determining the compensation that the entity would require for bearing non-financial risk related to insurance contracts issued by the entity is a single decision that is made by the entity that is party to the contract (ie the issuer of the insurance contract)*" [paragraph 21 of AP02]. This implies the pricing approach would be considered when setting the risk adjustment for non-financial risk and is a single decision taken at a particular time. However, given the current nature of risk adjustments, at any given reporting date, the price that would have been charged needs to reflect compensation the insurer would require based on currently-available information.

View 2:
The entity **does not need to consider** the basis of premium setting when determining the confidence level % for the LRC or in the measurement of the loss component for onerous contracts. Decisions made around the actual premium charged are driven by market forces and strategic business decisions and would not necessarily achieve the theoretical "technical price" plus profit margin calculated. For example, an entity that wishes to hold 75% confidence level for LRC on the balance sheet (either implicitly under the PAA or explicitly under the GMM) may use a different confidence level % in premium setting, such as 60%. Potential implications of this include that contracts may then be onerous if the profit margin is insufficient to support the LRC recognition at 75% confidence level across a group of contracts.

Proponents of this view argue that the Summary for the May 2018 TRG notes the following.

> 14. Some TRG members agreed with the staff analysis … .
>
> 15. … Some TRG members commented that they could read the requirements in AASB 17 differently. Those TRG members read the requirements as requiring different measurement of the risk adjustment for non-financial risk for a group of insurance contracts at different reporting levels if the issuing entity would require different compensation for bearing non-financial risk than the consolidated group would require. TRG members observed that:
>
> (a) if the risk adjustment for non-financial risk is determined differently at different reporting levels in the group structure there could be multiple risk adjustments for non-financial risk for the same group of insurance contracts, depending on the reporting level; ….
>
> 16. TRG members also observed that in some cases the compensation that an entity requires for bearing non-financial risk could be evidenced by capital allocation in a group of entities.

Given that the staff view was not shared by a large proportion of TRG members, as recorded in the Meeting Summary, an entity's compensation for bearing risk is not necessarily the result of a single decision that is made by the entity that is party to the contract. Accordingly, the risk adjustment could be based on a different confidence level than the confidence level reflected in the actual pricing.

Question 2: Should the confidence level percentage (%) be the same for the LIC and the LRC?

Relating to the same fact pattern above.

View 1: Even though the risk adjustment need not relate to a single decision made by the entity that is party to the contract, the confidence level % cannot vary between the LIC and LRC within a group of contracts.

The LIC risk adjustment and LRC risk adjustment are intrinsically the same thing, i.e. a representation of the entity's confidence level % at a different point in time, the only difference being that the LRC may include expected future cash inflows from premiums whereas the LIC would be expected to be predominantly cash outflows. Therefore, only one risk adjustment confidence level % would be expected for each group of insurance contracts.

Risk adjustments are determined on a basis that reflects the insurer's business and therefore it would not be expected that an entity's **confidence level %** would differ between the LRC and LIC cash flows.

Proponents of this view argue that this was the intention of the IASB staff, based on the discussion held in the May 2018 IASB TRG Agenda Paper 02. The Staff referred to "*the theoretical amount that would have been required if the entity had considered different compensation for bearing non-financial risk*" (i.e. the ideal / theoretical price that would be charged for uncertainty), implying that the Staff believe the confidence level would be consistent for all cash flows to meet the objective of the risk adjustment for non-financial risk.

If the confidence levels for the LRC and LIC risk adjustments were different, there could be a 'cliff effect' resulting from a lift or fall in confidence level % as the insurance liability transitions from the LRC to the LIC, which would immediately impact profit or loss.

View 2: Depending on the entity "facts and circumstances", the risk adjustments for the LRC and LIC for a group of contracts could have different confidence levels because the entity's view of compensation required to bear risk for a particular group of contracts can evolve over time.

Reasons that may justify differences in the % confidence level for LIC and LRC are considered below:

1. **Current (new) information** – an entity would be expected use current information [AASB 17.33(c) and B54 to B60] when measuring insurance liabilities, which may affect expectations about the amount and timing of cash flows, including informing the entity's current view on the compensation required for bearing the uncertainty about the amount and timing of cash flows. In particular, this could be common when the coverage period for the LRC is relatively short (such as one year), but the claims tail is long (such as decades). It would be inappropriate to only consider the potential impacts of current information on the estimated amounts and timing of cash flows and neglect to consider its potential impact on the confidence level relating to risk adjustments (e.g. information emerges to indicate that underlying data used in cash flow projections does not adequately reflect new and emerging risks and therefore the level of uncertainty and the entity would adjust the required confidence level % accordingly).

2. **Technique** - AASB 17 requires that the confidence level for the risk adjustment in the LIC and LRC is disclosed, it does not specify a confidence level methodology. A risk adjustment must reflect the entity's risk appetite, however, it can be set or expressed in different ways and using different methodologies. Where a different technique is used to determine the risk adjustment for the LRC and LIC (for example a cost of capital (CoC) approach for the LRC and a quantile approach for the LIC), this may result in different confidence levels for the LIC and LRC.

3. **Time Horizon:**

    a. **Renewal expectations of LRC** – when setting the 'desired premium' there is either an implicit or explicit risk adjustment built into the compensation the entity requires. For some products (e.g. homogenous retail business or PHI business) the risk adjustment may take into account not just the single contract issued but the expectation of future renewals which, combined with the ability to reprice, would enable the entity to set a lower % confidence level as the uncertainty can be mitigated over time. Even though future renewals will not form part of the current contract boundary they may

be taken into account by the entity when considering its required compensation for risk. This may be less likely for contracts which are more 'individual' in nature such as one-off complex commercial risks.

b. **Non-renewal nature of the LIC** – uncertainty in the LIC is considered without any expectation of future renewals and therefore all the uncertainty needs to be reflected in the risk adjustment. This may drive a desire for a higher % confidence level, as an entity may require a higher degree of compensation for uncertainty in the LIC cashflows. This is demonstrable in Australian market transactions (business combinations or portfolio transfers) where entities appear to seek a risk margin of at least 75% (which is the level specified by the Regulator for capital purposes).

4. **The existence of the CSM "buffer"** – changes in risk adjustment related to current and past service are reflected in P&L as they occur. Changes in risk adjustment related to future service are reflected in the CSM (explicitly in the GMM and implicitly in the PAA) and the existence of the CSM to provide a "buffer" for uncertainty in the non-financial risk may lead an entity to require a lower confidence level in the LRC vs LIC.

5. **Components of LIC vs LRC** – the LRC includes both expected cash inflows and outflows and to the extent that the uncertainty of inflows and outflows are mitigated this may result in a lower confidence level % required as compensation for uncertainty. The LIC has no, or limited, offsetting cash inflows and, therefore, there may be a desire to hold a larger % confidence level as compensation.

6. **Mix of LIC risks** – the nature and uncertainty of LIC risks may differ compared to LRC risks, even for the same type of product. For example, the LRC includes cashflows relating to all (future) claims, while the LIC only includes cashflows relating to existing claims that have not yet settled. Many general insurance products are characterised by smaller, simpler claims that settle shortly after a claim is made, and larger, more variable claims that take longer to settle. An entity may require a higher degree of compensation (and a higher confidence level) for the LIC because the remaining liabilities are more variable than the liabilities within the LRC. The risk appetite of the entity may differ substantially regarding long tail and complex portfolios.

Different confidence levels for the LRC and LIC risk adjustments would not necessarily result in a 'cliff effect' because a change in confidence level may emerge over time as more relevant (new) information becomes available about the uncertainty of the amount and timing of claims cash flows and, as a result, the entity's view on compensation required to bear the relevant risks evolves.

Question 3: Will the risk adjustment for the LRC or LIC need to be consistent with the Regulator's Capital Requirements?

Additional fact pattern

Existing capital requirements prescribed by the Regulator require a 75% confidence level for the LIC and is focussed on prudential supervision and ensuring adequate solvency to meet claims. Therefore, the entity has set a confidence level of 85% to ensure it is in excess of regulator's capital requirements reflecting the conservative nature of the Board.

View 1:
The risk margin set for capital calculations is specific to the Regulator's requirements and **does not have to be the same** as the AASB 17 risk adjustment **unless** it is also a reflection of "the compensation" an entity requires. For example, an Entity may consider the relevant level of capital required to support insurance contracts when assessing the compensation required for bearing uncertainty in cash flows in order to protect capital. Some products that are more capital intensive than others, such as lenders mortgage, and may carry a higher risk adjustment at inception, which is released throughout the period of cover, to ensure that variation on cash flows does not erode capital. The level of capital required could therefore drive a desire for a higher confidence level% in setting the LIC for some products.

View 2
Any other views?

Question 4: Additional factors to consider when applying the PAA?

For contracts accounted for using the PAA, the insurer assumes no contracts in the portfolio are onerous at initial recognition, unless facts and circumstances indicate otherwise [AASB 17.18].

Additional fact pattern

An insurer that applies the PAA sets the premiums for a group of contracts based on a Combined Operating Ratio Target % and expects to profit from bearing risk over the coverage period. It sets a COR% target of 90%.

Subsequently, the insurer identifies the premiums set for the group of contracts would only achieve the equivalent of a 55% confidence level for the risk adjustment and the confidence level routinely applied to the LIC for each group of contracts is 80%. A key issue is whether this would be regarded, of itself, as a relevant "fact and circumstance" indicating the group of contracts might be onerous.

View 1
The knowledge that the premium set for a group of contracts would only achieve **the equivalent of a 55% confidence level, of itself, is a relevant fact and circumstance** indicating the group of contracts might be onerous.

View 2
Other facts and circumstances indicating the group of contracts might be onerous would also need to be present to justify testing to determine whether the group of contracts is onerous. For example, instead of the expected 90% COR%, early claims indicate the COR% will be 100%. It is relevant to note that an insurer applying the PAA and pricing contracts on a target COR% or a cost of capital basis may not be aware that its contracts would be regarded as onerous if the same confidence level were applied to determine risk adjustments for the LRC and LIC.

Appendix A – Technical references

AASB 17:32 On initial recognition, an entity shall measure a group of insurance contracts at the total of:

a) the fulfilment cash flows, which comprise:
   i. estimates of future cash flows (paragraphs 33–35);
   ii. an adjustment to reflect the time value of money and the financial risks related to the future cash flows, to the extent that the financial risks are not included in the estimates of the future cash flows (paragraph 36); and
   iii. a risk adjustment for non-financial risk (paragraph 37).
b) the contractual service margin, measured applying paragraphs 38–39.

AASB 17.37 An entity shall adjust the estimate of the present value of the future cash flows to reflect 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.

AASB 17 Appendix A Risk adjustment for non-financial risk - The compensation an entity requires for bearing the uncertainty about the amount and timing of the cash flows that arises from non-financial risk as the entity fulfils insurance contracts.

AASB 17.B87 The risk adjustment for non-financial risk for insurance contracts measures the compensation that the entity would require to make the entity indifferent between:

d) fulfilling a liability that has a range of possible outcomes arising from non-financial risk; and
e) fulfilling a liability that will generate fixed cash flows with the same expected present value as the insurance contracts.

AASB 17.B88 Because the risk adjustment for non-financial risk reflects the compensation the entity would require for bearing the non-financial risk arising from the uncertain amount and timing of the cash flows, the risk adjustment for nonfinancial risk also reflects:

a) the degree of diversification benefit the entity includes when determining the compensation it requires for bearing that risk; and
b) both favourable and unfavourable outcomes, in a way that reflects the entity's degree of risk aversion.

AASB 17.119 An entity shall disclose the confidence level used to determine the risk adjustment for non-financial risk. If the entity uses a technique other than the confidence level technique for determining the risk adjustment for nonfinancial risk, it shall disclose the technique used and the confidence level corresponding to the results of that technique.

IASB TRG Agenda Paper references

May 2018 Agenda Paper 02

16. Paragraph B88 of IFRS 17 says 'the compensation the entity **would require** for bearing the non-financial risk' [emphasis added]. The entity does not charge the policyholder an explicit separate amount for bearing non-financial risk. Rather, this is implicit within the overall actual amount charged by the entity. Therefore, the risk adjustment for non-financial risk represents the compensation that the entity would require if it was to charge the policyholder an explicit separate amount for bearing non-financial risk.

17. An entity may choose or be required, for reasons unconnected with bearing that non-financial risk, to charge a premium which does not result in a full recovery of the risk-adjusted cash flows. This could be for legal, commercial or regulatory reasons. Such pricing decisions are reflected in the loss component and consequently in profit or loss. The faithful representation of circumstances in which the entity has charged insufficient premiums for bearing the risk that the claims might ultimately exceed expected premiums was considered by the Board when it decided that a separate risk adjustment was required, as explained in paragraph BC211(c) of the Basis for Conclusions on IFRS 17.

18. The staff view is that the term 'would require' should not be interpreted in a manner that is inconsistent with the objective of the risk adjustment for non-financial risk. Therefore, 'the compensation the entity would require' does not extend to consider the theoretical amount that would have been required if the entity had considered different compensation for bearing non-financial risk.