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 November 2021 (M184) NZASB December 2021
Topic	Risk adjustment – alignment of confidence levels	**Agenda item**	AASB 5.3
		Date	26 October 2021
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		Decision-making	High
		Project status	Board deliberation

Objective of this paper

1. The objective of this paper is for the AASB and the NZASB to:

    (a) be briefed on an interpretation issue potentially affecting all insurers regarding whether, under AASB 17/PBE IFRS 17 *Insurance Contracts*, the risk adjustment for a liability for remaining coverage and the risk adjustment for the related liability for incurred claims must achieve the same confidence level;[1] and

    (b) **decide** whether to incorporate content on this issue in the forthcoming Exposure Draft *Accounting for insurance contracts in the public sector – Proposed Amendments to AASB 17/PBE IFRS 17* Insurance Contracts.

Summary of staff recommendations

2. Staff recommend that the Boards not make any specific proposals in the Exposure Draft about the interpretation issue noted in paragraph 1(a).

3. Staff also recommend, in the Basis for Conclusions to the Exposure Draft, the Boards:

    (a) acknowledge the interpretation issue; and

    (b) include observations of current public sector practices[2] regarding confidence levels used to determine risk adjustments for liabilities for remaining coverage and risk adjustments for the related liabilities for incurred claims.

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1 The 'confidence level' generally refers to a percentage of adequacy. That is, for example, a liability having a confidence level of 75% means that the liability is estimated to be adequate to meet actual claims (and related costs) three years in every four years (i.e. 75% of the time).

2 That is, current practices in the context of AASB 1023/PBE IFRS 4 and the risk margins used in measuring 'unexpired risk liabilities' (under the liability adequacy test) and the related 'outstanding claims liabilities'.

4. Please note that the working draft Exposure Draft (Agenda Paper 5.2) does not currently mention this issue.

Structure of this paper

5. This staff paper is set out in three sections:

   - Section 1 summarises the current proposals of each Board on public sector entities applying the risk adjustment requirements of AASB 17/PBE IFRS 17 to measure liabilities for incurred claims (paragraphs 6 –8).
   - Section 2 discusses confidence levels to be used for measuring liabilities for remaining coverage versus confidence levels used for measuring related liabilities for incurred claims under IFRS 17 (paragraphs 9–22).
   - Section 3 includes the staff recommended approach (paragraphs 23–26).

Section 1 Boards' current proposals on risk adjustments regarding measurement of liabilities for incurred claims

6. The AASB has decided to propose no modifications to AASB 17 regarding the requirement to include a risk adjustment for non-financial risk in measuring a liability for incurred claims, for the reasons identified in paragraphs BC165 to BC166 of the working draft Exposure Draft (Agenda Paper 5.2).

7. The NZASB has decided to propose modifications to PBE IFRS 17 that would require a public sector entity to apply a rebuttable presumption that the compensation the entity requires for bearing the uncertainty about the amount and timing of the cash flows that arises from non-financial risk is an adjustment to reflect a 75% confidence level for liabilities for incurred claims.

8. The NZASB's reasons for proposing the modifications are identified in paragraphs BC167–BC171 of the working draft Exposure Draft.

Section 2: Confidence levels – liability for remaining coverage versus liability for incurred claims

9. The Table below outlines the liability measurement (including risk adjustment) requirements under AASB 17/PBE IFRS 17 and AASB 1023/PBE IFRS 4.

AASB 17/PBE IFRS 17	AASB 1023/PBE IFRS 4	Comments
Liability for remaining coverage		
General model: The fulfilment cash flows, which include a **risk adjustment** for non-financial risk related to expected future events, plus a contractual service margin, if any [AASB 17/PBE IFRS 17.32]	**Unearned premium (UEP):** Premium that has not been recognised in the statement of comprehensive income is premium that is unearned and recognised in the statement of financial position as an unearned premium liability	There is an explicit risk adjustment under the general model. The risk adjustment under the PAA and UEP is (only) implicit in the
Premium Allocation Approach (PAA): Premiums, if any, received, minus any insurance acquisition cash flows, plus or		

AASB 17/PBE IFRS 17	AASB 1023/PBE IFRS 4	Comments
minus any amount arising from the derecognition any asset for insurance acquisition cash flows … [AASB 17/PBE IFRS 17.55]	[AASB 1023.7.1/PBE IFRS 4 Appendix D.7.1]	pricing of the premiums.
Inadequacy of liability for remaining coverage (loss components)		
General model: As above, automatically takes into account expected losses – instead of a contractual service margin there is a 'loss component' [AASB 17/PBE IFRS 17.49] **PAA:** If facts and circumstances indicate insurance contracts are onerous – the loss equals the difference between the PAA and general model liabilities for remaining coverage [AASB 17/PBE IFRS 17.57]	**UEP:** If the PV of cash flows for expected future claims, plus an additional **risk margin** to reflect inherent uncertainty in the central estimate, exceed the UEP less related deferred acquisition costs (DAC) – DAC is written off and any remaining deficiency is a loss and unexpired risk liability [AASB 1023.9.1/PBE IFRS 4 Appendix D.9.1]	Risk adjustments are taken into account in determining whether a liability for remaining coverage is adequate under all measurement approaches (general model, PAA and UEP).
Liability for incurred claims		
General model: As above, the fulfilment cash flows, which include a **risk adjustment** for non-financial risk related to expected future events [AASB 17/PBE IFRS 17.40(b)]	The central estimate of the PV of expected future payments for claims incurred with an **additional risk margin** to allow for inherent uncertainty [AASB 1023.5.1/PBE IFRS 4 Appendix D.5.1]	Risk adjustments are taken into account in determining liabilities for incurred claims under both Standards.

Current practice

10. Practice has developed under AASB 1023/PBE IFRS 4[3] such that the risk margin used to determine whether a liability for remaining coverage (unearned premium liability) is inadequate/onerous can be different (usually a lower confidence level) than the risk adjustment used to determine a liability for incurred claims. For example, it is common in the private for-profit sector for:

    (a) the confidence level applied to a liability for incurred claims to be between 80% and 90%, while

    (b) the confidence level implicit in premiums (used as the basis for an unearned premium liability) to be 75%.

    If a commercial private sector insurer were to charge premiums that met an 80% to 90% confidence level, in many markets, the insurer would be uncompetitive.

11. Practice in the public sector is varied:

    (a) some entities (probably most) are applying the same confidence level to the risk adjustments in their liability for incurred claims as they apply to the risk adjustments

3 Please note the same issue has emerged in many jurisdictions, not only Australia-New Zealand.

used in performing the liability adequacy test and, therefore, measuring their unexpired risk liability; and

(b) some entities are applying a higher confidence level to the risk adjustments in their liability for incurred claims compared with the confidence level for the risk adjustment they use in performing the liability adequacy test and, therefore, measuring their unexpired risk liability.

Interpretation issue

12. An issue that is currently being debated within the insurance industry is whether, under IFRS 17, insurers are permitted to continue using different confidence levels for the risk adjustments for measuring different insurance liabilities. That is, for example, can an insurer apply:

(a) a 75% confidence level to measure the risk adjustment either:

(i) under the general model for a liability for remaining coverage; or

(ii) in assessing the adequacy of a PAA, the liability for remaining coverage; versus

(b) an 85% confidence level to measure the risk adjustment for a related liability for incurred claims?

13. Some stakeholders consider that the confidence level for risk adjustments relating to the two liabilities must be the same, while others do not.

What's changed?

14. Some stakeholders might argue that AASB 1023/PBE IFRS 4 already implies that the same confidence level would be used for risk adjustments in measuring unexpired risk liabilities and the related liabilities for incurred claims. However, other stakeholders consider there are two main differences (see the Table below) between AASB 1023/PBE IFRS 4 and AASB 17/PBE IFRS 17 that more strongly imply the same confidence levels should be used.

AASB 17/PBE IFRS 17	***AASB 1023/PBE IFRS 4***	***Comments***
The PAA is designed to be a simplified measure of the general model liability for remaining coverage. [The general model is the default approach and involves discounting expected future cash flows – it can be applied to measure both liabilities for remaining coverage and liabilities for incurred claims[4]]	Under AASB 1023/ PBE IFRS 4: (a) the unearned premium liability is based on actual premiums, and not directly on expected cash flows; whereas (b) the liability for incurred claims is measured using discounted expected cash flows	Under AASB 17/PBE IFRS 17, there is a direct connection between the measurement bases for liabilities for remaining coverage and liabilities for incurred claims Under AASB 1023/ PBE IFRS 4 the two liabilities are measured on two different bases

4 Under the general model, the measurement basis for a liability for remaining coverage and a liability for incurred claims are the same, except the liability for incurred claims has no CSM or loss component.

AASB 17/PBE IFRS 17	*AASB 1023/PBE IFRS 4*	*Comments*
The notion of a risk adjustment being 'compensation' for bearing risk can be viewed as needing to be applied consistently to liabilities for remaining coverage and liabilities for incurred claims That is, in concept, all other things being equal, the extent to which an insurer wants to be compensated shouldn't change as between coverage and claims in terms of the confidence level[5]	There is no underlying principle (such as compensation for bearing risk) for measuring risk margins – they can be regarded as simply reflecting the inherent uncertainty of cash flows for a nominated confidence level	The absence of an underlying principle (such as compensation for bearing risk) potentially leaves the way open to wider interpretation under AASB 1023/ PBE IFRS 4 (relative to AASB 17/PBE IFRS 17)

What would be the impact on public sector entities if the same confidence levels must apply?

15. An example helps to illustrate the potential impacts. Assume a public sector entity with arrangements that are routinely onerous uses a 75% confidence level for measuring the unexpired risk liability and an 85% confidence level for measuring the liability for incurred claims. If the entity has to align the confidence levels, it could:

    (a) align the confidence levels at 75% and have a lower liability for incurred claims;

    (b) align the confidence levels at 85% and have a higher unexpired risk liability (up-front onerous contract loss); or

    (c) align the confidence levels at some other percentage, such as 80% and have both a lower liability for incurred claims and higher unexpired risk liability.

16. Accordingly, there would be a balance sheet impact but, year-on-year, there would probably be no material impact for the income statement.

A range of possible interpretations

17. A range of possible (interrelated) interpretations has emerged from discussion within the insurance industry, including the following:

    [1] confidence levels **must be the same** for the two liabilities;

    [2] confidence levels **can be different** for the two liabilities:

        (a) confidence levels for either liability can be **higher or lower** than for the other liability;

        (b) the confidence level for a liability for remaining coverage can only be **lower** than for its related liability for incurred claims;

5 If the incurred claims are inherently riskier than the expected claims (originally covered), the same confidence level would allow that to be reflected in a relatively larger risk adjustment.

(c) the confidence level for a liability for remaining coverage can only be **higher** than for its related liability for incurred claims; and

[3] confidence levels **can be different** for the two liabilities, **but not significantly different**.

18. The Table below uses the following abbreviations:

CL = confidence level

LfRC = liability for remaining coverage

LfIC = liability for incurred claims

CSM = contractual service margin (deferred profit under the general model when measuring LfRC)

RA = risk adjustment.

Please note that staff do not necessarily subscribe to one or other of the interpretations or to the comments identified in the table in support of each interpretation. The comments have been gleaned from outreach across the industry.

Interpretation	Comments in support of interpretation
[1] CLs must be the same	The general model measurement is the same for LfRC and LfIC (except for CSM/loss components) so, logically, the risk adjustment CLs must be the same. On expiry of coverage, unpaid incurred claims are transferred from the LfRC to the LfIC – if the CLs are different, there would be an immediate recognition of revenue/expense simply due to that difference. See Appendix A to this agenda paper for an illustrative example.
[2](a) CLs can be higher or lower	RAs = compensation an insurer requires for bearing risk – so an insurer might determine different levels of compensation for different liabilities, even though the LfIC relates to contracts from within the same pool of contracts to which the LfRC relates. IFRS 17 does not specify the technique used to measure RAs. By applying a technique other than a CL technique (e.g. a 'cost of capital' technique), the equivalent CLs for the LfRC and LfIC are bound to be different.
[2](b) CL for LfRC can only be lower than CL for LfIC	When pricing contracts, insurers need to be competitive, and the competition in most markets drives down premiums and limits the extent to which insurers can seek compensation for bearing risk. In contrast, the compensation the insurer might require for the related claims is not limited by competition.
[2](c) CL for LfRC can only be higher than CL for LfIC	When pricing contracts and providing coverage, insurers have less information about how the contracts will perform than after the coverage period has expired. Once the coverage period has expired and claims experience is known, this additional information should mean the insurer requires a lower CL for LfIC relative to the LfRC.
[3] CLs can be higher or lower, but not significantly	While the comments for [2](a) are correct, their impact would be limited because the LfRC and LfIC are drawn from the same pool of contracts. It would be counterintuitive for the CLs to be markedly different. Even though a different technique (e.g. a 'cost of capital' technique) can result in different CLs, they would never be expected to be significantly different.

Could the interpretation differ between the public and private sectors?

19. The modifications agreed by the Boards for the purposes of the [DRAFT] Exposure Draft that could potentially impact on the basis for determining confidence levels used to measure risk adjustments include:

    (a) not requiring the sub-grouping of contracts based on whether they are onerous or non-onerous at initial recognition (AASB and NZASB);

    (b) not requiring the sub-grouping of contracts based on whether they are issued more than a year apart (AASB and NZASB);

    (c) requiring a risk adjustment that reflects an amount that is estimated to achieve a 75% confidence level for the relevant insurance liabilities, which can be rebutted (NZASB).

20. For most public sector entities, the unit of account modifications [(a) and (b) above] would mean that the liability for remaining coverage relates to contracts issued over a period of a year, whereas the liability for incurred claims could relate to multiple generations of contracts. On balance staff do not consider that this would, of itself, lead to a different outcome on confidence levels in the public sector. For example, if an entity changed its view on compensation required to bear risk from year to year, the overall confidence level for the liability for incurred claims should not change depending on whether the calculation is performed on a weighted average basis for multiple generations of contracts or separately for each generation of contracts.

21. If interpretation [1] (confidence levels **must be the same** for the two liabilities) is valid, the NZASB proposal for a rebuttable 75% confidence level might imply that 75% applies to both liabilities, not just the liability for incurred claims. However, an entity could theoretically rebut the 75% confidence level for one liability and not the other.

22. Accordingly, staff consider that a public sector entity applying the:

    (a) AASB and NZASB proposals on not requiring the sub-grouping of contracts; and

    (b) NZASB proposal for a rebuttable 75% confidence level for risk adjustment;

    would not necessarily be any more affected by the outcome of the interpretation issue than an insurer applying AASB 17/PBE IFRS 17 unmodified.

Section 3: Staff recommendation

23. Staff suggest not making any specific proposals on the interpretation issue in the Exposure Draft in order to avoid disrupting any interpretation process that might occur at the IASB or across the industry over the coming months. [Staff note that it is currently unclear when a consensus might be reached on the interpretation issue explained in Section 2 relating to confidence levels.]

24. However, staff consider that it would be beneficial for the Basis for Conclusions to the Exposure Draft to:

    (a) acknowledge the interpretation issue relating to whether the risk adjustment for a liability for remaining coverage and the risk adjustment for the related liability for incurred claims must achieve the same confidence level; and

    (b) include observations of current public sector practices.

25. Staff support acknowledging the interpretation issue in the Exposure Draft because the measurement of risk adjustments is a relatively significant matter for public sector entities.

26. Depending on the Exposure Draft feedback, either Board retains the right to alter their existing proposals and/or also mandate a particular interpretation of risk adjustments for public sector entities in their jurisdiction. This is the case regardless of whether the interpretation issue:

    (a) remains unresolved by the IASB or through industry practice; or

    (b) is resolved in favour of a particular interpretation that either Board considers unsuitable for the public sector.

Questions for Board members

Q1 Do Board members agree to not make any specific proposals in the Exposure Draft on the interpretation issue relating to whether the risk adjustment for a liability for remaining coverage and the risk adjustment for the related liability for incurred claims must achieve the same confidence level?

Q2 Do Board members agree that the Basis for Conclusions to the Exposure Draft should:

(a) acknowledge the interpretation issue; and

(b) include observations of current public sector practices?

Q3 If you disagree with Q1 or Q2, what alternative approach do you wish to take?

Appendix A: Illustrative example – Insurance liabilities

A1. On expiry of coverage, unpaid incurred claims are transferred from the liability for remaining coverage to the liability for incurred claims.

A2. If the confidence levels are different for the two liabilities, there would be an immediate recognition of revenue/expense simply due to that difference.

A3. This difference would not typically be evident because of the number of other changes occurring as coverage is provided and claims are incurred. However, the highly-simplified example below seeks to demonstrate the impact.

Facts

(a) one contract is issued for a premium of $100, which is paid up-front

(b) one claim is expected of $100 (best estimate)

(c) the actual claim is $100 (best estimate) and remains unpaid at year end

(d) the risk adjustment for the liability for remaining coverage at a 75% confidence level is $15

(e) the risk adjustment for the liability for incurred claims at an 85% confidence level is $20

(f) ignoring discounting/inflating:

(i) the liability for remaining coverage would be $115 ($100 plus $15 risk adjustment) up to the time the claim is incurred

(ii) at the time the claim is incurred (assuming it is still expected to be the only claim), the liability for remaining coverage would be $0, and a liability for incurred claims of $120 (($100 plus $20 risk adjustment) would be recognised

(g) when the claim is incurred, the journal entries would be as follows:

	Debit	Credit	
Liability for remaining coverage	$115		Derecognition of liability
Insurance service expense	$5		Due to different confidence level
Liability for incurred claims		$120	Recognition of liability