Australian Government
Australian Accounting Standards Board

XRB EXTERNAL REPORTING BOARD
Te Kāwai Ārahi Pūrongo Mōwaho
NZ ACCOUNTING STANDARDS BOARD

Staff paper

Project	**Insurance Activities in the Public Sector**	**Meeting**	AASB (M181)/NZASB June 2021
Topic	Discounting and inflating under AASB 17 / NZ IFRS 17 by public sector entities	**Agenda item**	AASB 14.2 NZASB 8.2
		Date	7 June 2021
Contacts	Angus Thomson athomson@aasb.gov.au Vanessa Sealy-Fisher vanessa.sealy-fisher@xrb.govt.nz Patricia Au pau@aasb.gov.au	**Project priority**	Medium
		Decision-making	High
		Project status	Board deliberation

Objective of this paper

In respect of the measurement of a liability for incurred claims, the objective of this paper is for the AASB and the NZASB to decide whether public-sector-specific modifications or guidance is needed in AASB 17/PBE IFRS 17 *Insurance Contracts* regarding:

(a) the discounting requirements; and

(b) the requirements for presenting the impacts of inflation in the statement of profit or loss and other comprehensive income.

This staff paper is set out in six sections:

- Section 1 sets out the basis for discounting and inflating under AASB 1023/PBE IFRS 4
- Section 2 sets out the basis for discounting and inflating under AASB 17/PBE IFRS 17
- Section 3 sets out the basis for discounting under AASB 137/PBE IAS 37
- Section 4 outlines the existing discounting and inflating practices of public sector entities with activities that might be within the scope of AASB 17/PBE IFRS 17 and feedback received from recent stakeholder engagement
- Section 5 provides an analysis of the discounting requirements in AASB 17/PBE IFRS 17 for public sector entities
- Section 6 provides an analysis of the inflating requirements in AASB 17/PBE IFRS 17 for public sector entities.

Staff are recommending there be no public sector modifications to AASB 17/PBE IFRS 17 relating to discounting or inflating. However, staff expect the issues and reasoning for taking no action to be explained in a Basis for Conclusions.

Abbreviations for Standards identified in this paper are referenced in full in Appendix B.

Background comments on discounting and inflating claims

Almost all premiums/levies received by public sector entities with activities that might be within the scope of AASB 17/PBE IFRS 17 would be received prior to coverage commencing or early in the coverage period. In addition, public sector entities with activities that might be within the scope of AASB 17/PBE IFRS 17 are likely to apply the premium allocation approach (PAA) when measuring the liability for remaining coverage.[1] Discounting is not typically expected to apply to premiums/levies under the PAA.[2]

Discounting is most likely to apply to claims liabilities, which in some cases may remain outstanding for decades. Claims inflation also needs to be taken into account in measuring claims liabilities because the costs associated with settling claims can change over time. Discounting (in the absence of negative rates) reduces the claims liabilities and inflating (in the absence of negative rates) increases the claims liabilities.

1. Discounting and inflating in accordance with AASB 1023/PBE IFRS 4

1.1 AASB 1023.6.1/PBE IFRS 4 (Appendix D.6.1) requires expected future cash flows to be discounted at a risk-free rate.

> 6.1 The outstanding claims liability shall be discounted for the **time value of money using risk-free discount rates** that are based on current observable, objective rates that relate to the nature, structure and term of the future obligations.

It is implicit in this requirement that the discount rate does not incorporate the entity's own credit risk. Although not explicitly stated, discounting typically would not be applied to claims expected to be settled within one year of the end of the reporting period.

1.2 AASB 1023.5.1.2/PBE IFRS 4 (Appendix D.5.1.2) comments on inflation.

> 5.1.2 The longer the expected period from the end of the reporting period to settlement, the more likely it is that the ultimate cost of settlement will be affected by inflationary factors likely to occur during the period to settlement. These factors include changes in specific price levels, for example, trends in average periods of incapacity and in the amounts of court awards for successful claims. For claims expected to be settled within one year of the end of the reporting period, the impact of inflationary factors might not be material.

Inflation is therefore more than simply price inflation. It also includes inflation in costs from all likely sources.

1 Subject to deliberations by the Board on June 2021 agenda paper 14.3/8.3 on PAA eligibility.

2 Appendix C outlines the very limited cases in which discounting might apply to the liability for remaining coverage when the PAA is applied.

Australia

1.3 Existing actuarial practice is guided by Australian Professional Standard PS 302 *Valuations of General Insurance Claims*.[3]

1.4 PS 302 requires discount rates to be determined by reference to a 'replicating portfolio'.

> 'Replicating Portfolio' means a notional portfolio of current, observable, market-based, fixed-interest investments of highest credit rating, which has the same payment profile (including currency and term) as the relevant claim liability being valued. [section 3.1]

1.5 Practice largely involves applying sovereign bond yields for durations that match the relevant claims liabilities, with extrapolation when needed. This is probably driven to some extent by wanting to align with Australian Prudential Regulation Authority (APRA) prudential requirements. Prudential Standard 340 *Insurance Liability Valuation*[4] states:

> 28. The rates to be used in discounting the expected future claims payments of insurance liabilities denominated in Australian currency for a class of business are derived from yields of Commonwealth Government Securities (CGS), as at the calculation date, that relate to the term of the future insurance liability cash flows for that class.
>
> 29. Where the term of the insurance liabilities denominated in Australian currency exceeds the maximum available term of CGS, other instruments with longer terms and current observable, objective rates are to be used as a reference point for the purpose of extrapolation. …
>
> 30. For foreign insurance liabilities not denominated in Australian currency, the risk-free discount rate must be based on the yields of highly liquid sovereign risk securities with current observable, objective rates, in the currency of the insurance liabilities …

1.5 PS 302 requires allowance to be made for 'claim inflation'.

> 10.2.1 The Member must allow for any future escalation of Claim Payments (often called "claim inflation"). Whether the allowance is explicit or implicit will depend on the valuation methods being used. The escalation assumptions must consider:
>
> (a) wage and/or price inflation; and
>
> (b) superimposed inflation (any residual claim inflation arising for reasons other than wage and/or price inflation).

New Zealand

1.6 Existing actuarial practice is guided by New Zealand actuarial Professional Standard No. 30 *Valuations of General Insurance Claims*.[5] PS No. 30 takes a more direct approach than PS 302:

> Discount rates used must be based on risk-free rates of appropriate duration, having regard to the liabilities, as at the Valuation Date. [paragraph 10.5.2]

---

3 Professional Standard PS 302 *Valuations of General Insurance Claims*, the latest version of which was issued in March 2021 by the Actuaries Institute

4 APRA Prudential Standard 340 *Insurance Liability Valuation*, July 2019.

5 Professional Standard No. 30 *Valuations of General Insurance Claims*, the latest version of which was issued in December 2017 by the New Zealand Society of Actuaries.

1.7 The PS 30 requirement (paragraph 10.2.1) to allow for 'claim inflation' is identical to the requirement in PS 302.

1.8 However, individual public sector entities do not have any discretion in determining discount rates and any consumer price (CPI) components[6] of inflation rates. The New Zealand Treasury publishes a table of risk-free discount rates and consumer price index (CPI) assumptions that must be used for the purpose of preparing the financial statements of the Government of New Zealand.[7] [8] These rates also apply to all Government reporting entities submitting valuations to Treasury for measuring insurance claims liabilities under PBE IFRS 4.[9]

1.9 The New Zealand Treasury risk-free discount rate methodology uses as its starting point the market yield curve of New Zealand Government Bonds as the most appropriate proxy for the return on a very safe asset.

Staff comment

1.10 Despite the differing ways in which the requirements are expressed, practice in both jurisdictions is centred largely on applying sovereign bond yields for durations that match the relevant claims liabilities, with extrapolation when needed.

2. Discounting and inflating under AASB 17/PBE IFRS 17

Discounting

2.1 AASB 17/PBE IFRS 17.36 requires estimated future cash flows to be discounted for the time value of money, the characteristics of the cash flows and the liquidity characteristics of the insurance contracts.

> 36 An entity shall adjust the estimates of future cash flows to reflect the **time value of money and the financial risks related to those cash flows**, to the extent that the financial risks are not included in the estimates of cash flows. … :
>
> (a) reflect the time value of money, the characteristics of the cash flows and the liquidity characteristics of the insurance contracts;
>
> (b) be consistent with observable current market prices (if any) for financial instruments with cash flows whose characteristics are consistent with those of the insurance contracts, in terms of, for example, timing, currency and liquidity; and
>
> (c) exclude the effect of factors that influence such observable market prices but do not affect the future cash flows of the insurance contracts.

---

6 As noted in paragraph 1.2, inflation under PBE IFRS 4 is a broader notion than consumer price inflation.

7 https://www.treasury.govt.nz/information-and-services/state-sector-leadership/guidance/reporting-financial/discount-rates/discount-rates-and-cpi-assumptions-accounting-valuation-purposes

8 Both forward and spot rates are provided up to 2101 (80 years hence). New Zealand Treasury notes that: (a) ideally, forward rates should be used for the accounting valuations; however, (b) the ability to use forward rates will be dependent on the type of valuation model used; and (c) the model must be able to cope with different discount rates for each year in order to use forward rates.

9 The rates also apply to measuring employee benefits under PBE IPSAS 25 *Employee Benefits*, and building a risk-adjusted discount rate for measuring student loans.

2.2 In addition, under a fulfilment cash flows model, as applies under AASB 17/PBE IFRS 17, liabilities are measured without reference to the entity's own credit risk. That is, no adjustment is made to discount rates (or expected cash flows) to reflect the risk that the entity will not settle the liability. The Basis for Conclusions to IFRS 17 notes:

> BC197 IFRS 17 requires an entity to disregard its own credit risk when measuring the fulfilment cash flows. …

2.3 Despite the difference in language between AASB 1023.6.1/PBE IFRS 4 (Appendix D.6.1) and AASB 17/PBE IFRS 17.36, the only significant difference appears to be an explicit requirement to adjust discount rates upwards for illiquidity. This is evident from the application guidance in AASB 17 /PBE IFRS 17.B80 & B81, which outlines two possible approaches (bottom-up and top-down) to determining discount rates.

> B80 Hence, for cash flows of insurance contracts that do not vary based on the returns on underlying items, an entity may determine discount rates by **adjusting a liquid risk-free yield curve** to reflect the differences between the liquidity characteristics of the financial instruments that underlie the rates observed in the market and the liquidity characteristics of the insurance contracts (a bottom-up approach).
>
> B81 Alternatively, an entity may determine the appropriate discount rates for insurance contracts based on a yield curve that reflects the current market rates of return implicit in a fair value measurement of a reference portfolio of assets (a top-down approach). An entity shall adjust that yield curve to eliminate any factors that are not relevant to the insurance contracts, but is not required to **adjust the yield curve for differences in liquidity characteristics** of the insurance contracts and the reference portfolio.

Liquidity premium[10]

2.4 In concept, the size of a liquidity premium has a positive correlation with:

(a) the length of time over which claims (cash flows) are expected to be paid; and

(b) the predictability of the cash flows.

Accordingly, the longer the time to expected settlement and the more predictable are the cash flows, the larger is the liquidity premium.

2.5 Larger liquidity premiums would mean lower liabilities, all other things being equal. Accordingly, it would be expected that insurance liabilities measured under AASB 17/PBE IFRS 17.36 would be lower, on average, than under AASB 1023.6.1/PBE IFRS 4 (Appendix D.6.1).

2.6 The IFRS 17 Basis for Conclusions includes the following on 'liquidity':

> ***Liquidity***
>
> BC193 Discussions of the time value of money often use the notion of risk-free rates. Many entities use highly liquid, high-quality bonds as a proxy for risk-free rates. However, the holder can often sell such bonds in the market at short notice without incurring significant costs or affecting the market price. This means that the holder of such bonds effectively holds two things:

10 The term 'liquidity premium' is used here – it is sometimes referred to as 'illiquidity premium'.

(a) a holding in an underlying non-tradable investment, paying a higher return than the observed return on the traded bond; and

(b) an embedded option to sell the investment to a market participant, for which the holder pays an implicit premium through a reduction in the overall return.

In contrast, for many insurance contracts, the entity cannot be forced to make payments earlier than the occurrence of insured events, or dates specified in the contract.

Appendix A to this Staff Paper includes further extracts from the IFRS 17 Basis for Conclusions as background on liquidity premiums.

2.7 In preparing for the application of AASB 17, private sector insurers appear to be considering various approaches to liquidity premiums, ranging from applying a zero premium to applying various prudential benchmarks.

2.8 For prudential reporting purposes, the APRA LPS 112 *Capital Adequacy: Measurement of Capital*[11] sets an illiquidity premium for life insurers.

> Until 1 December 2013, APRA's illiquidity premium (in basis points) added to the risk-free forward rates for the first 10 years after the reporting date was:
>
> 15% x AA spread + 15% x A spread [LPS 112, Attachment H, paragraph 7].
>
> From 1 December 2013, APRA's illiquidity premium (in basis points) added to the risk-free forward rates for the first 10 years after the reporting date is:
>
> 33% x A spread 3 year [APRA letter dated 27 March 2014 to: All CEOs and Appointed Actuaries of life insurers (including friendly societies)].

2.9 APRA Prudential Standard LPS 112, paragraph 7, also notes:

> The spreads must be obtained from "Table F3 Capital Market Yields and Spreads – Non-Government Instruments" published by the RBA on its website. "AA spread" and "A spread" are the spreads over bonds issued by the Australian Government for corporate bonds with broad credit ratings (as determined by Standard and Poor's) of AA and A respectively.
>
> If the RBA ceases to publish this information, an alternative method of calculating the illiquidity premium may be used with the prior written approval of APRA.
>
> The maximum illiquidity premium is 150 basis points and the minimum is zero.

2.10 There is no equivalent APRA document on liquidity premiums for general insurers.

2.11 The relationship between financial reporting and prudential reporting is still being considered by APRA, and it is not clear whether APRA will maintain these Prudential Standards once AASB 17 is in force.

Inflating

2.12 AASB 17/PBE IFRS 17.B59 requires insurers to take inflation into account when relevant.

> B59 … , if cash flows allocated to a group of insurance contracts are sensitive to inflation, the determination of the fulfilment cash flows shall reflect current estimates of possible future inflation rates. Because inflation rates are likely to be

11 APRA LPS 112 *Capital Adequacy: Measurement of Capital*, January 2013.

> correlated with interest rates, the measurement of fulfilment cash flows shall reflect the probabilities for each inflation scenario in a way that is consistent with the probabilities implied by the market interest rates used in estimating the discount rate …

2.13 The requirements relating to inflation rates are much less stringent than the requirements relating to discount rates. However, the need for consistency between the discount and inflation rates applied indirectly introduces some additional rigour to the inflation rate requirements.

Insurance service result versus insurance finance income/expense

2.14 AASB 17/PBE IFRS 17 requires the 'underwriting result' to be presented in two components.

AASB 17/PBE IFRS 17	***AASB 1023/PBE IFRS 4***
Insurance service result [80(a)]	Underwriting result
Insurance finance income and expenses [80(b)] – includes impact on insurance liabilities of changes due to discount rates and some types of inflation	

2.15 The initial impact of discounting fulfilment cash flows affects the insurance service result; however, under AASB 17/PBE IFRS 17.87(a), the subsequent discount rate changes are presented in insurance finance income and expenses. These subsequent changes include:

(a) the effect of the time value of money – that is, the impact on insurance liabilities of the unwinding of the discount as time passes; and

(b) and changes in the time value – that is, the impact on insurance liabilities of changes to discount rates.[12]

2.16 The initial impact of inflating fulfilment cash flows affects the insurance service result; however, under AASB 17/PBE IFRS 17.B128, **only some** of the subsequent impacts of inflation rate changes are presented in insurance finance income and expenses.

> B128 Paragraph 87 requires an entity to include in insurance finance income or expenses the effect of the time value of money and financial risk and changes therein. For the purposes of IFRS 17:
>
> (a) assumptions about inflation based on an index of prices or rates or on prices of assets with inflation-linked returns are assumptions that relate to financial risk;

12 At its June 2020 meeting, the AASB 17 *Insurance Contracts* Transition Resource Group considered where the impacts of discounting fulfilment cash flows should be presented. The Group effectively concluded that, while the initial impact of discounting is presented within the 'insurance service result', the subsequent impacts of discounting (unwinding of the impact of discounting and the impact of changes in discount rates) are included in 'insurance finance income and expenses, based on the IFRS 17 Illustrative Examples and Effects Analysis [https://www.aasb.gov.au/admin/file/content102/c3/Minutes_TRG_22JUN20_FINAL.pdf].

(b) assumptions about inflation based on an entity's expectation of specific price changes are not assumptions that relate to financial risk; …[13]

2.17 Table 2-1 outlines two possible interpretations of the distinction between AASB 17/PBE IFRS 17.B128(a) versus (b). There may be other possible interpretations that staff have not identified.

Table 2-1
Interpretation A: changes in insurance liabilities resulting from changes in inflation assumptions are: (a) 'insurance finance income and expenses' [under B128(a)] when the assumption is **an index based on prices or rates alone**; and (b) 'insurance service result' [under B128(b)] when the assumption is based on both prices/rates and non-price factors. For example: • minimum hourly wage rates would be indices based only on price/rate factors and, therefore, impact on 'insurance finance income and expenses' while • Average Weekly Earnings (AWE: Australia) and Median Weekly Earnings (MWE: New Zealand) are indices based on a price factor (wage rates) and a non-price factor (hours worked) and, therefore, impact on 'insurance service result'.
Interpretation B: changes in insurance liabilities resulting from changes in inflation assumptions are: (a) 'insurance finance income and expenses' [under B128(a)] when the assumption is **any index related mainly to price or rate changes**; and (b) 'insurance service result' [under B128(b)] when the assumption is based on 'superimposed inflation', which is a reasonably well-established notion in insurance accounting (see paragraphs 1.5 and 4.9). For example: • minimum hourly wage rates and AWE/MWE would be indices based on price/rate factors and, therefore, impact on 'insurance finance income and expenses'; while • estimated escalations in court awards and other environmental factors are non-price factors and, therefore, impact on 'insurance service result'.

2.18 One possible benefit of separately presenting 'insurance service result' from 'insurance finance income and expenses' could be greater transparency around the impact of discount rates and inflation rates on financial performance. However, the uncertainty around the meaning of AASB 17/PBE IFRS 17.B128 is a potential concern – please see Section 6.

2.19 Staff do not consider that the requirements in AASB 17/PBE IFRS 17.B128 are aimed at identifying 'real' discount rates. This is because the discount rates are already supposed to take into account the impact of inflation when relevant, and AASB 17/PBE IFRS 17.B74 says:

> B74 Estimates of discount rates shall be consistent with other estimates used to measure insurance contracts to avoid double counting or omissions; for example: …
>
> (c) nominal cash flows (ie those that include the effect of inflation) shall be discounted at rates that include the effect of inflation; and
>
> (d) real cash flows (ie those that exclude the effect of inflation) shall be discounted at rates that exclude the effect of inflation.

13 AASB 17/PBE IFRS 17.B128(c) relates to transactions that are not conducted by public sector entities in Australia and New Zealand.

3. Discounting under AASB 137/PBE IAS 37

3.1 AASB 137/PBE IAS 37.47 requires estimated future cash flows to be discounted for the time value of money.

> 47 The discount rate (or rates) shall be a pre-tax rate (or rates) that reflect(s) current market assessments of the time value of money and the risks specific to the liability. The discount rate(s) shall not reflect risks for which future cash flow estimates have been adjusted.

3.2 Some entities interpret this requirement as being the same or similar to the discounting requirements in AASB 1023/PBE IFRS 4.

3.3 Other entities interpret this requirement as being different from the discounting requirements in AASB 1023/PBE IFRS 4. A key potential difference is that the focus of AASB 1023/PBE IFRS 4 (and AASB 17/PBE IFRS 17) is from the entity perspective because an insurer is expected to fulfil its insurance liabilities. In contrast, the focus of AASB 137.36/PBE IPSAS 19.44 is on settlement.

> 36 The amount recognised as a provision shall be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period.

3.4 A settlement amount involves both the entity and the counterparty (or a third-party transferee) agreeing on the terms, which could include:

(a) a counterparty (or third-party) agreeing to settle for less than face value, for example, because the entity is not creditworthy;[14] or

(b) a counterparty (or third-party) demanding more than face value to accept the liability to compensate for uncertainty.

3.5 AASB 137/PBE IPSAS 19 do not include specific requirements on applying inflation rates to measure provisions. Some may interpret the requirement in AASB 137.36/PBE IPSAS 19.44 to use a 'best estimate' as meaning that expected inflation should be taken into account; however, this is not explicit.

4. Discounting and inflating practice among relevant public sector entities and stakeholder feedback

Discounting practice

4.1 Most public sector entities that have activities which might fall within the scope of AASB 17/PBE IFRS 17 and are currently applying AASB 1023/PBE IFRS 4, appear to derive their discount rates from national government bond yields. This is consistent with practice among for-profit private sector insurers currently applying AASB 1023/PBE IFRS 4.

14 In theory, 'own credit risk' should have little or no impact on discount rates for entities in the public sector, given the creditworthiness of government entities in Australia and New Zealand.

4.2 Most of the entities currently applying AASB 137 also appear to derive their discount rates from national government bond yields. A small number of entities applying AASB 137 are using higher discount rates.

4.3 Many of the claims liabilities are cash flow projections over decades. Accordingly, relatively small changes in discount rates can lead to large changes in liability measurements.

Feedback on discounting

4.4 Most of the public sector entities that would potentially be within the scope of AASB 17/PBE IFRS 17 operate on a break-even basis. Typically, this involves breaking even in the long-run on an overall basis, including the impact of investment returns on assets held to meet liabilities. Accordingly, when determining the amount of premiums or levies to be charged to participants, the expected return on assets is taken into account.

4.5 The long-run return on assets is generally higher than the 'time value of money' and, therefore, all other things being equal:

(a) premiums/levies can appear to be unsustainably low; and

(b) insurance liabilities can appear to be unsustainably high relative to the assets available to meet them.

4.6 Some of the stakeholders recently consulted by staff consider that it would be appropriate to discount insurance liabilities using the long-run investment returns, which would line up with the approach to pricing and, in their view, would enable the entity to better present its economic position.[15] Please also refer to the discussion in Section 5.

4.7 Some of the stakeholders recently consulted by staff expressed serious concerns about the impact on their entities' reported financial position and performance due to the volatility of discount rates from period to period. This has been exacerbated by the low level of government bond rates; whereby small changes in rates have a relatively large impact on liability measurement. Many regard this volatility as a distraction from their entities' overall results.

4.8 Please note that the stakeholder feedback identified above applies in respect of both AASB 1023/PBE IFRS 4 and AASB 17/PBE IFRS 17. That is, some stakeholders consider that the existing and new Standards both require:

---

15 In order to help address these concerns, some entities include additional information in their financial statements.

(a) Some entities show separately (sometimes in a note to the financial statements):

(i) those components of reported outcomes that are regarded as being within the entity's capacity to manage; and

(ii) those reported outcomes that are not regarded as being within the entity's capacity to manage. Changes in discount rates are regarded as being outside the entity's capacity to manage and, accordingly, the related movements in liabilities are regarded as being outside the entity's capacity to manage.

(b) Some entities present metrics aimed at indicating the relationship between the available funding, which is typically provided by a pool of investments, relative to the liabilities. This can include 'funding ratios' of investment assets and insurance liabilities remeasured using discount rates higher than those applied under AASB 1023/PBE IFRS 4.

(a) discount rates that are too low and, therefore, liabilities being measured at amounts that are higher than they should be; and

(b) frequent discount rate changes and, therefore, liability measurement volatility that clouds underlying reported outcomes.

These stakeholders acknowledged that, using the period-to-period investment rate of return would also result in volatility and, instead, a long-run (averaged) rerun would need to be applied to resolve both of these concerns.

Practice and feedback on inflating

4.9 Most public sector entities that have activities which might fall within the scope of AASB 17/PBE IFRS 17 and are currently applying AASB 1023/PBE IFRS 4, appear to derive their assumptions about inflation in the same manner as private sector for-profit insurers.

(a) Historical price changes and current price trends are used to inflate costs expected to be incurred in paying future claims. An example would be historical rates of medical and para-medical cost inflation in the case of injuries and acquired disabilities.

(b) Knowledge about regulation, court awards, and technological changes and other environmental factors are also used to inflate costs expected to be incurred in paying future claims. An example would be expected increases in the average sum awarded by courts for certain types of acquired disabilities. Another example, would be expected technological developments that might make more expensive, or less expensive, treatments available to injured claimants. This type of inflation is sometimes referred to as 'superimposed inflation'.[16]

4.10 In many cases, entities have negotiated multi-year agreements with service providers (for example, for medical services) and would have a degree of certainty over inflation rates for those periods. However, many of their liabilities extend well beyond those negotiated agreements.

4.11 There was general satisfaction with the requirements of AASB 17/PBE IFRS 17 and AASB 1023/PBE IFRS 4 on inflation. However, staff have not specifically discussed the presentation requirements in AASB 17/PBE IFRS 17.B128 with public sector stakeholders.

5. Analysis on discounting

Independent liability measurement and fulfilment cash flows

5.1 Conventionally, assets and liabilities are measured independently. That is, for example, the measurement of a liability is based on the liability's inherent characteristics, not on the characteristics of any assets that might be available to settle the liability. Consistent with this general convention, AASB 17/PBE IFRS 17 requires that:

> B78 Discount rates shall include only relevant factors, ie factors that arise from the time value of money, the characteristics of the cash flows and the liquidity characteristics of the insurance contracts. …

16 AASB 1023.5.2.11/PBE IFRS 4 (Appendix D.5.2.11 refers to 'superimposed inflation'.

5.2 Accordingly, it would be inconsistent with AASB 17/PBE IFRS 17 to measure insurance liabilities based on the expected return on assets available to support the liability, unless those assets are a 'replicating portfolio', which is a **theoretical portfolio** of assets providing cash flows that exactly match the cash flows from the liability in all scenarios.

5.3 A notional 'replicating portfolio' typically would be very different from the actual investment portfolio held by the relevant public sector entities. Among public sector entities, actual investment portfolios are typically designed to achieve maximum returns for the risks taken – they are not designed to match the cash flows on the underlying liabilities. Accordingly, a replicating portfolio approach would not be available to resolve the concerns of public sector stakeholders. Further background on the replicating portfolio approach is in Appendix D to this paper.

Any private sector versus public sector differences?

Source of discount rates

5.4 Under AASB 1023/PBE IFRS 4, most private sector insurers in Australia and New Zealand typically make reference to sovereign bond yields in determining their discount rates in much the same way as public sector entities applying AASB 1023/PBE IFRS 4. It seems likely that the same sources of yield will be used in determining their discount rates under AASB 17/PBE IFRS 17 and, accordingly, the source of discount rates is unlikely to be different between the sectors and would not be a basis for a public sector modification.

Underwriting losses

5.5 Many private sector commercial insurers routinely make underwriting losses and only achieve profits (overall) after taking into account their investment earnings. Those private sector insurers also factor their expected investment returns into the determination of their premiums. Accordingly, in general terms, the use of relatively lower discount rates in measuring liabilities compared with expected investment returns used in pricing is not unique to the public sector and would not be a basis for a public sector modification.

5.6 However, in theory, the gap between:

(a) long-run investment returns; and

(b) the discount rates applied under AASB 1023/PBE IFRS 4 (and to be applied under AASB 17/PBE IFRS 17);

could typically be larger for public sector entities, relative to their private sector counterparts. This is because the investment choices made by APRA/RBNZ-regulated private sector insurers are constrained by prudential capital penalties imposed when insurers make more risky investments. Public sector entities may be less constrained in their investment choices.

Staff view – a wider issue

5.7 To a large extent the same discounting issues from applying AASB 17/PBE IFRS 17 that face public sector insurers also apply in the for-profit and not-for-profit private sector.

5.8 In addition, concerns about the impact on public sector entities' reported financial position and performance due to the volatility of discount rates from period to period is not confined to AASB 1023/PBE IFRS 4 (or AASB 17/PBE IFRS 17).

5.9 The same concerns arise in respect of the accounting for:

(a) employee benefits, particularly defined benefit plan liabilities (under AASB 119/PBE IPSAS 39); and

(b) accounting for provisions (under AASB 137/PBE IPSAS 19).

5.10 Any solution to concerns about discount rates would probably need to be addressed broadly across all the affected asset and liability types – rather than being something that the Boards should tackle in the context of the insurance project.

Question DI1

5.11 Do the Boards agree that there are no public sector specific reasons for modifying the discounting requirements of AASB 17/PBE IFRS 17 and, therefore, no further work on this issue should be conducted in the context of the project on applying AASB 17/PBE IFRS 17 in the public sector?

6. Analysis on inflating

6.1 Given that:

(a) all the discount rate impacts are included in 'insurance finance income and expenses'; and

(b) discounting and inflating will (in the absence of negative rates) have opposing effects;

it is important that the inflation impacts included in 'insurance finance income and expenses' be identified in a way that achieves a sensible outcome.

6.2 The issues facing public sector insurers regarding inflation are essentially the same as those facing private sector insurers, including the uncertainty around which types of inflation impacts are within 'insurance finance income and expenses' and which are not (see discussion of AASB 17/PBE IFRS 17.B128 in paragraphs 2.14 to 2.19).

6.3 Accordingly, although it may seem worthwhile to seek to provide guidance, there is no public sector specific basis for doing so. In theory, the industry practice to be developed on this topic will be able to be applied by public sector entities. Staff will continue to monitor developments in the industry.

Question DI2

6.4 Do the Boards agree that, at this stage, no further work on the inflation assumptions that impact on 'insurance service result' versus 'insurance finance income and expenses' should be conducted in the context of the project on applying AASB 17/PBE IFRS 17 in the public sector?

6.5 Appendix E shows an example of how the classification of the impacts of inflation could affect the reporting of results.

Appendix A

Extracts from IFRS 17 Basis for Conclusions

BC194 The Board concluded that, in principle, the discount rate for a group of insurance contracts should reflect the liquidity characteristics of the items being measured. Thus, the discount rate should equal the return on the underlying non-tradable investment (see paragraph BC193(a)), because the entity cannot sell or put the contract liability without significant cost. There should be no deduction in the rate for the implicit premium for the embedded put option, because no such put option is present in the liability.

BC195 The Board concluded that it is not appropriate in a principle-based approach:

(a) to ignore the liquidity characteristics of the item being measured, or to use an arbitrary benchmark (for example, high-quality corporate bonds) as an attempt to develop a practical proxy for measuring the specific liquidity characteristics of the item being measured; or

(b) to provide detailed guidance on how to estimate liquidity adjustments.

BC196 However, in response to feedback suggesting that it may be difficult to determine a liquidity premium in isolation, the Board observed that in estimating liquidity adjustments, an entity could apply either of the following:

(a) a ‘bottom-up’ approach based on highly liquid, high-quality bonds, adjusted to include a premium for the illiquidity.

(b) a ‘top-down’ approach based on the expected returns of a reference portfolio, adjusted to eliminate factors that are not relevant to the liability, for example market and credit risk. The Board expects a reference portfolio will typically have liquidity characteristics closer to the liquidity characteristics of the group of insurance contracts than highly liquid, high-quality bonds. Because of the difficulty in assessing liquidity premiums, the Board decided that in applying a top-down approach an entity need not make an adjustment for any remaining differences in liquidity characteristics between the reference portfolio and the insurance contracts.

Appendix B – Abbreviations

PBE IFRS 4 *Insurance Contracts* [PBE IFRS 4]

PBE IFRS 17 *Insurance Contracts* [PBE IFRS 17]

AASB 4 *Insurance Contracts* [AASB 4]

AASB 1023 *General Insurance Contracts* [AASB 1023]

AASB 17 *Insurance Contracts* [AASB 17]

AASB 119 *Employee Benefits* [AASB 119]

PBE IPSAS 39 *Employee Benefits* [PBE IPSAS 39]

AASB 137 *Provisions, Contingent Liabilities and Contingent Assets* [AASB 137]

PBE IPSAS 19 *Provisions, Contingent Liabilities and Contingent Assets* [PBE IPSAS 19]

Appendix C – PAA and discounting

C1 Under the PAA, discounting only arises for a 'significant financing component' – please see the table below.

AASB 17		*Comment*
55	Using the **premium allocation approach**, an entity shall measure the liability for remaining coverage as follows:	
55(a)	on initial recognition, the carrying amount of the liability is:	
55(a)(i)	the premiums, if any, received at initial recognition;	Agenda paper 6 IFRS 17 TRG May 2018 clarifies this: "means premiums actually received at the reporting date. It does not include premiums due or premiums expected."
55(a)(ii)	minus any insurance acquisition cash flows at that date, unless the entity chooses to recognise the payments as an expense …;	These are also 'actual' cash flows.
55(a)(iii)	plus or minus any amount arising from the derecognition at that date of:	
55(a)(iii)(1)	any asset for insurance acquisition cash flows applying paragraph 28C	This is any deferred acquisition costs incurred and recognised prior to the contract's initial recognition.
55(a)(iii)(2)	any other asset or liability previously recognised for cash flows related to the group of contracts as specified in paragraph B66A	This could include a 'pre-coverage' liability relating to premium received prior to the contract's initial recognition.
55(b)	at the end of each subsequent reporting period, the carrying amount of the liability is the carrying amount at the start of the reporting period:	
55(b)(i)	plus the premiums received in the period;	Agenda paper 6 IFRS 17 TRG May 2018 clarifies this: "means premiums actually received at the reporting date. It does not include premiums due or premiums expected."
55(b)(ii)	minus insurance acquisition cash flows; unless the entity chooses to recognise the payments as an expense applying paragraph 59(a);	These are also 'actual' cash flows.
55(b)(iii)	plus any amounts relating to the amortisation of insurance acquisition cash flows recognised as an expense in the reporting period; unless the entity chooses to recognise insurance acquisition cash flows as an expense …;	Relates to any accrued acquisition cash flows that are being amortised in relation to the relevant contracts.
55(b)(iv)	plus any adjustment to a financing component, applying paragraph 56	Relates to unwinding of any 'significant financing component' that initially adjusts the

AASB 17		*Comment*
		LfRC. The 'discount rate' = the rate that would have been used on initial recognition under the general measurement model. Please see paragraphs C2 to C5.
55(b)(v)	minus the amount recognised as insurance revenue for services provided in that period (see paragraph B126); and	Premium revenue is credited to income and debited to the LfRC regardless of whether the premium cash has been received.
55(b)(vi)	minus any investment component paid or transferred to the liability for incurred claims.	Not relevant to public sector contracts.

C2 AASB 17/ PBE IFRS 17.56 explains that a 'significant financing component' which adjusts the LfRC would be based on the same discount rate used to discount incurred claims cash flows (for the equivalent relevant period). That is, a discount rate representing the time value of money and the financial risks related to the cash flows, which is generally taken to be a risk-free rate adjusted for illiquidity.

C3 Entities are not required to discount the LfRC if, at initial recognition, the entity expects the time between providing services and the related premium due date is no more than a year. That is, a financing component need only be recognised when the premium is expected to be received a year or more after the coverage relating to that premium is provided. A time gap of this length is rare in a retail insurance setting – the most likely application is in a commercial-scale reinsurance setting.

C4 Presumably, an entity could choose to recognise a financing component in the LfRC if the time between providing services and the related premium due date is less than a year.

C5 The impact of initially recognising a financing component would be to have a lower LfRC than would otherwise be the case. As the financing component unwinds, the LfRC is increased (credit) and a financing expense (debit) is recognised within 'insurance finance income and expenses' [AASB 17/PBE IFRS 17.87(a)]. 'Insurance finance income and expenses' is a separate line item from 'insurance service result' [AASB 17/PBE IFRS 17.80].

Appendix D – Replicating portfolios

The IFRS 17 Basis for Conclusions notes:

> BC204 … A replicating portfolio is a theoretical portfolio of assets providing cash flows that exactly match the cash flows from the liability in all scenarios. If such a portfolio exists, the appropriate discount rate(s) for the replicating portfolio would also be the appropriate discount rate(s) for the liability. If a replicating portfolio existed and could be measured directly, there would be no need to determine separately the cash flows and the discount rate for the part of the liability replicated by that portfolio. The measurements of the replicating portfolio and the replicated cash flows arising from the contracts would be identical.

Accordingly, for an asset portfolio to be a 'replicating portfolio', it would need to possess all the characteristics of the insurance liabilities. That would include zero (or at least an immaterial level of) credit risk.

Appendix E – Example
Presentation of insurance finance income and expense

E1 The IFRS 17 Effects Analysis includes an example that shows where the impacts of (positive) discounting are presented in the income statement.[17] The IFRS 17 Effects Analysis does not illustrate the impacts of inflating.

E2 The illustrative example in the Table below uses different numbers, but essentially the same line item 'labels', as the IFRS 17 Effects Analysis example. The Table also adds a line item to show the impact of unwinding (positive) inflation on the incurred claims liability. The Table does not attempt to show the impacts of unwinding negative discount/inflation rates or the impacts of changes in discount/inflation rates.

Scenario A shows all the impact of unwinding the inflation of the incurred claims liability in the 'net financial result'

Scenario B shows all the impact of unwinding the inflation of incurred claims liability in the 'insurance service result'

Scenario C shows some of the impact of unwinding the inflation of incurred claims liability in the 'insurance service result' and some in the 'net financial result'.

All Scenarios are based on inflation being positive.

IASB EG	*Scenario A*	*Scenario B*	*Scenario C*
Insurance revenue	10,000	10,000	10,000
Incurred claims other expenses	(11,000)	(11,000)	(11,000)
Release from risk adjustment	300	300	300
Insurance finance income (inflation unwind)	-	180	80
Insurance service result	**(700)**	**(520)**	**(620)**
Investment income	760	760	760
Insurance finance expense (discount unwind)	(250)	(250)	(250)
Insurance finance income (inflation unwind)	180	-	100
Net insurance financial result[18]	**690**	**510**	**610**
Profit or loss	**10**	**10**	**10**

E3 Given the significance attributed to the 'insurance service result' versus the 'net financial result' by some stakeholders, the interpretation of how different types of inflation are classified (discussed in paragraphs 2.14 to 2.19 of this paper) is important to those entities.

17 From IFRS 17 *Insurance Contracts* Effects Analysis (May 2017), page 123.

18 The example in the Effects Analysis uses the term 'net financial result', but IFRS 17 itself does not. Most of the large firms' illustrative financial statements have adopted the term 'net insurance financial result' (which is also not used in IFRS 17).