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 August 2022 (M189) NZASB August 2022 (M102)
Topic:	Emerging issues: adverse development covers and investment components	**Agenda item:**	AASB 4.4 NZASB 8.4
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Objectives of this agenda paper

1. The objectives of this agenda paper are for the AASB and the NZASB to:
   (a) CONSIDER two emerging issues in the public sector regarding:
      (i) adverse development covers; and
      (ii) investment components; and
   (b) DECIDE on whether to monitor these emerging issues or address them now.

Adverse development covers

Background

2. Most general insurance is for claims incurred due to events that arise in the coverage period.

3. By way of example, an insurer that issues contracts which cover claims arising from incidents that occur during a one-year coverage period and that subsequently manages the claims to settlement can be considered as having two liabilities:
   (a) a liability for the risk of [future] incidents occurring over the one-year coverage period; and
   (b) a liability for [past] incidents which occurred during the one-year coverage period that may take years to settle.

4. Typically, an insurer would treat (a) as a liability for remaining coverage and recognise premium revenue over one year, and treat (b) as a liability for incurred claims.

5. The IASB's Transition Resource Group for IFRS 17 clarified that, under IFRS 17, an insurer could exercise an accounting policy choice to treat (b) as a second form of coverage for

'consequential risks'.[1] However, few if any entities are expected to treat consequential risks as coverage, since it would be inconsistent with longstanding industry practice.

6. However, under AASB 17.B5/PBE IFRS 17.AG5, if the insurance contracts change hands after the initial coverage period, an insurer acquiring a liability for [past] incidents from another insurer would have only the one coverage period relating to the period of settlement of claims.

7. In these cases, entities are required to treat the consequential risks as coverage under AASB 17.B5/PBE IFRS 17.AG5, which notes [emphasis added]:

> B5/AG5 Some insurance contracts cover events that have already occurred but the financial effect of which is still uncertain. An example is an insurance contract that provides insurance coverage against an adverse development of an event that has already occurred. **In such contracts, the insured event is the determination of the ultimate cost of those claims**.

Accordingly, AASB 17/PBE IFRS 17 requires a liability for incurred claims in the hands of the originating insurer to be converted into a liability for remaining coverage in the hands of the acquiring entity.

8. The following examples are intended to illustrate the possible accounting treatments.

Example 1: Insurer A issues insurance contracts and manages the claims to final settlement

	Coverage for incidents occurring in a one-year period	10-year period of claims settlement [and possible adverse development]	Implications
Expected practice	Recognise liability for remaining coverage	Recognise liability for incurred claims	Coverage [and revenue recognition] period is one year
Possible policy choice	Recognise liability for remaining coverage	Recognise liability for remaining coverage for 'consequential risks'	Coverage [and revenue recognition] period is 11 years [one plus 10]

Example 2: Insurer A issues insurance contracts and Insurer B acquires the contracts from Insurer A after the initial coverage period and manages the claims to final settlement

	Coverage for incidents occurring in a one-year period	10-year period of claims settlement [and possible adverse development]	Implications
Required practice	Insurer A: Recognise liability for remaining coverage	Insurer B: Recognise liability for remaining coverage	Coverage [and revenue recognition] period is one year for Insurer A Coverage [and revenue recognition] period is 10 years for Insurer B

1 In particular, paragraphs 9(b) of the *Summary of the Transition Resource Group for IFRS 17 Insurance Contracts meeting held on 26–27 September 2018*.

Feedback on AASB ED 319/NZASB ED 2022-3

9. In one comment letter on AASB ED 319/NZASB ED 2022-3, and based on several staff discussions with stakeholders, adverse development coverage has emerged as a possible issue in the public sector.

Implications

10. If an adverse development arrangement, based on an assessment of the indicators, falls within AASB 17/PBE IFRS 17, the adverse development coverage relates to the claims run-off period, which is potentially a long period. This may make it difficult to meet the eligibility criteria for applying the premium allocation approach, in which case the more complex general measurement model would need to be applied.[2]

11. Adverse development coverage would typically end either at the time claims are actually settled, or close to that time. Accordingly, the insurer may never recognise a liability for incurred claims and there may never be any claims development disclosures to help demonstrate how well the insurer has estimated claims over the long term.

Stakeholder feedback received during outreach

12. There is currently one arrangement staff are aware of being established by a public sector entity in Australia that assumes the claims liabilities of private sector insurers five years after the events that gave rise to the claims. The public sector entity is compensated by a levy on the premiums for the contracts issued by the private sector insurers. There are two potential issues:

- accounting for the arrangement on an ongoing basis for future contracts; and
- accounting for the backlog of existing contracts under the arrangement.

13. In respect of **future contracts**, this particular arrangement has some of the features of an adverse development cover. However, staff also note the following two significant factors.

    (a) Further analysis might determine this particular arrangement is not an adverse development cover. This is on the basis that the relevant legislation might make the public sector a party to the insurance contacts when they are first issued by the private sector entity, rather than being contracts that are transferred from the private sector entity to the public sector entity at the claims settlement stage.

    (b) It is not yet clear whether further arrangements that have some of the features of an adverse development cover might arise in future, including across other jurisdictions.

14. In respect of the **backlog of contracts**, on transition to AASB 17/PBE IFRS 17, an accounting policy choice is available that permits the ‘acquired contracts’ to be treated as resulting in a liability for incurred claims [AASB 17/PBE IFRS 17.C9A]. However, other than at transition, there is no relief available in AASB 17/PBE IFRS 17 to cater for the introduction of new arrangements or the transfer of insurance contracts between entities under common control, such as from one public sector entity to another.

15. One option the Boards could consider is to provide the same policy choice as the transitional provision for a public sector entity to account for the insurance contracts acquired in their settlement period as an adverse development cover or as a liability for incurred claims.

2 One of the eligibility criteria for an entity to apply the simpler premium allocation approach to measure liabilities for remaining coverage is when the coverage period of the contract is one year or less [AASB 17/PBE IFRS 17.53(b)].

Private versus public sector context

16. There is no explicit basis for regarding the issue of adverse development covers in the public sector as being different from the private sector.

17. Even though there may ordinarily be an expectation among users that a public sector entity would report claims and claims development during a claims settlement period, consistent with all the other claims that it might manage, the same could probably be said for private sector entities.

Staff recommendation[3]

18. Based on the feedback received to date, staff have not identified a public-sector-specific reason to modify AASB 17/PBE IFRS 17 regarding this matter. Staff recommend not taking any action now, except to monitor the issue of adverse development covers among public sector entities.

Question for Board members

Q1: In respect of adverse development covers, do Board members agree with the staff recommendation to take no action now, but to monitor the issue in respect of public sector entities?

Investment components

Background

19. IFRS 17 has been designed to apply to all types of insurance contracts, many of which have conventionally been hybrid contracts that include both an insurance component and an investment component.

20. Under AASB 17/PBE IFRS 17, an 'investment component' is defined as follows:

> The amounts that an insurance contract requires the entity to repay to a policyholder in all circumstances, regardless of whether an insured event occurs.

21. This definition could potentially be applicable to a range of general insurance contracts that have not been conventionally considered to have investment components, as demonstrated in the following simplistic example for a workers' compensation contract with a coverage period from 1 July 20X1 to 30 June 20X2.

Premium from employer to insurer	Paid on 15 July 20X1	$1,000
Expected claims	Coverage for 1 July 20X1 to 30 June 20X2	$900
Rebate if actual claims are below $800	Coverage for 1 July 20X1 to 30 June 20X2	$50

22. The insurer will repay the employer $50 in all circumstances, either as claims or a premium rebate, as shown in the following table. Accordingly, the $50 is an investment component.

3 Please note that staff do not presume the Boards would wish to modify AASB 17/PBE IFRS 17 in the event that adverse development covers became a material issue in the public sector, since the information resulting from applying AASB 17/PBE IFRS 17 [unmodified] may be considered useful.

Level of claims	Repaid to employer	Nature of repayment
$1,100	$1,100	All claims
$900	$900	All claims
$800	$800	All claims
$700	$750	Part claims, part rebate
$0	$50	All rebate

Accounting treatment of investment components

23. AASB 17/PBE IFRS 17 paragraphs10–13 and AG31 require insurers to identify ***distinct*** 'investment components' and account for them separately under AASB 9/PBE IPSAS 41, which would involve:

- presenting investment components in the balance sheet as a financial liability, rather than as part of the insurance liabilities; and
- accounting for the revenue and expense impacts of the investment component under AASB 9/PBE IPSAS 41.

24. When 'investment components' relate to cash flows that are highly interrelated with the relevant insurance contracts, they are ***non-distinct*** based on AASB 17.B32/PBE IFRS 17.AG32, and are accounted for under AASB 17/PBE IFRS 17, which would involve:

- presenting investment components in the balance sheet as part of the insurance liabilities; and
- not recognising any revenue or expense impacts of receiving or repaying the investment component in the income statement under AASB 17 [or AASB 9].

The workers' compensation example above is for a ***non-distinct*** investment component and would be accounted for within AASB 17/PBE IFRS 17.

Stakeholder feedback received during outreach

25. Staff have been conducting outreach among workers' compensation insurers in the public sector to help determine whether investment components are likely to arise. Based on the feedback received so far from entities that have considered the issue:

- most claims-related premium adjustments [including rebates] are made to the following year's premiums, which does not give rise to an investment component because it relates to a different coverage period and claims-related premium adjustments are a valid form of risk-rating for the subsequent premium; and
- there is only an immaterial level of claims-related premium adjustments that are made to current year premiums, which could give rise to an investment component.

26. However, some public sector entities have not yet given sufficient consideration to the issue to determine whether they would have material investment components.

Public versus private sector context

27. The notion that a public sector entity would exclude a portion of its levy/premium income from its income statement on the basis that it represents investment components may seem counter-intuitive to users of the financial statements. That is, there may ordinarily be an

expectation among users that a public sector entity would report as income all the levies/premiums it collects for accountability purposes.

28. However, there is no explicit basis for regarding the issue of non-distinct investment components in the public sector as being different from the private sector.

Staff recommendation [4]

29. Based on the feedback received to date, staff have not identified a public-sector-specific reason to modify AASB 17/PBE IFRS 17 regarding this matter. Staff recommend monitoring the issue of investment components among public sector entities.

Question for Board members
Q2: In respect of the investment component issue, do Board members agree with the staff recommendation to take no action now, but to monitor the issue in respect of public sector entities?

4 Please note that staff do not presume that the Boards would wish to modify AASB 17/PBE IFRS 17 in the event that investment components became a material issue in the public sector, since the information resulting from applying AASB 17/PBE IFRS 17 [unmodified] may be considered useful.