Australian Government
Australian Accounting Standards Board

AASB Transition Resource Group for AASB 17 *Insurance Contracts*

Implementation question discussed by the Private Health Insurers (PHI) focus group – PAA Eligibility

Submission date	01/06/2021
Name	Ciara Wasley
Title	Coordinator of PAA Eligibility paper
Organisation	PHI focus group (a working group of the AASB TRG)
Stakeholder group	Industry Group

Potential implementation question

The purpose of this paper is to discuss the likely extent of, and approach for Private Health Insurance (PHI) applying the Premium Allocation Approach (PAA) for the measurement of insurance contract liabilities.

The default measurement model under AASB 17 is the General Measurement Model (or GMM). In certain circumstances, AASB 17 allows the simpler PAA to be used instead of the GMM.

Accounting for insurance liabilities under the PAA is more similar than the GMM to the current application of AASB 1023 General Insurance Contracts. The PAA does not require separate identification and tracking of the profit component of premium, does not require full cash flow modelling for profitable business, the disclosures are more straightforward, and there is potentially less work required when considering whether a group of contracts is onerous.

Paragraph of IFRS 17 *Insurance Contracts*

AASB 17.53-54.

Analysis of the question

The analysis of the question should include a detailed description of the different ways the new Standard may be applied, resulting in possible diversity in practice.

Refer to appendix A for the paper drafted and discussed by the PHI industry

Is the question pervasive?

Explain whether the question is expected to be relevant to a wide group of stakeholders.

The question is relevant for PHI's and may also impact others with similar products in Australia.

Appendix A – PAA Eligibility considerations for Australian PHI

A.1. PAA Eligibility

PAA can be used for the following groups of contracts:

- The group consists entirely of contracts with a coverage period of 12 months or less; or
- Measurement of the Liability for Remaining coverage (LfRC) for the group under the PAA would not reasonably be expected to differ materially from measurement under the GMM.

The table below summarises the likely application to typical PHI business:

Contracts	Eligible to use PAA?	
	Contract boundary 12 months or less[1]	**Contract boundary more than 12 months**[2]
Monthly payment and auto-renewal (e.g. Domestic and Overseas Visitor Cover (OVC))	Yes	
Prepaid 12-month in advance (e.g. Domestic)	Yes	
Overseas Students Health Cover (OSHC) that have 12-month or less coverage period	Yes	
OSHC that have more than 12-month coverage period		Yes, but only if testing is passed
Prepaid in advance in excess of 12 months (e.g. Domestic)		Yes, but only if testing is passed

[1] Domestic, OVC and a small portion of OSHC contracts have been determined to have a coverage period of 12 months or less, and therefore automatically qualify for PAA as outlined in the contract boundary paper presented at the 22 March 2021 AASB17 Transition Resource Group (TRG) meeting.

[2] A PAA eligibility assessment is required to demonstrate that the LfRC under the PAA would not differ materially from the one that would be produced when applying the GMM. For example, PAA eligibility testing to assess for a sample of 3-year and 5-year OSHC contracts, whether the PAA would produce a measurement of LfRC that will not differ materially from LfRC that would be produced when applying the GMM.

A.2. PAA Eligibility assessment

A.2.1 Accounting requirements

AASB 17:53 provides guidance to allow an entity to use PAA for measuring a group of insurance contracts if, and only if, at the inception of the group:

a) the entity reasonably expects that such simplification would produce a measurement of the liability for remaining coverage for the group that would not differ materially from the one that would be produced applying the GMM; or
b) the coverage period of each contract in the group (including insurance contract services arising from all premiums within the contract boundary determined at that date) is one year or less.

AASB 17:54 clarifies that the criterion in paragraph 53(a) is not met if at the inception of the group an entity expects significant variability in the fulfilment cash flows that would affect the measurement of the liability for remaining coverage during the period before a claim is incurred. Variability in the fulfilment cash flows increases with, for example:

(a) the extent of future cash flows relating to any derivatives embedded in the contracts; and
(b) the length of the coverage period of the group of contracts.

A.2.2 Applicability to PHI

A. Domestic insurance contracts, OVC and OSHC with contract boundaries that are 12 months or less.

For PHIs with a 1 April contract boundary for domestic and OSHC contracts, the following insurance contracts have contract boundaries that are 12 months or less[1]:

- Fortnight or monthly and auto-renewal domestic insurance contracts.
- Members on other prepayment frequencies, i.e. quarterly, half yearly, annual.
- OSHC insurance contracts that have a coverage period of 12 month or less.

[1]Note: Under some fund rules, contracts can be prepaid up to 14 months (or more) in advance. This is the case for which is expected to be an insignificant number of policies. Given the insignificant number of policies and dollar value it is concluded that the timing of cashflows under these policies will not deviate materially from contracts prepaid for 12 months or less. Note that each PHI will need to make their own assessment of this and validate this conclusion, including the consequences of a longer contract boundary.

As such, those contracts meet the AASB 17:53(b) criterion and are automatically eligible for the application of PAA.

B. OSHC contracts with contract boundaries that are longer than 12 months

The remaining contracts that do not automatically qualify for PAA are OSHC insurance contracts that have coverage periods (i.e. contract boundaries) that are more than 12 months. The coverage periods of these contracts vary, mostly depending on the duration of the tertiary courses that policyholders have enrolled into. A large proportion of the products sold are 3-year policies, but some are 5 years.

To qualify for PAA, these contracts would be assessed to determine whether measurement under PAA would differ materially from if the GMM were applied: AASB 17:53(a).

A.2.3 Testing Methodology – Possible Approaches:

A number of methodologies for testing PAA eligibility are available. Set out below are two possible methods considered by PHIs to date:

<u>Insurer 1:</u>

<u>Approach to Baseline PAA Eligibility Testing</u>

Insurer 1 has proposed PAA eligibility testing using the following approach:

The PAA LfRC at each modelled balance sheet date is tested to check whether it is within 10%* of the GMM LfRC.

$$\frac{(GMM\ LfRC\ at\ time\ t) - (PAA\ LfRC\ at\ time\ t)}{(GMM\ LfRC\ at\ time\ t)}$$

* Each insurer should determine a percentage and document the rationale for the percentage chosen

If the group of contracts fails the tests above, then any potential difference in LfRC is assessed in terms of financial statement materiality and a judgement is taken over whether it is still appropriate to apply PAA accounting.

<u>Consideration of Materiality</u>

For the purposes of the PAA eligibility testing, insurer 1 proposed that a relatively large standard stress of an absolute increase in the loss ratio of 10% is applied as a start point, which can then be reviewed in line with 'reasonable expectations' for an individual product if the test is failed. Insurer 1 considered loss ratio stress of 10% at AASB 17 group granularity is expected to be sufficiently large, beyond 'reasonably expected' and concluded that it will not lead to material omissions or misstatements in as

defined in AASB 101 *Presentation of Financial Statements.* This will need to be assessed in the context of the insurer's materiality policy.

<u>Sample Size</u>
Insurer 1 proposed the PAA eligibility assessment for PHIs can be performed using a sample representative 3-year contract (the average product tenure) and a 5-year contract (the higher end of the range). If each sample passes the PAA eligibility test, it can then be assumed all OSHC contracts will pass the test. This is because all of the OSHC contracts within a portfolio have substantially the same characteristics and measurement factors (for example, discount rates, timing of claims). Note that each insurer will need to ensure that populations sampled from are appropriately homogenous in nature to achieve appropriate stratification of sampling.

<u>Ongoing testing and materiality</u>
Insurer 1 proposed that if the testing is passed, no further formal testing is required for OSHC if through qualitative assessment, it can be demonstrated that the conclusions reached in prior quantitative eligibility assessments can be relied upon to demonstrate eligibility for the new groups. This assessment should take into account experience changes over time.

<u>Stress Testing</u>
AASB 17.53(a) states the premium allocation approach can be applied where "at the inception of the group the entity reasonably expects that such simplification would produce a measurement of the liability for remaining coverage for the group that would not differ materially from the one that would be produced applying the requirements in paragraphs 32–52".

Therefore, PHIs are required to consider a range of potential scenarios that may be reasonably expected to occur in each future reporting period within the coverage period and compare the liability for remaining coverage using the GMM and the liability for remaining coverage using the premium allocation approach under these scenarios.

Insurer 1 considered the following examples of scenarios for stress testing can include:

Stress	**Threshold**
Loss ratio (LR)	• A PHI's insurance contracts that do not automatically qualify for the PAA are still relatively short term and tend to have claims patterns that are highly predictable, so significant variability in the fulfilment cash flows is not expected. Note that this will need to be validated for each PHI, particularly smaller PHIs with growing portfolios which may have loss ratios that are much more uncertain. • For the purposes of the PAA eligibility testing, it is proposed that a relatively large standard stress of an absolute increase in the loss ratio (LR) of 10% percentage points is applied as a start point, which can then be reviewed in line with 'reasonable expectations' for an individual product level if the test fails. As per above however, for small and growing portfolios this percentage may need to be increased where volatility is higher.
Risk adjustment	• The Risk Adjustment is modelled as a percentage of future claims paid. This means that the LR sensitivity described above would serve as an appropriate proxy for the risk adjustment sensitivity. • The risk adjustment stress can also encompass stress over a variance in management expenses.
Interest rate (YC)	• A variance in interest rates that would be expected to be significant, i.e. 1% change in percentage points.

Stresses are applied on an individual and combined basis, as follows:

LR +10%
LR -10%
YC +1%

YC -1%
LR +- 10% & YC +-1% (the combination producing the largest stress is selected)

The stresses are applied at time period 1 (i.e. at the end of month 1 or quarter 1, depending on payment patterns), as this would generally be expected to result in the largest variance in the LfRC.

Insurer 2:

Approach to Baseline PAA Eligibility Testing

Insurer 2 modelled insurance contract liabilities balance as at June 2020 under different scenarios estimated using their forecast model:

- The base case included a risk adjustment of 9% (to be determined by each insurer individually) on the fulfilment cash flow liabilities including the Liability for Incurred Claims (LfIC) and the contractual service margin for GMM and a premium earning pattern based on the risk profile and a risk adjustment of 9% for LfIC for the PAA.
- An alternate scenario removed the 9% risk adjustment on the GMM and PAA.
- A third scenario changed from a risk-based premium earning pattern to uniform earning pattern for the PAA.

As the LfIC is measured on the same basis under both the GMM and PAA approach, any difference in total insurance liabilities is as a result of the LfRC. All approaches gave materially similar results.

Consideration of Materiality

Insurer 2 proposed that materiality would be subject to overall materiality for the financial report as a whole based upon approximately 5% of profit before tax in line with the audit plan. The risk under this approach is the cumulative impact of summary of unadjusted misstatements.

Sample Size

Insurer 2 modelled its total population of OSHC policies.

Ongoing testing and materiality

Insurer 2 proposed doing testing annually to satisfy the requirement that annual report is materially correct. For interim reporting, if there is no material change to the OSHC portfolio e.g. change in contract periods, there is no indication that testing would produce different results and therefore would not be required.

The alternative is to test a sample of 3-year policies and 5-year policies instead of the total population of OSHC policies and establish a policy framework to require retesting only when there is a material change in OSHC portfolio.

Stress Testing

Similar stress tests were applied as for Insurer 1.

A.3. Summary of discussions of PAA Eligibility

PHI insurance contracts with coverage periods of 12 months or less are automatically eligible for PAA. For contracts with coverage in excess of 12 months the ability to use PAA will need to be demonstrated through an assessment of the contracts for PAA eligibility potentially including modelling of the relevant contracts. The requirement for PAA eligibility testing is expected to primarily focus on OSHC contracts due to their longer coverage. The PHI focus group members reached a general consensus on adopting the approach of “Insurer 1” for PAA eligibility testing and materiality.

For contracts that apply PAA a summary of the key accounting requirements compared to current accounting under AASB 1023 are included in A.4. Note that this listing does not cover all accounting requirements.

A.4. PAA accounting approach

Revenue recognition under AASB 17 is generally expected to be the same as that adopted under AASB 1023:

- Straight-line passage of time basis for Domestic and OVC
- Pattern of incidence of risk/expected pattern of release of risk for OSHC, assuming PAA eligible

Balance sheet:

- Within a portfolio, insurance assets are netted off against insurance liabilities on the balance sheet under AASB 17 resulting in a net insurance asset or liability.
- Insurers may consider a practical expedient of determining that unearned premium less premium receivables less deferred insurance acquisition cash flows (for current group) under AASB 17 equates to the LfRC under the PAA (i.e. premiums received adjusted for any premium earned for which premium is not yet received).
- Insurers may choose to recognise any insurance acquisition cash flows as expenses when it incurs those costs, provided that the coverage period of each contract in the group at initial recognition is no more than one year.
- Loss component recognised for contracts which are onerous at inception, or groups which subsequently become onerous, similar to the concept of the liability adequacy test albeit at a potentially more granular level.

Outstanding claims provision (AASB 1023) / LfIC (AASB 17):

- the LfIC under the PAA approach, is similar to that measured using the GMM.
- Some insurance service expenses currently recorded through other creditor balance sheet accounts are required to be included in LfIC for presentation purposes.
- No fundamental changes to the principles in estimating future cash flows when measuring the outstanding claims liabilities under AASB 1023 are expected when measuring the LfIC under AASB 17. Under AASB 17 the LfIC will comprise of all outstanding liabilities/assets relating to insurance contracts arising from earned business. Some of these will be of certain amounts (e.g. processed but unpaid liabilities) and some will be uncertain (claims costs, risk equalisation asset/liabilities). The risk adjustment will be relevant to the uncertain liabilities/assets (e.g. a percentage increase to the uncertain liabilities/assets). The risk adjustment may be zero for certain assets/liabilities (e.g. processed but unpaid liabilities). Refer to The Risk Equalisation and Risk Adjustment papers for further discussion on components to be included in LfIC.