



Implications for public sector insurers of a revised IFRS 4

1. This paper:
 - (a) provides a high-level outline of the insurance landscape in the public sector;
 - (b) identifies three matters for the Board to consider in terms of whether a revised IFRS 4 *Insurance Contracts* might need modification for public sector insurers; and
 - (c) seeks the Board's preliminary views on those three matters and asks what next steps the Board wants to take.

Landscape

2. Insurance, as an activity, is not inherently a for-profit activity. The main issues in this paper relate to the public sector context compared with the private sector commercial context in which the IASB has been preparing the revised IFRS 4. Accordingly, this paper does not address the for-profit versus not-for-profit context that is normally the case when the Board considers the implications of a draft new or revised IFRS for entities within its wide mandate.
3. Some public sector insurers are regarded as for-profit entities and others as not-for-profit (public benefit) entities. For example, the financial statements of the Victorian Transport Accident Commission are prepared on the basis that the Commission is a for-profit entity, while the financial statements of the NZ ACC are prepared on the basis that it is a public benefit entity.
4. Some Australian states have entities that operate mainly as insurers. These include, for example, the Motor Accidents Insurance Board in Tasmania and the Victorian Workcover Authority. New Zealand's Accident Compensation Corporation (NZ ACC) provides a wide range of insurance risk coverage, including for injuries relating to motor vehicle and workplace incidents.
5. It is also relevant to note that the landscape has been changing with an underlying trend towards more private sector involvement. For example, from 1 July 2016, the Motor Accident Commission in South Australia will cease to write new business and a scheme similar to that operating in NSW, Queensland and the ACT will be introduced.¹
6. Some public sector insurance entities are effectively self-managed insurance agencies for other parts of government. These include Comcover that reports as part of the Australian government's Department of Finance and the Victorian Managed Insurance Authority (VMIA) that manages risks such as those relating to hospitals, schools and public works. At the whole of government level, these entities are self-insuring, at the individual entity level, they are typically insurers, taking on risks on behalf of other entities (see definitions in paragraph 12 of this paper).

¹ The NSW, Queensland and ACT compulsory third party motor vehicle insurance markets involve private sector insurers selling policies at premiums and with terms and conditions within regulated bands.

7. Many public sector insurers, such as the NZ ACC and VMIA also have a significant role in risk prevention through advice and education.

Standards being applied

8. AASB 4/NZ IFRS 4 *Insurance Contracts* and AASB 1023 *General Insurance Contracts* and Appendix D *Financial Reporting of Insurance Activities* of NZ IFRS 4 are currently applied to insurance contracts and insurance-like contracts of public sector entities. Staff are not aware of any life insurance contracts within government entities that are accounted for using AASB 1038 *Life Insurance Contracts* or Appendix C *Life Insurance Entities* of NZ IFRS 4.
9. The revised IFRS 4 will include two models – the ‘general model’, which is essentially for contracts with multi-year coverage periods and the ‘simplified model’, which can be used when it would result in materially the same accounting as the general model.
10. The general model is similar to the approach in AASB 1038 and Appendix C of NZ IFRS 4 and involves measuring insurance liabilities by discounting all the expected cash flows, including expected premiums yet to be received. The simplified model is highly similar to the accounting required by AASB 1023 and Appendix D of NZ IFRS 4 and involves initially measuring insurance liabilities at the amount of the premium, subject to an onerous contract (or liability adequacy) test.
11. There is a presumption that the simplified model can be applied to contracts with coverage periods of one year or less. The insurance contracts held by public sector entities in Australia and New Zealand would typically have coverage periods of one year or less and would qualify to use the ‘simplified model’ under the revised IFRS 4 (but see the section below on ‘Contract length’).

GAAP-GFS

12. In general, Government Finance Statistics (GFS) seeks current value amounts and, essentially, the revised IFRS 4 will require or permit current value measures for the liabilities associated with insurance contracts. The measurement of assets is not directly affected by IFRS 4.
13. GFS regards the re-measurement of insurance liabilities as a ‘revaluation’, however, both the existing and forthcoming insurance standards generally require re-measurements of insurance liabilities to be included in profit or loss to the extent they are not adjusted against the margin on services (under AASB 1038 *Life Insurance Contracts*) or contractual service margin (under a revised IFRS 4). An exception would be when an insurer chose, under a revised IFRS 4, to recognise the impact of changes in discount rates on insurance liabilities in other comprehensive income.

At this stage, the **staff view** is that the Board need not further consider issues relating to GFS.

Does the Board agree with the staff view?

Features of public sector insurers

Monopoly providers

- 14. Many public sector insurers are effectively monopoly or near monopoly providers of particular types of insurance and their activities might be regarded more as ‘social benefit’ activities. This is how the IPSASB characterised some insurance activities conducted by governments in its 2015 Consultation Paper *Recognition and Measurement of Social Benefits*. That Paper included a preliminary view that social benefits similar to insurance contracts should be accounted for as insurance.
- 15. It is possible to theorise that a monopoly is not really bearing insurance risk because it can pass that risk back to its customers by adjusting future premiums for its ‘captive’ policyholders. Based on this theory, its contracts might be regarded as not meeting the insurance contract definition. The existing IFRS 4 definitions, which the IASB is not proposing to change, include the following:

insurance contract: A contract under which one party (the issuer) accepts significant **insurance risk** from another party (the **policyholder**) by agreeing to compensate the policyholder if a specified uncertain future event (the **insured event**) adversely affects the **policyholder**.

insurance risk: Risk, other than **financial risk**, transferred from the holder of a contract to the issuer.

- 16. Staff consider that, in respect of contracts currently in-force and at the individual contract level, the definition would be met. Staff also consider that, if the definition were regarded as not being met, provided the contracts were ‘insurance-like’, they would probably be best accounted for as insurance contracts by analogy.²
- 17. The main alternative (to applying the insurance requirements) under existing GAAP would be to apply AASB 137/NZ IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* to ‘insurance-like’ contracts. This not a new issue – public sector entities have already had to choose whether they would apply the insurance standards or AASB 137/NZ IAS 37 to insurance-like contracts. The only new aspect is whether the revisions to the insurance standards should be a reason for changing this choice.
- 18. In some cases, AASB 137/NZ IAS 37 might be a simpler solution to accounting for such contracts and in other cases a more complex solution, particularly given that the simplified model in the revised IFRS 4 is likely to apply in most cases (but see the section below on ‘Contract length’). The main differences would be:

<i>AASB 137/NZ IAS 37</i>	<i>Insurance accounting</i>
One liability for each contract or set of contracts	Two liabilities – one for future coverage – one for claims liabilities
Movements in provisions would be the only sources of income	Income would be from releases from the risk margin and the CSM and from changes in claims liabilities
General disclosures around the risks and uncertainties of the provisions	Targeted disclosures about insurance risks

2 In accordance with paragraph 11 of AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors*.

At this stage, **staff recommend** that the Board not provide clarifications about the effect of the monopoly position of a public sector insurer (or any other public-sector factor) on whether its contracts are within the scope of the revised IFRS 4, essentially because the issue is not new.

Does the Board agree with the staff recommendation?

Contract length

19. Given the monopoly status of many public sector insurers, it might be argued that, even though their contracts or other arrangements typically have one-year coverage periods, policyholders have little choice but to insure with the entity and the entity may have no choice but to accept any prospective policyholder.
20. The revised IFRS 4 will require the contract boundary to be set from inception to the point at which “the entity has the right or the practical ability to reassess the risks ... and, as a result, can set a price or level of benefits that fully reflects those risks”. This can be applied at a portfolio level. If public sector insurers are able to annually reset premiums or levies³, they would generally be able to reflect an up-to-date assessment of risks. However, governments may use public sector insurers as instruments of public policy and require them to manage their premiums in a way that does not ‘fully reflect’ the relevant risks.
21. There has been considerable discussion at the IASB and among its stakeholders about how to treat contracts when insurers can only adjust premiums up to a ceiling percentage that is subject to government approval.⁴ There has been no clear response from the IASB specifically on this issue, but indications are that the approved percentage ceilings would need to be able to allow insurers to fully reflect the relevant risks. To the extent that an insurer is unable to fully reflect the relevant risks after the expiry of the current nominal contract period, the length of the contract could be deemed to extend for as long as the inability to fully re-price is expected to continue. This, in turn, may require the entity to apply the general model in the revised IFRS 4 in accounting for those contracts, which would involve considerably more work than their existing accounting.
22. Although this issue of potentially not being able to fully reflect risks in future premiums is not unique to the public sector, it may be more prevalent in the public sector.

At this stage, **staff recommend** that the Board, as an expedient for the public sector, should consider having nominal contract lengths treated as the contract lengths for the purposes of the revised IFRS 4. This expedient would largely allow existing accounting approaches to be applied while the outcomes of the IPSASB’s work on social benefits, which covers public sector insurance schemes, becomes clearer.

Does the Board agree with the staff recommendation?

3 Some public sector insurers, such as NZ ACC, collect some premiums via levies on payroll or other bases.
4 Health insurance in Australia operates on this basis.

Unit of account and onerous contracts

23. Although the IASB has made tentative decisions on a number unit of account issues, it has yet to determine how they might all function together. Accordingly, it is not entirely clear whether some of the concerns we currently have with the tentative decisions will be addressed by the time the revised IFRS 4 is finalised. This issue is also covered in agenda paper 10.3.
24. In brief, the IASB's ED/2013/7 *Insurance Contracts* included proposals implying various units of account having implications for determining risk margins (including the extent to which diversification is taken into account), determining the CSM and assessment of onerous contracts. This paper focuses on onerous contract issues.
25. ED/2013/7 proposed recognition of an onerous contract liability if, at initial recognition or subsequently, facts and circumstances indicate that the portfolio of insurance contracts containing the contract is onerous. The IASB has since made a number of clarifications indicating that a portfolio is identified as a group of contracts covering similar risks and having similar expected profitability (that is, a similar CSM as a percentage of premium) at inception.
26. The assessment is to be based on all the information available to the insurer and there is no exception to the level of aggregation for determining onerous contracts when regulation affects the pricing of contracts.
27. The issue is best explained with an example, such as transport accident personal injury insurance in some Australian states under which premiums are the same for all non-business passenger vehicles. It will be known that some sub-groups of drivers will be loss-making (such as male drivers under 25). Based on the IASB's tentative decisions, those sub-groups would be required to be identified as onerous at inception, even though premiums for all drivers have been set at a profitable or break-even level for the non-business passenger vehicle portfolio as a whole.
28. The same issue exists for some private sector insurers that are required to rate communities of policyholders.⁵ Accordingly, this issue is not unique to the public sector, but it may be more prevalent in the public sector than elsewhere.

At this stage, **staff recommend** that the Board, as an expedient for the public sector, should consider deeming contracts that by regulation have the same premiums as portfolios and the unit of account for the purposes of identifying onerous contracts under the revised IFRS 4. This expedient would largely allow existing onerous contract approaches to be applied while the outcomes of the IPSASB's work on social benefits, which covers public sector insurance schemes, becomes clearer.

Does the Board agree with the staff recommendation?

⁵ Again, Health insurance in Australia operates on this basis.