Superannuation Entities – Insurance Arrangements

The purpose of this paper is to provide relevant information for the Board to decide on the approach to be included in the replacement standard for AAS 25 *Financial Reporting by Superannuation Plans* for dealing with the recognition and measurement of items arising from insurance arrangements that superannuation entities have for their members.

1. Background

1.1 Most superannuation entities offer members life insurance and some offer disability insurance either as an integral part of their superannuation or as something a member can elect to have. It is expected that MySuper will include some level of life insurance cover as a default.

1.2 Members usually have 'units' of cover that relate to group (or master) insurance policies taken out by the superannuation entity trustee.

1.3 The main tensions on this topic have been around whether, in relation to the insurance cover provided to members, a particular superannuation entity is acting merely as an agent (see ED 223, paragraph AG20 quoted below) or is accepting insurance risk (see ED 223, paragraph AG21 quoted below). Confusion sometimes arises because there is a widely held view in the superannuation industry that, provided the superannuation entity reinsures the risks, it need not account for insurance risk.[1] However, it depends on the facts in each case as to whether the superannuation entity is bearing material insurance risk for which it needs to account.

1.4 ED 223 *Superannuation Entities* (December 2011) proposed the following:

ED 223.20 In applying Australian Accounting Standards:

(a) …;

(b) liabilities arising from insurance arrangements provided to members shall be recognised in accordance with the approach applicable to defined benefit obligations under AASB 119 *Employee Benefits*; and

(c) reinsurance assets arising from insurance arrangements provided to members shall be recognised in accordance with the approach in paragraphs 6.1-6.1.2 of AASB 1038 *Life Insurance Contracts*.

ED 223.21 All recognised assets and liabilities except those relating to member benefits, tax, acquired goodwill and insurance arrangements, shall be measured at fair value at each reporting date.

ED 223.25 Liabilities arising from insurance arrangements a superannuation entity provides to its members shall be measured in accordance with the approach in AASB 119 for defined benefit obligations.

ED 223.26 The following items are recognised and presented as gains or losses in the income statement in the period in which they occur:

(a) …;

1 AASB 4 *Insurance Contracts* specifically notes that reinsurance assets must not be offset against insurance liabilities and that income or expense from reinsurance contracts must not be offset against the expense or income from the related insurance contracts [paragraph 14(d)].

(b) changes in obligations and assets arising from insurance arrangements that a superannuation entity provides to its members; …

ED 223.AG20 When a superannuation entity is acting as an agent for an external insurer, the only impact on the financial statements is to present insurance premiums charged to members' accounts as a line item in the statement of changes in member benefits. The premiums are not revenues or expenses of the superannuation entity and do not give rise to insurance liabilities or reinsurance assets.

ED 223.AG21 When a superannuation entity is acting in the capacity of an insurer, in addition to being presented as a line item in the statement of changes in member benefits, the relevant premiums are revenue, and the relevant reinsurance costs are expenses of the superannuation entity to be recognised in the income statement. The entity may also have material insurance liabilities and reinsurance assets to be recognised in the statement of financial position.

ED 223.AG22 Insurance liabilities in respect of both defined contribution and defined benefit members are recognised and measured in accordance with the requirements relating to defined benefit obligations in AASB 119. Consistent with the AASB 119 approach, short-hand techniques could be applied to measure insurance obligations, for example, deferring and matching premiums over the period, provided the amount is not materially different from the amount that would be determined using the projected unit credit method identified in AASB 119.

ED 223.AG23 Consistent with the approach under AASB 119, liabilities arising from insurance arrangements a superannuation entity provides to defined benefit members:

(a) are measured as part of the entity's obligations for such members' accrued benefits; and

(b) need not be presented separately from the entity's obligations for such members' accrued retirement benefits in the statement of financial position.

ED 223.AG24 When a superannuation entity recognises material liabilities arising from insurance arrangements it provides to defined contribution members, it presents them separately from its obligations for such members' vested benefits.

ED 223.AG25 Consistent with the approach under AASB 1038 *Life Insurance Contracts*, any assets arising from the reinsurance arrangements of a superannuation entity are presented separately from any insurance liabilities in the statement of financial position.

1.5 ED 179 *Superannuation Plans and Approved Deposit Funds* (May 2009) proposed that obligations and assets arising from insurance contracts issued by a superannuation entity should be accounted for in accordance with the principles and requirements applicable to life insurance contracts under AASB 1038.

1.6 AAS 25 does not refer to insurance contracts, other than providing relief from many of the requirements of the standard in the context of plans that have long-term insurance policies that match, and fully guarantee, the benefits to be paid to individual members (see agenda paper 7.2).

2. Feedback on ED 223 – written comments and December 2011 roundtables

2.1 There was general agreement that there are some superannuation entities that overtly self-insure, usually in relation to defined benefit members, and it is reasonable in these cases to require the recognition and measurement of any insurance assets and liabilities by applying the measurement requirements applicable to defined benefit obligations. It was also generally acknowledged that such self-insurance is becoming less prevalent and most superannuation entities enter into insurance/reinsurance contracts with insurers to cover their exposure to the insurance provided to their defined benefit members.

2.2 In the case of insurance cover provided to defined contribution members, all superannuation entities enter into insurance/reinsurance contracts with insurers. Most constituents expressed the view that these superannuation entities would be doing so as agents. While in many cases, the superannuation entity may be able to establish that they have only an agency relationship with members in respect of insurance arrangements, it also became evident that the arrangements for some superannuation entities are less clear.

2.3 In the cases where the nature of the insurance arrangements is not entirely clear, it seems that insurance cover can generally be repriced at short notice and, effectively, any insurance exposure is for such short periods that it is highly unlikely to give rise to material insurance assets and liabilities. Put another way, the financial impact of insurance risk is limited by the fact that, for example, if claims prove to be higher than expected, premiums charged to members can be increased to cover the higher cost – therefore, the risk can be transferred to, or at least shared, with members.

2.4 Some constituents also made the following comments.

* There should be further clarification about when a superannuation entity is considered to be acting as an agent and when it is considered to be an insurer.
* On occasions, superannuation entities make ex gratia payments in respect of death and disability claims where the trustees judge that a benefit should be paid even though it is not covered by reinsurance. Even if such practices were considered to give rise to constructive obligations, they would not be material.
* Referring to both AASB 119 and AASB 1038 in relation to insurance is potentially confusing, particularly to those who are not familiar with accounting for insurance liabilities. It might be best to replace the reference to AASB 1038 with requirements for any assets to be consistent with AASB 119 measurement of insurance liabilities (adjusted for the extent of cover provided by the reinsurance).
* A liability should not be recognised when an entity is inadvertently self-insuring (generally only a small portion of the overall exposure to insurance risks) due to the interaction of the insurance formula and the entity's financial position. [More discussion on this point is included in section 4 of this paper.]
* The level of detail of information that would need to be collected on insurance transactions in order to account for them under AASB 1038 is much greater than that which needs to be collected for the purposes of accounting under AAS 25.

Accordingly, relevant data (premiums in revenue, premiums charged to members, reinsurance costs, claim recoveries) is not currently captured in general ledgers. Therefore, costs of modifying systems will be incurred and these disclosures will form a complex component of any potential retrospective application.

* Full reinsurance accounting is unwarranted given the minor extent of residual risk carried by the trustee.

2.5 Staff note that, in broad terms, the aspects of AASB 1038 that would be least familiar to superannuation entities include:

* incorporating a (profit) margin in the liability (which is a present value of expected future cash flows) in respect of future services expected to be provided;
* identifying factors (profit carriers) and applying them to determine the amount of margin to amortise (release) to reflect the timing of the provision of the relevant services; and
* accounting for differences between expected and actual experience.

3. Board tentative decisions since ED 223

3.1 At its June 2012 meeting, after considering the feedback on ED 233, the Board tentatively decided that any insurance assets and liabilities should be measured consistently with the principles underpinning the measurement of defined benefit accrued benefits and guidance should be included that acknowledges (in respect of insurance coverage of members) that superannuation entities might:

(a) act only as agents and not have insurance assets and liabilities;

(b) have insurance contracts of such short duration that they would not be expected to be exposed to material insurance risks and, therefore, not have material insurance assets and liabilities; and

(c) bear material insurance risks and therefore would be expected to recognise insurance premiums, claims, assets and liabilities.

4. Recent consultation

4.1 During recent targeted consultation with key constituents, there was further discussion about whether a superannuation entity with defined benefit members might inadvertently be bearing insurance risk due to the interaction of the insurance formula and the entity's financial position.

4.2 Most trust deeds connected with defined benefit superannuation plans provide members with insurance cover – normally life insurance cover and often also disability cover. In general, this involves agreeing to pay a sum to nominated beneficiaries based on a projected retirement benefit in the event of the death or disablement of the member.

4.3 The expected timing and probabilities of members leaving a defined benefit plan (whether through transfer, resignation, retirement, death or disability) are factored into an actuarial determination of an amount for accrued benefits. However, in some circumstances, the resulting accrued benefit amount may not fully capture the risk associated with members leaving through death or disability. Such circumstances might include the following.

* The death and disability benefit might be based on a formula that uses total service to a maximum retirement date, whereas the actuarial determination might only factor in service to the reporting date even for members expected to leave the plan due to death or disability. The justification for this approach might be the view that the relevant insurance contracts will cover any gap.
* The death and disability benefit might be based on vested benefits.
* The insurance contracts acquired to cover the risks might be based on vested benefits.
* The insurance contracts acquired to cover death and disability risks might not be regularly adjusted to take account of changes in the difference between accrued benefits and the assets available to meet those benefits.

4.4 Staff note that the proposal in paragraph 20(b) of ED 223 (quoted in paragraph 1.4 of this paper) was intended cause superannuation entities to apply the AASB 119 approach to measuring defined benefit liabilities such that the insurance risks are fully captured. However, that point was not widely appreciated by constituents.

4.5 Board has tentatively agreed to change the requirement for measuring accrued benefits of defined benefit members from applying the requirements in AASB 119 to a more principle-based present value of future cash flows approach. Nevertheless, the same approach as taken in ED 223 could be used with this (revised) measurement principle, such that the insurance risks are fully captured in the accrued benefit liability calculation.

4.6 In the triennial actuarial investigation, actuaries are required to consider insurance issues, in particular, whether the insurance together with assets in the plan are sufficient to cover benefits or whether there is some self-insurance.[2] If there is an element of self-insurance there will typically be some comment in the actuarial report on how it is being managed.

4.7 There are a number of factors that should mitigate against the insurance risks that are not captured in accrued benefit calculation being material. These include:

* most defined benefit plans are closed to new members and as members approach retirement age there is less future service element;
* the Stronger Super reforms will place pressure on plans to be better funded; and

2 Institute of Actuaries of Australia PS 400 *Investigations of the Financial Condition of Defined Benefit Superannuation Funds* (August 2010)

- * the Stronger Super reforms are likely to encourage trustees to take a closer look at the insurance arrangements in place for defined benefit members and to result in less self-insurance.

5. Staff comments and recommendations

Guidance on agency

5.1 Staff consider that the replacement standard for AAS 25 should provide further guidance (sought by constituents responding to ED 223) to help superannuation entities determine when they are acting as agents (rather than insurers). That guidance should be along the following lines:

- * it is indicative of a superannuation entity acting as an agent in respect of the insurance cover provided to members when:
  - + members (or their beneficiaries) will only receive insurance benefits if the insurer/reinsurer pays claims;
  - + if insurance benefits are paid to members (or their beneficiaries) through the superannuation entity, this is essentially for administrative reasons;
  - + the superannuation entity is collecting premiums that are passed on to an insurer and the amounts collected are effectively set directly by reference to the premiums forwarded to the insurer; and
- * it is not necessarily indicative of a superannuation entity trustee acting as an insurer simply because:
  - + (group) insurance cover is taken out in the name of the superannuation entity trustee; and
  - + ex gratia payments have occasionally been made by the trustees in respect of death and disability benefits.

Guidance on materiality

5.2 Staff consider that the replacement standard for AAS 25 should provide further guidance to help superannuation entities that are identified as potentially acting as insurers (not agents) determine when insurance risk is material. That guidance should include the notion that, when a superannuation entity is effectively able to transfer, or at least share, the insurance risks with members by adjusting premiums charged to member accounts at short notice, the level of insurance risk is likely to be such that the entity would not have material insurance assets and liabilities.

5.3 It could be argued that, if a superannuation entity is effectively able to transfer, or at least share, the insurance risks with members, it does not have insurance contracts with them because the entity is not bearing 'insurance risk' as defined in AASB 4 ["risk, other than financial risk, transferred from the holder of a contract to the issuer" – AASB 4, Appendix A]. Although staff consider that this argument has merit, we think it is preferable to argue that there is a transfer of risk for a short time, meaning the consequences of the risk transfer are not material.

Recognising/measuring liabilities arising from insurance arrangements

5.4 Staff note that the Board has already tentatively agreed to change the requirement for measuring accrued benefits of defined benefit members from applying the requirements in AASB 119 to a more principle-based present value of future cash flows approach. The discussion below presumes this tentative decision is implemented.

5.5 Staff consider there to be three main approaches that the Board should consider in finalising a replacement standard for AAS 25:

A. broadly retain the ED 223 approach that liabilities arising from insurance arrangements provided to ALL members be recognised in accordance with the way in which defined benefit liabilities are recognised/measured;

B. retain the ED 223 approach that liabilities arising from insurance arrangements provided to members be recognised in accordance with the way in which defined benefit liabilities are recognised/measured ONLY in respect of defined benefit members AND require the use of AASB 1038 *Life Insurance Contracts* in respect of defined contribution members;

C. require the use of AASB 1038 *Life Insurance Contracts* in respect of ALL members.

Staff note that, consistent with paragraph 4.4 of this paper, if reference to "recognised in accordance with the way in which defined benefit liabilities are recognised/measured" is made in the replacement standard for AAS 25 in connection with insurance, it should be accompanied by an explanation that it means the insurance risks are fully captured in that measurement.

5.6 The main arguments in favour of Approach A are also the arguments against Approaches B and C:

* contributions in respect of self-insured defined benefits do not include explicit insurance premium components and, while a plan's actuary would normally estimate that component for tax purposes, that may not meet the relevant requirements [also raised at ED 223, paragraph BC154(a)];

* for some plans, a member's resignation benefits and death and/or disability benefits are linked and would be included as part of the defined benefit obligation, with the death and/or disability component not being separately calculated [also raised at ED 223, paragraph BC154(a)];

* the amount of any self-insured defined death and/or disability benefit may not be readily identifiable where the benefit is not defined in terms of an accrued (retirement) amount plus an insured component [also raised at ED 223, paragraph BC154(a)];

* applying AASB 1038 would impose significant additional costs, including the cost of systems for capturing the necessary information [also raised at ED 223, paragraph BC154(b)]; and
* requiring the use of AASB 1038 may involve a second set of implementation costs when the Phase II Insurance Contracts project is completed [also raised at ED 223, paragraph BC154(b)].

5.7 The main argument in favour of either Approach B or C is the key argument against Approach A – that requiring superannuation entities to recognise insurance contract liabilities in respect of defined contribution members in accordance with the way in which defined benefit liabilities are recognised/measured would involve some plans in applying that measurement basis specifically for the purpose of insurance accounting. That is, the advantages of applying the defined benefit liability recognition/measurement approach for insurance contract liabilities is only relevant in respect of defined benefit members.

5.8 Approaches A and C can be supported on the basis that they would each be faithful to the general view that the same accounting policies should be applied to the same types of transactions (whether they relate to defined contribution or defined benefit members).

5.9 On balance, staff consider that Approach B is the best option on the basis that:

* incorporating the insurance risk in the accrued benefit calculation provides a relatively cost-effective solution in respect of defined benefit members;
* the application of AASB 1038 is the most appropriate accounting response in relation to insurance contracts in respect of defined contribution members; and
* the general cost impact of having to apply AASB 1038 should be minimal because: some insurance contracts associated with defined contributions would involve agency arrangements, and most of those superannuation entities not acting as agents would not be expected to have material insurance assets and liabilities.

Recognising reinsurance assets arising from insurance arrangements

5.10 There is an argument that, if Approach B (above) were adopted as staff recommend, it would be inappropriate to require reinsurance accounting in line with AASB 1038 in respect of defined benefit member insurance contract liabilities. This is because the insurance contract liabilities would not be determined using AASB 1038.

5.11 However, staff note that the AASB 1038 reinsurance accounting requirements in relation to cedents (those passing on the insurance risks) are very general in nature [AASB 1038, paragraphs 6.1 to 6.1.2]. AASB 1038 requires reinsurance receivables to be recognised but does not specify how they are measured, other than to note they should be adjusted when they are impaired [AASB 1038, paragraph 7.1.1]. Accordingly, they imply that reinsurance assets are measured consistent with the measurement of the insurance contract liabilities to which they relate. If the insurance contract liabilities in respect of defined benefit members are measured in accordance with the way in which defined benefit liabilities are measured, the reinsurance assets under AASB 1038 would be measured on the same basis.

5.12 Accordingly, staff recommend requiring the application of paragraphs 6.1 to 6.1.2 and 7.1.1 of AASB 1038 in respect of reinsurance assets associated with defined benefit member insurance contract liabilities together with guidance explaining that reinsurance assets would be measured in a manner consistent with the related liabilities.

5.13 Staff recommend the same approach be adopted in relation to insurance arrangements provided to defined contribution members for the same reasons as outlined in paragraph 5.11.

Board members are asked to identify their views on the staff comments and recommendations on:

- **guidance on agency in paragraph 5.1**
- **guidance on materiality in paragraphs 5.2 and 5.3**
- **recognising/measuring liabilities arising from insurance arrangements in paragraphs 5.4 to 5.9**
- **recognising reinsurance assets arising from insurance arrangements in paragraphs 5.10 to 5.13.**