IFRS Transition Resource Group for IFRS 17 *Insurance Contracts* (TRG)
Submission form for potential implementation question

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Contact	James Barden
Title	Measurement of the risk adjustment
Organisation	Australian Accounting Standards Board (AASB) Transition Resource Group for AASB 17 *Insurance Contracts*
Address	530 Collins Street Melbourne Australia
Telephone	+61 3 9617 7600
Email address	standard@aasb.gov.au
Stakeholder group	National Transition Resource Group

Potential implementation question

In applying the IFRS 17.37 requirement to measure the risk adjustment as the compensation required for bearing non-financial risk (for both liabilities for remaining coverage and liabilities for incurred claims) how should insurers conceptually and practically apply these requirements to a consolidated Group?

Paragraphs of IFRS 17 *Insurance Contracts*

IFRS 17.33; IFRS 17.37; IFRS 17.119; IFRS 17.B54 to B60; IFRS 17.B86 to B92.

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.

1. Reason for bringing this issue to the TRG

1.1 The discussion at the May 2018 TRG meeting on Agenda Paper 02 (AP02) was inconclusive as regards the setting of a risk adjustment (as reflected in the meeting minutes) at the consolidated Group[1] level and highlighted that there are two alternative views on the way in which IFRS 17 could be interpreted in respect of this issue.

(1) The IASB staff view outlined in AP02 that the risk adjustment may not vary between a subsidiary and Group level reporting entity.

(2) The **reporting entity view** of the risk adjustment, which means risk adjustments may vary between a subsidiary and Group level reporting entity.

1.2 AP02 indicates the reference to 'entity' in IFRS 17, in the context of setting a risk adjustment, should be interpreted as the entity issuing the contract and not, where the issuing entity is controlled by another entity, the Group entity. The IASB staff view in AP02 is:

> 21 **Determining the compensation that the entity would require for bearing non-financial risk related to insurance contracts issued by the entity is a single decision that is made by the entity that is party to the contract** (ie the issuer of the insurance contract). In making that decision the entity chooses what factors to consider, including whether or not to consider the

1 The word 'Group' [capital 'G'] is used in this Paper to refer to a "A parent and its subsidiaries" [which is the definition of 'group' in IFRS 10 *Consolidated Financial Statements*], not to be confused with a 'group of insurance contracts'.

degree of risk diversification benefit available to the group of entities. Therefore, the staff view is that for a group of insurance contracts, **the risk adjustment for non-financial risk at the consolidated group level is the same as the risk adjustment for non-financial risk at the individual entity level**. Determining a different risk adjustment for non-financial risk at a consolidated group level would be inconsistent with the principles of the risk adjustment for non-financial risk in IFRS 17.

1.3 This Paper outlines why, in many circumstances, the IASB staff view in AP02 is both contrary to the concept of risk adjustments and impracticable because it does not adequately address the following matters.

(A) The AP02 emphasis placed on use of the words 'charged by the entity' in paragraph B87 is potentially contradictory to the definition of risk adjustment for non-financial risk and para 37 which refer to expected compensation required by the entity.

(B) The 'amount charged' at the inception of the insurance contract by the entity in respect of non-financial risk (i.e unit of account is individual contract) may be inconsistent with the current aggregated information available at the reporting date, (i.e. unit of account is group), when practically many insurers will make these assessments.

(C) The risk adjustment is required to be remeasured based on current and relevant information. The implications of AP02 are that the re-measurement is constrained to an update of the inception date view. Under the IASB staff analysis in AP02, that compensation for risk is a single decision made by the issuing entity, it is unclear what re-measurement of the risk adjustment for current information means. Is it:

(i) simply run off as the release from non-financial risk occurs;

(ii) updated for the impact of changes in non-financial risk on the compensation the issuing entity requires based on its approach to determining the required compensation at the time contract was issued; or

(ii) updated to reflect the issuing entity's current view of both the compensation required and the level of non-financial risk?

(D) Investors and other users of financial statements are more interested in changes in assessments on a consistent basis from a Group perspective than from a subsidiary perspective. And it is not feasible in all instances for a subsidiary that issues insurance contracts to incorporate Group-level assessments of compensation for bearing risk. Based on the view in AP02, a Group would then be required to incorporate subsidiary-level assessments of compensation for bearing risk which will reduce comparability between Group peers.

1.4 In relation to (C) and (D), the requirements to remeasure the risk adjustment mean the 'amount charged' at inception potentially becomes less relevant (depending on interpretation). Since investors are more interested in period-to-period changes in assessments on a consistent basis using current information from a Group perspective, an amalgamation of subsidiary-level perspectives of the 'amount charged' for compensation for bearing risk accumulated over multiple periods seems unlikely to provide relevant information.

1.5 Accordingly, it is requested that the TRG be afforded the opportunity to consider both views to ensure that a full understanding of the issue is obtained and to reconfirm whether the two views (AP02 and a reporting entity view) are appropriate. In the event that the IASB is requested to review the acceptability of the two views, we consider it critical to have both views fully explained.

1.6 While AP02 does not adequately address the above issues regarding the reporting entity view, it implies the following potentially useful interpretation of IFRS 17 that in determining the amount that 'would be charged', the risk adjustment may or may not take into account diversification 'pushed down' from the Group level to subsidiary entity level. The entity's practice in this regard will be a matter of fact. Accordingly, an insurer may be in a position to maintain only one set of records at the subsidiary or Group level, and this is a practical outcome for insurers. Therefore, this Paper does not address the reporting by the subsidiary of its risk adjustment for non-financial risks.

2. Analysis of reporting entity view of risk adjustment requirements

2.1 At the May 2018 TRG meeting, a significant number of TRG members said they consider IFRS 17 requires a **reporting entity view** of risk adjustments, rather than the IASB staff in AP02. This section of the Paper endeavours to document the reporting entity view. Those TRG members indicated the staff view may not provide meaningful information in some circumstances and would be impracticable to implement. This section outlines why the reporting entity view is considered both consistent with the IFRS 17 concept of determining compensation required for bearing risk, most likely to produce useful information for users of financial statements, and more practicable than the staff view. In preparing this Paper we have drawn on the depth of two decades of Australian experience with determining risk adjustments for financial reporting purposes.

(A) Why the reporting entity view of risk adjustments is most relevant

2.2 In IFRS standards, use of the word 'entity' refers to the entity required to prepare financial statements – when the entity preparing the financial statements is the subsidiary entity issuing insurance contracts, the requirements of IFRS 17 apply to that entity. However, when the Group is reporting, and required to prepare consolidated financial statements under IFRS, 'entity' must be read as the consolidated Group.

2.3 The *Conceptual Framework for Financial Reporting* is written from the perspective of each 'reporting entity' and CF.3.8 says:

> 3.8 Financial statements provide information about transactions and other events viewed from the perspective of the reporting entity as a whole, not from the perspective of any particular group of the entity's existing or potential investors, lenders or other creditors.

2.4 IFRS 17.37 compels each reporting entity to use its perspective to reflect the compensation it requires for bearing the uncertainty about the amount and timing of the cash flows that arises from non-financial risk. The use of the term 'amount charged by the entity' in B87 can be seen as contradictory to IFRS 17.37 and the definition of 'risk adjustment for non-financial risk' in Appendix A. IFRS 17.37 refers to 'expected compensation that the entity requires'[2] and as noted above is not restricted to the issuing entity when considering the Group.

2.5 In most cases, the main focus of investors is on the Group view of all aspects of its business, including risk adjustments. It is essential that Groups are able to show a Group-level view of risk adjustments. In Australia, users have a keen interest in analysing listed insurance Group financial statements based on targeted confidence levels (as required to be disclosed under IFRS 17.119). The same may apply in subsidiary entity jurisdictions, but in practice the relevant confidence levels among the insurer's peers across the subsidiary's market may not correspond to the risk adjustment attributed to the subsidiary at the Group level.

2.6 The objective of IFRS 17.B87 is to provide users with information about uncertainty arising from non-financial risk about the amount and timing of cash flows. Restricting this to 'the amount charged' at the subsidiary level is not consistent with IFRS 17.37 where there are issues with pushing down the Group-level diversification benefits to the subsidiary (see (D) below).

(B) Unit of account

2.7 In practical terms, the main 'unit of account' in IFRS 17 is the group of contracts. The group could comprise contracts issued up to a year apart [IFRS 17.22]. Some insurers will treat the individual contract as the unit of account and apply a charge for bearing risk each time a contract is issued. However, others will, consistent with IFRS 17.25, treat the group as the unit of account, with risk adjustments measured at the first reporting date taking into account all current information about the number and nature of contracts included in each group of contracts. This may result in a change in the risk adjustment from inception of the contract. The extent to which change occurs would vary between product types based on the stability of the market and level of homogeneity among contracts. That is, an insurer may not have a materially accurate knowledge of the compensation it requires to bear insurance risk for a group of contracts until the extent of diversification across the entity and/or Group is known. Sufficient information about business written over the course of the reporting period would often only be available after the point of policy inception for many contracts in the group cohort.

2 The definition says: "compensation an entity requires".

2.8 Undue focus on 'the amount charged' in IFRS 17.B87 could lead to an interpretation that the unit of account can only be the individual contract. Such a conclusion would clearly contradict IFRS 17.25.

(C) Requirement to remeasure based on current information

2.9 Regardless of the unit of account issue in (B), the requirements to remeasure the risk adjustment are clear and cannot be constrained by the amounts charged at inception of the contract. The general principle is that, along with all future cash flow estimates under IFRS 17, risk adjustments are remeasured using **current** information [IFRS 17.33 and IFRS 17.B54 to B60][3]. IFRS 17.B91(e) requires that, to reflect the compensation the entity would require for bearing non-financial risk, risk adjustments must be reduced or increased to take into account the extent to which emerging experience reduces or increases uncertainty about the amount and timing of cash flows. Accordingly, 'the amount charged' by the subsidiary when contracts are issued will inevitably become less relevant over time because updated information would be applied at each reporting date

2.10 The bulk of insurance liabilities of many general insurers are liabilities for incurred claims, particularly in relation to claims that take many years to settle. When new information becomes available about the riskiness associated with claims, insurers need to remeasure risk adjustments, at least at every reporting period, to satisfy the requirement to reflect the compensation the entity requires for bearing the uncertainty about the amount and timing of the cash flows [IFRS 17.37] at each reporting date. The view of the subsidiary Board of Directors or management in response to the changes in risk may differ from that of a Group parent.

2.11 While an entity's assessment of the compensation required for bearing the uncertainty about the amount and timing of the cash flows at a particular time is used in premium pricing, that level of compensation can change subsequently based on new, current information about the uncertainty of cash flows. Typically, in subsequent periods the information used in determining reserving for the liability for incurred claims would be of more relevance than the information used when a contract was originally priced.

2.12 The uncertainty of cash flows is likely to be affected by information that arises externally as well as internally, subsequent to insurance contracts being issued, which has not been factored into amounts an insurer has charged; yet that information would need to be used in determining risk adjustments.

2.13 Undue focus on 'charged' in B87 means that investors in the Group will not receive a true reflection of the economics attaching to changes in the risk adjustment. As noted in (D) below there are several reasons why the subsidiary view of risk will differ from the Group view, and cannot be pushed down.

(***D) Consideration of the Group view***

2.14 Groups may comprise subsidiaries that have businesses that will, of necessity, take a different view of risk adjustments from the view that is relevant at the Group level. The following are examples:

(a) A subsidiary's independent board of directors has a particular view of insurance risk based on jurisdictional norms, which is different from the Group-level view.[4]

(b) The Group applies IFRS 17, but a subsidiary must apply local non-IFRS GAAP to enable its local board of directors to meet reporting requirements in the subsidiary jurisdiction.

(c) The Group participates in a set share of the business written by an insurance pool and the Group is unaware of the view of risk taken by the pool when amounts relating to contracts are charged.

2.15 In these cases, some flexibility is required in interpreting how IFRS 17.B87 is applied in order for it to be possible for a Group to comply with IFRS 17.37 and measure a risk adjustment that reflects

3 This is also consistent with general insurance market practice in Australia where risk adjustments are currently measured and reported using a confidence level approach (as identified in IFRS 17.119) based on information at the reporting date.

4 Despite being controlled by a parent entity, each insurance subsidiary board of directors, particularly in the insurance industry, is usually required to take its own independent view on matters relating to risk.

the compensation the Group requires for bearing the uncertainty about the amount and timing of the cash flows that arise from non-financial risk.

2.16 More broadly, there is no requirement in IFRS 17 for the best estimate of insurance liabilities (i.e. before risk adjustment) as a whole being additive across a Group. For example, it is relatively common for expenses that are directly attributable at one level of a Group being different from another level due to the existence of a Group-level service company which charges a profit margin, which is eliminated only on consolidation.[5] Accordingly, the same logic should apply to other components of insurance liabilities such as risk adjustments IFRS 17.

3. Other considerations

3.1 For insurance contracts accounted for using the **premium allocation approach**, there is no specific consideration of a risk adjustment for the liability for remaining coverage other than to determine whether or not contracts are onerous. Future cash flows and risk adjustments are only explicitly considered for claim liabilities, often well after the time an amount is 'charged' to policyholders. Accordingly restricting the general model to 'charged', whilst allowing PAA to use a different approach would be inconsistent.

3.2 The risk adjustment for **reinsurance contracts held** represents the amount of risk being transferred by the holder to the reinsurer [IFRS 17.64] and, where a reinsurance treaty captures expected future contracts, will include non-financial risks transferred arising from business yet to be written.[6] For the insurer holding the contract, this assessment:

(a) cannot be based on the premium charged under the treaty as that is set by the reinsurer and reflects the reinsurer's required compensation for bearing non-financial risk, not the holder's;

(b) is based in part (or sometimes wholly) on expected cash flows relating to expected future underlying contracts, not 'amounts charged' for existing underlying contracts; and

(c) needs to be based on the holder's overall view of compensation required for bearing non-financial risk, not the premiums charged for individual contracts.

4 Conclusions

4.1 The **reporting entity view** is the most relevant interpretation of IFRS 17 in respect of determining risk adjustments in that it is conceptually more aligned to the fundamental principles underpinning IFRS 17 that:

(a) insurers use current information available to estimate the adjustment for non-financial risk [IFRS 17.B54 to B60 and B91(e)]; and

(b) each insurer must adjust the estimate the future cash flows to reflect the compensation it requires for bearing uncertainty about the amount and timing of cash flows regarding non-financial risk [IFRS 17.37]

4.2 The **reporting entity view** can be inferred from the current wording in IFRS 17 and no changes are needed to the existing IFRS 17 text.

4.3 In practical terms, and based on the principles in IFRS 17.37, B87 and B88, risk adjustments are measured at each reporting date based on the information known at each date, which would very often be different from the information available when each contract was issued.

4.4 The benchmark amount that would be charged for contracts when issued (including the risk adjustment either explicitly or implicitly included in the amount charged) would be expected to differ from the risk adjustments subsequently measured and included in liabilities for remaining coverage and liabilities for incurred claims due to internal and external changes in the factors determining risk.

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5 An insurer may have a service company at the Group level that performs administrative services related to the sale of contracts and charges fees to subsidiaries for those services. The subsidiary would regard those fees as being directly attributable insurance acquisition cash flows. The actual costs to the Group of providing those services could be different from the fees charged for example due to profit margins.

6 As identified in AP03 for the February 2018 IFRS 17 TRG meeting.

4.5 IFRS 17 needs to cater for circumstances in which the Group parent entity is not able to push down the full impact of Group diversification benefit adjustments, for example, because of the circumstances surrounding local subsidiary reporting requirements, including an independent subsidiary board of directors' view on risk.

4.6 This Paper concludes that IFRS 17 should be interpreted as requiring a **reporting entity view** of compensation required for bearing uncertainty about the amount and timing of the cash flows that arises from non-financial risk and, therefore, accommodate circumstances in which that compensation would vary between the subsidiary and Group levels. Accordingly, in those circumstances, the IASB staff view of risk adjustments outlined in AP02 is neither consistent with the principle underpinning the IFRS 17 risk adjustment requirements nor is it practicable.

5. Is the question pervasive?

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

The May 2018 TRG AP02 view that one decision is made when a contract is issued about how much would be charged in relation to non-financial risk is relevant to all insurers and their stakeholders because it relates to practical issues affecting subsequent measurement of risk adjustments. The issue is of particular relevance to general insurers that often have liabilities for incurred claims that are relatively large compared with their liabilities for remaining coverage. The May 2018 TRG AP02 view that subsidiary risk adjustments must add to the Group risk adjustment will be infeasible. The issue is of particular relevance to insurance Groups that operate across multiple jurisdictions.

6. Relevant IFRS 17 requirements

risk adjustment for non-financial risk	The compensation an entity requires for bearing the uncertainty about the amount and timing of the cash flows that arises from non-financial risk as the entity fulfils insurance contracts.

33 An entity shall include in the measurement of a group of insurance contracts all the future cash flows within the boundary of each contract in the group (see paragraph 34). Applying paragraph 24, an entity may estimate the future cash flows at a higher level of aggregation and then allocate the resulting fulfilment cash flows to individual groups of contracts. The estimates of future cash flows shall:

(a) incorporate, in an unbiased way, all reasonable and supportable information available without undue cost or effort about the amount, timing and uncertainty of those future cash flows (see paragraphs B37–B41). To do this, an entity shall estimate the expected value (ie the probability-weighted mean) of the full range of possible outcomes.

(b) reflect the perspective of the entity, provided that the estimates of any relevant market variables are consistent with observable market prices for those variables (see paragraphs B42–B53).

(c) be current—the estimates shall reflect conditions existing at the measurement date, including assumptions at that date about the future (see paragraphs B54–B60).

(d) be explicit—the entity shall estimate the adjustment for non-financial risk separately from the other estimates (see paragraph B90). The entity also shall estimate the cash flows separately from the adjustment for the time value of money and financial risk, unless the most appropriate measurement technique combines these estimates (see paragraph B46).

37 An entity shall adjust the estimate of the present value of the future cash flows to reflect the compensation that the entity requires for bearing the uncertainty about the amount and timing of the cash flows that arises from non-financial risk.

119 An entity shall disclose the confidence level used to determine the risk adjustment for non-financial risk. If the entity uses a technique other than the confidence level technique for determining the risk adjustment for non-financial risk, it shall disclose the technique used and the confidence level corresponding to the results of that technique.

B87 The risk adjustment for non-financial risk for insurance contracts measures the compensation that the entity would require to make the entity indifferent between:

(a) fulfilling a liability that has a range of possible outcomes arising from non-financial risk; and

(b) fulfilling a liability that will generate fixed cash flows with the same expected present value as the insurance contracts.

For example, the risk adjustment for non-financial risk would measure the compensation the entity would require to make it indifferent between fulfilling a liability that—because of non-financial risk—has a 50 per cent probability of being CU90 and a 50 per cent probability of being CU110, and fulfilling a liability that is fixed at CU100. As a result, **the risk adjustment for non-financial risk conveys information to users of financial statements about the amount charged by the entity for the uncertainty arising from non-financial risk about the amount and timing of cash flows**. [emphasis added]

B88 Because the risk adjustment for non-financial risk reflects the compensation the entity would require for bearing the non-financial risk arising from the uncertain amount and timing of the cash flows, the risk adjustment for non-financial risk also reflects:

(a) the degree of diversification benefit the entity includes when determining the compensation it requires for bearing that risk; and

(b) both favourable and unfavourable outcomes, in a way that reflects the entity's degree of risk aversion.

B91 IFRS 17 does not specify the estimation technique(s) used to determine the risk adjustment for non-financial risk. However, to reflect the compensation the entity would require for bearing the non-financial risk, the risk adjustment for non-financial risk shall have the following characteristics:

(a) risks with low frequency and high severity will result in higher risk adjustments for non-financial risk than risks with high frequency and low severity;

(b) for similar risks, contracts with a longer duration will result in higher risk adjustments for non-financial risk than contracts with a shorter duration;

(c) risks with a wider probability distribution will result in higher risk adjustments for non-financial risk than risks with a narrower distribution;

(d) the less that is known about the current estimate and its trend, the higher will be the risk adjustment for non-financial risk; and

(e) to the extent that emerging experience reduces uncertainty about the amount and timing of cash flows, risk adjustments for non-financial risk will decrease and vice versa.

B92 An entity shall apply judgement when determining an appropriate estimation technique for the risk adjustment for non-financial risk. When applying that judgement, an entity shall also consider whether the technique provides concise and informative disclosure so that users of financial statements can benchmark the entity's performance against the performance of other entities. Paragraph 119 requires an entity that uses a technique other than the confidence level technique for determining the risk adjustment for non-financial risk to disclose the technique used and the confidence level corresponding to the results of that technique