Invitation to Comment **March 2005**

Liability Adequacy Test in AASB 1023 *General Insurance Contracts*

Prepared by the
Australian Accounting Standards Board

Australian Government

Australian Accounting Standards Board

Commenting on this Invitation to Comment

The AASB is seeking comment on a proposed amendment to the liability adequacy test in AASB 1023 *General Insurance Contracts*. Constituents are encouraged to respond to the AASB by 4 April 2005. Comments should be addressed to:

The Chairman
Australian Accounting Standards Board
PO Box 204, Collins St West Vic 8007
AUSTRALIA
E-mail: standard@aasb.com.au

A copy of all non-confidential submissions will be placed on public record on the AASB's web site: www.aasb.com.au.

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The Customer Service Officer
Australian Accounting Standards Board
Level 4
530 Collins Street
Melbourne Victoria
AUSTRALIA

Phone: (03) 9617 7637
Fax: (03) 9617 7608
E-mail: publications@aasb.com.au
Postal address:
PO Box 204
Collins St West Vic 8007
AUSTRALIA

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Purpose of this Invitation to Comment

The AASB issued AASB 1023 *General Insurance Contracts* in July 2004. In January 2005 the AASB became aware of widespread concerns, within the insurance industry, with the liability adequacy test in AASB 1023. The AASB has considered various options for dealing with these concerns and has reached a preliminary conclusion on amendments to AASB 1023 that it plans to issue in May 2005 and that would take effect immediately. The AASB is seeking comments from constituents before it finalises these amendments.

Background

In October 2003 the AASB issued ED 122A *Request for Comment on Amendments to AASB 1023 General Insurance Contracts*. In issuing ED 122A the AASB considered:

(a) the recommendations of the HIH Royal Commission ("HIH RC");

(b) consistency with IASB ED 5 *Insurance Contracts*, the exposure draft which incorporated Phase I of the IASB's Insurance Project[1];

(b) consistency with Australian Prudential Regulatory Authority ("APRA") requirements; and

(c) the anticipated direction of Phase II of the IASB's Insurance Project.

In ED 122A, the AASB considered whether to continue with a deferral and matching model in AASB 1023, or whether to introduce a prospective model that was consistent with:

(a) the HIH RC recommendations;

(b) APRA requirements; and

(c) the anticipated direction of Phase II.

The AASB proposed in ED 122A that the revised AASB 1023 would incorporate a prospective model. The prospective model would not only be

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1 The updated AASB 1023 *General Insurance Contracts* (July 2004), incorporates Phase I of the IASB's Insurance Project. The IASB is currently progressing Phase II of the Insurance Project, which will consider the recognition and measurement of insurance contracts. This project is not expected to be completed before 2007. It is expected that the outcome of Phase II will be a revised insurance standard, which will replace AASB 1023.

consistent with HIH RC recommendations, APRA requirements and Phase II, but would also address some of the concerns with the deferral and matching model in previous AASB 1023 *Financial Reporting of General Insurance Activities*. A deferral and matching model has inherent difficulties, in particular: the liability adequacy test (which would not be required in a prospective model); and the recognition of reinsurance premiums expense and reinsurance recoveries. The prospective model was seen by the AASB as a more conceptually sound model.

ED 122A noted that if a deferral and matching model were retained, the liability adequacy test ("LAT") would need to be strengthened to recognise all deficiencies in full, and that the test would be performed at a class of business level.

ED 122A also proposed that insurance liabilities (being both incurred and unexpired risks) would be required to include an explicit risk margin. Again, this was consistent with the HIH RC recommendations, APRA requirements and the anticipated direction of Phase II.

In commenting on ED 122A, many in the insurance industry were strongly opposed to the proposed prospective model. Whilst they agreed with the change in principle, they had concern with the extent of change it represented, especially given the limited time available to implement the change and given uncertainty over the direction of Phase II.

The AASB responded by reverting to a deferral and matching model. The requirement for explicit risk margins was maintained as this had been supported by the insurance industry.

Under the deferral and matching model, insurance liabilities are effectively split into two balances: the outstanding claims liability ("OCL") and the unearned premium liability ("UPL"). Consistent with ED 122A, in issuing the revised AASB 1023 *General Insurance Contracts* in July 2004, after extensive consultation with the insurance industry, insurers were required to include an explicit risk margin in determining the OCL, and an explicit risk margin in determining the liability for future claims ("LFC"), which is used to test the adequacy of the UPL.

In January and February 2005 the AASB received correspondence from a Group of Australian General Insurers and the Insurance Council of Australia. At the February 2005 AASB meeting representatives of the Group made a presentation to the AASB. In their representations concerns were expressed with the LAT in AASB 1023. As a result of these representations, the AASB has considered four options for addressing the concerns.

Industry Concerns

The key points raised are as follows.

(a) Paragraph 9.1 of AASB 1023 requires general insurers to include an explicit risk margin in determining the LFC, which is used to test the adequacy of the UPL. This is consistent with the determination of the OCL. In paragraph 9.1.2 of AASB 1023 general insurers are required to include an appropriate risk margin as set out in paragraphs 5.1.6 to 5.1.11. Paragraphs 5.1.6 to 5.1.11 explain the determination of the risk margin for the OCL. The intention underlying paragraph 9.1.2, and the way in which it has been interpreted, is that the probability of adequacy ("POA") achieved in determining the OCL, and the POA achieved in determining the LFC, should be the same or similar.

(b) Whilst there is general agreement in principle with the LAT in AASB 1023, there is concern with the extent of change that this represents. The Group of Australian General Insurers commented that:

 (i) Phase I of the Insurance Project was intended to be a period of minimal change;

 (ii) changes during Phase I could be overturned by subsequent developments during Phase II; and

 (iii) the change would constitute significant additional work for general insurers.

 The LAT in the previous AASB 1023, which tested the recoverability of the deferred acquisition costs asset ("DAC"), was a far less detailed, high-level test of "reasonableness", and not an actuarially determined calculation.

(c) Several insurers currently determine their OCL using high POA. If these same levels of POA are applied in the LAT, deficiencies could be identified that would not be expected to eventuate in reality. This would increase volatility in earnings.

(d) The Group of Australian General Insurers indicated that they currently measure the adequacy of their insurance liabilities as a whole (that is, their OCL plus their unexpired risks liability "URL")). The Group noted that there would be no net effect to general insurers' balance sheets under the new LAT because

AASB 1023 would simply force insurers to make adjustments between the OCL and their URL.

(e) The Group of Australian General Insurers recommended that AASB 1023 be amended to require a LAT that takes risk and uncertainty into account using an implicit risk margin and that the test is performed at an entity level, rather than at a class of business level.

AASB Considerations

The AASB note that the LAT in AASB 1023 (July 2004) is different from the test in the previous version of AASB 1023 in order to:

(a) comply with IFRS 4 *Insurance Contracts*, the standard which arose from IASB ED 5, which requires insurers to use current estimates of future cash flows to assess the adequacy of insurance liabilities and to recognise any deficiency in full;

(b) meet the recommendations of the HIH Royal Commission ("HIH RC"). One of the sub-recommendations of Recommendation 8 was that insurance liabilities be valued at a level of sufficiency of at least 75% (the AASB has taken a more principles based approach in not being prescriptive about the POA, instead requiring full disclosure); and

(c) ensure consistent treatment of insurance liabilities.

The AASB acknowledges the insurance industry's desire for minimal change during Phase I of the Insurance Project and shares this desire subject to ensuring compliance with IFRS 4 and the recommendations of the HIH RC.

The Four Options

The AASB considered four options for dealing with the LAT.

1. Leave AASB 1023 unchanged.

2. Require the LAT to be performed at an entity level for all insurance liabilities, that is, compare OCL plus the UPR less the DAC to the central estimate plus risk margin for all insurance liabilities.

3. Adopt the recommendation of the Group of Australian General Insurers, that is, use an implicit margin or "balance of probabilities test" in testing the adequacy of the UPR at the entity level.

4. Leave the LAT unchanged except that:

   (a) the test is performed at the entity level; and

   (b) general insurers are permitted to adopt different POA in determining the OCL and LFC.

The AASB discussed these options with its Insurance Project Advisory Panel and other commentators in the insurance industry. The AASB also considered correspondence from the Insurance Council of Australia, which favoured option 3.

AASB Preliminary Conclusions

In the AASB's opinion, options 2 and 3 do not adequately address the HIH RC recommendation to include an explicit risk margin in the determination of insurance liabilities.

Under option 2, a high POA in the OCL could effectively mask a deficiency in the UPL. In the deferral and matching model required by AASB 1023, if the risk margin for the LFC were effectively included as part of the OCL, this would distort the recognition of profit.

Under option 3 the LAT would only include an implicit margin. This would make it difficult for users of financial reports to understand the way in which risk and uncertainty have been taken into account. The AASB also believes that this would not meet the HIH RC recommendation to include an explicit margin.

To be helpful to the insurance industry the AASB proposes option 4 over option 1. This will provide some relief to general insurers in:

(a) requiring the LAT to be performed at an entity level rather than a class of business level. The AASB notes that neither IFRS 4 nor the HIH RC recommendations require a LAT at a class of business level; and

(b) allowing different POA to be adopted in the OCL and LAT, subject to appropriate disclosure. The AASB notes that, whilst an entity would often be expected to have the same or similar POA for its OCL and LFC, it is also possible that different POA would be appropriate in certain circumstances. An entity would be expected to have the same or similar POA for its OCL and LFC where it has consistent quality of data across its classes of business. However, different POA may arise where there is a variation in the quality of data across the classes of business. For example, the OCL will have a higher proportion of long tail claims than the LFC and the central estimate for the OCL may exhibit greater inherent uncertainty. The historical claims data used to predict the development of claims could be less reliable in predicting future development than the data relating to a more homogenous book of short tail claims.

The implications of this preliminary conclusion are illustrated in the Appendix to this Invitation to Comment, which shows the marked-up sections of AASB 1023 affected by this preliminary conclusion.

Request for Comments

The AASB invites comments on the preliminary conclusion outlined above. The AASB would like to clarify that options 2 and 3 will not be accepted, as they go against the AASB's responsibility and commitment to address the HIH RC recommendations.

The AASB seeks comment on whether constituents support the adoption of Option 4, or would prefer leaving AASB 1023 unchanged.

APPENDIX

This Appendix shows relevant sections of AASB 1023 marked up for the proposed amendment outlined in this Invitation to Comment.

PREFACE

Liability Adequacy Test

This Standard includes a liability adequacy test. An insurer considers the adequacy of its unearned premium liability by considering current estimates of the present value of the expected future cash flows relating to future claims arising from the rights and obligations under current general insurance contracts. If the unearned premium liability less any related deferred acquisition costs and intangible assets is insufficient to meet future cash flows expected relating to future claims under current insurance contracts, then the entire deficiency is recognised in the income statement. The related intangible assets and deferred acquisition costs are first written down and any additional liability required is then recognised as an unexpired risk liability. The liability adequacy test for the unearned premium liability is performed at the reporting entity level. ~~by class of business. A class of business is to be determined using the Prescribed Classes of Business used by the Australian Prudential Regulation Authority ("APRA") for general insurers registered with APRA. Insurers not registered with APRA perform the test at the Prescribed Classes of Business level or at an equivalent class of business level. For example, a reporting entity that consists of a group of two entities, both of which write compulsory third party business, performs the liability adequacy test by looking at the combined results of the two compulsory third party portfolios.~~

Risk Margins Section

~~5.1.10 For the purposes of the liability adequacy test, required by section 9, the risk margin for the entity as a whole is apportioned across classes of business.~~

9 Liability Adequacy Test

9.1 The adequacy of the unearned premium liability shall be assessed by considering current estimates of the present value of the expected future cash flows relating to future claims arising from the rights and obligations under current general insurance contracts. If the present value of the expected future cash flows relating to future claims arising from the rights and obligations under current general insurance contracts, plus an additional

risk margin to reflect the inherent uncertainty in the central estimate, exceed the unearned premium liability less related intangible assets and related deferred acquisition costs, then the unearned premium liability is deficient. The entire deficiency shall be recognised in the income statement. In recognising the deficiency in the income statement the insurer shall first write-down any related intangible assets and then the related deferred acquisition costs. If an additional liability is required this shall be recognised in the balance sheet as an unexpired risk liability. The liability adequacy test for the unearned premium liability shall be performed at the reporting entity level~~ by class of business~~.

~~9.1.1 For general insurers registered with the Australian Prudential Regulation Authority ("APRA"), a class of business is determined using the Prescribed Classes of Business used by APRA. For general insurers not registered with APRA, the test is performed using the APRA Prescribed Classes of Business or at an equivalent level of aggregation. For example, a reporting entity that consists of a group of two insurers, both of which write compulsory third party business, would add together each insurer's unearned premium liability related to the compulsory third party business and review the adequacy of the two compulsory third party portfolios by considering all expected cash flows under existing insurance contracts in both insurers.~~

9.1.~~2~~<u>1</u> In determining the present value of the expected future cash flows relating to future claims arising from the rights and obligations under current general insurance contracts, the insurer applies sections 5 and 6 and includes an appropriate risk margin to reflect inherent uncertainty in the central estimate, as set out in paragraphs 5.1.6 to 5.1.11.

<u>9.1.2 Whilst the probability of adequacy adopted in performing the liability adequacy test may be the same or similar to the probability of adequacy adopted in determining the outstanding claims liability, this Standard does not require the same or similar probabilities of adequacy. However, the users of financial reports need to be presented with information explaining any differences in probabilities of adequacy adopted and insurers are required to disclose the reasons for any differences in accordance with paragraph 17.8(e).</u>

9.1.3 The unearned premium liability may include premiums in advance as described in paragraph 4.2.5. Insurers also consider whether there are any additional general insurance contracts, where the premium revenue is not recognised in the unearned premium liability, under which the insurer has a constructive obligation to settle future claims that may arise. That is, there may be general insurance contracts where there has not been a transfer of risk, as described in paragraph 4.2.5, but where a constructive obligation has arisen. The cash flows expected under these contracts are considered as part of the liability adequacy test.

9.1.4 In reviewing expected future cash flows, the insurer takes into account both future cash flows under insurance contracts it has issued and the related reinsurance.

9.1.5 The related intangible assets referred to in paragraph 9.1 are those that arise under paragraph 13.3.1(b). ~~As the liability adequacy test for the unearned premium liability is performed for the reporting entity as a whole at a class of business level, the intangible asset is allocated on a reasonable basis across these classes.~~

9.1.6 As the liability adequacy test applies to deferred acquisition costs and to intangible assets, these assets are excluded from the scope of AASB 136 *Impairment of Assets*.

17 Disclosures

Income Statement

17.1 In relation to the income statement, the financial report shall disclose:

~~**(a) the total deficiency recognised in the income statement under paragraph 9.1;**~~

~~**(b) any write-down of deferred acquisition costs under the liability adequacy test in section 9;**~~

~~**(c) any write-down of an intangible asset under the liability adequacy test in section 9;**~~

(a)~~d)~~ the underwriting result for the reporting period, determined as the amount obtained by deducting the sum of claims expense, outwards reinsurance premium expense and underwriting expenses from the sum of direct and inwards reinsurance premium revenues and recoveries revenue;

(~~e~~b) ***net claims incurred*** **shall be disclosed, showing separately:**

(i) the amount relating to risks borne in the current reporting period; and

(ii) the amount relating to a reassessment of risks borne in all previous reporting periods.

An explanation shall be provided where net claims incurred relating to a reassessment of risks borne in previous reporting periods are material; and

(~~f~~c) in respect of paragraphs 17.1(e)(i) and 17.1(e)(ii), the following components shall be separately disclosed:

(i) gross claims incurred – undiscounted;

(ii) reinsurance and other recoveries – undiscounted; and

(iii) discount movements shown separately for (i) and (ii).

Balance Sheet

17.2 The financial report shall disclose~~:~~

~~(a)~~ in relation to the outstanding claims liability:

(~~i~~a) the central estimate of the expected present value of future payments for claims incurred;

(~~ii~~b) the component related to the risk margin;

(~~iiib~~c) the percentage risk margin adopted in determining the outstanding claims liability;

(~~ivc~~d) the probability of adequacy intended to be achieved through adoption of the risk margin; and

(~~vd~~e) the process used to determine the risk margin, including the way in which diversification of risks has been allowed for.

Liability Adequacy Test

17.8 **~~17.8~~ In relation to the liability adequacy test in section 9 the financial report shall disclose:**

(a) **the amounts underlying the calculation performed, that is:**

(i) **unearned premium liability;**

(ii) **deferred acquisition costs;**

(iii) **intangible assets;**

(iv) **present value of expected future cash flows for future claims;**

(v) **deficiency or surplus;**

(b) **any write-down of deferred acquisition costs under the liability adequacy test;**

(c) **any write-down of intangible assets under the liability adequacy test;**

(d) **in relation to the present value of expected future cash flows for future claims:**

(i) **the central estimate of the present value of expected future cash flows;**

(ii) **the component of present value of expected future cash flows related to the risk margin;**

(iii) **the percentage risk margin adopted in determining the present value of expected future cash flows;**

(iv) **the probability of adequacy intended to be achieved through adoption of the risk margin; and**

~~(v)~~(v) **the process used to determine the risk margin, including the way in which diversification of risks has been allowed for.**

(e) where the probability of adequacy disclosed in paragraph 17.2(d) is not the same or similar to the probability of adequacy disclosed in paragraph 17.8(d)(iv), the reasons for the difference.

Other Disclosures

17.~~8~~9.1 This Standard addresses disclosure requirements in relation to general insurance contracts. Other Australian Accounting Standards may be relevant to a general insurer's financial report. In particular, the disclosure requirements in AASB 132 would normally be relevant to general insurers.