Actuaries Institute

AASB 17 Insurance Contracts

Information Note

Version 1.0 – draft for discussion

March 2018

NOTE: This Information Note is intended to help actuaries prepare for the implementation of the accou nting standard AASB 17 Insurance Contracts. It has been prepared by a Task Force established for this purpose.

The standard is complex and there are many challenges to fully understand its implications and to be ab le to provide definitive guidance. Notwithstanding this, the Task Force understands the desire of members for information as soon as practicable.

Accordingly, this particular version has been issued in draft form and it will form the basis of discussion with interested members. In particular, there will be a workshop on 3 April 2018. Practice Committees have not yet formally reviewed this document.

A final version will be produced. It is expected that further versions will be necessary in due course as acc ounting interpretations are clarified and members gain more experience with the standard.

Section A. Background Information

1 Introduction

1.1 New Accounting Standard for Insurance Contracts

In May 2017, the International Accounting Standards Board (IASB) issued a new accounting standard, International Financial Reporting Standard 17 *Insurance Contracts* (**IFRS 17**), after many years of development. In July 2017, the Australian Accounting Standards Board (AASB) adopted IFRS 17 effectively unchanged for with-profit private sector companies, and issued AASB 17 *Insurance Contracts*.

AASB 17 does not apply to superannuation entities applying AASB 1056 Superannuation Entities and not-for-profit public sector entities.

The AASB is considering the applicability of this Standard to those entities and has issued a Discussion Paper *Australian-specific Insurance Issues – Regulatory Disclosures and Public Sector Entities.* This sets out proposals for how AASB 17 could be extended to address have "insurance like" arrangements of some government entities and schemes that are currently reported under AASB 137.

AASB 17 is mandatory for reporting periods starting on or after 1 January 2021. Entities may adopt the Standard for their accounts before that time at their option, provided that they also apply AASB 9 *Financial Instruments* and AASB 15 *Revenue from Contracts with Customers* on or before adoption of AASB 17.

An International Actuarial Note (IAN) is being prepared by the International Actuarial Association to support the implementation of IFRS 17 across the global actuarial community.

1.2 Status of this Document

This document has been prepared by the AASB 17 Implementation Task Force of the Actuaries Institute to assist actuaries working in life insurance, general insurance or health insurance (primarily in Australia) in the application of AASB 17. It is an Information Note only. It is not a Professional Standard or Practice Guideline of the Actuaries Institute.

1.3 Accountants and Actuaries

This Information Note is not intended to provide guidance to accountants, though accountants may find it helpful in carrying out their responsibilities with respect to AASB 17.

Nor is this Information Note intended to indicate that any responsibilities of accountants be assumed by actuaries in respect of AASB 17.

1.4 Interpretation of AASB 17

Currently there is a wide range of approaches to insurance accounting for insurance contracts permitted across the globe under IFRS 4. There is also the potential for a variety of perspectives on what IFRS 17 means and how it should be implemented. To address this the IASB has set up a Transition Resource Group (TRG) comprised of individuals with extensive experience in insurance accounting from audit or preparers perspectives.

The purpose of the TRG (which is expected to be operating until mid-2019) is to:

- provide a public forum for discussion of significant implementation questions; and
- inform the IASB, in order to help it determine what, if anything, needs to be done in response to these questions (e.g. provide webinars, produce case studies, or refer to the International Financial Reporting Interpretation Committee or to the IASB Board).

The AASB has set up an Australian TRG to support the Australian representative on the IASB's TRG. Its purpose is similar and includes a discussion of:

- Australian issues and potential referrals to the IASB TRG; and
- IASB TRG papers to develop an Australian perspective.

1.5 Purpose of this Information Note

This Information Note is intended to allow an experienced actuary working in Australia to meet the requirements of AASB 17, without having to rely heavily on other references, such as the IAN, on this topic.

However, in preparing this Information Note, the Task Force has drawn on the work to date on the IAN, and there may be some duplication of content once the IAN is complete.

In any event, the IAN will be a useful reference document.

It is expected that this Information Note will be supplemented by other forms of guidance when there is more certainty about certain aspects of AASB 17.

It is important to note that:

- This Information Note is very much an Australian actuarial view, albeit informed by International Actuarial Association IAN working group papers and discussions with our Australian accounting colleagues;
- As an Accounting Standard, the interpretation of AASB 17 ultimately sits with the accounting profession;
- There are a number of implementation issues that remain to be resolved. Views and understandings of the requirements of IFRS 17 and AASB 17 will continue to develop and this Information Note will be revised as understanding develops; and

- This Information Note can only be an aid to discussion and understanding of the requirements of AASB 17

1.6 Information Note Structure

This Information Note is structured as a series of questions and answers (Q&A), in some cases, with a few simple examples for illustration. A limited but more detailed set of examples in Excel will be made available separately. The IASB also has published IFRS 17 Illustrative Examples.

To avoid duplication, certain topics, such as reinsurance, are covered in a special chapter and then referenced from other parts of the document as needed.

The first time an acronym is used, it is accompanied by the full text. Acronyms also are summarised in Chapter 14.

1.7 Materiality

'Materiality' requires judgement and, in the context of AASB 17 financial statement reporting, it is important for actuaries to bear in mind the specific entity's circumstances as well as the needs of the primary user of the report are relevant. In plain language terms, something is material to a user of that information if it influences the decisions they make, when included in or omitted from a financial report.

Materiality in this context is more a matter of accounting than actuarial judgement, where the actuarial role is to provide the analysis on which that judgement can be based. It is therefore important that actuaries discuss this with those responsible for issuing the entity's accounts.

There are a number of resources to which actuaries can refer to facilitate discussions on judgements on materiality, with the key useful ones being:

- ASA 320 *Materiality in* Planning *and Performing an Audit*; and
- IASB *IFRS Practice Statement on Making Materiality Judgements*, 14 Sept 2017.

1.8 Size of Company

Larger companies will have access to more data and may have a more diverse set of products than smaller companies. In turn, larger companies are likely to have more granular management analysis and reporting – for example by product type. It is expected therefore that the application of AASB 17 will reflect these features of the scale of the business.

1.9 Company and Funds

For regulatory purposes, Australian Life Insurers and Friendly Societies are subdivided into a series of funds (Statutory Funds, Benefit Funds, General Fund, Management Fund, etc.). However, this structure is irrelevant for general purpose financial

reporting where the entity is to be considered as a whole. Accordingly, this Information Note is written in that context, and the existence of funds is disregarded for this purpose.

1.10 Mutuals

IFRS 17 was developed by the IASB from the perspective of reporting for for-profit entities. Thus, it is not clear how the member's interest should be handled in financial reporting under AASB 17. One view is that if membership arises from purchase of a contract, the member's implied share of the mutual is included in the measurement of the contract. This information note deals with the application of AASB 17 in the context of reporting for for-profit entities.

1.11 Practical Considerations

There is scope for discretion in various parts of AASB 17, which could have implications for the amount of work involved and detail provided in the accounts. It is suggested that consideration be given to the practical usage of the information prepared for the accounts for business reporting purposes in deciding how to exercise any such discretion.

1.12 Comparison with Current Accounting Standards

This Information Note does not include detailed comparisons of AASB 17 with AASB 1023 *General Insurance Contracts* or AASB 1038 *Life Insurance Contracts*.

Even where there are similarities with existing accounting for insurance contracts under AASB 1023 and AASB 1038, especially for short term insurance contracts under AASB 1023, there are very significant differences in how AASB 17 works at the detail level. Two key differences that may not be readily apparent are set out below.

1.12.1 *Contract not Insurer Liability*

AASB 17 is an accounting standard for insurance contracts, not for insurance companies. It therefore differs from existing Australian insurance accounting standards in this respect (notwithstanding the names of those standards). Further, an insurance entity which is part of a wider group enterprise may contribute differently to the consolidated accounts of the group enterprise than is reflected in its own accounts.

Under AASB 1023 and 1038 "insurance liability" means an insurer's net contractual obligations under an insurance contract, which anchor the liability to that of the insurer issuing the contract. Under AASB 17, however, the liability is based on the fulfilment cash flows (FCF) arising for the reporting entity from a group of contracts, which can change on consolidation.

For example, when charges from other entities of the group enterprise which are part of the expenses of the insurer, prove upon look-through to include general overheads and/or profit mark-ups, these elements would drop out of the FCF and liability of the consolidated enterprise.

1.12.2 *Contract Boundary*

AASB 17 applies a contract boundary when measuring the FCF of a contract (see **Chapter 2 Aggregation and Contract Boundary**), and any cash flows arising beyond the contract boundary are deemed to relate to a future insurance contract.

Under AASB 17, the FCF of a contract capture all the expected cash flows within the contract boundary arising from all substantive rights and obligations, whether implicit or explicit, or arising from law or regulation under the contract (even if the exercise of those rights within the contract boundary produces subsequent cash flows which are beyond the boundary).

1.13 Prudential Reporting

Australian Prudential Regulation Authority (APRA) has advised that it does not intend to alter its prudential or reporting framework for AASB 17 until the new Standard's impacts are better understood, and it expects insurers to maintain their APRA reporting obligations (see **APRA 2017**). This position could change before the required implementation date of AASB 17.

This Information Note is not intended to assist in:

- assessing capital under APRA standards;
- in the preparation of APRA reports; or
- in assessing how insurance contract liabilities, profits and disclosures might be allocated to statutory and benefit funds under the Life Act.

1.14 AASB 17 Overview

1.14.1 *Scope*

AASB 17 is applied to insurance contracts issued, reinsurance contracts issued or held, and, provided the insurer also issues insurance contracts, investment contracts with discretionary participation features issued (no significant change from AASB 4 Insurance Contracts, AASB 1023 and AASB 1038).

More contracts will fall under AASB 17 than under AASB 1038, as the latter generally permitted the investment component to be separated and only the insurance rider to be treated as insurance. Under AASB 17 separation is only permitted, and required, where the investment component and insurance component are both able to lapse without the other component also lapsing (AASB 17.11 and AASB 17.B31-32). This means that in most

cases the investment linked and investment account contracts with insurance riders can no longer be unbundled and will need to be treated in their entirety as insurance contracts.

1.14.2 *Key Principles*

The Preface to AASB 17 sets out some key principles. They are that an entity:

(a) identifies as insurance contracts those contracts under which the entity 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.

(b) separates specified embedded derivatives, distinct investment components and distinct performance obligations from the insurance contracts.

(c) divides the contracts into groups it will recognise and measure.

(d) recognises and measures groups of insurance contracts at:

(i) a risk-adjusted present value of the future cash flows (the fulfilment cash flows) that incorporates all of the available information about the fulfilment cash flows in a way that is consistent with observable market information; plus (if this value is a liability) or minus (if this value is an asset)

(ii) an amount representing the unearned profit in the group of contracts (the contractual service margin).

(e) recognises the profit from a group of insurance contracts over the period the entity provides insurance coverage, and as the entity is released from risk. If a group of contracts is or becomes loss-making, an entity recognises the loss immediately.

(f) presents separately insurance revenue, insurance service expenses and insurance finance income or expenses.

(g) discloses information to enable users of financial statements to assess the effect that contracts within the scope of AASB 17 have on the financial position, financial performance and cash flows of an entity. To do this, an entity discloses qualitative and quantitative information about:

(i) the amounts recognised in its financial statements from insurance contracts;

(ii) the significant judgements, and changes in those judgements, made when applying the Standard; and

(iii) the nature and extent of the risks from contracts within the scope of this Standard.

1.14.3 *Core Requirements*

The core requirements of AASB 17 are:

- Portfolios of insurance contracts are divided into groups with inception dates no more than twelve months apart and are classified at inception as one of the following:
  - onerous;
  - no significant possibility of becoming onerous; and
  - remaining contracts.
- The insurance contract liability is comprised of a:
  - liability for remaining coverage (LRC); and
  - liability for incurred claims (LIC).
- The LRC is measured as the sum of:
  - FCF relating to future service:
    - A current present value of the expected cash flows allowing for financial risk; and
    - An explicit adjustment for non- financial risk.
  - Contractual Service Margin (CSM)
    - The unearned profit from the contract (which cannot be negative) adjusted for changes in FCF relating to future service.
- The LIC is measured as the FCF relating to coverage already provided.

The core requirements were previously referred to as the building block approach (BBA) - BBA was the terminology used by the IASB during development of IFRS 17. They have also previously been referred to as the general model or general measurement model.

1.14.4 *Variations to Core Requirements*

The core requirements are varied, in how they may or will apply for:

- Short term business, to simplify the measurement requirements of FCF for the future service component - Premium Allocation Approach (PAA).
- Direct participation business (which includes investment linked business within the scope of AASB 17) to recognise the link to the underlying assets - Variable Fee Approach (VFA).
- Reinsurance contracts held so that the cost of reinsurance is generally recognised over the life of the reinsurance contract.

- Specified contract amendments (e.g. those that cause a significant change in accounting treatment) so that the original is derecognised and the modified contract is treated as a new contract.

1.14.5 *Presentation and Disclosures*

The income statement under AASB 17 presents:

- An Insurance Service Result, comprised of;
  - Insurance revenue in a similar way to AASB 15 (which excludes any investment component), recognised as coverage is provided; less
  - Insurance service expenses (incurred claims and insurance contract expenses)

  and

- Insurance finance income and expenses, comprised of:
  - Insurance contract investment income; less
  - Insurance contract finance expense (unwind of discount on insurance contract liability)

Existing AASB 1023 & AASB 1038 disclosures have been carried forward and significantly enhanced to include:

- Reconciliations from opening to closing balances for insurance contract liability and components (expected values, inflows, outflows, risk adjustment thereon and CSM, incurred claims and risk adjustment thereon);
- Detail about contracts initially recognised in period including CSM;
- Quantitative information about expected release of CSM over future periods;
- Approach to the risk adjustment as well as its confidence interval; and
- Information about the effect of the regulatory framework on the reporting entity.

1.14.6 *Transition*

The transition date is a year prior to the adoption date, i.e. the start of the comparatives period and the balance sheet needs to be restated for AASB 17 at the transition date, as if AASB 17 had always applied, unless impracticable. If impracticable, AASB 17 allows two options:

1. **Modified retrospective approach** – which allows certain simplifications to be made to the retrospective determination of the CSM for a group of insurance contracts, in respect of:
    - the cash flows that have occurred for that group of insurance contracts including cash flows in respect of those contracts that were in the group but are no longer in force;
    - the yield curve for the group at inception;
    - the risk adjustment; and
    - the amount of CSM that would have been released due to coverage provided prior to transition date; or

2. **Fair value approach** - which allows the CSM to be determined at transition date without a retrospective element, as the fair value of the insurance contract liability less the FCF, subject to a minimum of zero.

Section B. Core Requirements

2 Aggregation and Contract Boundary

2.1 Introduction

Q2.1 What is the scope of this chapter?

AASB 17 deals purely with insurance. It would be impractical however for an entity to measure all insurance contracts at a contract unit level. This chapter provides information relating to the formation of ***portfolios*** and ***groups***, including considerations related to onerous contracts. Contract boundary related questions are then discussed. This chapter also covers elements of insurance contracts that may potentially fall outside of AASB 17.

Q2.2 Which sections of AASB 17 address this topic?

The core requirements covered in this chapter can be found in AASB 17.2, AASB 17.14-24, AASB 17.34-35 and AASB 17.B61-B71. IFRS 17.BC69-70 and IFRS 17.BC115-139 also provides background on the subject.

2.2 Identification of portfolios of insurance contracts

Q2.3 What is an insurance contract under AASB 17?

Under AASB 17 (Appendix A Defined terms) an ***insurance contract*** is

> *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.*
>
> AASB 17.2 further states that a *contract is an agreement between two or more parties that creates enforceable rights and obligations. Enforceability of the rights and obligations in a contract is a matter of law. Contracts can be written, oral or implied by an entity's customary business practices. Contractual terms include all terms in a contract, explicit or implied, but an entity shall disregard terms that have no commercial substance (i.e. no discernible effect on the economics of the contract). Implied terms in a contract include those imposed by law or regulation.*

Q2.4 What is a portfolio of insurance contracts?

It is defined in AASB 17 as insurance contracts *subject to similar risks and managed together* (AASB 17.14). Each portfolio forms a partition of the total insurance business of the reporting entity. Accordingly, each contract within the scope of AASB 17 is at each reporting date allocated to one portfolio, or may under certain circumstances,

be apportioned across multiple portfolios if the contract covers different types of risks and these risks are unbundled.

Q2.5 What is a group of insurance contracts?

The word "group" is used somewhat loosely within the Standard. It can easily be confused with "portfolio". However, ***groups of insurance contracts*** are a further partition of those portfolios according to when written and expected profitability (AASB 17.16 and AASB 17 Appendix A).

Hence a "group" is a set of new business or renewal contracts which incept no more than 12 months apart, to be measured together. It is a sub-set of a “portfolio”. Furthermore, each group is also known as a unit of account (though this term is not used in AASB 17).

Q2.6 What does *subject to similar risks* mean?

No clear definition of s*imilar risks* is given in the Standard.

AASB 17.14 states that contracts within a product line would be expected to have similar risks, and consequently could be considered as a portfolio if they are managed together.

In general, AASB 17 and IFRS 17 Basis for Conclusions contain several sections related to this question which can be vague, and can therefore be confusing. As such the guidance is relatively high level, and is as follows:

> If contracts cover similar risks and are within the same product line, they are *subject to similar risks*.
>
> "Similar" does not mean "identical". Some variation in risk is reasonable, as long as the contracts are sufficiently similar. Since insurance is diverse and all portfolios are different, no prescriptive guidance can be provided on the correct level of materiality for the definition of "similar" and the decision process is likely to be entity specific. Of note, some level of consistency in grouping products lines already exists in the insurance industry and may provide a starting point.

Note that AASB 17 discusses *similar risks*, which may not necessarily have the same interpretation as “similar insurance risks”. Therefore, an entity may consider other risks such as lapse and expense risk in their determination of what similar risks means.

Note that it is easy for the IFRS 17 Basis for Conclusions to be misinterpreted if sections are read in isolation. This is particularly so in relation to the expected profitability of contracts of *similar risk*. Reading section IFRS 17.BC119 – BC125 in isolation could give the impression that a portfolio should only include contracts of similar expected profitability - potentially a very large number of groups. The practical considerations are addressed in the following section, IFRS 17.BC126-135, which, then notes that this is not actually the intent, and that profitability is expected to be

considered in three distinct groupings. It is important for the reader to be cautious in interpreting sections of the IFRS 17 Basis for Conclusions in isolation, given its style of writing.

Q2.7 What does *managed together* mean?

Again, there is no clear definition in the Standard for this term. Hence judgement is required by actuaries on what constitutes *managed together*.

From a practical perspective, the considerations relating to *subject to similar risks* noted above will require a level of granularity in assignment of portfolios that, in many cases, could result in portfolios that are naturally *managed together*.

It is expected that the determination of the portfolio level will vary between entities, due to different sizes and complexity, as well as the different ways in which business is managed. A practical approach to determining the portfolios for an entity might rely on the internal management reporting systems. For example, an entity's internal management systems may consolidate results into product lines. These product lines could provide a suitable aggregation of similar risks; furthermore, an entity may have its systems aligned with its internal management structure and may disclose to market on that basis. This could constitute a suitable aggregation basis for what is considered as 'managed together'.

Other factors to consider against the test of *managed together* could include:

- distribution channel(s) that the contracts are sold through;
- the level at which regulation takes place, for example CTP insurance;
- capital allocation basis; and
- the operating model or management structure of the entity, including how management incentives are structured.

Product line groupings as prescribed by APRA may not necessarily be appropriate to define portfolios due to a different focus to AASB 17. The latter's primary focus is about reporting appropriate profits and losses (IFRS 17.BC119) rather than solvency.

Note that an entity may change how it manages its business over time. As a result, the number of portfolios may change over time. This is an anticipated response under the Standard, although it does not necessarily affect the number of groups as historical groups do not change and groups are a sub-set of the portfolios.

Q2.8 Can multi-peril (or multi-benefit) products be aggregated in the same portfolio?

This issue is not explicitly mentioned in AASB 17 or in the IFRS 17 Basis for Conclusions. The guidance, therefore, is based on the interpretation of the broad intent of the Standard and **paper AP01 for IASB Feb 18 TRG** and subsequent discussion.

Peril aggregation is a common feature of (general) insurance products. Benefit combinations is also a common feature of life insurance products. The Standard appears to indicate that as long as the cash flow risks impacting the contracts are similar, then these contracts can be aggregated together. Hence it could be concluded that multi-perils (or multi-benefit) contracts can be aggregated into groups as long as the product line is the same and the expectations around the variability in estimates are similar.

Additionally, it is noted:

- IFRS 17.BC119 states that aggregation set by regulators serves a different purpose than aggregation for financial reporting.
- Similarly, it can be concluded that peril type aggregation used for actuarial modelling of reserving would not necessarily be a suitable justification for a basis given its alignment with solvency and valuation requirements.

This supports the bundling of perils within groups and therefore portfolios from a practical standpoint. The attribution of premium income to multiple peril groupings could be challenging, particularly if those perils were not priced explicitly within an additive pricing structure. This added complexity would lead to potential inaccuracies in financial reporting, notably the consideration of whether the contract groups are onerous, which would not be in the spirit of the Standard. Materiality of the potential inaccuracies in financial reporting are a consideration for actuaries.

Overall, it is concluded that although not explicitly prohibited or prescribed in AASB 17, it is not expected that individual multi-peril contracts are to be split into separate portfolios for the purposes of measurement under AASB 17, purely due to their multi-peril nature. This is confirmed in **paper AP01 for IASB Feb 18 TRG** where the intention is clearly stated that a contract with legal form of a single contract would generally be considered a single contract in substance. It is acknowledged though that there might be circumstances where it is not the case. The TRG observed that *overriding the contract unit of account presumption by separating insurance components of a single insurance contract involves significant judgement and careful consideration of all relevant facts and circumstances. It is not an accounting policy choice* (TRG Summary Feb 18 paragraph 7(b)(ii)).

Q2.9 Can separate types of risk be split out from a contract?

The concept of a portfolio of contracts managed together and subject to the same risks is problematic if the contracts contain several distinct risks that are actually managed separately. Possible solutions include:

1) Follow the legal form of a single contract and assign to a portfolio based on the main risk of the contract; or
2) Apply the principle of substance over form, and split the contract into several components, and include those components in separate groups; or

3) Apply the principle of *similar risks*, and assign contracts to groups based on their similarity of a particular combination of benefits. This leads to a larger number of groups, and contracts being de-recognised as customers choose different benefits over time.

Following deliberations by the **February 2018 TRG**, it is generally agreed that the lowest unit of account is the contract. There is a presumption that a contract with the legal form of a single contract would generally be considered as a single contract in substance. However, there might be certain facts and circumstances where legal form does not reflect the substance, for example where transactions that are typically written as separate contracts have been bundled together as one legal contract for customer convenience. This will require careful considerations of the level of interdependencies between the different components such as shared deductibles and limits and where the lapse or termination of one component results in the termination of the whole contract. A master contract issued to a superannuation trustee covering current and future members also will require careful consideration.

Q2.10 When is a contract allocated to a portfolio of insurance contracts?

Practically, at the same time as groups are defined (refer to **Q2.13 When is an issued contract grouped?**).

Q2.11 Are portfolios of insurance contracts fixed for all times?

Since the definition of a portfolio refers to a purely business criterion, *managed together* may change over time. AASB 17 requires a current assessment for any new business written, which means that the portfolios for an entity may change over time for new business or renewal written.

Q2.12 Is the entity free to refine the partition of the business in force?

No. As an entity shall establish groups at initial recognition, organisational reasons may justify in line with the accounting policies to create further portfolios or to close a portfolio for new business and/or renewed business, but only as they fall due.

2.3 Partitioning into Groups

Q2.13 When is an issued contract grouped?

A contract is grouped at the latest date when insurance coverage commences or the initial premium becomes due. A contract might be grouped earlier if it turns out to be onerous - for example if a contract is written or issued in advance and the premium has not become due yet. Refer to AASB 17.25.

An entity shall establish the group at initial recognition and shall not reassess the composition of the groups subsequently (see AASB 17.24), except in the cases of a

specified contract modification (See AASB 17.72 and AASB 17.76) This applies even if contracts within a group, or the group as a whole, are subsequently found to be onerous when they were not at initial recognition.

Note that **Q2.11 Are portfolios of insurance contracts fixed for all times?** above refers to portfolios changing over time if the business manages its insurance contracts in different ways.

Significant contract modifications are covered in more detail within Chapter 10.

Q2.14 What is the meaning of the limitation to contracts being no more than one year apart at inception?

An entity shall not include contracts issued more than one year apart in the same group (AASB 17.22). This refers to the date of issue of the contract being recognised under AASB 17, which is not necessarily the same as date the contract was initially written, as due to the application of contract boundary (see **Sub-chapter 2.4 Testing Contract Boundary**) the renewal of a long term contract may be treated as creating a new contract under AASB 17.

Contracts that legally bind the insurer for only a short period, e.g. most general insurance contracts, typically get reissued at the renewal date. Therefore, the renewal date forms the issue date.

For contracts that bind the insurer for longer periods, e.g. most life insurance contracts, it is more complex. These contracts are guaranteed renewable, and the contract legally continues, subject to payment of the renewal premium due. However, although the contract legally continues, AASB 17 may treat the renewal date as the contract boundary (see **Sub-chapter 2.4 Testing Contract Boundary**) and the renewal as creating a new "contract" for AASB 17 purposes separate from the exiting contract. In which case, the underlying policy contract is treated as multiple "contracts" for AASB 17 purposes over its life (as per AASB 17.35). In this case "issue" date for the purpose of grouping under AASB 17 refers not to the original date of commencement, but to the renewal at the contract boundary that incepted the contract under AASB 17.

Q2.15 How is a contract allocated to a group by profitability?

Each contract to be grouped would be assigned to one of the three following categories:

- onerous;
- no significant possibility of becoming onerous; or
- any other contracts.

In practice, individual contract assignment might be possible but typically insurers will not attempt to assess the risk exposure in full detail and will therefore choose a

certain level of differentiation of contracts corresponding with such elements, such as differentiation of risk and pricing. *Reasonable and supportable* information is the terminology used in the standard. AASB 17.17 and IFRS 17.BC 129 highlights the Board's intention that the objective of assigning contracts to the three categories mentioned above can be achieved by assessing a set of contracts, if the entity can conclude, using reasonable and supportable information, that the contracts in the set will all be in the same group.

It is worth noting that groups assessed under the PAA will be assumed to be non-onerous unless facts and circumstances indicate otherwise.

Q2.16 How to consider regulatory pricing constraints?

The exemption in AASB 17.20 applies only when law or regulation specifically constrains the entity's practical ability to set a different price or level of benefits for policyholders with different characteristics. The categorisation would therefore be applied either to the portfolio as a whole, or groupings excluding the regulatory or legal constraints. Care needs to be taken in determining the extent of the legal or regulatory constraint, and delineating it from business decisions (see e.g. IFRS 17.BC133-BC134)

Q2.17 Is it appropriate to determine groups on a more granular level than prescribed?

As stipulated in AASB 17.21, it appears that there are no constraints on refinement of groups beyond the minimum level prescribed.

Q2.18 How are contracts added to an existing group?

The establishment of a group can be a process that spans up to a year. The original classification of the group determines the allocation of new contracts during that period. If the expected profitability of an open group changes during that period, it might be appropriate to close the open group and open a new one if new contracts added that differ in profitability level.

Q2.19 What is *reasonable and supportable information* when determining whether a set of contracts can be considered as a group?

AASB 17.17 indicates consideration should be given to the availability of *reasonable and supportable information* to justify the grouping of contracts. In the absence of such information, it shall determine the group to which the contracts belong by considering individual contracts.

Reasonable and supportable information could be considered to be readily available internal management and reporting information. Examples may include policy disclosure statements, valuation reports, pricing reports or other key profitability

metrics presented to senior management or the Board of directors. It would be appropriate for actuaries to consider the relevance of documentation supporting the basis for determination in order to satisfy themselves and their stakeholders that an appropriate process has been followed.

Where the entity can reasonably undertake a measurement approach at an individual contract level, this would also enable a grouping assessment to be made.

Q2.20 What is the difference between *no significant possibility of becoming onerous* and other non-onerous contracts?

The term *no significant possibility* indicates a high bar to reach, and in practice it may be that most contracts will fall into binary groupings within each portfolio (onerous versus remaining). IFRS 17.BC 130 discusses in a limited manner the intent of this separation.

Internal guidance may be created by an entity that specifies the details of the metrics that are required to determine whether contracts fall into the *no significant possibility* group. The approach is likely to vary across entities, given the judgmental nature of this determination, but could be dependent on:

- the variability of the type of insurance risk; and/or
- the duration of the contract; and/or
- the level of the risk adjustment that the entity has set; and/or
- the CSM level at inception, if using the general measurement approach.

Q2.21 Does the LIC need to be separated or identified by group (portfolio, underwriting year, level of onerousness)?

AASB 17.40 stipulates that:

> *The carrying amount of a group of insurance contracts at the end of each reporting period shall be the sum of:*
>
> *(a) the liability for remaining coverage […] and*
>
> *(b) the liability for incurred claims, comprising the fulfilment cash flows related to past service allocated to the group at that date…*

It is also noted that each group is a unit of account.

In practice though, it is anticipated that the outstanding claim valuation could be carried out at a different level of aggregation than the defined groups, then allocated down or aggregated up to the adopted unit of accounts. AASB 17.24, AASB 17.33 and AASB 17.40 make it clear that allocating to groups from a higher level of aggregation the resulting fulfilment of cash flows is quite acceptable for any type of valuation activity.

Q2.22 Allowance for community rating and legislated limitations on use of underwriting variables.

As per**Q2.16 How to consider regulatory pricing constraints?**, where law or regulation specifically constrains the entity's practical ability to set a different price or level of benefits for policyholders with different characteristics then those characteristics can be ignored for allocating policies between groups. Therefore, if a particular characteristic that is restricted would result in policies being split between onerous and other allocations, this characteristic can be ignored.

An example would be age, gender and pre-existing conditions in health insurance which are restricted from being used for pricing by legislation and would usually result in some policies being onerous based on current prices. In these circumstances policies that would or wouldn't be onerous due to these characteristics should be grouped together.

2.4 Testing Contract Boundary

Q2.23 What is the boundary of a contract?

AASB 17.34 states that the contract boundary is the end of the *period in which the entity can compel the policyholder to pay the premiums or in which the entity has a substantive obligation to provide the policyholder with services*.

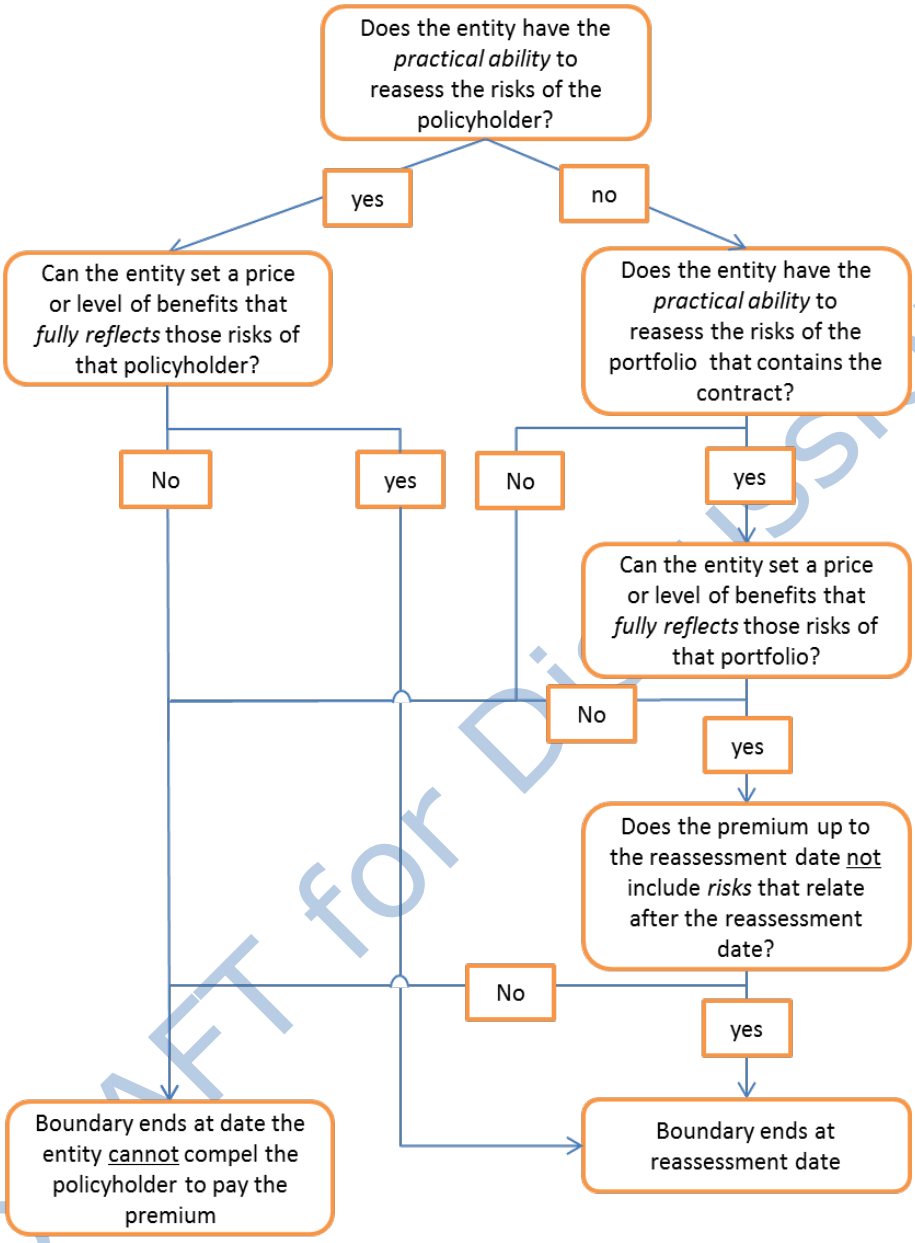
AASB 17.34 explains that

> *a substantive obligation to provide services ends when:*
>
> *(a) the entity has the practical ability to reassess the risks of the particular policyholder and, as a result, can set a price or level of benefits that fully reflects those risks; or*
>
> *(b) both of the following criteria are satisfied:*
>
> *(i) the entity has the practical ability to reassess the risks of the portfolio of insurance contracts that contains the contract and, as a result, can set a price or level of benefits that fully reflects the risk of that portfolio; and*
>
> *(ii) the pricing of the premiums for coverage up to the date when the risks are reassessed does not take into account the risks that relate to periods after the reassessment date*.

The contract boundary is interpreted to be the date from which an entity has the practical ability to set a price that fully reflects the risks in the contract, if the reassessment of this risk is performed at an **individual policyholder level** (AASB 17.34(a)). However, if the reassessment of the risks occurs at a **portfolio level**, then AASB 17.34(b)(i) ***and*** (ii) conditions (see above) are to be satisfied.

Figure 2.1 gives an overview of the features to consider when determining the contract boundary.

Figure 2.1: Overview of Contract Boundary Decision Points



Q2.24 What constitutes a *practical ability* to set a price or benefit level?

As specified in AASB 17.B64, an entity has the *practical ability* to set a price or level of benefits that fully reflects the risks:

- **In a contract**: *in the absence of constraints that prevent the entity from setting the same price it would for a new contract with the same characteristics as the existing contract issued on that date, or if it can amend the benefits to be consistent with the price it will charge*.

- **In a portfolio**: *when it can reprice an existing contract so that the price reflects overall changes in the risks in a portfolio of insurance contracts, even if the price set for each individual policyholder does not reflect the change in risk for that specific policyholder*.

Practical ability is considered to relate to any contractual or other legal restriction that may constrain the entity's ability to reprice or set an appropriate level of benefits.

The practical ability to reprice is not removed if the entity makes a commercial (non-contractual) decision to price at a certain level. IFRS 17.BC 161 notes that any restriction must have *commercial substance* - i.e. must restrict the economics of the contract conditions in some material manner.

Q2.25 What is the coverage period for health insurance policies where benefits can be modified by the health fund at very short notice?

Private Health Insurance (PHI) policies usually have no end date, with all policies continuing while monthly premiums are paid. Health insurers generally have the ability to change premium rates only once a year on 1 April through the rate change submission to the Minister for Health. In contrast, health insurers can change benefits with short notice (at least 30 to 60 days' written notice) to policyholders between premium changes. However, there are other requirements in the PHI Code of Conduct that may limit health insurers' ability to change the level of benefits to fully reflect the risk of the policies without changing the premium. For example, the Code of Conduct has certain limitations, and certain minimum benefits must be offered for a policy to be covered by the PHI rebate.

For most policies, the contract boundary will be the earliest time that a health fund has the ability to reprice existing contracts so that the price reflects the risks in the portfolio of insurance contracts. For policies without an agreed term, this will be the next 1st April, in which case the coverage period is at most 12 months and the contracts would be eligible for PAA.

Health funds also write some longer term policies, where they agree not to change the premiums in exchange for prepayment of premiums. This may change the contract boundary. In this circumstance, the first time the health insurer has the *practical ability* to fully reprice will be when the term agreed ends. Therefore, this will be the contract boundary.

Q2.26 What risks are to be considered when assessing when a substantive obligation ends?

AASB 17.B64 notes, among other things, that *when assessing whether the entity has the practical ability to set a* price *that fully reflects the risks in the contract or portfolio, it shall consider all the risks that it would consider when underwriting equivalent contracts on the renewal date for the remaining coverage*.

The reference to underwriting suggests that the entity should consider *insurance risks* (Appendix A). The **IASB Feb 18 TRG paper AP02** addresses this question and it was noted that:

- In the TRG discussion, that Paragraph 34(b) of IFRS 17 should be read as an extension of the risk assessment in paragraph 34(a) from the individual to portfolio level, without extending policyholder risks to all types of risks and considerations applied by an entity when pricing a contract;
- the staff noted that policyholder risk includes both the insurance risk and the financial risk transferred from the policyholder to the entity and therefore excludes lapse risk and expense risk;
- a *practical ability* to reassess risks only at a general level (for example, for a general community) rather than reflecting the experience of the specific portfolio does not qualify; and
- the outcomes depend on the fact pattern, and the facts and circumstance of each contract should be assessed to reach an appropriate conclusion in applying the requirements of IFRS 17.

The benefit terms of the contract and how this is priced in practice are considerations bearing in mind AASB 17.34(b) (see **Q2.23 What is the boundary of a contract?**), in particular when the reassessment of risks (whether this be just insurance risks or all risks) occurs at a portfolio level.

For particular product groups in Australia and internationally, this area will lead to further discussion within the accounting profession and possibly again at the IASB TRG.

Q2.27 What does pricing of premiums for coverage only for risks up to the reassessment date mean?

AASB 17.34 (b)(ii) states that *pricing of the premiums for coverage up to the date when the risks are reassessed should not take into account the risks that relate to periods after the reassessment date*. There are three key terms in this statement: "risks", "pricing" and "reassessment date".

"Risks" refers to insurance risks and financial risks transferred from the policyholder to the entity per previous question.

The term "pricing" in this context does not refer to the practical ability. Therefore, one could consider whether this is based on the actual pricing process or a theoretical pricing process. For example, in theory a Yearly Renewable Term (YRT) life product could be priced using long-term discounted cash flow models or it could be priced using the expected risk over the next year with loadings added for expenses and profit. Whether the actual or theoretical pricing approach is assumed is likely to require justification accordingly.

The “reassessment date” is the date at which pricing or the level of benefits can be reassessed under the contractual terms. It would usually represent the end of a policy year or anniversary where new coverage details are determined along with a new premium, if applicable.

Q2.28 What is the contract boundary for long-term policies which contain annual or more frequent pricing or underwriting review features?

Stepped YRT products and multi-year reinsurance contracts products are examples of contract types that have both long-term (greater than one year) and short-term contract features. This makes the determination of the contract boundary very challenging.

The contract boundary definition outlined in previous questions is critical. It depends on the interpretation of what "risks" are included, the pricing process involved and whether this pricing process can fully reflect the risks up to the reassessment date (and not beyond).

In addition, the entity needs to consider how this definition of contract boundary fits with the grouping of contracts. A more granular product grouping may result in a different accounting outcome as it may be more or less difficult to have a practical ability to reprice a granular portfolio of risks to fully reflect the risks of that group (for example, due to regulation as per AASB 17.20).

AASB 17.B64 discusses considering underwriting an equivalent new contract on the renewal date and whether an entity could charge the same premium for a renewal or not. This test enables us to check the contract boundary definition in respect of whether repricing can be carried out at a contract level, but may not be appropriate when considering whether the entire portfolio can be repriced to fully reflect the risks of that portfolio. There may be instances where similar risks within a portfolio are priced at different levels, but contractual terms allow the premiums across the entire portfolio to increase or decrease to fully reflect the risks.

There are differing views as to the contract boundary for yearly renewable term life insurance typical in Australia. Arguments can be made for categorisation of this business as either a long term or a short term contract. Ultimately the categorisation for a particular product and company will depend on the details of the specific case. The picture will become clearer as the merits of the various arguments emerge.

2.5 Insurance Items Potentially Falling Outside of AASB 17

Q2.29 Once the rights have been acquired by the insurer, do salvage and subrogation recoveries fall outside of AASB 17?

The inclusion of salvage and subrogation cash flows are explicitly stated in AASB 17.B65(k) to be within the insurance contract boundary with regards to future claims. However, on past claims such cash flows will not be included if they do qualify for recognition as "separate assets". The remaining question is whether or not outstanding salvage and subrogation recoveries on existing claims qualify as "separate assets" in the AASB standards.

Subrogation does not appear to be covered in any other accounting standards due to lack of a customer relationship with the third party and therefore would appear to remain within AASB 17. As for salvage, AASB15 could apply for some of the recoveries. This would depend on the extent to which the salvage arrangements involve the insurer in controlling the process of selling salvageable assets to third parties, assuming inventory risks and assuming risks on the receivables from sales. In practice, there are potentially materiality considerations on the net proceeds of the salvage activity that could be invoked to maintain salvage within scope of AASB 17.

Q2.30 What contracts are within the scope of AASB 17?

AASB 17.3 notes: *An entity shall apply* AASB 17 *to: (a) insurance contracts, including reinsurance contracts, it issues; (b) reinsurance contracts it holds; and (c) investment contracts with discretionary participation features it issues, provided the entity also issues insurance contracts.*

Contracts that do not meet the definition of an insurance contract or investment contract with discretionary participation features fall outside the scope of AASB 17. Similarly, if the contract meets the definition of an investment contract with discretionary participation features, but the entity does not write other insurance contracts (i.e. is not currently an insurer), then the contract falls outside the scope of AASB 17.

Accordingly, there may be contracts currently within the scope of AASB1038 which will not be within the scope of AASB 17. In particular, unless contracts that are currently accounted for as life investment contracts under AASB1038 are components that cannot be separated from insurance contracts, they will fall out of the scope of AASB 17.

Examples of products offered by life insurers which may fall outside the scope of AASB 17 include term certain annuities and non-participating investment accounts.

Contracts that fall outside the scope of AASB 17 may fall within the scope of AASB9 or AASB15.

Within general insurance a potential example is claim salvage activities as discussed in **Q2.29 Once the rights have been acquired by the insurer, do salvage and subrogation recoveries fall outside of AASB 17?**.

Q2.31 What components have to be separated from insurance contracts?

AASB 17.10 notes that *an insurance contract may contain one or more components that would be within the scope of another Standard if they were separate contracts*. AASB 17.11 and AASB 17.12 require the separation of specified embedded derivatives, distinct investment components and distinct performance obligations from the insurance contracts. Separated components that fall outside the scope of AASB 17 may fall within the scope of AASB9 or AASB15.

3 Current Estimates

3.1 Introduction

Q3.1 What Is the scope of this chapter?

This chapter provides information concerning the estimates of future cash flows for use in the measurement of contracts within the scope of AASB 17. This includes estimates both at issue of the contract and at subsequent measurements.

Q3.2 Which sections of AASB 17 address this topic?

AASB 17.33-35 and AASB 17.B36-B71 provide guidance on this topic. IFRS 17.BC146-184 also provides background on the subject.

3.2 General Issues

Q3.3 What are the requirements of AASB 17 regarding the measurement of estimates of future cash flows?

AASB 17.33 includes the key characteristics of the measurement of estimates of future cash flows. They:

- include all future cash flows within the contract boundary;
- are the probability weighted mean of the full range of possible outcomes;
- are unbiased;
- reflect the perspective of the entity;
- are current; and
- are explicit (i.e. they don't include the risk adjustment for non-financial risk).

Q3.4 What future cash flows are within the contract boundary?

These are all the cash flows that arise from the provision of cover up to the contract boundary. Cash flows arising from cover provided after the contract boundary are treated as relating to separate insurance contracts (see AASB 17.35).

Q3.5 What are the typical types of cash flows to be included?

Cash flows referred to in AASB 17 are primarily payments of cash exchanged between the parties under an insurance contract in accordance with the terms and conditions of the contract. The term "cash flow" can also be used as shorthand for other transfers of economic resources (cash flow equivalents) that are not settled in cash between the parties to the insurance contract. They may also include such items as

administration costs, payments to third parties and non-cash transactions such as the provision of goods and services.

Some non-cash transactions may be subject to other Australian Accounting Standards (AAS) that determine the amount of transfer of resource caused by fulfilling the contracts in the respective period. Measurement of future cash flows accordingly includes the allocation or transfer of resources to those future periods under the applicable AAS.

Those cash flows may refer to any component of the insurance contract that is covered by AASB 17, excluding components separated under AASB 17.11-12 (see AASB 17.13). Cash flows do include components that might sometimes be seen as separate but aren't under AASB 17 (e.g. policy riders or policy loans).

AASB 17.B65 provides examples of cash flows that are typically included within the boundary of the contract. They include but are not limited to:

1. Premiums
2. Payments to policyholders including claims that have been reported but not yet paid, incurred claims that have not yet been reported and future claims on unexpired risks
3. An allocation of insurance acquisition costs
4. Claim handling costs including those for payments in kind
5. Policy administration and maintenance costs
6. Transaction-based costs such as premium taxes
7. Potential cash inflows from recoveries
8. An allocation of fixed and variable overheads

Sometimes, it might be permissible (e.g. due to materiality) to also consider cash flows exchanged between the parties under the contract not based on the actual payment date, but based on a due date or the date when the triggering event occurs.

Q3.6 At what level are cash flows determined?

Cash flows are generally identified at the individual contract level, but for measurement purposes contracts may be aggregated. Moreover, AASB 17 allows the entity to estimate the cash flows at whatever level of aggregation is most appropriate from a practical perspective. If the entity makes estimates at a higher level, it needs to be able to allocate those estimates to groups of insurance contracts (GIC) so that the appropriate amounts are included in the measurement of the GIC' FCF for future service and incurred claims as per **Q2.5 What are the typical types of cash flows to be included?**.

AASB 17 requires that for certain purposes, particularly the initial measurement of the CSM and the initial allocation of a contract to a group of contracts, and ongoing

measurement of the resultant GIC, contracts be aggregated or broken down to a prescribed level. See **Chapter 2 Aggregation and Contract Boundary** for a discussion of aggregation for the measurement of the CSM.

Assumptions may be derived at aggregation levels that are different from the aggregation level applied for measuring contracts. In that case, judgement will be needed to determine what adjustment, if any, is needed to apply them at the required aggregation level. For example, maintenance expenses may be determined for all life insurance contracts, but separate assumptions may be needed for term insurance and whole life contracts.

In some cases, particularly for general insurance contracts covering multiple risks and/or perils, it may be helpful to analyze the experience separately for each of those multiple coverages. Such separation, for analysis and projection purposes, is particularly appropriate where the balance of coverages varies from contract to contract within a line of business, such as small business package policies. Such coverage cash flows are then combined at the contract level before contract cash flows are aggregated into groups and portfolios for measurement purposes. Similar concerns will also apply to life insurance contracts with multiple risks (e.g. mortality and disability) or GIC with multiple durations (e.g. 10, 20 and 30-year terms to end of contract or contract boundary in the same GIC).

In summary, IFRS 17.BC117 states: *IFRS 17 allows an entity to estimate the fulfilment cash flows at whatever level of aggregation is most appropriate from a practical perspective. All that is necessary is that the entity is able to allocate such estimates to groups of insurance contracts so that the resulting fulfilment cash flows of the group comply with requirements of IFRS 17*. AASB 17.24 gives effect to this.

3.3 Issues concerning the definition of cash flows to be included

Q3.7 What is a current estimate?

A current estimate at the report date is the entity's estimate based on currently available information in a manner consistent with relevant accounting guidance (AASB 17.33(c)). The term "current estimate" is used in this chapter as a short form for the "current unbiased estimate of the expected future contractual cash flows within the contract boundary".

AASB 17 defines the term FCF as including the risk adjustment and the effect of discounting. This chapter, however, does not refer to issues regarding calculating present values, but focuses on the identification of cash flows and estimating unbiased expected values of those cash flows.

Q3.8 What is the meaning of expected value?

For AASB 17 purposes, "expected value of cash flows" represents the mean of the (typically unknown) probability distribution of cash flows. In line with this mathematical concept, AASB 17 requires that conceptually all scenarios are covered in determining the value of the cash flows, including scenarios in the extreme tails of the distribution. Where the variability in future cash flows follows a symmetrical distribution, actuaries may conclude that the impact and likelihood of favorable and unfavorable extreme scenarios not explicitly considered in a model may broadly offset each other; however, where the distribution of future cash flows is skewed it may be necessary to adjust the expected value to reflect extreme scenarios not allowed for in the model.

For example, the probability distributions of general insurance property claims tend to be positively skewed. The available data for similar products is rarely sufficient to fully reflect the future impact of natural catastrophes, and it is necessary to rely on other sources of data and judgement to adjust the models, which tends to increase the expected value to reflect these high-cost but low frequency events. Similarly, actuaries may consider it appropriate to take into account favorable extreme scenarios such as, for life insurance, a fall in mortality rates if an affordable cure for cancer is developed. All such adjustments would require judgement on the likely impact and probability of occurrence to adjust the modelled expected value.

The reference in AASB 17 to scenarios is about the defining characteristic of the mean value of a distribution function rather than providing guidance regarding how to estimate the mean value. It does not imply a requirement that all possible (or even any) scenarios be explicitly constructed, nor is it expected that entities will develop stochastic models for all AASB 17 reporting.

Q3.9 Does this mean that the distribution function of cash flows needs to be determined?

Not necessarily. The accounting purpose is to derive a current unbiased estimate of the expected value of cash flows. AASB 17 does not provide any guidance regarding how the estimate is to be made. Any statistical or non-statistical approach applied in determining figures for AASB purposes needs to comply with general accounting requirements, e.g. as outlined in this chapter.

There is a variety of approaches that can be used for determining unbiased estimates of expected values without a need to know the underlying distribution function. If the cash flows depend significantly on circumstances that cannot be described statistically but require the choice of scenarios, as, for instance, for future market prices or interest rates affecting the value of the cash flows, the consideration of a limited range of scenarios that capture the array of possible cash flows) might be all that is needed to estimate the expected values (compare AASB 13.B28).

Q3.10 What does "unbiased" mean?

An estimator is unbiased if its mean value equals the mean of the value to be estimated. Therefore, an unbiased estimate does not include either conservatism or optimism.

Q3.11 What are some examples of current estimates as intended by AASB 17 and other possible objectives (e.g. best estimate, median or conservative estimate)?

AASB 17 calls for an estimate of the statistical mean, rather than the statistical median or mode. Other descriptions, such as best estimate, used in other accounting structures, may often not be the same. Before using cash flows developed for other purposes, their fitness for reporting under AASB 17 needs to be assessed.

Q3.12 How are cash flows belonging to the entity in general treated?

Cash flows belonging to the contract are those that are specifically generated because the contract is in existence (e.g. benefits, commissions, direct administrative expense). Indirect administrative expense, including general overhead are included only if they are directly attributable to fulfilling a portfolio of insurance contracts as per AASB 17.B65(l) and AASB 17.B66(d). If they are not, they are general expenses of the entity not belonging to the contract and are thus not considered in measurement of the expected cash flows of the contracts.

AASB 17 is silent with respect to techniques to be used for estimating cash flows; therefore, no special techniques are required to determine these indirect expenses. The customary methods used for pricing or other types of reporting can also be used for this purpose so long as the result meets the requirements of AASB 17.

Any cash flows or costs of the entity related to other standards are not discussed herein: only those required by AASB 17 are discussed. When investment administration expenses are estimated, only expenses that are required by the contract are included, not the expenses of the actual investments of the entity. Under normal circumstances, investment expenses are not included in the FCF. Instead they are subject to AASB 9. For contracts with direct participation features, investment expenses may need to be taken into account in determining the value of underlying items.

Q3.13 To what extent do the expected values have to differentiate contracts' characteristics (e.g. age, gender), and other known peculiarities of contracts?

Statistical estimates are usually only differentiated for a limited number of characteristics of the item to be estimated and include the average effect of other

characteristics. Since insurance is based on statistical estimates, AASB 17 does not require the entity to assess all characteristics of a contract that might be relevant to the outcome and establish estimates on that basis. AASB 17.B37 does require consideration of *all reasonable and supportable information available at the reporting date without undue cost or effort.*

Accordingly, it is a matter of judgement as to what degree characteristics of individual contracts are considered in the measurement and grouping. It may be appropriate for individual contracts to be aggregated into groups of contracts that are not further distinguished. AASB 17.B37 does note, however, that *information available from an entity's own information systems is considered to be available without undue cost or effort.*

AASB 17.17 may require identification of the FCF of an individual contract, for the purposes of initial grouping. Accordingly, assumptions that are appropriate for that purpose would need to be chosen for each contract. It is necessary to determine the degree to which the assumptions are differentiated for the characteristics of individual contracts. The individual characteristics of each contract are only considered to the extent that the assumptions are differentiated on the basis of those characteristics.

The actuary may consider a wide range of factors in an internal experience analysis used for determining liabilities for remaining coverage and incurred claims. The objective of this consideration is to determine whether it is appropriate to incorporate those factors explicitly into the analysis and whether it is appropriate to then incorporate them into the measurement. Factors need not be incorporated in the analysis unless there is reason to suppose that they can reasonably be collected and used by the insurer without undue cost and that they are likely to materially impact the measurement of the FCF of the GIC.

Many characteristics of contracts will not be available to the entity in any case. For other characteristics, even if known, the entity might not be able to assess their impact due to limited statistical data or the undue cost or effort to obtain them. Other characteristics of contracts will not be consistently available for all contracts and, as a consequence, may be ignored since they can only be averaged over other contracts. Other characteristics, which might be assessable or are even assessed at outset, might be ignored in pricing since the overall benefits from such a differentiation would not outweigh the cost of doing so. For example, certain medical examinations or adjusting information systems to differentiate a certain characteristic could be more expensive than the price effect. An entity might thus limit the differentiation of contract characteristics to a certain number that can reasonably be administratively and statistically managed. Administrative convenience, however, should not be confused with a marketing decision to cross-subsidise between identifiable sets of contracts.

Accordingly, the differentiation of assumptions as applied to individual contracts will usually start with the differentiation used for pricing. A lower level of differentiation

than applied in pricing might, if applied to individual contracts, result in inconsistencies between premiums and the measurement of the related cash outflows, if the cash flows would be based on averaged assumptions while the associated premiums are more differentiated.

There are exceptions to this principle. IFRS 17.BC135 (a) refers to an *intentional pricing strategy*. If the entity under-prices certain contracts intentionally, e.g. to gain market share, by ignoring certain relevant and known characteristics of the contracts, it might have the same consequences as if the entity chooses to charge insufficient premiums. Accordingly, measurement considers those peculiarities of the respective contracts and differentiates assumptions on that basis. As a consequence, the premiums agreed for that contract might turn out to be insufficient to cover the value of the risk.

Furthermore, AASB 17.20 allows an exception for grouping, where law or regulation constrains the use of specific characteristics for pricing (e.g. where pricing of annuities must be on a unisex basis). In such cases, the insurer may include such contracts in the same group, but only if they would otherwise fall into a different group due solely to the regulatory pricing constraints. Note that this does not allow those specific characteristics to be ignored in the measurement process, only for grouping.

It is acceptable to allow for the average impact of considered characteristics for the contracts in a group, so that only the average impact of the characteristics is reflected in the measurement, provided that it reflects the true mix of such characteristics in the group. If the composition of a group changes, however, it may be necessary to reassess the average impact, so that it continues to reflect the mix of characteristics in the group.

For small portfolios, where there is a level of subjective underwriting in the premiums charged, and sometimes for larger portfolios, it may be possible for the actuary to conclude that the premium charged is the best available measure of the relative levels of expected costs between contracts. In such cases, it is acceptable to use the premium as a proxy for most or all of the characteristics of the contracts.

Q3.14 How are contractual rights (e.g. policy loans) handled?

Under AASB 17, the measurement (see AASB 17.33 and AASB 17.B61) needs to include all future cash flows within the boundary of the contract which are defined as those that arise from all contractual rights under the policy, including those imposed by law, regulation or implied by the customary business practices (see AASB 17.2). These include:

- non-forfeiture premium advances required to be made under section 210 of the Life Act;
- loans on policies provided as right under terms of the contract or by customary business practice; and

- cash flows (including those that may extend beyond the boundary of the original contract) that arise from the exercise within the contract boundary of any other contractual rights.

It is clear from IFRS 17.BC114 that the IASB see these as being part of the cash flows to be included in the measurement of the insurance contract liability.

Where policy loans, for example, are a contractual component of the insurance contract, loans and repayments of policy loans are therefore part of FCF. If future policy loans are within the contract boundary, expected future loans and repayments should be included in the cash flows as well as interest accrued on outstanding loans. To the extent that interest accrued on the loan is accumulated at a rate different than from the discount rate applied in measurement under AASB 17, there will be an effect on CSM.

The same applies to cash flows that arise from the exercise of any other contractual rights.

If the potential take-up of future policy loans, for example, is within the contract boundary, expected future loans and repayments are to be included in the cash flows as well as interest accrued on outstanding loans.

Currently, policy loans (and non-forfeiture premium advances) are normally treated as investment assets secured against the policy (and often as part of the assets backing the VSA and/or participating retained profits). In this case they would also be part of the underlying items under VFA (see **Chapter 8 Direct Participation Features**).

A possible alternative approach, dependent upon materiality, both for policy loans and any other contractual right, is to:

- include in the cash flows the net cost (or profit) to the entity if the loan (or exercise of any other option) is taken up in the period. The CSM for business under the VFA approach will thus reflect the expected cost to the entity if the option is exercised;
- in the case of a loan, when taken up, continue to measure the policy liability as if it wasn't taken up, but include the loan among the investment assets (and the pool of underlying items), with the difference between actual and expected take-up, multiplied by the net cost to the entity, being treated as an experience item in the period; and
- for disclosures, deduct the loan from investment assets and net off the policy liability.

3.4 Inflows

Q3.15 What are the cash inflows to be considered?

All cash inflows arising under rights of the insurance contracts and within the contract boundary are considered. The primary inflow is, of course, premium. Investment income, other than that related to policy loans (see below), is not included since it is a cash inflow due to investments and not specifically related to the fulfilment of the contracts.

Other cash inflows considered include such items as salvage, subrogation, contract charges such as cost of insurance charges, and claw-backs of agent commissions originally paid related to the contract. The treatment of such recoveries is not specified in AASB 17. Any actuarial estimates of such recoveries should follow their accounting treatment.

Cash inflows on insurance riders and future insurance options, such as disability premium waiver, hospitalisation, term insurance, guaranteed future insurance (including cash flows from the expected exercise of such guarantees) will also be included if they are within the contract boundary (see also **Chapter2 Aggregation and Contract Boundary**).

As contracts are measured gross of reinsurance with reinsurance being separately measured, reinsurance cash flows would only be included in the measurement of the reinsurance contract.

Q3.16 How are premiums prepaid with interest accretion treated?

Prepaid premiums are treated the same as premiums paid at their due date. They are part of the cash inflows and the frequency and effect of their occurrence is included as part of future cash flows. In some cases, there is an agreement that the insurer grants a rebate on prepaid premiums in form of interest accreted. If this agreement is a component of the insurance contract and not separated as a distinct investment component, the rebate is considered in measurement and treated as an adjustment to premium as per AASB 17.B65(a).

AASB 17 does not directly address the issue of recognition of prepaid premiums. In the same way as insurance acquisition cash flows arising before recognising the group of insurance contracts are an asset according AASB 17.27, liabilities arising from prepaid premiums might be recognised as a liability, until the insurance contract liability is recognised.

Q3.17 How are extra premiums paid for substandard risks included?

Extra premiums for substandard risks are treated identically to other premiums. Moreover, it is important that expectations for the related future benefits are estimated on the basis of the correspondingly higher risk, so as to be consistent with the extra premiums. Actuaries might also consider whether the statistical knowledge available about the higher risk provides an adequate basis from which to develop an appropriate estimate that deviates from the extra premium determined. Similar considerations apply for premium rebates for risks better than standard.

3.5 Methods to estimate expected future cash flows

Note: Some of what follows might be regarded as commentary on generic actuarial techniques, but it has been included for completeness and to aid understanding.

Q3.18 What kind of data is used to estimate future cash flows?

The Standard (AASB 17.B41) requires assumptions to be based on information obtained including, importantly, the entity's own experience to the extent it is available, supportable and credible. This data can be adjusted if there is reason to believe that historical trends will not continue in the future or if other influences may affect them. If such internal data is not available, either in whole or in part, then industry or other available data, e.g. population data, may be used as a basis for the assumptions. In general, an entity's experience will be analysed for this purpose using an internal experience study.

While the entity's own experience is the primary source for setting assumptions, to the extent that there is market information available, assumptions should be consistent with that information unless there is a justification for a divergence.

AASB 17.33(a) and AASB 17.B37 set limits on the effort required to collect the statistical basis of determining the assumptions. In general, information used should be reasonable, supportable and obtainable without undue cost. Information available from the insurer's own information system, e.g., internal experience studies, and other sources used for pricing may be suitable for measurement.

Q3.19 What use can be made of data available post-reporting date?

AASB 17.B55 specifies that *The probability assigned to each scenario shall reflect the conditions at the end of the reporting period. Consequently, applying AASB 110 Events after the Reporting Period, an event occurring after the end of the reporting period that resolves an uncertainty that existed at the end of the reporting period does not provide evidence of the conditions that existed at that date*.

Information on conditions in place at the end of the reporting period (e.g. subsequent reporting of bond prices for trading at the end of the reporting period) is data that can be used to estimate future cash flows. Data that arises from events occurring after the reporting period (e.g. actual lapse rates, claim development, or new claims or events) should not be used to change the estimate of the future cash flows.

New information or events may require disclosure under AASB 110 that a non-adjusting event occurred after the end of the reporting period.

Q3.20 What methods may be used that might be dependent on market variables?

Stochastic projections (see **IAA book on Stochastic Modeling**) are allowed but are not necessarily required. Stochastic methods will more likely be used to develop estimates of a risk adjustment (see **IAA Monograph on Risk Adjustments**) or interest rate dependent cash flows than the usual mean estimate. AASB 17 refers to, but does not require, using stochastic modelling regarding cash flows that are interest rate dependent (AASB 17.B48) and also if cash flows reflect a series of interrelated options (see AASB 17.B39 and AASB 13.B28 about the extent of such modelling needed).

Q3.21 How are available inputs from financial markets and from other external sources applied to cash flow estimates?

Available inputs from financial markets and from other external sources may not represent characteristics of the cash flows of a certain portfolio; if that is the case, the entity's estimate or adjustment to financial market information is generally to be used, as applicable. However, if, for example, the portfolio has new elements on which the entity has no or limited experience, external inputs, such as industry experience, could be used. As the entity obtains sufficiently robust experience of its own, it will supplement or substitute its own experience.

Q3.22 What needs to be considered in estimating policyholder behaviour?

The basis for the expected value is the expected behaviour based on experience, not financial rational behaviour (see AASB 17.B62). Experience might cover only a very limited range of circumstances as incurred up to the present. Accordingly, for a wide variety of possible future circumstances, no past experience may be available. In filling that gap, the actuary may wish to consider whether the chosen assumptions have a significant effect on the outcome compared with the outcome resulting from assuming that the behaviour would be in line with past experience even in changed circumstances. If the difference is relevant, the actuary may consider if and how the experience needs to adjusted to reflect current conditions (AASB 17.B41(c)). Risks from such assumptions are to be considered in the risk adjustment to the extent they are non-financial risk, depending on the nature of the risk. The expected value considers both advantageous and disadvantageous behaviour of policyholders.

3.6 Internal Costs

Q3.23 What methods are appropriate to estimate expected future internally incurred costs?

Estimates of future management costs will usually make use of any forecasts the entity makes, including budgets and business plans. Those future unit costs will usually anticipate inflation consistent with the discount rates being used. It is also appropriate to allow for expected future economies (or diseconomies) of scale, consistent with the likelihood of these scenarios and unbiased mean.

Future unit costs will also consider the likelihood of the reporting entity being measured as a going concern. Unit costs may therefore need to reflect a reasonable development of future new business, if appropriate, in deriving an unbiased estimate of the mean.

Q3.24 How are administration costs that are paid or expected to be paid prior or subsequent to contractual due date handled?

The measurement is based on the actual payment date, not the due date, and allows for any consequences of early or late payment (e.g. pre-paid or annualised commissions, interest accreted, penalties charged). If this can be shown to give materially the same result, the measurement could be based on due dates, with an approximation of the interest effect to the actual payment date.

Q3.25 How are overheads and other cash flows not exchanged between the parties treated?

The key guidance for differentiating cash flows other than those exchanged between the parties is the exclusion of general overhead cost in AASB 17.B66 (d) if they *cannot be directly attributed to the portfolio of insurance contracts that contain the contract*. Those general overhead costs are not included in the FCF under AASB 17 and are accordingly subject to authoritative guidance in other AASBs determining their recognition, measurement, presentation and disclosures. This Chapter does not discuss such items.

The reference to *directly attributable* is a generally-used phrase in AAS and the entity might have previously adopted interpretations of that term in its accounting policies. This Chapter does not discuss further the accounting meaning of this phrase. The accounting interpretation of this phrase might, however, result in the need to choose the partition of the business into portfolio suitably to allow an adequate split of currently incurred and future expected cost between those *directly attributable* to a PIC and general overhead that is not considered in measurement and presentation of insurance contracts.

After identifying those internal costs that can be directly attributed to portfolios of insurance contracts, those costs might be differentiated regarding their function in fulfilling the insurance contracts. AASB 17 distinguishes insurance acquisition cash flows from other internal costs. AASB 17 is silent regarding how to accomplish this separation and accordingly might be seen as an indication that normal cost accounting approaches, particularly key allocations between functions are appropriate.

In summary, the identification of costs considered in measurement might be split in three separate steps:

1) Exclude costs that are not directly attributable to a portfolio of insurance contracts (AASB 17.B66 (d)).
2) Allocate the remaining costs to functions, i.e. insurance acquisition cash flows, servicing contracts during their coverage period and settling claims based on normal cost accounting principles (AASB 17.B65(e), (f), (h) and (l)).
3) Allocate the identified costs per function to each group of insurance contracts *using methods that are systematic and rational, and are consistently applied to all costs that have similar characteristics* (AASB 17.B65(l)).

Q3.26 What are insurance acquisition costs?

Insurance acquisition cash flows are defined (AASB 17 Appendix A) as *the costs of selling, underwriting and starting a **group of insurance contracts** that are directly attributable to the **portfolio of insurance contracts** to which the group belongs. Such cash flows include cash flows that are not directly attributable to individual contracts or **group of insurance contracts** within the portfolio.* These include direct payments, such as commission, underwriting costs, certain stamp duties and other costs of contract issue specific to a particular contract, but also include such costs incurred for a portfolio of contracts. They do not include any allocation of overhead expenses.

To differentiate acquisition costs from other costs, particularly contract administration costs, the contract boundary might be of relevance. If a payment is contingent on persistency beyond the contract boundary, it might be seen as an acquisition cost outside the contract boundary. Therefore, those costs are not included in the cash flows of the existing contract, but might instead be an asset (in line with AASB 17.27, if applicable) of the entity. In that case, the item is recognised as an expense only when the new contract becomes in force. If the payment is contingent only on persistency within the contract boundary it is generally an administration cost.

Q3.27 How are insurance acquisition cash flows considered if paid prior to initial recognition of the related group of insurance contracts?

Insurance acquisition cash flows paid prior to initial recognition are reflected as paid but otherwise treated identically to other insurance acquisition cash flows. They are considered to relate to existing contracts only if at least one contract of the related

group of insurance contracts is already issued even if not yet recognised. In that case, the insurance acquisition cash flows may be capitalised until the related group of insurance contracts is issued, otherwise they are immediately expensed (See AASB 17.27).

Q3.28 How are insurance acquisition cash flows considered if paid in a reporting period (in the same year, in a subsequent year) after initial measurement (e.g. renewal commissions or asset based commissions)?

Insurance acquisition cash flows paid after the initial sale, are reflected in the same way as other future costs, regardless of the year in which they are paid. That is, they are included in the contract's expected future cash flows on a probabilistic basis. Therefore, for example, if the payment of the commission is dependent on the policy continuing within the contract boundary, the probability of lapsation is reflected.

In this sense, they are considered to be directly attributable expenses. The question of whether they are acquisition costs or direct administration costs is moot.

Q3.29 If agent/agency compensation is contingent upon agent/agency survival, how might those expenses be reflected (and if so, how might agent/agency turnover be considered?)?

These expenses are usually included in expected cash flows in the same way as for other contingent cash flows, e.g. claim handling costs. Hence if agent /agency turnover materially affects expected cash flows, this needs to be considered in determining expected cash flows whether the expenses are for acquisition or maintenance of the contract.

Q3.30 What are some examples of expenses that are or are not insurance acquisition cash flows?

Insurance acquisition cash flows include:

- Commissions
- Managerial overrides
- Underwriting costs
- Contract set up expenses

The following are unlikely to qualify as insurance acquisition cash flows:

- Agency overrides
- Managerial bonuses for persistency

- Premium and commission processing costs
- Overhead of underwriting units if not directly attributable to a portfolio of insurance contracts

Q3.31 Are any taxes included in cash flows?

See AASB 17.B65(i), all transaction based taxes (such as premium taxes or stamp duty, value added taxes and goods and services taxes) and levies (such as fire service levies and guarantee fund assessments) are included in cash flows. Wage based taxes, referred to as payroll taxes, social security taxes and similar items, are also included to the extent the wages they are based on are included.

Also, included would be any taxes paid on behalf of the policyholder by the insurer in a 'fiduciary' capacity to meet tax obligations incurred by the policyholder (AASB 17.65(j)) . It is unclear if tax paid on investment income on assets backing investment linked and Australian par business is eligible for inclusion. As the Australian Tax Act specifically identifies and segregates virtual pooled superannuation trust (VPST) and segregated exempt assets (SEA) business for taxation at concessional policyholder rates, it seems likely that the (Investment minus Expenses) tax on this business can be included as 'fiduciary'. However, for ordinary business, where the corporate tax rate applies with no distinction between policyholder and insurer, it seems unlikely that these would qualify as "fiduciary".

Note that, apart from transaction specific taxes or taxes paid in a 'fiduciary' capacity, taxes are not included in the cash outflows. The profit that is eventually recognised is thus effectively gross of tax. Tax payable by the entity is then separately dealt with under AASB 112 *Income Taxes*.

Q3.32 How are cash flows from profit shares handled?

Profit shares can take two forms: contractual and regulatory.

Contract based profit shares are a clearly defined obligation of the entity under the contract. They pertain to both life and general insurance. These typically involve sharing favourable claims experience usually defined as a percentage of premiums (as proxy for expected claims) in excess of incurred claims.

Regulatory based profit shares are legislated sharing of profits across entities. An example is the laws applying to the writing of NSW CTP insurance. These profit shares are on an entity rather than a contract basis, and are discussed further in **Q9.29 What are key considerations for regulatory risk equalisation, profit-sharing and pooling mechanisms?**

As part of the contractual cash flows, the out-workings of a contract based profit share would be reflected in the expected value of cash flows under the contract, and to the extent that only favourable experience is shared, the impact of that on the

expected value across all scenarios needs to be appropriately reflected where material.

The basis used in the profit share calculation will be set out in the contract, including the time period involved, frequency and prescribed assumptions (e.g. discount rate or yield curve) and/or methodology (e.g. calculation of Incurred But Not Reported (IBNR) reserves). Consequently, the experience cash flows for the profit share may differ from those in the FCF under AASB 17 and, where material, would need to be appropriately allowed for when incorporating the expected cash flows from the profit share into the FCF.

This could be done as follows:

- If the start date of the profit share period has yet to incept, the expected profit share cash flows will be included within the LRC and if a PAA is used, unless facts and circumstances indicate that the portfolio is expected to be onerous, no explicit profit share calculation is required. Otherwise, depending on materiality, projected premiums, paid claims and reserves could be used in the calculation as currently done for APRA prudential reporting and embedded value calculations.
- If the end date of the profit share period has passed, the expected profit share cash flows will be included within the LIC.
- If the start date of the profit share period has incepted but the end date of the profit share cohort of claims has not passed, the expected profit share cash flows relating to future coverage within the profit share period will be included within the LRC (as described above) and that relating to coverage already provided within the LIC. The split could be based on the passage of time, or the expected timing of incurred claims if significantly different.
- Where PAA is used, an estimate of the expected claims relating to the future coverage period may be needed to combine with the expected profit share cash flows captured within the LIC to check overall experience profit / loss under PAA is appropriate.

If the contracts subject to profit share are also reinsured, the profit share will need to be determined separately in the gross underlying contract liability and in the reinsurance contract liability consistent with the way it flows through the reinsurance treaty. Note, if contract boundaries for the gross contract and reinsurance are different (see **Chapter 9 Reinsurance and External Risk Transfers**) this will lead to further accounting mismatches.

The profit share arrangement might cover business written in one or more portfolios if the risks are considered dissimilar and not managed together. Within each portfolio, the profit share arrangement might cover business written in one or more groups. Note it is possible for profit / loss share arrangements to change whether a group is onerous or not when more than one underlying contracts are grouped. An entity might be required to apportion or calculate the profit share separately for each

portfolio and group when presenting the statement of financial position (see AASB 17.78).

The AASB 17 risk adjustment is unlikely to be included in the expected profit share unless the contract specifies the accounting basis in the profit share. It is also most likely simplest to exclude any risk adjustment within the profit share component of the contract liability to avoid risk of double counting in the overall risk adjustment within the FCF.

Q3.33 Are there any special considerations for discretionary or voluntary payments to policyholders?

For policyholder bonuses or dividends see **Chapter 8 Direct Participation Features**. Similar items on non-participating contracts (e.g. excess interest payments) should be measured in the same way they would be measured on a participating contract. For other discretionary cash flows of the entity, including any fair dealing in determining claims payable, whether their consequences are within or beyond the contract boundary needs to be considered. If they are within the contract boundary, they are measured at the expected value. Otherwise, they are not included.

Q3.34 How are policyholder dividends or bonuses projected for traditional participating contracts?

See **Chapter 8 Direct Participation Features**.

Q3.35 How are delayed benefits, benefits which are expected never to be paid, events that create rights contingent on future events (e.g. annuities to persons under third party liability, or joint life) accounted for?

These benefits are normally included (in the LIC) taking into account their expected probability of payment.

Q3.36 How are interest credits paid to policyholders projected?

These are effectively bonuses on Investment Account contracts. See **Chapter 8 Direct Participation Features**.

Q3.37 Where is there available guidance for estimating inflation and its effects on inflation-sensitive benefits, claims and expenses?

AASB 17.B128 (b) provides guidance on when inflation risk is to be seen as non-financial risk. AASB 17.B51 provides as an example a reference to observed market interest rates. General living cost indices or wage indexes might be useful for many cash flows, but building, medical and other insurance relevant expenses may also

have their own indices or may be responsive to specific factors other than general inflation. In addition, as inflation applies to the entity's internal expenses, the relative change in productivity and changes in the number of units can also influence trends in unit expenses. As long as observations can be made regarding (neutral) expected values of inflation in market prices, these observations should not be contradicted by the entity's expectations.

Q3.38 How can cash flows on blocks of business with no prior experience or no relevant experience (e.g. new line of business for entity, mortality past age 90 or coverage durations longer than the product has been issued) be estimated?

The best available relevant experience, both internal and from the general market is considered. This will likely be supplemented by judgement.

Q3.39 How might cash flows on a single contract with multiple insured items, particularly if there is an open number of insured items in the contract (e.g. a group life contract or a corporate auto contract) be adjusted for added or deducted insured items?

Where the additional insured items are subject to an additional premium to be agreed for each additional insured item (e.g. group life, health or disability), then as the additional insured item(s) are beyond the contract boundary, estimates can be made on the basis of the insured items active at the measurement date, since before it is added.

Where this is not the case, e.g. a fixed premium or premium rate is charged even if the number of insured items can change within the contract boundary (such as workers' compensation that covers all employees or group life insurance), then an expected value approach is appropriate estimating the open number of insured items which will be covered within the contract boundary.

3.7 Changes in Estimates

Q3.40 How often are estimates re-evaluated?

In compliance with AASB 17.33 (c) and AASB 17.B54-B60, the assumptions for estimations have to be re-evaluated at each reporting date. If there is no positive indication that anything relevant has changed, however, no change is required.

4 Discount Rates

4.1 Introduction

Q4.1 What is the scope of this Chapter?

This chapter provides information relating to the adjustment of cash flows for the time value of money and the financial risks related to those cash flows, to the extent that the financial risks are not included in the estimate of cash flows. It also covers discount rates used to accrete interest on the CSM.

Q4.2 Which sections of AASB 17 address this topic?

AASB 17.36 and AASB 17.B72-B85 provide guidance on this topic. IFRS 17.BC185-205 also provides background on the subject.

Q4.3 What other documents are relevant to this topic?

The IAA has published a **Monograph on Discount Rates** in Financial Reporting, which could be useful for this purpose.

Q4.4 What are the general discounting principles within AASB 17?

AASB 17.36 states discount rates applied to the estimates of the future cash flows are to:

(a) *reflect* the *time value of money, the characteristics of the cash flows and the liquidity characteristics of the insurance contracts;*

(b) *be* consistent *with observable current market prices (if any) for financial instruments with cash flows whose characteristics are consistent with those of the insurance contracts, in terms of, for example, timing, currency and liquidity; and*

(c) *exclude the effect of factors that influence such observable market prices but do not affect the* future *cash flows of the insurance contracts.*

Financial risks are only included in the discount rate *to the extent that the financial risks are not included in the estimates of cash flows* (see **Chapter 3 Current Estimates** when this condition is not met). ***Financial risk*** is defined as:

> *The risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, currency exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract* (AASB 17 Appendix A).

Uncertainty about the amount of the cash flows which arises from non-financial risks is reflected through the risk adjustment for non-financial risks, and not in the discount rate (see **Chapter 5 Risk Adjustment** for a discussion).

AASB 17.B74-B75 expands on the requirement for discount rates to reflect the characteristics of the cash flows. It requires discount rates to be *consistent with other estimates used to measure insurance contracts to avoid double counting or omissions*. Examples are provided including that:

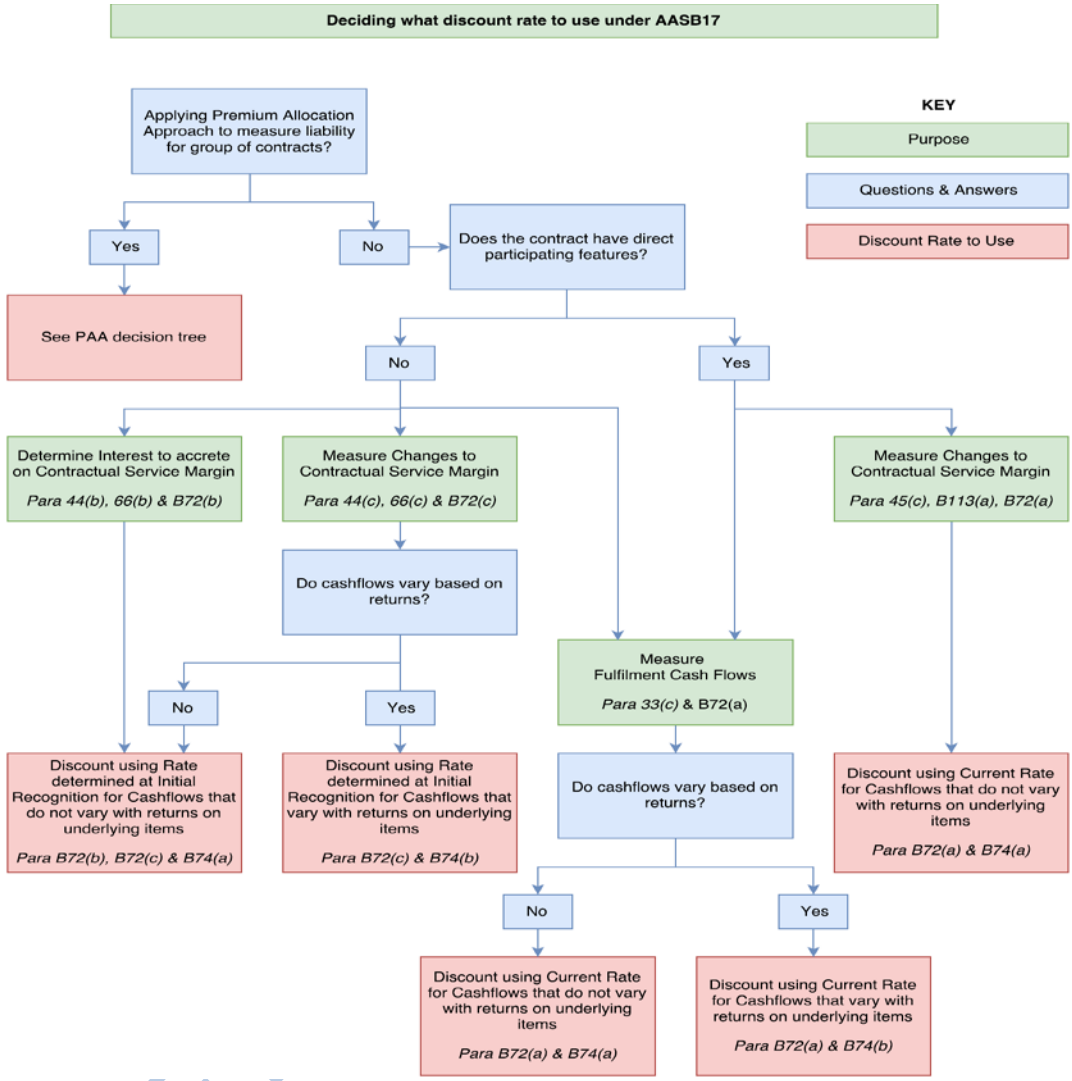
- cash flows that do not vary based on the returns on any underlying items shall be discounted at rates that do not reflect any such variability; and
- cash flows that vary with returns on any financial items shall be discounted using rates reflecting that variability, to the extent that the variability has not already been reflected in the cash flows.

Q4.5 Which discount rate should be applied under the Core Requirements?

Discount rates to use under the core requirements (and also VFA) are outlined in the following table. A decision tree is also presented below, in which it is assumed the OCI option is not taken (see **Q4.9 What is included in P&L and OCI under the systematic allocation of insurance finance income and expense in P&L?** where it is).

Table 4.1: AASB 17 Discount Rates to use under the Core Requirements

Discount Rate	When to use?
Not Using OCI Accounting Policy Choice	
Current Discount Rates	Measure FCF (i.e. LRC and liability for future incurred claims)
Discount Rates at Initial Recognition	Changes in CSM based on changes in FCF relating to future service Accretion of interest on CSM
Using OCI Accounting Policy Choice – Amount Reflected in Profit or Loss	
Discount Rates at Initial Recognition	Measure FCF without substantial effect of financial risk
Discount rates that allocate the remaining revised expected finance income or expenses over the remaining duration of the group of contracts at a constant rate	Measure FCF with substantial effect of financial risk
Using OCI Accounting Policy Choice – Amount Reflected in OCI	
Reflect difference in Total Finance Income or Expenses on basis that OCI option not taken and amount recognised in profit or loss	



A discussion relating to when financial risk has a 'substantial effect' on FCF is covered in **Chapter 7 Premium Allocation Approach**.

Q4.6 Which discount rate should be applied under the VFA?

The VFA is just a modification of the core requirements. As such, the discount rates operate as they generally would under the core requirements with the following differences:

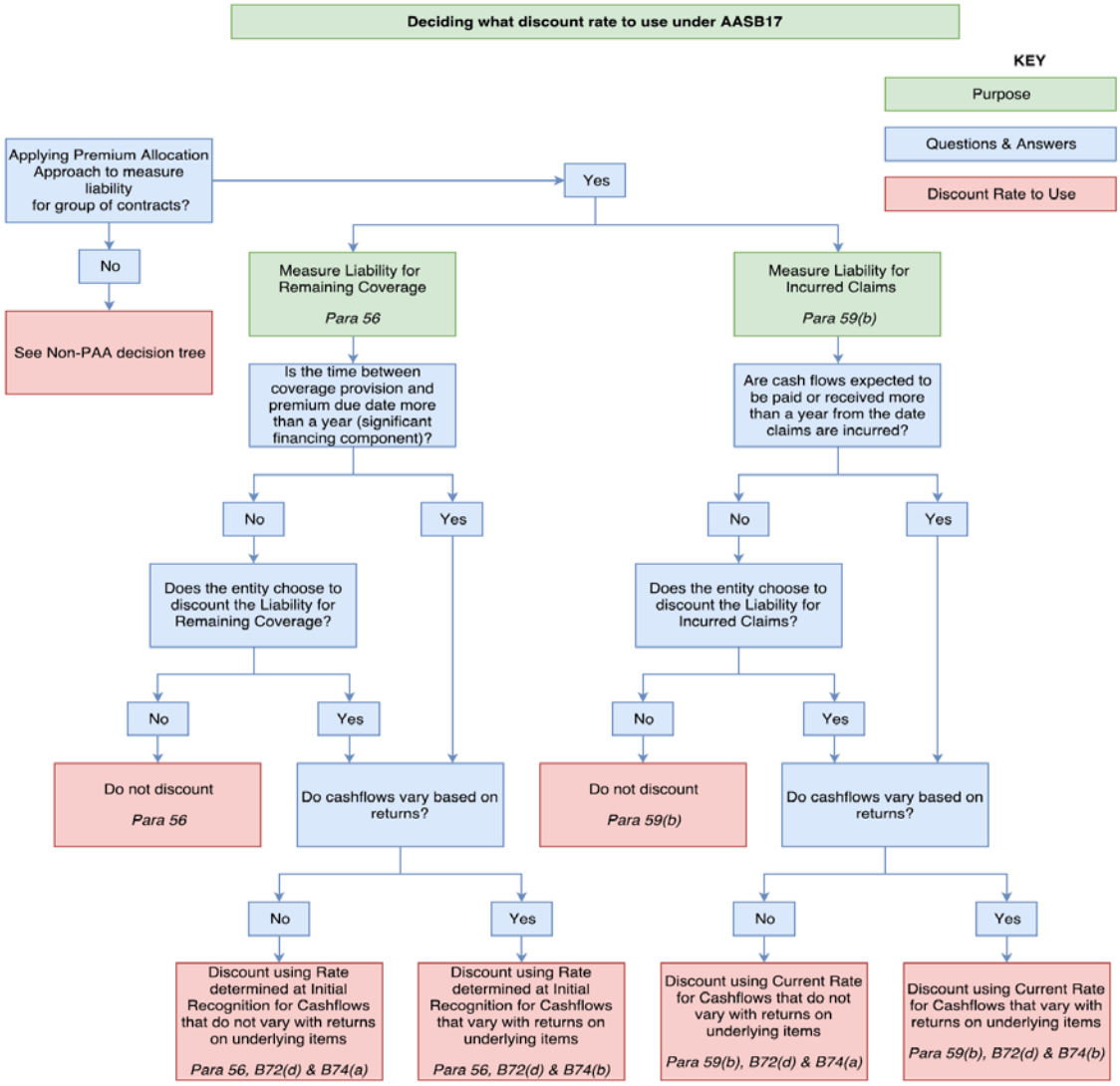
- No explicit interest is accreted on the CSM since it is remeasured when it is adjusted for changes in financial risks; and
- Changes in FCF arising from time value of money and financial risks is regarded as part of the variable fee and recognised in the CSM unless the changes exceed the CSM or the risk mitigation option is taken (see AASB 17.B115-B118.

Q4.7 Which discount rate should be applied under the PAA?

Discount rates to use under the PAA are outlined in the decision tree and table below.

Table 4.2: AASB 17 Discount Rates to Use under PAA

Discount Rate	When to use?
Not Using OCI Accounting Policy Choice	
Undiscounted (Optional)	Measure LRC without significant financing component Measure LIC expected to be paid/received in less than one year Otherwise see below
Discount Rates at Initial Recognition	Measure LRC with significant financing component (IFRS 17.B72(d)
Current Discount Rates	Measure LIC not expected to be paid/received in less than one year
Using OCI Accounting Policy Choice – Amount Reflected in Profit or Loss	
Undiscounted (Optional)	Measure FCF without significant financing component Measure LIC expected to be paid/received in less than one year Otherwise see below
Discount Rates at Initial Recognition	Measure LRC with significant financing component
Discount Rates at Date of Incurred Claim	Measure LIC not expected to be paid/received in less than one year
Using OCI Accounting Policy Choice – Amount Reflected in OCI	
Reflect difference in Total Finance Income or Expenses on basis that OCI option not taken and amount recognised in profit or loss	



Note: **Chapter 7 Premium Allocation Approach** provides a discussion relating to the interpretation of 'significant financing component' and 'expectation' in assessing whether incurred claims are expected to be paid/received in less than one year.

Q4.8 When required, which discount rates are used for onerous PAA contracts?

If the group of insurance contracts becomes onerous (as per AASB 17.57(b)), the difference between the carrying amount of the liability using PAA (AASB 17.55) and the Core Requirements (applying AASB 17.33-37 and AASB 17.B36-B92) is calculated. The calculation of liability values under the Core Requirements is conducted at either the current rate or the locked in rate depending on the purpose for which discounting is required.

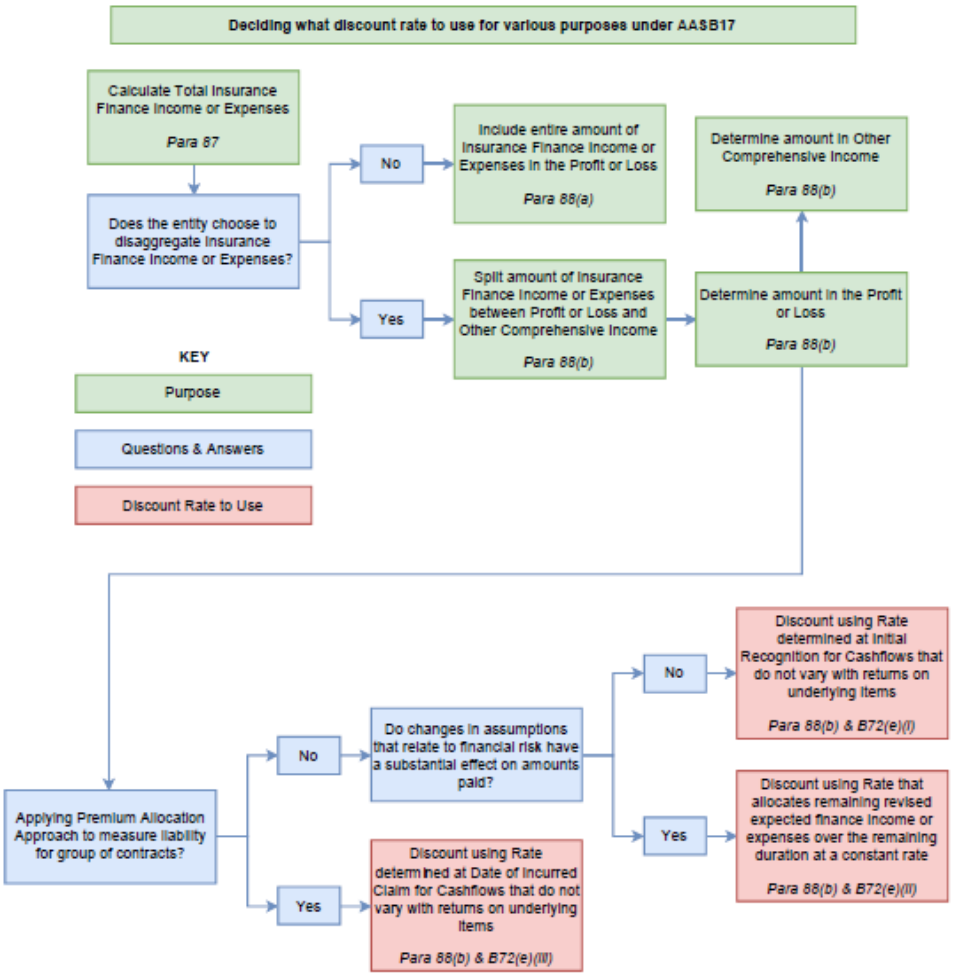
Q4.9 What is included in P&L and OCI under the systematic allocation of insurance finance income and expense in P&L?

For groups of contracts for which changes in financial assumptions do not have a substantial impact on amounts paid to policyholders, e.g. benefits are largely fixed in dollar terms, then the systematic allocation of finance income and expenses in P&L is based on the inception discount rate for the group (AASB 17.B131) profits over the duration of the contract. The impact of the difference between inception and current discount rates falls into OCI (AASB 17.89.

For non-VFA contracts, where changes in financial assumptions do have a substantial impact on amounts paid to policyholders, the systematic allocation of finance income and expense into P&L can be made by either:

- using a constant rate approach whereby the revised expected finance income and expenses are allocated at a constant rate over the remaining duration of the group. IFRS 17 Illustrative Example 15A shows how this could work in practice; or
- for crediting rate products, using the amounts credited in the period and expected to be credited. IFRS 17 Illustrative Example 15B shows how this could work in practice.

Figure 4.3: Presentation Discount Rate Decision Tree



4.2 Discounting cash flows not dependent on the return of underlying items

4.2.1 *Overview*

Q4.10 How are the discount rates determined?

AASB 17.B79 sets out the approach expected to be applied for cash flows that do not vary based on underlying items. The applicable discount rate should reflect a yield curve for items with *no or negligible credit risk, adjusted to reflect the liquidity characteristics of the group of insurance contracts*.

AASB 17 does allow either a 'bottom-up' or 'top-down' approach to be used.

"Bottom-up" approach

The bottom-up approach, as set out in AASB 17.B80, involves *adjusting a liquid risk-free yield curve to reflect the differences between the liquidity characteristics of the financial instruments that underlie the rates observed in the market and the liquidity characteristics of the insurance contracts*.

Essentially, this involves adding a liquidity risk premium to the liquid risk-free yield curve.

"Top-down" approach

The top-down approach, as set out in AASB 17.B81, begins with constructing *a yield curve that reflects the current market rates of return implicit in a fair value measurement of a reference portfolio of assets* and then *adjust that yield curve to eliminate any factors that are not relevant to the insurance contracts, but the entity is not required to adjust the yield curve for differences in liquidity characteristics of the insurance contracts and the reference portfolio*.

AASB 17.B82-B83 goes on to explain how the yield curve should be derived from observable active market prices, where available, as well as what to do in the absence of market information and how to adjust the resulting yield curve so that it matches the characteristics of the liability, including the removal of credit risk.

AASB 17.B84 explains, that, in principle, *there should be a single illiquid risk-free yield curve that eliminates all uncertainty about the amount and timing of cash flows. However, in practice, the top-down approach and bottom-up approach may result in different yield curves. This is because of the inherent limitations in estimating the adjustments made under each approach, and the possible lack of an adjustment for different liquidity characteristics in the top-down approach.*

Q4.11 Can an entity switch from using a top-down to bottom up approach? How frequently or infrequently can this occur?

A bottom-up approach or a top-down approach may be applied to derive discount rates. The approach chosen by an entity will depend on the relative difficulties in assessing an illiquidity premium and comparing reference portfolios and insurance contracts. The selected approach becomes an accounting policy. Under the broader framework of accounting standards (AASB 101 *Presentation of Financial Statements* and AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors*), accounting policies need to be consistently applied and can only be changed in certain specific circumstances with additional disclosures provided (such as restated comparatives).

4.2.2 *Risk Free Rates*

Note: Some of what follows might be regarded as commentary on generic actuarial techniques, but it has been included for completeness and to aid understanding.

Q4.12 How are risk-free interest rates determined?

AASB 17.B80 assumes the existence of a single, liquid risk-free yield curve. The most suitable "base" rates from which to derive such a liquid risk-free yield curve are market quoted interest rates which:

- are in the appropriate currency with respect to the liabilities;
- are liquid or, in other words, reflect assets in active markets that a holder can typically sell without incurring significant costs;
- maximise the use of observable inputs; and
- contain the smallest possible amount of credit risk (i.e. very close to zero or negligible credit risk).

AASB 17 also requires the entity to reflect all reasonable and supportable information on non-market variables available without undue cost or effort. This is a new requirement and additional guidance may be helpful to ensure consistent interpretation.

Three potential options for determining a risk-free yield curve are set out below. In some cases, the entity may consider a combination of more than one option to derive the entire curve. Thus, deriving the liquid risk-free curve is likely to involve some judgement.

1. Government bond rates

Under AASB 17, government bond rates may be appropriate or may be an appropriate starting point for determining risk-free rates. Politically stable governments in economically developed countries are believed to have a low probability of defaulting on their debts due to taxing power and ability to expand money supply. Government bonds are arguably the least risky asset for many countries and their yields, in the short-to-medium term, are easily observable.

In Australia, a yield curve can be fitted to yields on government bond rates up to (approximately) 10 years in duration. If the cash flows of insurance contracts extend beyond this duration, other techniques are required to estimate the risk-free rates beyond that point.

Note that this is not the case for all governments. Certain governments may be considered to have a material possibility of defaulting, and hence, the yields may not be reliable to derive liquid risk-free rates. The credit rating of the government bonds can be used as an indicator of whether the bonds of a specific government can be considered risk free. Other governments may not have easily observable or have reliable government bond markets.

Using a basket of government bonds with a high rating is also a possibility, excluding a currency union like the Eurozone. In the situation of a currency

union, an individual government does not have the ability to expand the money supply, which may cause credit risk and this should be considered.

2. Swap Curve

In many markets swap curves are observable and available for a range of terms. In some cases, they are more liquid and available for a greater range of terms than government bonds.

Swaps are viewed by the market as the primary instrument for replicating and hedging interest rate risk arising from derivative assets which makes them a natural reference to derive the risk-free interest rates. Furthermore, swap contracts are typically collateralised and there is no risk on the principal, which substantially reduces the exposure to a credit default event (or counterpart is a highly rated bank). For example, the EIOPA prescribes monthly sets of risk-free rates for European Solvency II purposes using swap rates for currencies with deep financial markets – these are readily available online.

An entity may need to adjust underlying swap quoted rates in order to reflect:

- The counter-party credit risk - a party who is receiving a fixed interest rate of a swap from another party will require a higher fixed interest rate to compensate for the risk of repayment. The "swap rate" will include an allowance for credit risk and an adjustment would be required, taking into account collateralisation requirements and mid-rates.
- The underlying reference security credit risk - swap rates are typically based on the yield on an underlying reference security and therefore any material credit risk premia within this security should be removed to obtain a risk-free rate.

It would be appropriate for actuaries to understand both the bases underlying quoted rates in order that any adjustment in relation to counter-party risk and credit risk is appropriate.

3. Corporate Bond Rates

The use of corporate bond rates is not the normal base for developing a risk-free yield curve. However, in some jurisdictions or at some parts of the curve, it may be the most observable, traded market. Credit risks need to be considered in the context of default risk by the particular corporates.

Q4.13 What is the impact of inflation on discount rates?

Based on economic theory, a risk-free interest or discount rate is comprised of the expected inflation rate plus the expected growth in the economy, measured by Gross Domestic Product (GDP) or similar. A higher level of expected inflation in the future should increase discount rates with all else being equal.

Historical inflation rates do not necessarily affect the discount rates, other than to the extent that the market perceives a different expected rate of inflation in the long-term.

AASB 17.B74 notes that nominal cash flows (i.e. those that include the effect of inflation) shall be discounted at rates that include the effect of inflation. Real cash flows (i.e. those that exclude the effect of inflation) shall be discounted at rates that exclude the effect of inflation.

There are several potential methods that may be suitable for deriving inflation and/or real earning rate expectations. These methods and some aspects to consider in their application are discussed below. The considerations listed may not be exhaustive.

- Market based approaches:
  - Estimating inflation by taking the difference between nominal bond yields and inflation-linked bonds.
  - Inflation swaps / other market instruments.
- Publicly available estimates:
  - Monetary body targets for inflation.
  - Forecasts of economic commentators and / or government bodies.
  - Views of a long-term real risk-free rate.

Publicly available estimates may not be the same as the results of market based approaches or may not align with realised inflation. If the two estimates are not similar over a horizon, then an evaluation of the causes of difference may be useful. The appropriate adjustments will be based on the cause of the differences.

Some cash flows of an insurance contract may depend on a different inflation index than the consumer price indices (CPI) most commonly available. If this is the case, the appropriate inflation expectation would need to be used in the measurement or in accordance with paragraph AASB 17.B74(d) and the inflation component is excluded from both the cash flows and the discount rate.

Q4.14 How are risk-free yield curves updated?

AASB 17.36 requires that the discount rate is consistent with observable current market prices (if any) for financial instruments with cash flows whose characteristics are consistent with those of the insurance contracts, in terms of, for example, timing, currency and liquidity. With the exception of "locked in" discount rates, all parameters underlying the derivation of the risk-free yield curve are expected to be appropriate at each reporting date.

In many situations, current market prices are available for the risk-free rate up to a last liquid point. If an ultimate forward rate or an ultimate spot rate is used, it may be updated less frequently than in every reporting period, because it's not an observable

market price. Judgement will be required to determine the most appropriate frequency to update the ultimate rates, considering the materiality of those updates on the financial results.

4.2.3 *Extrapolation*

Note: Some of what follows might be regarded as commentary on generic actuarial techniques, but it has been included for completeness and to aid understanding.

Q4.15 When does the observable market end for determining risk-free rates?

The determination of the end of the observable market is a function of financial market being considered at the longest part of the curve. For example, if the risk-free curve is based on swap rates then the end of the observable market in the context of swap rates in that currency should be considered.

The following attributes could be looked at to assess whether the market data at the longest durations are both observable and relevant:

- availability of financial instruments;
- bid-ask spread;
- trade frequency; and
- trade volume

As an example, in a given market, 1, 3, 5, 7, 10, 20 and 30-year instruments may be available and actively traded. A 50-year instrument may be occasionally issued, but does not have any significant trade frequency or volume. Since the 50-year instrument is infrequently traded, the observable yield for the 50-year instrument may include a premium for illiquidity. This would therefore not be considered relevant for construction of a liquid, risk-free curve.

There is no guidance in AASB 17 to assist in determining which observable instrument is relevant or forms the "last liquid point" on the curve. Judgement is required based on the financial market being considered.

Q4.16 How does the yield curve extend beyond the observable market end and what assumptions are necessary?

In constructing a risk-free discount curve, a core principle is that the discount rates are consistent with observable market prices. If liability cash flows extend beyond the point at which the observable market is deemed to end, the discount curve will need to be extended.

The following four approaches could be used to extend the risk-free rate curve:

1 Extrapolate the curve assuming a constant forward rate from the last observable and relevant point;

2 Extrapolate the curve assuming a constant spot rate from the last observable and relevant point;

3 Assume an ultimate forward rate and fit a curve between the end of the observable period and the ultimate forward rate; or

4 Assume an ultimate spot rate and fit a curve between the end of the observable period and the ultimate spot rate.

The constant forward and spot rate approaches result in stable yield curves over time. The constant forward rate produces a smooth curve, while the constant spot rate may result in a jump or spike in the forward rate curve. Both of these approaches make the least sense from an economic point of view.

The use of ultimate forward rates makes sense from an economic point of view and produces a smooth curve. While it is realistic in time, it is not necessarily stable over time and so there may be some volatility in the longer durations under this approach.

The use of an ultimate spot rate is most consistent with the Standard since the guidance explicitly requires that *the entity might place more weight on long-term estimates than on short-term* fluctuations (AASB 17.B82(c)(i)). The ultimate spot rate results in a curve that is more stable in time. However, the discount factors for cash flows with very long durations become entirely stable, which is not very realistic. Using an ultimate spot rate may result in a jump or spike in the forward rate curve as well.

In any approach, the level and position of the end points have to be determined. Therefore, the year at which the ultimate or constant rate is achieved needs to be set. For example, one approach seen in Canada for the Life Insurance Capital Adequacy Test is based on an ultimate spot rate and the transition from the last liquid point to the ultimate spot rate is linear over a period of 50 years. It is generally accepted that convergence to the ultimate forward rate is achieved earlier than convergence to the ultimate spot rate.

Q4.17 How is the ultimate rate level set?

A retrospective or prospective approach can be used in the process of setting the ultimate rate. In either case, it is important that the entity articulates its methodology and why its selection of the ultimate rate is plausible based on historical information or future expectations.

A retrospective approach involves looking back over an observed period of time to see what the risk-free interest rates have been, on average. The observed period should be long enough to eliminate cyclical effects, but consideration needs to be given to any major shifts in macroeconomic fundamentals over time. This approach has the advantage of being simple, although the choice of the starting point for the observed period is arbitrary. Retrospective approach examples would be an arithmetic mean (normal underlying distribution) or a geometric mean (lognormal underlying distribution) of the historical nominal interest rate or real-rate.

Using a prospective approach, a very simple approach would be repeating the rate at the last liquid point. Another approach would be to make use of well-known economic metrics reflecting market participant future expectations of risk-free interest rates. One example of a prospective approach is to use the central bank inflation target or neutral rate plus an allowance for the long-term GDP growth forecast.

4.2.4 *Illiquidity Premium*

Q4.18 What are possible methods to calculate the illiquidity premium using a 'bottom-up' approach?

Three possible methods to estimate the illiquidity premium using a bottom-up approach are:

- Credit Default Swap (CDS) basis

  The spread on an insured portfolio (using CDS against the default of a bond issued) - that has relatively low liquidity and is free of credit risk - relative to a liquid risk-free bond may be used for estimating illiquidity premium.

- Structural model

  Comparison of the yield on an illiquid corporate bond portfolio with the yield on a liquid position with otherwise equivalent risk characteristics (use of Merton model).

- Covered Bond spreads

  If (illiquid) covered bonds are viewed as being essentially free of credit risk, the spread over the risk-free reference rate can be considered as an estimate for the illiquidity premium.

Of these methods, the CDS basis is likely to be the most familiar to Australian insurers.

Q4.19 Can an entity continue to use the simple formula specified for regulatory capital purposes to estimate the illiquidity premium under a CDS basis?

For financial reporting, some life insurers adopt the calibration specified for regulatory capital purposes in a letter to CEOs and Appointed Actuaries of life insurers dated 27 March 2014. This APRA approach provides a simple formula for calculating an illiquidity premium based on readily available data from the Reserve Bank of Australia (RBA) (see **APRA 2014**).

In a letter to CEOs and Appointed Actuaries of life insurers dated 30 March 2012, APRA stated that the formula *adopted a level of conservatism* and provided reasons why a conservative proxy formula approach to the CDS basis was preferred to allowing a direct use of the CDS basis. APRA's reference point in calibrating the

formula was credit default swaps, with consideration of the spreads on semi-government bonds (see **APRA 2012**).

While this methodology is based on observable market data, we note that APRA's comments on the level of conservatism would not align well with AASB 17's best estimate principles. Users of this proxy formula would need to consider materiality versus the use of a basis without conservatism.

Q4.20 What information has the Institute published on calculating on a CDS basis?

Pre-dating APRA's formula, a working party of The Actuaries Institute produced a proposal dated 17 November 2011 (see **Actuaries Institute 2011**). This provided a large body of information on different methodologies, giving examples of illiquidity premium estimates from historic data for Credit Default Swaps, semi-government bonds and government guaranteed bonds. This was then re-stated as a formula using corporate bond spreads as an input, using least squares regression techniques.

Such a technique to calibrate an illiquidity premium formula could offer a robust methodology that aligns to AASB 17 principles. However, the data source used in the Institute model at the time was subsequently changed and so the model would require updating for it to be used for AASB 17 purposes.

Q4.21 Is the AASB 17 Taskforce intending to update the Institute working group 2011 illiquidity paper?

The Taskforce has no current intention to update the data source and recalibrate the 2011 working party illiquidity estimates. However, it is interested in member's views.

Q4.22 What is the key complexity with the CDS basis and possible approaches to overcome it?

A key complexity with the CDS basis and its derivatives is the availability of credible market observable data. The corporate bond market, on which the CDS swap market is based, tends to have fewer data points beyond five to seven years. This makes it more difficult to apply a linear extrapolation in the context of the requirement in AASB 17.36 to use observable current market prices where possible. Extrapolation of the illiquidity premium for longer durations is therefore a challenge.

An alternative is the use of semi-government bonds which tend to be available in longer durations. This was the approach of the Actuaries Institute's working party, who derived a formula for durations below five years based on corporate bonds and above 12 years based on semi-government bonds, with a linear blending for durations between.

A further alternative was applied by APRA, where their formula reverts to a flat 20 basis points for durations beyond 10 years from the reporting date. This was

calibrated based on historic illiquidity premiums, noting that prior to the Global Financial Crisis the illiquidity premium was smaller than that observable today.

Q4.23 What is a structural approach to calculating an illiquidity premium?

The structural model approach involves more complex techniques than commonly in use in Australia. As noted by the Actuaries Institute illiquidity premium working party, *the method is complex, model-dependent and requires subjective estimates of parameters which may not be directly observable in markets*.

Although this is an approach that some actuaries may wish to investigate further, it is not discussed further in this note. Research papers are available on this topic, an Australian example is **Bu. Di. and Liao. Y. (2013)**.

Q4.24 What is a covered bond approach to calculating an illiquidity premium?

In Australia, the covered bond approach also has difficulties as the only issuers to date have been banks, with issuance falling since 2011 levels. This does not provide a deep market for analysis, and limits the analysis of illiquidity premium to financial sector debt. Other forms of debt that have implicit default guarantees are semi-government bonds. The Actuaries Institute's working party noted that these may understate the illiquidity premium given their higher liquidity than insurance liabilities. However, this type of debt may be useful for durations beyond those available for corporate bonds.

Q4.25 Can the illiquidity premium be negative?

It may be possible for a methodology or derivation to result in a negative illiquidity premium. A negative illiquidity premium implies an asset is so liquid that investors receive less than the risk-free rate. If a negative illiquidity premium is derived, the actuary will need to consider whether this is truly reflective of market behaviours or whether this is the result of a limitation in the derivation and a floor of zero is appropriate.

Q4.26 How is an illiquidity premium calculated using a top-down approach?

Top-down approach takes a different derivation path to the bottom-up methodology. Instead of adding illiquidity premiums to the risk-free rates, the return on a reference portfolio is used, after deducting all risks not relevant to the liability. AASB 17 gives market and credit risk as examples of these. The largest remaining components are likely to be similar (but not exactly the same) as a risk-free discount rate adjusted for illiquidity premiums.

As the reference portfolio should reflect characteristics of the liabilities, it would be expected that timing/duration and currency are as closely aligned as possible. To

eliminate risks not relevant to the liability, similar techniques to those described in the bottom-up section could be applied to estimate credit and market risk. It is theoretically possible to include non-debt instruments such as equities in the reference portfolio, however finding a robust and practical methodology to address issues such as dividend timing/policy and undefined future cash flows would be challenging. We concur with their conclusion that the use of debt instruments in the reference portfolio is more practical.

4.2.5 *Grouping*

Q4.27 How is the discount rate for a group of contracts determined?

AASB 17.B73 allows an entity to *use weighted-average discount rates over the period that contracts in the group are issued* to determine the discount rates at initial recognition for a group of contracts, noting that this period cannot exceed one year. This enables a single yield curve at initial recognition to be applied to the entire group, rather than recording discount rates at initial recognition for each contract. A separate yield curve may be required for groups that are onerous at recognition, groups that have no significant possibility of becoming onerous subsequently and remaining contracts because the weighted average discount rate might materially differ. Thus, the inception yield curves could also differ by portfolio, where the portfolios ordinarily have the same discount rate assumption.

Under AASB 17.28, this weighted-average discount rate is applied from the start of the reporting period in which the new contracts are added to the group.

Q4.28 What weight should be used in determining the average discount rate?

The Standard does not specify the weight and it is subject to interpretation / confirmation. One potential approach to weighting might be to use expected cash flows.

Q4.29 Can a single equivalent discount rate be used instead of the locked-in discount curve?

Current practice allows the use of a single discount rate, which produces an equivalent adjustment to the cash flows as the use of a discount rate curve that allows for the time value of money based on the expected timing of the cash flows. AASB 17 does not prohibit the use of a single discount rate curve and so this practice could be continued, provided that this approach produces results materially similar to those produced using a discount rate curve for all reporting periods.

However, a change under AASB 17 is that the entity will need to maintain multiple sets of discount rates at different dates if the Other Comprehensive Income (OCI) option is taken. The LRC must be measured on both the “locked in” discount rates at

inception as well as the discount rates at the reporting date (with some exceptions under the PAA). The expected cash flow profile may change over time, which would affect a single discount rate used in place of the locked in discount rates and the discount rates at the reporting date. With this in mind, it will be practically more difficult under AASB 17 to calculate sets of single discount rates at each balance date and justify that the results are not materially different. Furthermore, this process would need to be done at a product group level, which may be more granular than currently performed.

Q4.30 What happens if the interim or financial year end cut short the grouping year? Is the reported weighted discount rate restated allowing for the remaining months?

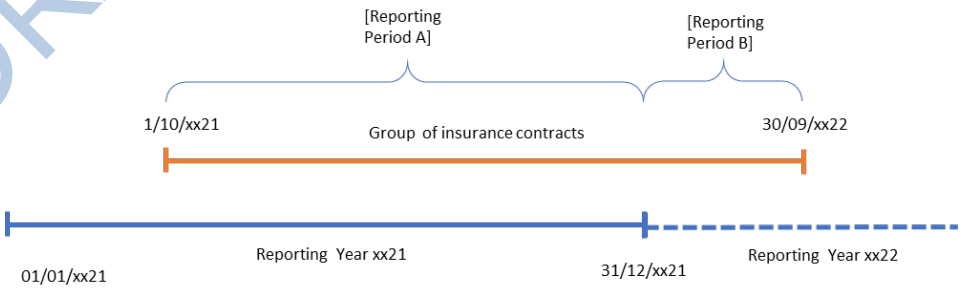
An entity may add contracts to a group, as long as they are not issued more than one year apart from any other contracts in the group.

As contracts are added to a group, this may result in a change in the weighted-average discount rates at the date of initial recognition for the group. As noted by AASB 17.28, these revised discount rates are applied from the start of the reporting period in which the new contracts are added to the group.

As an example, if a group of insurance contracts issued over a twelve month period covers nine months in reporting year xx21 [Reporting Period A] and three months in reporting year xx22 [Reporting Period B].

- The discount rates at initial recognition in Reporting Year xx21 for the group are based on weighted average coverage units provided in Reporting Period [A] (i.e. over nine months) by the contracts added to the group during the nine months.
- The discount rates at initial recognition in Reporting Period xx22 for the group are based on weighted coverage units provided in Reporting Period [A] and Reporting Period [B] (i.e. over twelve months) by the contracts added to the group during the twelve months.

Figure 4.4: Non-Aligned Group Year and Financial Year



Q4.31 Does the discount rate move along (i.e. ride) the locked-in discount curve over time?

Yes, the locked-in discount curve is ridden and not shifted over time.

4.3 Discounting cash flows dependent on the return of underlying items

Q4.32 What approaches are available if returns vary solely based on the returns on underlying items?

For cash flows that vary with returns on underlying items, insurers have a choice of:

(1) discounting those cash flows adopting a discount rate that reflect that variability; or

(2) adjusting the cash flows for the variability and discounting at a rate that reflects the adjustments made (AASB 17.B74(b)).

Under (i), cash flows are projected based on the expected risky returns of the financial underlying items. If the dependency is linear, this could be done using a deterministic real-world projection rate (or curve), i.e. including a risk premium. In that case, the discount rate (or curve) to be used reflects that variability, and thus, also include a risk premium.

Under (ii), cash flows are adjusted for the effect of that variability. Again, if the dependencies is linear, one could project cash flows using a deterministic risk-free rate (or curve). In that case, the discount rate (or curve) to be used is on a risk-free basis.

Both approaches avoid any valuation mismatch and double counting, since the discount rate is consistent with the rate used for the cash flow projection. Theoretically, both valuations are expected to lead to the same result.

Q4.33 What approaches are available if returns vary partially based on the return on underlying items?

As discussed in AASB 17.B76, cash flows could vary with returns on underlying items, but be subject to a guarantee of a minimum return. These cash flows do not solely vary based on the returns on the underlying items, because there might be some scenarios where the cash flow will not vary based on the underlying items, i.e. when the guarantees are in-the-money.

In this case, where there is asymmetry, the following approaches might be used in the valuation:

- Stochastic modelling techniques based on risk neutral scenarios. In this technique both the underlying item and the discount rate are projected stochastically. In

each scenario the net present value is calculated. The value of the cash flows of the insurance contract is equal to the average of the net present values of all scenarios.

- Replicating portfolio techniques. These are discussed further below.
- Considering the cost of the guarantee separately (e.g. by identifying the additional liability cash flows due to the guarantee and discounting these at the risk-free rate) and adding this to the liability ignoring the guarantee, if material.

Q4.34 How can replicating portfolios be used?

As per AASB 17.B46:

> *An important application of market variables is the notion of a replicating asset or a replicating portfolio of assets. A replicating asset is one whose cash flows **exactly** match, in all scenarios, the contractual cash flows of a group of insurance contracts in amount, timing and uncertainty. … If a replicating portfolio exists for some of the cash flows that arise from a group of insurance contracts, the entity can use the fair value of those assets to measure the relevant fulfilment cash flows instead of explicitly estimating the cash flows and discount rate.*

Because of non-financial risks and all insurance contract particularities, it might be very difficult to find a replicating asset that exactly matches the insurance contract cash flows in all scenarios. Nonetheless, replicating assets may exist for some of the cash flows that arise from insurance contracts. One may also strive to find a portfolio of assets which will reproduce some of the insurance contract characteristics. Such techniques could be referred to as partial-replicating strategies. Here are some:

1. **Asset cash flow matching**: Insurance contract cash flows are adjusted for non-financial risk. They are then replicated in terms of amount and timing with available asset cash flows.

2. **Optimisation**: Insurance contract cash flows are adjusted for non-financial risk. Assets are then chosen to match, as closely as possible, the key financial risk metrics related to these cash flows (e.g. duration matching).

3. **Dynamic replication**: Stochastic valuation techniques are used to derive risk-factor sensitivities that can be replicated directly.

The choice of method depends primarily upon the nature and complexity of the asset or liability under consideration and the purpose of the replicating strategy. For example, if the asset or liability is relatively simple, it might be possible to identify a pure replicating portfolio (e.g. capital guaranteed equity product and a vanilla European equity option).

However, for more complex assets or liabilities, such corresponding assets may not exist, even theoretically. In this case, optimisation techniques could be used (e.g.

path-dependent guaranteed cash flow as a proxy for by a portfolio of vanilla and exotic options).

In other complex cases, optimisation techniques may deliver poor results, hence the need to make use of dynamic replication techniques.

In any case, as per AASB 17.B48, judgement is required to determine the technique that best meets the objective of consistency with observable market variables in specific circumstances. The general process starts with the simplest method and progresses to the use of more involved methods as necessary.

Q4.35 When do cash flows need to be divided?

An entity is not required to divide estimated cash flows into those that vary based on the returns on underlying items and those that do not. If it does not, it shall, as per AAAB 17.B77, apply discount rates appropriate for the estimated cash flows as a whole; for example, using stochastic techniques.

In some cases, it may be easier to divide cash flows than to apply discount rates appropriate for the estimated cash flows as a whole. One example could be a life insurance contract which provides a fixed death benefit plus the amount of an account balance if the insured person dies, and the account balance if the contract is cancelled. In this case, dividing the cash flows and applying different approaches might be practical for cash flows that vary based on the returns on underlying items versus those that do not.

In some other cases, it could be easier using stochastic techniques than trying to divide the cash flows. This could be the case when cash flows do vary with returns on underlying items but are subject to a guarantee of a minimum return.

Q4.36 How should the discount rate be adjusted for illiquidity if cash flows do vary based on the return of underlying items?

Consistent with AASB 17.B74 (b), if the cash flows that vary based on the return of underlying items do contain an illiquidity premium, this illiquidity should also be reflected in the discount rate. If the cash flows that vary with the return on underlying items are projected without an illiquidity premium, the discount rate is chosen accordingly.

Cash flows in an insurance contract may depend on a combination of the return on underlying items, a guarantee on the return of the underlying items and other insurance cash flows subject to non-financial risk.

All elements contribute, depending on their significance in the value of the cash flows, to the overall illiquidity:

- the illiquidity premium from the underlying item that is passed to the policy holder in so far it is included in the projection;
- the guarantee on the return of the underlying items; and
- other insurance cash flows subject to non-financial risk.

As previously discussed, the risk adjustment reflects the uncertainty of non-financial risk and the other insurance cash flows can be discounted using an illiquid rate.

Q4.37 How does the approach for discounting (where the cash flows depend on the returns on underlying items) compare to current practice?

General insurance contracts do not vary with the performance of underlying items and are not discussed further.

Under LPS 340, the gross rate used to discount expected future cash flows must, to the extent the benefits under the policy are contractually linked to the performance of the assets held, reflect the expected investment earnings applicable to the assets backing the benefit being valued.

This is one of the options under AASB 17 but the Standard also provides the option of adjusting the cash flows for the variability and discounting at a rate that reflects the adjustments made.

LPS 340 also requires that where cash flows could vary with returns on underlying items, but be subject to a guarantee of a minimum return, that the value of those options must be determined (via a suitable option pricing method) and added to the best estimate liability, or the best estimate assumptions adjusted so as to appropriately capture the value of the options as part of the best estimate liability.

This seems reasonably consistent with AASB 17 (although LPS 340 addresses options and asymmetric outcomes generally, including from non-economic assumptions – not just in relation to guarantees on performance of underlying items).

5 Risk Adjustment

5.1 Introduction

Q5.1 What is the scope of this chapter?

This chapter provides information concerning the estimates of risk adjustment for non-financial risk, hereafter referred to as the "risk adjustment".

Q5.2 Which sections of AASB 17 address this topic?

AASB 17.37 and AASB 17.B86-B92 provide guidance on this topic. IFRS 17.BC206-217 also provides background on the subject.

Q5.3 What other documents are relevant to this topic?

The IAA intends to publish a **Monograph on Risk Adjustments** under IFRS, which could be useful for this purpose.

Section E sets out key reference material, which themselves show further references that might be useful.

Q5.4 What is the purpose of the AASB 17 risk adjustment?

The purpose of the AASB 17 risk adjustment is to reflect:

> *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* (AASB 17 Appendix A).

The risk adjustment is meant to inform users of the financial statements about the value that the entity places on the uncertainty and variability of insurance cash flows. Its purpose therefore differs from a solvency objective of having adequate capital to cover adverse deviation in more unusual circumstances.

According to AASB 17.B87, the risk adjustment *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.

Q5.5 What is the definition of non-financial risk?

AASB 17 does not define 'non-financial' risk. It effectively defines it by reference to ***financial risk***, which is defined in AASB 17 Appendix A as:

> *The risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, currency exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract.*

Q5.6 Which risks are non-financial?

The non-financial risks to be covered by the risk adjustment are insurance risk and other non-financial risks such as lapse risk and expense risk (AASB 17.B86).

The following is a non-exhaustive list of the risks considered by the risk adjustment:

- claim occurrence, amount (including inflation risk), timing and development;
- lapse, surrender and other policyholder actions;
- expense risk, including inflation risk, associated with the costs of servicing the contract; and
- external developments and trends, to the extent that they affect insurance cash flows.

The risk adjustment would not include the uncertainty due to operational risk, asset-liability mismatch risk and price or credit risk on underlying assets.

In some instances, there may be interactions between financial variables and non-financial variables that impact expected cash flows, making the distinction between financial risk and non-financial risk less clear. For instance, policyholder behaviour may be influenced by investment performance where there are linkages between investment returns and credited rates / contractual values. In this instance, the expected cash flows reflect this influence. The risk of policyholder behaviour being different from what is reflected in estimates of the expected cash flows would be considered non-financial risk.

A further example is spread compression risk due to earned / credited rate differences where crediting rates are discretionary. The risk of this discretionary spread compression being different from what is reflected in the estimates of expected future cash flows would again be considered a non-financial risk.

General insurance examples would include Builders Warranty and Creditor insurance, where economic factors will drive both financial risks and the likelihood of claims arising (as both builder insolvency and unemployment are influenced by the economy). These would still be considered non-financial risks.

Q5.7 What is the treatment of financial risk?

Financial risk is included in the estimates of the future cash flows or the discount rate used to adjust the cash flows (see **Chapter 4 Discount Rates**).

The uncertainty in timing of cash flows that arise from non-financial risks is covered by the risk adjustment (AASB 17.37).

Care is needed to ensure that the financial risk for contracts eligible for the VFA (particularly any arising from guaranteed returns) does not 'fall through the cracks'. It may be arguable that if the risk faced by the entity is inherent in the contract (rather than just arising from the use of current values in the measurement of the underlying items, say) then it is a non-financial risk and some compensation is warranted for the bearer of that risk.

5.2 Calculation steps

Q5.8 Is it necessary to calculate a risk adjustment if a theoretical replicating portfolio is available?

An explicit calculation of the risk adjustment would not be required if a replicating asset or portfolio of assets could be constructed to transform uncertain to certain cash flows. We note, however, this is a theoretical question with limited likely application.

Q5.9 What are the steps to calculate a risk adjustment?

There are five broad steps required to explicitly calculate a risk adjustment. These should not be considered exhaustive or sequential.

1. **Uncertainty and variability** – To understand and assess the uncertainty and variability (i.e. Risks) inherent in the cash flows for insurance contracts being valued;
2. **Risk aversion** – To understand and assess the risk aversion of the entity, as it relates to the uncertainty and variability of insurance cash flows and required compensation;
3. **Diversification benefits** – To understand the extent to which the entity considers diversification benefits in setting the compensation it requires to bear risk;
4. **Quantification** – To assess a value that reflects the entity's risk aversion, in the context of those risks, and in the context of that diversification; and
5. **Communication** – To communicate how the risk adjustment is derived and judgements in arriving at that assessment.

5.2.1 *Uncertainty and variability (Step 1)*

Q5.10 How would inherent uncertainty and variability (i.e. risks) be assessed?

In order to set the risk adjustment, the types and characteristics of risks as applying to the insurance contract need to be examined (see next question). Different insurance contracts give rise to different sources of uncertainty and variability.

In addition to variability in mortality, morbidity, longevity, lapses and expenses etc in the calculation of the risk adjustment, it is important to recognise the variability of cash flows that could arise due to the various optionalities incorporated into the product design. Ever-evolving product innovation can result in risks that were not originally anticipated or are challenging to calibrate and quantify.

Q5.11 Are the risks covered by the risk adjustment the same as those covered by APRA regulatory risk margins?

The risk adjustment covers non-financial risks, which is a subset of the risks covered by APRA regulatory risk margins as shown in the following table.

Table 5.1: Comparison of risk covered by the AASB 17 risk adjustment with the APRA regulatory risk margin

Risk Types	Examples	APRA Risk Margin		AASB Risk Adjustment	
		Applicable Risk Definition	Risk Included	Applicable Risk Definition	Risk Included
Claims risks	Claims volatility at a benefit level (e.g. mortality, morbidity and longevity) and liability classes (e.g. householders, commercial motor and travel).	Insurance Risk	✓	Insurance Risk – non-financial risk	✓
Lapse and persistency risks	Claims volatility and/or insurance profitability impact in respect of voluntary policy termination or termination of pool of policies within a group portfolio.	Insurance Risk	✓	Other non-financial risk	✓
Expense risks	Potential overrun of maintenance expenses in	Insurance Risk	✓	Other non-financial risk	✓

Risk Types	Examples	APRA Risk Margin		AASB Risk Adjustment	
		Applicable Risk Definition	Risk Included	Applicable Risk Definition	Risk Included
	servicing the in-force policies.				
Market risks	Impact on balance sheet arising from adverse fluctuations in investment market variables including interest rates, inflation, exchange rates, equities and property values.	Asset Risk	✓	Financial risk	×
Credit risks (reinsurer)	risk of non-performance by the issuer of the reinsurance contract, including the effects of collateral and losses from disputes	Asset Risk	✓	Other non-financial risk	✓
Credit risks (non reinsurer)	Impact on balance sheet arising from movements in credit-risky asset values due to widening of credit spreads and default.	Asset Risk	✓	Financial risk	×
Operational risks	Financial impact from generic operational events which do not relate to the cash flows of the insurance contract, including internal and external fraud.	Operational Risk	✓	General risk	×

5.2.2 *Risk aversion (Step 2)*

Q5.12 How would the entity's risk aversion and compensation for bearing risk be assessed?

The risk adjustment incorporates *both favourable and unfavourable outcomes, in a way that reflects the entity's degree of risk aversion* (AASB 17.B88(b)). The entity's compensation for bearing risk should be consistent with the entity's risk management framework.

The AASB 17 principle of risk compensation for a specific entity recognises that each reporting entity can have different risk preferences, risk aversion, risk appetite and risk tolerance. Consequently, the risk adjustment reflects the measurement of risk as well as the value that the entity places on different levels and characteristics of cash flow risks.

Q5.13 What are the factors in the risk management framework to consider when assessing compensation for risk?

The table below outlines some areas that could be factored in to create an internally considered view between how risks are controlled within the entity and how the entity expects to be compensated for the risks to which it remains exposed.

Table 5.2: Risk management framework and the risk adjustment under AASB 17

Area	Comments
Business economic objectives	In managing the risk return trade-off in relation to strategic risks and insurance risks, an entity could have a target economic return that it aims to achieve over a certain financial period (e.g. statutory return on capital and internal rate of return). This economic return is expected to be generated on existing business that is written within the risk tolerances and boundaries in which that entity is willing to operate, as governed by the Board's risk appetite. The risk environment would include all sources of risks (i.e. Both financial and non-financial risks) which could ultimately have an impact on the economic return generated. An entity's required economic return, for example a minimum required return on capital, could be a measure of the compensation that the entity requires for taking on the various sources of risks that it is exposed to. This metric can be used to inform the compensation required for specifically taking on non-financial risks. For example, the additional level of return required by the entity for writing business that is considered to exhibit higher than average claims risk, could be used as an indication of the marginal compensation expected to take on the incremental non-financial risk. Government entities may have very different views on risk writing and the required trade-off, due to restrictions on choice to underwrite, their cost of capital, monopoly status and their objectives.

Area	Comments
Risk controls and mitigation	Calibration of the risk adjustment could consider the impact and effectiveness of risk controls (as governed by the institution's risk management framework) in mitigating the uncertainty in outcomes arising from fulfilment of liabilities. (Note this mitigation is about risk controls rather than reinsurance.) Effective risk controls (e.g. claims and underwriting management, data governance controls) could lower the level of uncertainty in the underlying cash flows and thus the corresponding risk adjustment. The influence of risk controls on the risk adjustment could be considered in the selection of the functional forms of distributions of the underlying cash flow components. This is similar to the expectation that risk mitigation (to the extent that it is already a documented risk management objective) such as derivative instruments could be factored into the determination of the movements in CSM from financial risks.
Governance	Internally, as per CPS220 the Board owns the risk management framework and the risk appetite therein. This is unchanged under AASB 17. The Board of Directors also have the responsibility to ensure that the financial statements (of which the measurement of insurance contracts form a part) represent a true and fair view of the financial position and performance of the entity. Thus there would be an expectation that the Board is comfortable with the risk adjustment in the context of the risk appetite and risk management framework.

Q5.14 Is the risk adjustment tied to the market's valuation of risk?

With the possible exception at transition, the risk adjustment differs from what might be used for market-consistent, fair value, transfer valuation, settlement value, market model valuation, or valuations based on specific entity costs. This is because it is based on the entity's view of risk aversion rather than a market view. The exception at transition is discussed in **Chapter 12 Transition**.

Currently some general and health insurers in Australia adopt a different confidence level for the risk margin on outstanding claims compared to the risk margin used when applying the Liability Adequacy Test to premium liabilities.

Q5.15 What is the relationship between the risk adjustment and regulatory, economic and target capital?

Areas of relationship between the risk adjustment and other measures of capital (regulatory, economic and target capital) are outlined in the table below.

Table 5.3: Relationship between the risk adjustment and other measures of capital

Measurement basis of capital			Relevance for risk adjustment
APRA Regulatory Capital	Cash flows	For life insurance business, the need to apply termination values when calculating adjusted policy liabilities for the purposes of regulatory capital may produce a substantial buffer over the value the entity would ascribe to the cash flows. A stressed best estimate liability approach (i.e. without termination value applied) may be better when considering future cash flows for the purpose of the risk adjustment.	The risk adjustment relates to the uncertainty of future cash flows (which may be related to past, current or future service).
Economic Capital and Target Capital supporting Credit Rating	Probability distributions	Depending on the entity's internal modelling approach (other than fully stochastic capital modelling), measurement of insurance risks may not be fully reflective of the underlying risk distribution of the liability cash flows specific to the entity. This is particularly the case where portfolio deterministic capital factors (e.g. established by a parent entity or rating agencies) are applied to the various liability components. Some of these liability components (e.g. gross sum-at-risk) may not be driven by any probability distributions and may not inform the underlying uncertainty of the FCF.	Regardless of the chosen measurement approach for the risk adjustment, there remains a need to translate the results to a confidence interval equivalent – which ultimately requires the entity to have a view on the fulfilment cash flow distributions

Q5.16 Does the confidence level need to be the same between LIC and LRC?

The risk adjustment represents the level of compensation the entity would require so that the entity would be indifferent between (a) the risky insurance liability and (b) a certain stream of cash flows. The LIC and the LRC comprise different types of risk. It is plausible that an entity's risk aversion might differ between non-financial risks, and therefore the confidence level applicable may also differ.

5.2.3 *Diversification benefits (Step 3)*

Q5.17 What allowance should be made for risk diversification?

The risk adjustment incorporates *the degree of diversification benefit the entity includes when determining the compensation it requires for bearing that risk* (AASB 17.B88(a)). The allowance made for risk diversification is expected to be consistent with the entity's risk management framework.

The risk adjustment aims to fully reflect the impact of risk diversification across all of the insurance risks that the entity regards as a common pool. Typically, this pool will comprise all of the insurance risks underwritten by the entity. The assumed correlation is up to the entity and not prescribed.

This reflects the fact that the entity might issue diverse products with cash flows that can be sensitive in varying degrees to certain risks, with the potential for realising the benefit of diversification in the aggregation of the risks.

Q5.18 At what level of aggregation should the risk adjustment be determined?

The level of aggregation for determining the risk adjustment is specific to the insurer's view of the compensation.

The risk adjustment might be set at the enterprise level incorporating all diversification benefits in the entity aggregated across all of its portfolios and then allocated down. Alternatively, the risk adjustment might be set at the portfolio or group level, where the only diversification benefits would be those achievable at that portfolio or group level. The risk adjustment might be calculated separately for cash inflows (receipts) and cash outflows (payments), or net of inflow/outflow.

Q5.19 What are the implications of differing levels of aggregation?

Given its portfolios and risk aversion, determining aggregation at the enterprise level will:

- likely produce the highest level of diversification of risk for the entity; and
- likely produce the smallest risk adjustment.

Given its portfolios and risk aversion, determining aggregation at the portfolio level will:

- likely produce the lowest level of diversification of risk for the entity; and
- likely require a diversification benefit to be applied because in aggregate the entity might be holding a total risk adjustment at a much higher confidence level than intended.

Theoretically, calculating a risk adjustment separately for cash inflows (receipts) and cash outflows (payments) might:

- result in a negative risk adjustment because the risks associated with inflow exceed those of outflow. In such a case, the risk adjustment would be set to zero; and
- result in the sum of the component risk adjustment being greater than the risk adjustment for the aggregate cash flows (for example, if the risk adjustment technique was not additive).

Q5.20 Can the risk adjustment be negative?

It is not envisaged that in practice the risk adjustment would be negative.

Q5.21 What is the impact of statutory funds on risk diversification?

Statutory funds are a regulatory construct rather than an accounting one.

Q5.22 What are the issues to consider for consolidated enterprise accounting?

When looking at the potential impact of diversification, it is worth considering whether only the diversification benefits available to the AASB 17 entity are reflected, rather than diversification benefits across the consolidated enterprise. For example, where AASB 17 accounts are being prepared for a consolidated enterprise, diversification benefits across the enterprise can be considered in setting the risk adjustments across the enterprise. However, where stand-alone AASB 17 accounts are being prepared at a lower level for an AASB 17 reporting entity within an enterprise, diversification benefits available to that entity need to be considered.

Q5.23 How does the level of aggregation for the risk adjustment interact with that for the CSM?

The level of aggregation for the risk adjustment and for the CSM can be considered separately. The CSM is measured, at issue, to represent a current estimate of the FCF less a risk adjustment. The CSM is measured at a group level of aggregation.

Therefore, the computation of the CSM at inception requires a risk adjustment appropriate for the level of aggregation used for the CSM. Hence, if the risk adjustment is determined at a level higher than a group, it will need to be allocated down to the group level for purposes of computing the CSM.

The CSM is required to be unlocked at subsequent valuation periods to reflect the changes in the estimates of future cash flows. The CSM also needs to be adjusted (or a loss component created) to reflect the current estimate of the risk adjustment that relates to coverage and other services for future periods. Hence, if the risk adjustment is determined at a level higher than group, it will need to be allocated

down to the group level in order for the insurer to appropriately re-measure the unlocked CSM.

Q5.24 Can the diversification be calculated across both the LIC and the LRC?

Yes it can. The value at which an entity would be willing to transfer liabilities will differ whether they have just a LIC, or both a LIC and a LRC.

For general insurers, this is different to current practice for regulatory capital purposes as you can only allow for diversification in risk margins on your LAGIC calculations if you're passing your liability adequacy test.

5.2.4 *Quantification (Step 4)*

Q5.25 Which estimation technique is prescribed?

AASB 17 does not specify or limit the estimation technique(s) used to determine the risk adjustment (see AASB 17.B91). Examples of estimation techniques available include:

- quantile techniques – used to reflect differences in risk based on knowledge and analyses that describe the uncertainty of outcomes by means of a probability distribution;
  - confidence level (percentile or value at risk);
  - conditional tail expectation (tail value at risk);
- cost of capital technique – an entity will determine its risk preference based on the entity's selection of a capital amount appropriate for the risks being measured and the cost of that capital;
- premium principles – the application of actuarial principles related to the pricing of aggregate insurance risk (e.g. Wang Transformation); and
- directly adding margins to assumptions.

Actuarial judgement is required when determining the estimation technique(s) to use. Any of the above techniques could be acceptable under certain circumstances and no one technique is expected to meet all of the selection criteria in all situations.

Sub-chapter 5.5 Estimation techniques provides illustrative examples of a few estimation techniques.

Q5.26 What are the criteria to consider in selecting an estimation technique?

Guidance is provided on five characteristics that the risk adjustment should possess. These relate to frequency versus severity, short versus longer duration, wider versus

narrower probability distribution, degree of knowledge about the best estimate and its trend, and impact of emerging experience on uncertainty (see AASB 17.B91).

Other criteria to consider include:

- consistency with how the entity assesses risk from a fulfilment perspective;
- practically of implementing the estimation technique; and
- ability to translate the result, either directly or indirectly, into a confidence level. This is necessary for disclosure requirements.

Q5.27 How is the risk adjustment calculated at transition?

Q&A relating to the risk adjustment at inception, subsequent measurement and transition is covered in **Chapter 12 Transition**.

Q5.28 Does AASB 17 specify any differences in methodology for determining the risk adjustment at inception versus subsequent measurement?

No, as the entity's view of the amount, timing and uncertainty of future cash flows changes, so too would the risk adjustment. The risk adjustment will be recalculated at each valuation to reflect the entity's current view of future cash flows, the risk inherent in those cash flows and the compensation required for taking on that risk.

Q5.29 Do subsequent risk adjustment calculations rely on previous risk adjustment calculations?

No. Unlike the subsequent measurement of the CSM, which is calculated with reference to the previous CSM or the CSM at inception, the risk adjustment is calculated at each valuation with reference only to a forward looking view of future cash flows (and the uncertainty of these cash flows) and is not contingent on previous risk adjustment calculations.

Q5.30 Could we use the pricing profit margin as a proxy for the risk adjustment?

It is not necessarily appropriate simply to apply the profit margin basis to the risk adjustment. For example, it will be necessary to exclude any part of the profit margin that does not relate to the risks that relate to the insurance cash flows, such as operational and asset-liability matching and, usually, investment risks.

5.2.5 *Communication / disclosure (Step 5)*

See **Chapter 11 Disclosure**.

5.3 Leveraging the existing framework for setting APRA regulatory risk margins

Q5.31 What areas might be considered prior to leveraging an existing risk margins framework?

The three key areas to consider prior to leveraging an existing risk margins framework are:

- level of probability of sufficiency;
- time horizon and risk volatility; and
- distribution of outcomes.

A comparison of the treatment of each item for regulatory and financial reporting purposes is presented in the following table.

Table 5.4: Comparison of the AASB 17 risk adjustment with the APRA regulatory risk margin

Areas of Consideration	APRA Regulatory Risk Margin	AASB 17 Risk Adjustment
Level of probability of sufficiency	For life (re)insurers, risk margins are required to be set at a 1-in-200 year sufficiency level For general (re)insurers, risk margins are first calibrated at a 1-in-4 year sufficiency. Capital factors are applied to the total outstanding claims liability, including the risk margin, based on the class of business. The capital amounts calculated to be held in respect of the insurance risk then raise the overall probability of sufficiency for the balance sheet significantly above the 1-in-4 year level. Taking all of the regulatory capital elements together, the APRA capital is designed such that the entity has less than a 1-	There is no prescribed level for probability of sufficiency expected within AASB 17 in setting the risk adjustment. Entities are expected to form a view on what compensation they would want for the uncertainty of outcomes due to non-financial risks. Applying a regulatory risk margins approach may create a biased view of the overall uncertainty of the liabilities and profitability, on which the risk adjustment is established. This may be addressed by a different choice of functional form for risk distributions.

	in-200 year chance of assets falling below liabilities (i.e. insolvency). Risk margin methods under the regulatory framework are typically designed to evaluate the mid-to-tail segments of the distribution of outcomes, to ensure the sufficiency of the adverse insurance outcomes are not understated.	
Time horizon of risk volatility	Risk margins are set in respect of risk volatilities arising over a 12-month period, whether it is direct claims volatility or variations in best estimate assumptions.	Definition of the risk adjustment relates specifically to the uncertainty arising from fulfilment of liabilities, which relates to all future periods. The contract term could be much shorter or longer than 12 months. As a concept, risk volatilities considered within the risk adjustment are broader than what is accounted for within the risk margin framework.
Distribution of outcomes	Risk margins are set to define the prescribed percentile of adverse outcome. It is only concerned with the side of the distribution of outcomes that negatively affect the entity.	In deriving the risk adjustment, both the favourable and negative outcomes relate to the view of the uncertainty of outcomes. Risk adjustment methods that only inform adverse risk outcomes may give a biased view on the favourable risk outcomes.

5.4 Risk mitigation

The Q&A relating to the reinsured risk adjustment is covered in **Chapter 9 Reinsurance and External Risk Transfers.**

Q5.32 Can risk sharing mechanisms be taken into account when determining the risk adjustment?

Yes, provided they are expected to affect the uncertainty and variability in the insurance cash flows. Examples of risk sharing mechanisms include:

- participation;
- investment linkage;
- deductibles and excesses;
- profit / loss sharing;
- Legislated pooling arrangements across entities;
- retrospective experience rating; and
- prospective experience rating schemes such as no-claim discounts (within the contract boundary).

Risk sharing arrangements can affect the contractual insurance cash flows between the insurer and the policyholder. Such cash flows may be contingent on insurance claims or other factors that may lessen the risk and variability of the entirety of the insurance cash flows. The risk adjustment will reflect all of these contract cash flows, with due consideration to the contingencies involved.

Q5.33 Can risk sharing mechanisms reduce the risk adjustment to nil?

Yes, but it will depend on the risk sharing arrangement, the level of confidence that the risk adjustment is set at relative to the arrangement and past/future claims experience within the current contract.

5.5 Estimation techniques

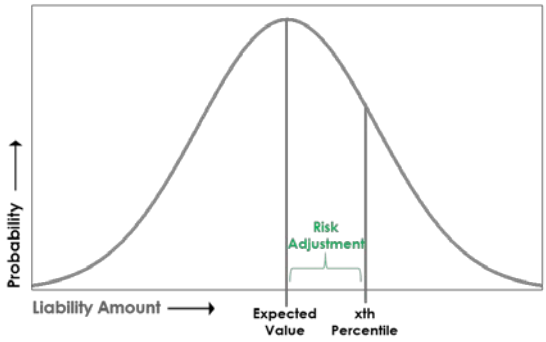
5.5.1 *Confidence level approach*

Q5.34 How is the risk adjustment determined using the confidence level approach?

It is determined as the extra amount that has to be added to the expected value of the insurance liabilities, such that the probability that the actual outcome will be less than the liability (including the risk adjustment) is equal to a targeted probability (the confidence level).

The risk adjustment is the difference between the probability-weighted expected value and the corresponding result at the selected percentile of the probability distribution. The confidence level approach is illustrated in the figure below, where it is assumed that risks are normally distributed for simplicity:

Figure 5.1: Confidence level approach to determine the risk adjustment



The following is a highly simplified method of determining the risk adjustment using a confidence level technique.

Step 1 – Calculate the Insurance Risk Charge at the valuation date for the group.

The Insurance Risk Charge as determined under APRA Prudential Standard GPS 115 Capital Adequacy: Insurance Risk Charge (for general insurers) and APRA Prudential Standard LPS 115 Capital Adequacy: Insurance Risk Charge (for life insurers) could be a starting point. Capital for financial risks would automatically be excluded. Such an amount should allow for diversification benefits at the group level.

Step 2 – Rescale down the 1-in-200 year capital to the confidence level required

Assuming a normal distribution of the current estimate and 75% confidence level, the IRC is multiplied by 26% to calculate the risk adjustment.

Assuming a lognormal distribution of the current estimate and 75% confidence level, the IRC is multiplied by X% to calculate the risk adjustment, where:

X% = EXP(0.674*SQRT(LN(St_Dev^2+1)))/SQRT(St_Dev ^2+1)-1

and St_Dev = standard deviation

Q5.35 How can the target confidence level be determined?

The target confidence level will depend on the entity's risk aversion, in the context of the relevant risks, and in the context of the diversification affecting the compensation for such risks.

5.5.2 *Cost of capital technique*

Q5.36 How is the risk adjustment determined using the Cost of Capital (CoC) Method?

It is determined by considering the cost to the entity of holding capital to back the non-financial risks. This technique is based on the concept that the entity will determine its risk preference based on the entity's selection of a capital amount appropriate for the non-financial risks related to the insurance contract.

To apply this technique the entity might:

- project the run-off of gross and reinsured FCF in each future year;
- project the capital amount associated with the FCF in each future year;
- determine the cost of capital in each future year by multiplying the applicable capital amount by a cost of capital rate; and
- discount each cost of capital to the valuation date at the applicable discount rate.

Q5.37 How is the cost of capital rate determined?

The cost of capital rate is defined as the difference between the:

- return required on shareholders' capital to compensate for the risk to that capital; and
- expected earned rate on assets backing the shareholders' capital.

Q5.38 How is the amount of capital determined?

AASB 17 does not provide any rules or details regarding the choice or criteria of the amount of capital.

In this respect, it is noted that APRA regulatory capital requirements (including target capital) might be a starting point for an entity in allocating or assigning capital to associated cash flows, since they serve a different purpose to the risk adjustment. For example, allowance for financial risks and operational risks should not be allowed for under the risk adjustment.

Q5.39 What are areas to consider before using the Cost of Capital Method?

The IAA education **Monograph on Risk Adjustments** outlines areas to consider before using the Cost of Capital Method including:

- distribution of the amount and timing of cash flows;
- capital amounts appropriate for the risk and timing of cash flows; and
- period and cost of capital applicable to the capital amount.

In particular, the selection of capital amount is not defined as any specific basis of capital measure - for instance, the capital requirement or available capital under APRA regulatory capital framework, economic capital or capital to attain targeted credit rating for the entity. While references can be made towards these measures of capital, distinctions can be made in context of the measurement objective of the risk adjustments.

Q5.40 What are the advantages and disadvantages of the Cost of Capital Method?

The Cost of Capital Method has the advantage of being easily determined once the future amounts of capital and costs of capital rate are available.

However, it has a number of disadvantages including:

- not producing a confidence level for disclosure purposes. To do this, it becomes necessary to model the liability distribution to determine an equivalent confidence level;
- potentially ignoring any risk with an extremely low probability and may not be sensitive to these risks, such as catastrophe risk. These risks and their probability of occurrence have to be considered under AASB 17 (See **KPMG 2017**);
- introduces circularity. The technique relies on the capital requirement, where the capital requirement is the capital over the liability (including the risk adjustment). This means in theory an iterative process may be required. In practice, approximations can be used to overcome this. For example, defining capital as the capital in excess of the Best Estimate Liability (see **Coulter. B. 2016**).

Q5.41 Can you provide an illustrative example of the Cost of Capital Method?

The Cost of Capital Method is illustrated in the following table. It is assumed the expected earned rate is 4% p.a., required shareholder return is 10% p.a. and the cost of capital rate is 6% p.a.

Table 5.5: Cost of Capital Method to determine the risk adjustment

Year	Expected Average Capital Amount* over the year	Cost of Capital (CoC)	Present Value Factor	Present Value of CoC
	A	B = 6% x A	C = (1+10%)^-(t-0.5)	D = B x C
1	100	6.0	0.953	5.7
2	65	3.9	0.867	3.4
3	45	2.7	0.788	2.1
4	30	1.8	0.716	1.3
5	20	1.2	0.651	0.8
6	15	0.9	0.592	0.5
7	10	0.6	0.538	0.3
8	7	0.4	0.489	0.2
9	3	0.2	0.445	0.1
10	0	0.0	0.404	0.0
Risk adjustment				**14.4**

* Capital in excess of liability

6 Contractual Service Margin and Onerous Groups

6.1 Introduction

Q6.1 What is the scope of this Chapter?

The chapter provides information about the contractual services margin (CSM) – what it is, how it should be determined, how it might change because of a range of factors – and the treatment of onerous contracts.

Q6.2 Which sections of AASB 17 address this topic?

AASB 17.38-39, AASB 17.43-44, AASB 17.47-52 and AASB 17.B96-B100 provide guidance on this topic. IFRS 17.BC218-BC226, IFRS 17.BC228-BC237, IFRS 17.BC270-BC275, and IFRS 17.BC277-BC287 also provides background on the subject.

6.2 The CSM

Q6.3 What is the contractual services margin

Under the core requirements of AASB 17, the CSM is a component of the Insurance Contract Liability for a group of contracts. The CSM represents the unearned profit after allowing for the cost of bearing non-financial risk (i.e. after the risk adjustment), see AASB 17.38.

It is measured at inception for a group of contracts as the excess (if any) of the expected present value of cash inflows over cash outflows within the boundary of the contract (including acquisition costs), after adjustment for non-financial risk.

If there is no excess of inflows over outflows at inception, the contract is onerous, no CSM is established and a loss is recognised at time of issue.

Thereafter the CSM of the group is simply a roll forward with inception interest, adjustments for some experience items, cash flow estimates and risk. The CSM is then released based on service provided in the period and now expected to be provided.

This means that while the initial determination of the CSM for the group is a prospective calculation, thereafter it is primarily a retrospective calculation or roll forward.

The CSM reflects the IASB's view that profit on insurance contracts should only be recognised as service is provided, consistent with AASB 15 (see IFRS 17.IN7 and IFRS 17.BC18) and not on day of policy sale.

6.3 Determining the CSM

Q6.4 How is the CSM determined at initial recognition

For the measurement of a group of insurance contracts which an entity issues, AASB 17 specifies that the CSM can never be negative and, if there is no excess of inflows over outflows, the contract is treated as onerous (see **Sub-chapter 6.6 Onerous contracts**). However, AASB 17 makes an exception for groups of reinsurance contracts held and allows the CSM to go or be negative (see **Chapter 9 Reinsurance and External Risk Transfers**).

If the contract is not considered onerous, the initial CSM is the sum of the absolute values of the negative amount of the FCF (which includes the adjustment for non-financial risk) of all contracts in the group of contracts as they would be determined in the normal measurement at that day plus any pre-coverage cash flows which effectively considers all contractual cash flows (future and past) within the contract boundary. In the case of a profitable contract, the outcome of measuring all cash flows should be negative (total cash outflows minus total cash inflows). This asset is eliminated by the creation of the CSM as an additional component of the liability of the entity. However, pre-coverage cash flows, can impact the amount actually recognised on the balance sheet which is an asset if pre-paid acquisition costs exceed pre-paid premiums, a liability otherwise.

Conceptually, the CSM at inception is determined on an individual contract basis but AASB 17 envisages the determination of the CSM of the group based on estimation at the group level or even higher level, provided they can be appropriately allocated to the group (see **Chapter 2 Aggregation and Contract Boundary**).

Q6.5 What are pre- coverage cash flows

Pre-coverage cash flows include contractual cash flows relating to the contract which were paid/received by the insurer before the recognition date of the contract. The recognition date determines which cash flows are "pre-coverage" and which are not. Example of pre-coverage cash flows include:

- Premiums under the contract paid prior to the recognition date
- Commissions spent due to contractual obligations with an intermediary in response to writing the contract
- Cost arising during the application and underwriting process (underwriting cost) and issuance cost

The calculation of the CSM for a group of insurance contracts includes all contractual cash flows including pre-coverage cash flows, including any insurance acquisition cash

flows for which an asset or liability is held prior to the recognition of the group that gave rise to them (see AASB 17.27 and ASB 17.38). Further, this includes both cash flows that are directly or indirectly allocated to a contract e.g. acquisition cost spent without success, provided they are directly attributable at portfolio level.

Note that the recognition date of the contract (see AASB 17.25) is the earliest of the following:

- The beginning of the coverage period of the group of contracts;
- The date when the first payment from a policyholder in the group becomes due; and
- For a group of onerous contracts, when the group becomes onerous.

6.4 Updating the CSM?

Q6.6 After initial recognition, what changes are recognised in the CSM?

The remaining amount of the CSM at the end of the reporting period for insurance contracts without direct participating features is the carrying amount at the end of the prior reporting period adjusted for the items specified in AASB 17.44 (see also AASB 17.B96), including the amount recognised as revenue for services that were provided in the period (see **Q6.11 What is a coverage unit?**).

Q6.7 Which changes in FCF qualify for adjusting the CSM?

The table below summarises how components underlying the FCF should be treated for contracts valued under the Core Requirements:

Table 6.1: Which Changes in FCF Qualify for Adjusting the CSM

Item	Unlock CSM?
Change in estimates of incurred cash flows for past coverage (claims liability)	No
Experience differences on current period cash flows	No
Change in present value of cash flows related to future coverage and other services due to	
Assumptions changes	Yes
Experience differences (premium and investment component)	Yes
Contract holder info changes (ex: age, sex)	Yes
Contract feature changes (premium pattern, face amount, etc.)	Yes
Change in market variables	No
Change in value of underlying items, if applicable	No

Note that the treatment of non-investment experience is different from the treatment under AASB 1038. AASB 1038 recognises all non-investment experience immediately, whereas AASB 17 absorbs future profits (from volume changes) in the CSM to emerge in the future.

Q6.8 What is the investment component?

The investment component is defined in AASB 17 Appendix A as:

> *The amounts that an insurance contract requires the entity to repay to a policyholder even if an insured event does not occur.*

This could be determined as the surrender value payable at the date of claim if no insured event had occurred at that date (see IFRS 17.BC34). Note, for annuities with no surrender value beyond that for any guaranteed payments, this is the surrender value of any guaranteed payments and does not include the commutation of any future annuity payment dependent on longevity, as such commutations are not possible if the insured event does not occur, i.e. the annuitant is not alive at the time of surrender of the annuity.

Q6.9 How are risk adjustment changes reflected in CSM?

The CSM should be adjusted for changes in risk adjustments for non-financial risk relating to services provided in future periods, subject to the condition that the margin should not be negative.

Changes in the risk adjustments for non-financial risk relating to coverage and other services provided in the current or past periods should be recognised in profit or loss.

The entity has the option (see AASB 17.81) to disaggregate the change in risk adjustment relating to the LRC into:

- that relating to the provision of coverage in the current period: and
- that relating to the change in the time value of money (discount rates) in the current period.

If no disaggregation is made, the CSM is adjusted for all the movement in risk adjustment in the LRC.

However, if the entity is able to derive an impact of time value of money and changes in discount rates, and the disaggregation is made, this impact would be ignored in the CSM adjustment (similarly to the impact of changes in market variables on the present value of future cash flows).

6.5 Releasing the CSM

Q6.10 How is CSM released

The amount released from the CSM for the group (AASB 17.44(e) and AASB 17.B119), is based on:

(a) The amount of the CSM for the group at the end of period, i.e. after interest accretion, adjustment for changes relating to future service for cash flow estimates, premiums received and risk adjustment; investment component experience;

times

(b) The ratio of coverage provided in the current period over the sum of coverage provided in the current period and expected to be provided for future periods (within the contract boundary)

where coverage is based on coverage units (see **Q6.11 What is a coverage unit?** below).

Q6.11 What is a coverage unit?

Coverage unit is defined by AASB 17.B119(a) as:

> *The number of coverage units in a group is the quantity of coverage provided by the contracts in the group, determined by considering for each contract the quantity of the benefits provided under a contract and its expected coverage duration.*

The interpretation of this for insurance contracts without investment component went to the IASB's Feb 18 TRG (paper AP05) and it was observed that:

- the likelihood of insured events occurring affects coverage units:
  - only to the extent that they affect the expected duration of contracts in the group; and
  - do not, to the extent that they affect the amount expected to be claimed in the period;
- the expected duration should reflect expected lapses and cancellation; and
- in principle different levels of cover across periods should be reflected, but noted there were a number practical challenges in doing this.

Coverage units will be considered further at a subsequent TRG, in particular:

- whether coverage units are based on pure insurance risk excluding any investment component or investment service present;
- whether the use of the maximum level of cover versus the expected level of cover in periods. For example:

- a contract provides project cover for fire damage up to a maximum amount. The value of the property covered is expected to increase from zero when construction starts up potentially up to the maximum amount when it completes. Question is should the coverage units expected to be provided in future periods reflect the maximum limit, or the lower but increasing value on which the entity is actually exposed to insurance risk?
- mortgage default cover, which pays out the balance after recovering the value of the property on which the mortgage is secured. The staff conclusion was that in principle the coverage units should reflect the contractually scheduled declining balance of the mortgage, but were uncertain if it should also include any expected increase in the value of the property.

- how to handle contracts with a range of cover types, for example can it be reduced to a common unit where coverage includes both lump sum and recurring amounts (e.g. income replacement while disabled) in the one contract.

It was also noted that use of coverage units for release of CSM is dissimilar to the basis used for PAA, being passage of time or expected timing of expected insured service expense (this reflects the fact that release under PAA is primarily about releasing the margin for expected claims in the premium).

Aspects of AASB 17 and the IFRS 17 Basis for Conclusions relevant In interpreting coverage unit are:

- The ***coverage period*** which is also defined in AASB 17, Appendix A as:

  The period during which the entity provides coverage for insured events. This period includes the coverage that relates to all premiums within the boundary of the insurance contract.

  - The ***insured event*** in turn is defined as

    An uncertain future event covered by an insurance contract that creates insurance risk.

  - The ***insurance risk*** in turn is defined as

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

    The application guidance (AASB 17.B7-B32) makes clear what constitutes insurance risk.

- The Basis of Conclusions (IFRS 17.BC279-BC282) which sets out the IASB's thinking and rationale for the release of the CSM and the use of coverage units for this purpose. This gives some indication as to how coverage units and release of the CSM might be interpreted. In particular, the following were discussed and rejected by the IASB as the basis for release of the CSM:
  - pattern of expected cash flows (IFRS 17.BC279(a));

- the change in the risk adjustment caused by release from risk (IFRS 17.BC279(a));
- when the returns on investment components occur even where this drives total expected fee (IFRS 17.BC280); and
- release based on services other than insurance service (IFRS 17.BC280)

The following sets out present understanding of the argument for each of the views on coverage units.

A) **Pure Insurance risk** excluding any investment component or investment service present;

- The insurance risk excludes repayment of the investment component upon the insured event occurring including the waiver of any surrender penalties on the investment component (see in particular AASB 17.B9, AASB 17.B18 and AASB 17.B21 and AASB 17.B23);
- The coverage period, and hence coverage, ends when the entity ceases to provide coverage for insured events due to there not being significant insurance risk present;
- It is consistent with the requirement to separate the investment component where distinct and report it under AASB 9 and the investment service under AASB 15 (AASB 17.11 and AASB 17.12);
- A calculation based on pure insurance risk falls naturally out of the calculation of future cash flows which is required for the valuation;
- It is consistent with the requirement to exclude the investment component from insurance revenue and incurred claims (AASB 17.42(a), IFRS 17.BC33-34); and
- The change from coverage to investment service (AASB 17.71(c)) as the basis for release for investment contracts with discretionary participation features, which would not be necessary if coverage includes investment service.

B) Includes investment component for any investment service present**;**

- Where the quantity of benefits provided under the contract include payment of the investment component they are directly captured by the definition of coverage units – i.e. the issue is about coverage, not usual benefit. The potential coverage for a contract where there is an investment component is the full insured benefit, even if the value of the investment component were to fall to zero. Finally, there is the issue of contracts (like Income Protection) where there is no fixed amount for the Insurance Benefit (expected claims over the life of the business may be appropriate in such circumstances).;

- While the definition of coverage period requires insurance risk to be present, it does not of itself exclude the investment component from being part of the benefit in the coverage unit definition.
- The investment component is only included in the insurance contract if it cannot be separated, the contract as a whole contributes to the unearned profit represented by the CSM and it is consistent to include it in the coverage units used to release the CSM.
- IFRS 17.BC280 also notes that the Board rejected the view that an allocation based on coverage units would result in premature profit recognition. Yet this is exactly the case if pure insurance risk runs off quickly (e.g. the death benefit is maximum of account balance and a fixed amount) resulting in no insurance risk while investment management is the predominant service and source of profit over the life of the insurance contract.

C) **Similarity to PAA,** where passage of time or expected incurred claims can be used**;**

- Including investment component in coverage units means coverage units are generally likely to be more stable and consistent with passage of time under PAA;
- Expected incurred claims would be similar to coverage units if propensity to claim is expected to be stable relative to sum insured across contracts within the group and across time (e.g. not increase with age).

D) **Common unit of coverage** across different types of cover**;**

- If coverage units are defined as the quantity of insurance coverage provided, an interpretation of coverage units that could work across most types of cover would be - the maximum amount payable if a claim were to occur for all covers under each contract in the group, e.g:
  - maximum lump sum payable upon claim (gross or net of any investment component depending upon interpretation);
  - sum of the maximum regular payments payable upon claim event in coverage period (again net or gross of any investment component).

For example, coverage could be:

- for term life insurance, the sum insured payable upon death;
- for income protection, the sum of the annual income payments if the insured became disabled and remained disabled for the remaining life of the contract;
- for general insurance contracts the limit of indemnity (where applicable) or maximum probable loss – e.g. for non-life property insurance the full limit of indemnity might only be paid if the property is written off, but most

claims are for much less. An alternative view is that it should be based on the expected level of cover (valid claim) and will be discussed as noted above at a later TRG.

Note: this interpretation may not be practicable for some contracts. e.g. stop loss insurance.

Unexpected Outcomes – each of these interpretations may lead to unexpected outcomes depending on circumstances, for example:

- excluding the investment component leads to:
  - much earlier release of CSM for conventional life insurance business and for investment linked business with insurance riders; this can be partly offset by not discounting the coverage duration (see **Q6.13 Should discounted or undiscounted future coverage be used for release of CSM?**);
  - potentially very early release of CSM where sum insured is maximum of account balance and sum insured;
  - potentially no release of CSM for lifetime annuities during the term-certain period;
  - potentially very different CSM release patterns for products offering otherwise similar benefits.

- Using sum insured instead of:
  - regular premiums leads to earlier recognition of CSM where premium rates increase with age; or
  - expected claims - leads to:
    - earlier recognition of CSM for income protection where claims are paid over time; and
    - later recognition of CSM for mortgage insurance both life and lender's insurance, where expected claims potentially decline much faster than coverage.

Determination of coverage units where there are multiple insurance components, or where one contract covers many individuals (e.g. reinsurance or group insurance business) is also unclear, and will also be discussed at a latter TRG).

Note that for stand-alone investment contracts with discretionary participation features, the coverage units are based on the investment service, and hence on when the returns on the underlying items occur. Although the way in which this is determined will need to be considered, the subject is not addressed further in this note.

Note also that as underlying business and reinsurance are separate, coverage units need to be determined gross rather than net.

Q6.12 When does coverage period start?

AASB 17, Appendix A defines ***coverage period*** as:

> *The period during which the entity provides coverage for insured events. This period includes the coverage that relates to all premiums within the boundary of the insurance contract.*

Coverage starts from the point at time at which a claim could be made if the claim event were immediately known, which normally would be the start date of the insurance contract. In some circumstances, coverage may:

- start later, e.g. for travel insurance coverage may only start from the date of travel; or
- start earlier, e.g. a reinsurance treaty may provide cover on claims notified basis (e.g. for emergence of claims not yet reported to the cedant but arising prior to the start date) but coverage of notified claims only starts from the start date of the reinsurance contract, (unless the treaty also specifically covers claims notified prior to the start date of the treaty).

Normally coverage will cease at the end date specified in the contract, or contract boundary if earlier, or in many cases upon a valid claim arising before the end date. Any claims arising from events occurring after that time cannot give rise to a valid claim under the contract. Note that notification or settlement of the claim may occur after the end date and the claim amount payable ultimately may continue to develop after the end of the coverage period. However, these are part of the incurred claim liability and do not represent the provision of further coverage.

In other cases, e.g. stop loss reinsurance, while a sequence of independent events might trigger the incurrence of a claim, such events of themselves are not part of the coverage, it is the occurrence of underlying claims for amount that in total trigger a stop loss claim. Here coverage is for claim payments arising in excess of the stop loss trigger point and again coverage starts from the point at which a valid claim could be made under the contract and not the underlying individual events.

Further, subsequent events may change the amount of the claim ultimately payable but they represent development of the claim amount and not the provision of further cover, e.g. an accident may cause a disability which gives rise to the payment of an annuity for the remaining life of the person disabled. In this case, the cover is for the occurrence of an event which causes such disablement.

Q6.13 Should discounted or undiscounted future coverage be used for release of CSM?

AASB 17 makes no mention of whether time value of money needs to be allowed for in determining the release pattern (i.e. the coverage ratio (b) in **Q6.10 (How is CSM released)** above) for the CSM and IFRS 17 Basis for Conclusions makes it clear that this has been deliberately left to the discretion of the reporting entity (IFRS 17.BC282).

Not discounting the quantum of coverage expected to be provided in future, will tend to defer the release of profit, which may be appropriate to balance those circumstances where the definition of coverage unit is seen as unduly bringing profit forward. For example, where a significant element of profit over the life of the contract comes from an investment component which grows over time while the insurance component declines (and sum at risk is used for coverage unit) then discounting would help offset this.

Q6.14 What happens if the CSM becomes negative?

Except in the case of reinsurance (see **Chapter 9 Reinsurance and External Risk Transfers**), the CSM cannot go negative and is instead set to zero, resulting in loss being reported equal to amount by which the CSM otherwise would have been negative.

The negative balance is also set as the loss component, which is not part of the insurance contract liability, but instead tracks the amount available for loss reversal under favourable circumstances (see **Sub-chapter 6.6 Onerous contracts**).

6.6 Onerous contracts

Q6.15 What is an onerous group of contracts and how are they treated?

A group of contracts is considered onerous if the CSM would otherwise be negative i.e. there are future losses expected on the contract after including allowance for the risk adjustment for non-financial risk. The amount by which the contract is onerous is recognised immediately as a loss when it is known that it is loss making (see AASB 17.48).

Q6.16 What is a loss component?

The loss component represents the amount of losses arising from onerous contracts which are available for reversal (see AASB 17.49). The initial loss amount is tracked and adjusted for further losses, loss reversals and released over time so that the loss component for a group of contracts is fully unwound by the end of their coverage (see AASB 17. 52)

Q6.17 How should the loss component be tracked over time?

The loss component is tracked by:

- allocating any changes in the FCF due to changes in estimates of future cash flows relating to future service, which if:
  - unfavourable increase the loss component and give rise to a further loss; and
  - favourable reduce the loss component, give rise to loss reversal and re-establishment of CSM once loss component is extinguished.

- allocating the remaining change in the FCF of the group on a systematic basis between the loss component and the balance of the LRC (see AASB 17.50(a) and AASB 17.51).

The systematic basis used needs to ensure the loss component is extinguished by the end of the coverage period of the group. This can be done for example by:

- using the same release method that would have been applied to the group if there had been CSM, e.g. coverage; or
- using the opening balance of the loss component as a percentage of the future cash flows and risk adjustment relating to future service (see IFRS 17 Illustrative Example 8).

Note that a reconciliation of opening to closing balance of the loss component needs to be disclosed (see AASB 17.100(b))

Q6.18 When are onerous contracts recognised?

A group of onerous contracts needs to be recognised when the group is identified as being onerous, even if this is before coverage has commenced or the first premium is due (see AASB 17.25).

Q6.19 How are onerous contracts dealt with if they are acquired through a transfer of business?

AASB 17.B95 outlines that the amount identified as being onerous (i.e. the excess of the FCF over the consideration paid) can be classified as either goodwill or as a loss on contracts acquired in a transfer.

Section C. Variations to Core Requirements

7 Premium Allocation Approach

7.1 Introduction to Premium Allocation Approach

Q7.1 What is the scope of this chapter?

This chapter provides information about the PAA for liability calculation, including eligibility, measurement, onerous groups and other considerations.

Q7.2 Which sections of AASB 17 address this topic?

Paragraphs AASB 17.53-59 provide guidance on this topic. IFRS 17.BC288-295 also provides background on the subject.

Q7.3 What is the PAA?

The Core Requirements is the default model for measuring insurance contracts under AASB 17. However, AASB 17.53 allows an entity to simplify the measurement of a group of insurance contracts using the PAA in certain circumstances. The following sets out key considerations for actuaries applying the PAA under AASB 17. The PAA method applies specifically to the LRC; however, considerations relating to the LIC are also included below for completeness.

The PAA method is similar to the current 'unearned premium reserve' approaches used for general insurance contracts and some life insurance contracts. A liability is established based on the premium coverage period less an allowance for acquisition costs as in current methods. The LRC then reduces as revenue is 'earned' over the coverage period. While the broad principles underlying the PAA are similar to current approaches, there are some differences set out below.

7.2 Eligibility for PAA

Q7.4 What are the key considerations for PAA eligibility if contract boundary exceeds 12 months

When the contract boundary exceeds 12 months, AASB 17.53 specifies that PAA may be only be used if, at inception of the group of insurance contracts, the LRC for the group would not differ materially from the LRC determined based on the Core Requirements.

Q7.5 What are the key considerations for the application of 'materiality' when applying this test?

In the context of AASB 17.53(a), some key points for consideration in the application of materiality (see **Sub-chapter 1.7 Materiality**) include:

- The measurement of liability for assessing PAA eligibility is performed at inception of the group. AASB 17.53(a) requires that the entity *reasonably expects* that the LRC for the GIC using PAA *would not differ materially from* that using Core Requirements. This implies that, whilst the assessment is performed at the inception of the group, consideration of future expected changes in the liability should also be considered by the entity in making the assessment.
- One possible interpretation of *reasonably expects* is that the PAA and Core Requirements liabilities (calculated at inception) should not show a material difference in a range of scenarios that have a reasonable possibility of occurring. In making this determination, the entity should consider the likelihood of occurrence of each scenario. For example, if there is a reasonably possible scenario modelled whereby the LRC for the PAA and Core Requirements are materially different then the PAA could not be used.
- Differences between PAA and Core Requirements that may affect the assessment of PAA eligibility for a group of contracts include:
    - The expected pattern of revenue recognition over time. In particular, the CSM under Core Requirements is allocated based on *coverage units* reflecting the expected quantity of benefits and duration of contracts in the group (AASB 17.B119) while revenue under the PAA is based on *the passage of time* or *expected pattern of release of risk* (AASB 17.B126).
    - The entity's approach to the recognition of insurance acquisition cash flows and whether it has opted to recognise these cash flows when incurred under AASB 17.59(a) for PAA. This option is not available to contracts measured using Core Requirements.
- AASB 17.53(a) requires PAA eligibility to be assessed for the GIC and therefore materiality should, in the first instance, be considered at the GIC level. However, the materiality of the GIC to the overall financial statements is also a key consideration.
- If a materiality assessment is made based on the materiality of the GIC to the financial statements then the entity may need to re-assess materiality of the relevant GIC or GICs to the financial statements in future periods (for example, if their relative size is expected to change).

The above illustrates how highly reliant on judgement materiality can be, and that close discussion with the internal accounting function and auditors for the entity-specific circumstances will be required.

The choice of the PAA method as a simplification to the Core Requirements should also bear in mind the following question.

Q7.6 What is meant by *significant variability* in AASB 17.54 when considering PAA eligibility?

AASB 17.54 explicitly prescribes that the criterion in AASB 17.53(a) is not met if, at the inception of the group of insurance contracts, the entity expects *significant variability* in the FCF that would affect the LRC during the period before a claim is incurred. AASB 17.54 provides the following examples of where variability in the FCF increases:

1 Where future expected cash flows include the cost of any derivatives embedded in the contracts; and

2 Where the length of the coverage period increases.

The interpretation of *significant variability in the fulfilment cash flows* is currently subject to debate. There are two alternative views as to the role of the risk adjustment in the assessment of the *variability of the fulfilment cash flows*:

- **View 1:** the risk adjustment will, in certain circumstances, move in the opposite direction to changes in the underlying FCF thereby reducing the overall variability of FCF relating to the LRC.
- **View 2:** the risk adjustment will either be unaffected by, or a multiplier for, the variability in future cash flows relating to the LRC.

If view 1 is held then this would reduce the *variability of the fulfilment cash flows* (which is defined to include expected cash flows, risk adjustment, and time value of money) relative to considering the variability of expected cash flows only. In this case, a group of contracts with significant variability in the expected cash flows (i.e. before inclusion of the risk adjustment) would still be eligible for PAA due to the offset provided by the risk adjustment.

If view 2 is held then the variability of FCF will not be affected by the risk adjustment and a group of contracts with significant variability in the expected cash flows would not be eligible for PAA.

View 1 is supported by the following arguments.

- FCF involve a central estimate, discounting and a risk adjustment. A change in central estimate may not change the FCF, either at all or to the same extent, as the impact of the change in risk adjustment may be in the opposite direction depending on the nature of the change.
- Where the risk adjustment includes allowance for certain risks that later crystallise, this is likely to result in a reduction in the risk adjustment following the event's occurrence which would act to offset the variability in expected cash flows, as measured at inception.
- The risk adjustment for future service liability releases over the coverage period, and, in extremis, if all contracts where to lapse or claim, the risk adjustment relating to coverage would release and any offset in incurred claim risk adjustment is outside the ASB 17.54 criteria.

- AASB 17.54(a) - (b) provide examples where the variability in fulfilment cash flows would be expected to increase (longer coverage period and inclusion of embedded derivatives). If these factors are not allowed for in setting the risk adjustment, then AASB 17.54 would not contradict view 1.
- If view 1 is held, then is important to consider which risks are allowed for in the risk adjustment as part of assessing the expected variability of the FCF.

View 2 is supported by the following arguments.

- Variability in the FCF can be explained by random fluctuations from the central estimate. This random variation is not affected by the occurrence of events and subsequent changes to the expected cash flows. The risk adjustment is unchanged and would not affect the variability of the FCF.
- As noted above, AASB 17.54(a) - (b) provide examples where the variability in FCF would be expected to increase (longer coverage period and inclusion of embedded derivatives). AASB 17.B91(b) - (c) indicate that these factors should be allowed for when setting the risk adjustment. If these factors are allowed for in setting the risk adjustment, then this would imply that the risk adjustment is not considered a factor in assessing the variability of the FCF.

If view 2 is held, then the variability of the expected cash flows (with any addition of the risk adjustment) should be considered.

7.3 Measurement considerations

Q7.7 How should insurance revenue be allocated over the coverage period for a group of insurance contracts?

As set out in AASB 17.B126, insurance contract revenue is the amount of expected premium receipts allocated to each coverage period;

> *(a) on the basis of the passage of time; but*
>
> *(b) if the expected pattern of release of risk during the coverage period differs significantly from the passage of time, then on the basis of the expected timing of incurred insurance service expenses.*

Importantly, the revenue recognised is based on expected premium receipts – i.e. irrespective of whether the premiums have actually been received from the policyholder and allowed for as part of the LRC (refer **Q7.11 What are the key considerations under the PAA when testing for onerous contracts subsequent to initial recognition?**).

Considerations:

- meaning of the term *differs significantly from the passage of time*;

- identification of those products whose risk may not be consistent with the passage of time or linear. Examples may include, extended warranty, LMI, crop, construction risk policies; and
- Insurance service expenses would appear to equate to the pattern of risk experienced.

7.4 Onerous Group Considerations

Q7.8 What *facts and circumstances* should be used to determine whether the contracts are measured for onerousness under the PAA approach?

Again, the Standard is not explicit on this matter. It is understood that there also is no strict accounting definition of what *facts and circumstances* mean.

Facts and circumstances is likely to refer to available management information in the form of regular reports, business planning activities, underwriting reviews, industry analysis or commissioned technical analysis that indicate changes in the expected profitability level of a set of contracts. It is also likely to include any material information that is known to the entity or easily ascertained, e.g. if some contracts pay such a high level of acquisition commission that that they are onerous (if the future renewals are outside the contract boundary, and so are ignored) then, the Feb 18 TRG discussion of AP04 *Insurance acquisition cash flows paid on an initially written contract,* indicates that these should be grouped as onerous.

The indication could be in the form of a change in trend assumption or the identification of a subset of contracts that is expected to generate different profitability level within a portfolio. It is not expected that a valuation assessment will be performed strictly for the purpose of finding onerous contracts. This is likely to be part of the regular internal management processes, which may be heavily reliant on actuarial experience investigations and analysis of change.

An overarching principle is that the onerous contract tests should be carried out by using *all reasonable and supportable information available without undue cost or effort*.

Q7.9 What are the key considerations under the PAA when testing for onerous contracts subsequent to initial recognition?

AASB 17.57 requires that, if facts and circumstances indicate a group of contracts may be onerous at any time during the coverage period, then the entity needs to test this by performing a calculation of the difference between:

- the LRC for the group, assessed using PAA, and

- the FCF for the remaining coverage, estimated based on the approach prescribed in AASB 17.33-37, including discounting and an explicit risk adjustment.

AASB 17.58 then prescribes that if the FCF calculated using this approach exceed the carrying amount of the liability using PAA, then the group of contracts is onerous and a loss must be recognised in the P&L and there must be an increase in the LRC.

The above implies that a method for projecting cash flows, discounting them, and allowing for an explicit risk adjustment should be considered for the purpose of onerous contract testing.

The test set out in AASB 17.57 is not required to be performed on a regular basis for any or all groups of contracts but rather is only required if facts and circumstances indicate that the contracts may be onerous at any time during the coverage period. For further information on what constitutes indicative facts and circumstances, refer **Chapter 2 Aggregation and Contract Boundary**.

Q7.10 What are the key considerations in determining whether a group of contracts has a *significant financing component* as noted in AASB 17.56 and what are the key considerations when allowing for the time value of money as part of the LRC?

LRC

Discounting the LRC is optional when a group is deemed not to have a significant financing component. The term *significant financing component* is not defined in AASB 17 and interpretations are still developing.

Some guidance is provided with IFRS 17.BC292(a), which states that a group is deemed not to have a significant financing component when the period between premiums being due and the provision of coverage is one year or less. By implication, a significant financing component could be argued to occur when the period between premiums being due and the provision of coverage is more than 12 months.

LIC

Discounting the LIC is also optional if those cash flows are **expected** to be paid or **received** in one year or less from the date the claims are incurred (AASB 17.59(b)).

The term 'expected' can be inferred from a reading of AASB 17.33(a), AASB 17.B18, AASB 17.B37 etc. to relate to 'probability-weighted estimate'. In other words, the probability-weighted mean (IFRS 17.BC19(a)).

The term 'received' has the same meaning as given to other usages of that term in the Standard, notably 'premiums received'.

7.5 Other PAA considerations

Q7.11 What are key considerations relevant to *premiums received* per AASB 17.55 when applying PAA?

It is important to make a distinction between the following two key paragraphs which are relevant to the discussion below:

1. AASB 17.55 which prescribes the measurement of the LRC; and
2. AASB 17.B126 which prescribes how revenue is recognised over the coverage period.

The definition of 'premiums' in each paragraph differs as follows:

- AASB 17.55 refers to *premiums received* upon initial recognition and subsequently for the purpose of liability measurement, however
- AASB 17.B126 refers to *expected premium receipts* (which may or may not have been actually received by the entity) for the purpose of allocation of revenue over the coverage period.

The AASB 17 use of *premiums received* in calculating the LRC means that the liability determined under PAA is affected by:

- early or late payment of premiums by policyholders, and
- the timing of payments by policyholders – e.g. monthly, quarterly, annually in arrears or in advance.

The timing of premium payments may result in different reserves under PAA compared with AASB 1023. Under AASB 1023 the liability is based on the 'unearned' portion of the premium due at the balance date and a 'premium receivable' asset is established for premiums due.

To illustrate this, consider the following very simple example:

- Home and contents policy, premium of $500 p.a. payable in advance.
- For simplicity, assume no upfront acquisition costs.
- Premium is earned evenly over the 12 month coverage period.
- Period on risk is 1 January – 31 December but premium has not been paid by the policyholder on 1 January inception date.
- The premium is eventually paid by the policyholder on 15 February.

AASB 1023 balance sheet

Inception:

Liability for remaining coverage:	*500*
Premium receivable asset	*500*

Net asset position	*0*

At 30 January

Liability for remaining coverage:	*458.3 (i.e. 11/12ths of premium still to be earned)*
Premium receivable asset:	*500*
Net asset position:	*41.7*

Under AASB 1023, 1/12th of the premium is 'earned' during the month and released through the P&L. This is irrespective of whether the premium has been actually received from the policyholder.

At 28 February

Liability for remaining coverage:	*416.7 (i.e. 10/12ths of premium still to be earned)*
Premium receivable asset:	*0*
Cash:	*500*
Net asset position:	*83.3*

Under AASB 1023, 2/12ths of the premium has been earned and the cash has now been received resulting in a credit to the premium receivable.

AASB 17 balance sheet

At inception:

Liability for remaining coverage:	*0 (as no premium received)*
Premium receivable asset:	*N/A (no allowance for this in AASB 17)*
Net asset position:	*0*

AASB 17 balance sheet

At 30 January

Liability for remaining coverage:	*-41.7 (as no premium received but revenue has been recognised in accordance with AASB 17.B126 and **expected** premium receipts)*
Premium receivable asset:	*N/A (no allowance for this in AASB 17)*
Net asset position:	*41.7*

At 28 February

Liability for remaining coverage:	*416.7 (i.e. -41.7 opening liability + 500 received – 41.7 additional revenue recognised)*
Cash	*500*
Net asset position	*83.3*

At the end of February, the premium has now been received and the LRC more appropriately reflects the premium liability yet to be earned. While the premium is outstanding, the risks to which the entity is exposed (namely insurance coverage) are not well reflected in the LRC.

Because the LRC is calculated based on premiums received (per AASB 17.55) but revenue is recognised based on expected premium receipts (per AASB 17.B126), revenue can be recognised on contracts where premiums have not yet been received.

In summary, the interpretation of 'premiums received' is clear under the Standard, however for the reasons noted above, this is likely to lead to counterintuitive outcomes in some circumstances. As a result, there is some discussion on this topic and further clarification of the treatment of premiums under AASB 17 may be expected in the future.

It is noted that this treatment is also relevant for life insurance policies valued under AASB 1038 using an 'accumulation' method to simplify the calculation. Some life insurance policies are expected to use PAA under AASB 17 and this issue also applies in these circumstances.

This treatment is also relevant for health insurance. For policies payable monthly in advance, there would be no expected premium receipts (unless a policyholder is late on payment) and no LRC. If a policyholder was late on payment treatment would follow the same general approach as the Home and Contents example above, with a negative asset for the expected premiums receipts for the month already earned.

This treatment of *premiums received* does not impact the contract boundary.

Q7.12 How are acquisition costs recognised under PAA?

When using the PAA an insurer may either recognise any insurance acquisition cash flows as expenses when it incurs those costs (allowable if coverage is a year or less) or amortise acquisition costs in line with the earning of the premium associated with the contract giving rise to the acquisition costs. Amortising of all or part of the acquisition costs cannot be deferred beyond the contract boundary of the initial contract that gave rise to the costs.

8 Direct Participation Features

8.1 Introduction

Q8.1 What is the Scope of this Chapter?

This chapter provides information about the treatment of contracts with direct participation features under AASB 17, including eligibility.

Q8.2 Which sections of AASB 17 address this topic?

AASB 17.B101-B118 specifically address this topic, but there are also references in many other paragraphs. IFRS 17.BC238-BC269 also provides background on the subject.

Q8.3 What is the VFA?

The variable fee approach or "VFA" is a modification of the core requirements of AASB 17 that is **only applicable** to life insurance contracts with direct participation features. The entity's interest in the investment portfolio underlying these products is viewed as "equivalent" to a "variable fee" that is charged to policyholders and expressed as a share of returns. The fee could be, for example, a percentage of funds under management, or a share of profits.

(The variable fee approach was the terminology the IASB used during development of IFRS 17 for these modifications, but is not used in AASB 17 or supporting material issued by the IASB.)

8.2 Eligibility to use the Variable Fee Approach

Q8.4 How does the VFA differ from the Core Requirements?

On inception, there is no difference between the VFA and the Core Requirements. All of the building blocks are calculated in the same way. The difference arises in subsequent periods where, in summary, changes in the entity's share of future profits are adjusted for in the CSM and interest accretion uses current rates rather than locked in rates as under the Core Requirements. See **Section B Core Requirements** for a detailed discussion of the Core Requirements.

Q8.5 What are *insurance contracts with direct participation features*?

Insurance contracts with direct participation features are substantially investment-related service contracts under which an entity promises an investment return based

on underlying items (AASB 17.B101). Three criteria must be met at inception for this classification:

- *the contractual terms specify that the policyholder participates in a share of a clearly identified pool of underlying items* (AASB 17.B105-106 expand on this criteria);
- *the entity expects to pay to the policyholder an amount equal to a substantial share of the fair value returns on the underlying items* (AASB 17.B107 expands on this criteria); and,
- *the entity expects a substantial proportion of any change in the amounts to be paid to the policyholder to vary with the change in the fair value of the underlying items* (AASB 17.B107 expands on this criteria).

The interpretation of *the term "substantial" is in the context of the objective of insurance contracts with direct participation features being contracts under which the entity provides investment-related services and is compensated for the services by a fee that is determined by reference to the underlying items* (AASB 17.B107-B108).

Only contracts that meet the above definition are eligible to use the VFA, and they must use the VFA if so eligible.

Q8.6 What is a *clearly identified pool of underlying items*?

The pool of underlying items referred to in AASB 17.B101(a) can comprise any items. This might include, for example, a reference portfolio of assets, the net assets of the entity, or a specified subset of the net assets of the entity, as long as they are clearly identified by the contract (AASB 17.B106).

Q8.7 Does the entity need to hold the underlying items?

No. The life company does not need to hold the identified pool of underlying items (AASB 17.B106). For example, the underlying items could be an index to which benefits are linked.

Q8.8 What is a *substantial share* of the fair value returns from the underlying items?

AASB 17.B107 specifies that the interpretation of *'substantial'* is in the context of contracts which provide investment-related services for which the entity receives a fee (explicit or implicit, as described in **Q8.3 What is the VFA?**) that is determined by reference to the underlying items. The fee will usually be a small percentage of the returns, such that the bulk of the returns will be passed on to the policyholder. What is a *substantial share* is thus a judgement call about the **usual** (since it could vary between periods) size of this percentage.

Q8.9 Can the entity exercise discretion and still be eligible for the VFA?

Yes. The requirement for the policyholder to participate in a substantial share of the returns does not preclude the use of discretion by the entity to vary the amounts paid to the policyholder. However, the link to the underlying items must be enforceable (AASB 17.B105).

For many older participating contracts, the Life Insurance Act 1995 ('Life Act') could be considered to create the enforceable link to the underlying items.

Q8.10 What is a *substantial portion* of any change in the cash flows that the entity expects to pay to the policyholder that vary with cash flows from the underlying items?

AASB 17.B107 specifies that, here, too, the interpretation of *'substantial'* is in the context of contracts which provide investment-related services for which the entity receives a fee that is determined by reference to the underlying items. The assessment of a *substantial portion* will depend on how the expected returns on the underlying items compare with any guarantee – and hence what proportion of the benefit to the policyholder is expected to be fixed, and what proportion is expected to vary with the underlying items. Usually, the lower the guarantee, the higher will be the proportion expected vary with the underlying items. This issue is elaborated on further in **Q8.11 How does having a minimum guarantee affect the assessment of eligibility for VFA?**

Q8.11 How does having a minimum guarantee affect the assessment of eligibility for VFA?

Where there are minimum guarantees (e.g. minimum crediting or bonus rates) the third "test" for VFA treatment needs to reflect the expected present value over all scenarios (see AASB 17.B108). As a result, where a guarantee results in only a small proportion of a policyholder's return being expected to vary, the product would not be subject to VFA treatment.

Q8.12 How does the level of bonuses affect the assessment of eligibility for VFA?

In contrast to the previous question, the expected present value over all scenarios looked at in assessing the third "test" needs to consider the level of bonuses relative to the guaranteed component of the benefit to policyholders. As a result, where the level of bonuses is sufficiently low, the product would not be subject to VFA treatment.

Q8.13 When is the assessment done?

Assessment for VFA eligibility is done at inception of the contract and may not be reassessed subsequently (see AASB 17.B102) unless the contract is modified in a significant enough way that reassessment is required for the modified contract under AASB 17.72.

Q8.14 Can the VFA be applied to reinsurance contracts?

No. Under AASB 17.B109, reinsurance contracts held or issued cannot be treated as insurance contracts with direct participation features and hence the variable fee approach cannot be used to measure these contracts. (This might be a problem for co-insurance of old Conventional contracts, but is unlikely to be material.)

See **Chapter 9 Reinsurance and External Risk Transfers** for more discussion on reinsurance.

8.3 Likely VFA eligibility for Australian products

Q8.15 Will the VFA be used for all products that are currently participating?

Not necessarily. The definition of whether a contract is "participating" per the Life Act (supported by Prudential Standard LPS 600 Statutory Funds, issued by APRA), is different to the AASB 17 definition of an insurance contracts with direct participation features. Hence the application of the VFA approach may not apply to all participating products. However, there is likely to be a strong correlation between the two groups of products.

Q8.16 Which Australian products will meet the criteria for VFA treatment?

Each company's product set is unique and needs to be considered individually to determine the appropriate AASB 17 classification. The likelihood of the VFA being used for "standard" Australian products is set out in the table below. All three tests need to be satisfied for the product to be eligible for the VFA (although the conclusion from AASB 17.B101 is that products need to be substantially investment related as well – although we are aware that some jurisdictions may not take that view).

Existing products are, accordingly, classified into the following four main groups:

- most likely to be eligible for VFA;
- probably eligible for VFA;
- probably not eligible for VFA; and
- not eligible for VFA.

See the 'light blue' coloured dividers in the table.

Table 8.1: Which Australian products will meet the criteria for VFA treatment

Product[1]	Par or Non-par[2] under Life Act	Substantially Investment Contract (AASB 17.B101)	Three tests for direct participation features (AASB 17.B101)		
			Clearly identified pool of assets?	P/H share of pool experience is substantial?	Substantial proportion of changes in policy holder cash flow comes from pool experience?
Most likely to be eligible for VFA					
Participating Conventional life insurance	Par	Yes	Yes	Yes	Yes, although the level of bonuses relative to guaranteed benefits needs to be considered.
Investment linked contracts with term rider that cannot be separated by the policy owner.	Non-Par	Yes	Yes	Yes	Yes
Probably eligible for VFA					
Investment account	Par	Yes	Yes	Yes	Probably. It depends on expected return allowing for pool experience versus guaranteed return.
Investment account	Non-Par	Yes	Sometimes	Yes	
Participating annuity contracts	Par	Yes	Yes	Yes	
Probably not eligible for VFA					
Participating group insurance contracts	Par	No	Yes	Yes	Probably not. Most benefit to policyholders comes from fixed claim payments, not the profit share, and so the proportion of benefit that varies with underlying items is small. This is consistent with the consideration of guaranteed investment returns (see AASB 17.B108).
Group insurance contracts with-profit sharing	Non-Par	No	Yes	Yes	Probably not. Most benefit to policyholders comes from fixed claim payments, not the profit share, and so the proportion of benefit that varies with underlying items is small. This is consistent with the consideration of

Product[1]	Par or Non-par[2] under Life Act	Substantially Investment Contract (AASB 17.B101)	Three tests for direct participation features (AASB 17.B101)		
			Clearly identified pool of assets?	P/H share of pool experience is substantial?	Substantial proportion of changes in policy holder cash flow comes from pool experience?
					guaranteed investment returns (see AASB 17.B108).
Not eligible for VFA					
Stand Alone Investment Linked contracts	Not an insurance contract under AASB 17				
Individual life insurance or disability contracts (both level term and stepped).	Non-Par	No	No	n/a	n/a
Group Life insurance contracts no profit share.	Non-Par	No	No	n/a	n/a
Investment Linked contracts with separable term riders	If the benefits can be separated by the entity, then they should be, with eligibility for the VFA assessed for each separate component.				
Investment account contracts with a separable IA investment option	If the benefits can be separated by the entity, then they should be, with eligibility for the VFA assessed for each separate component – as above, the IA investment option may then be eligible for the VFA.				
Non-Participating Conventional life insurance	Non-Par	Arguably, Yes	No	n/a	n/a
Life annuity contracts	Non-Par	Arguably, Yes	No	n/a	n/a
Term annuity contracts	Non-Par	Arguably, Yes	No	n/a	n/a

Product[1]	Par or Non-par[2] under Life Act	Substantially Investment Contract (AASB 17.B101)	Three tests for direct participation features (AASB 17.B101)		
			Clearly identified pool of assets?	P/H share of pool experience is substantial?	Substantial proportion of changes in policy holder cash flow comes from pool experience?
General insurance contracts	n/a	No	No	n/a	n/a
Health insurance contracts	n/a	No	No	n/a	n/a

[1] Conventional, investment account, annuity and unit linked contracts can be on an individual or group basis.

[2] Per Life Insurance Act 1995 – section 15, with supporting clarifications in LPS 600 – Statutory Funds.

Note that contracts issued by Discretionary Mutual Funds are not considered insurance, and have been excluded from this analysis.

Q8.17 What are the underlying items per the VFA definition likely to be?

Each company's products and product management approach needs to be considered individually to determine the correct pool of underlying items. The table below is a guide to what is likely to be included.

Table 8.2: Guide of Likely Underlying Items per VFA Definition

Product	Underlying Items
Participating Conventional life insurance (Whole of Life and Endowment). **Participating Investment Account.**	The returns from underlying items can be viewed as the contribution of investment, expense, mortality, morbidity, lapse and policy alteration experience to policyholder returns. The investment returns are generally provided by ring-fenced assets. In the case of participating business, the assets are normally the Value of Supporting Assets (VSA), Policy Owner Retained Profits (PRP) and Shareholder Retained Profits Participating (SRPP), although support may be provided by Shareholder Retained Profits Non Participating (SRPNP). (Note that SRPP may be in the pool, but not necessarily in the liability.) Bonuses are the mechanism for paying the policyholder, with concepts such as Policyholder reasonable benefit

Product	Underlying Items
	expectations (PRBE), asset shares and estates often guiding bonus decisions.
Investment linked contracts with term riders that cannot be separated by the policy owner.	Invested assets.
Non-Participating Investment account contracts.	The returns from the underlying items can be viewed as the contribution of investment experience to policyholder returns. The investment returns are generally provided by a ring-fenced asset pool. Crediting rates are the mechanism for paying the policyholder, with concepts such as Investment Fluctuation Reserve (IFR) often guiding crediting rate decisions.
Participating annuity contracts	Mechanisms (where investment or mortality experience results in adjustments to annuity payments) are an underlying item per the VFA definition.

Note that it is not necessary for the entity to actually hold the pool of underlying items, neither is it necessary for the pool just to consist of assets (see AASB 17.B106).

The movement in the pool drives bonuses – i.e. the policyholder has a substantial share of the pool returns, not of the pool itself.

It is not clear what the pool is for group risk business with-profit sharing, if such business is eligible for the VFA (see **Q8.16 Which Australian products will meet the criteria for VFA treatment?**).

8.4 Projection of FCF

Q8.18 Is a projection of future cash flows required under the VFA?

The VFA is just a modification of the core requirements of AASB 17. As such, all the components of a liability (future cash flows, risk adjustment, discounting, CSM - see AASB 17.32) exist under the VFA, and generally operate as they would under the core requirements. However, the specifics of that operation may differ under the VFA.

Q8.19 What is the estimate of future cash flows?

The estimate of future cash flows shall be an estimate of the probability-weighted mean of the full range of outcomes within the boundary of the contract. The requirements for such estimation are stipulated in paragraphs AASB 17.33–37, and AASB 17.B36–B92. There is nothing in AASB 17 that says that those requirements are different under the VFA than generally.

It is noted that the cash flows are those made by (or to) the entity (see AASB 17.33(b)) – i.e. they are to (or from) the policyholder or some other party. Accordingly, the CSM relates to future profit attributable to the entity only – it should not include profit to any other party.

Q8.20 How are policyholder bonuses to be treated?

The cash flows include (among other things) benefit payments under the contract to policyholders (see AASB 17.B65(b)). Policyholder bonuses are included in such benefit payments and so need to be included in the estimation of cash flows. AASB 17.B65(c) specifically refers to *payments to (or behalf of) a policyholder that vary depending on returns on underlying items*. The opening paragraph of AASB 17.B65 also refers to *cash flows for which the entity has discretion over the amount or timing*.

For this purpose, the full "supportable" bonus is assumed to be included in the cash flows as soon as it is earned. (See the comment below about the need to include PRP to cater for differences between past supportable bonuses and those that have actually been declared.)

The outcome of this is that the CSM is essentially the profit due to the entity or shareholder (the 'profit' to the policyholder being included in the estimate of future cash flows). It is expected that the present value at inception of the shareholder profit will be the same as currently (e.g. 20% of the investment returns on the underlying items). The pattern of release of that profit (i.e. through P&L) will depend on the rules under AASB 17 (i.e. in proportion to coverage units) rather than currently (in proportion to bonuses). Accordingly, the recognition of profit over time will differ under AASB 17 from currently – the balance of unrecognised profit will be retained in the CSM component of the liability.

The quantification of the future policyholder bonuses to be included in the projection of future cash flows needs to be determined separately from the liability calculation under AASB 17. Unlike currently, the (expected) policyholder bonuses will not be an outworking of the valuation calculations. (Currently, the liability is effectively the value of the pool of underlying items, from which the policyholder bonuses are derived. Under AASB 17, and assuming no changes to the Life Act, policyholder bonuses are still to be estimated similarly – according to the contractual terms – even though the pattern of recognition of profit for the shareholder may not be linked to such bonuses.) Thus, if policyholder bonuses are based on the returns on the Value of Supporting Assets (say, 80% of those returns) then policyholder bonuses are still to be

determined in that way (but see following paragraph). However, because the liability under AASB 17 includes the CSM, and CSM is not released in the same way that profit is currently, the liability under AASB 17 will deviate from the Value of Supporting Assets.

The liability under AASB 17 should also include a component equivalent to PRP (positive or negative) to allow for differences between past expected bonuses and actual declared bonuses. Such differences have arisen from returns on the underlying items, and are expected to be declared in future, and so the estimation of future cash flows needs to include them.

Q8.21 How should other discretionary cash flows be treated?

The same applies where the cash flows include other discretionary items, as per the reference in the opening of AASB 17.B65 to *cash flows for which the entity has discretion over the amount or timing*. For example, bonuses might be paid via reductions in premiums, or expenses could vary based on returns on underlying items. These should also be included in the estimation of cash flows. As with policyholder bonuses paid by way of augmentation to policyholder benefits, such cash flows need to be quantified separately from the liability calculation under AASB 17 – i.e. as currently determined, based on the pool of underlying items.

Q8.22 How should mutual cash flows be treated?

AASB 17 includes paragraphs specifically dealing with mutual cash flows (i.e. cash flows that affect or are affected by cash flows to policyholders of other contracts – see AASB 17.B67–B71). AASB 17.B103 specifically says that such cash flows may arise in the context of contracts eligible to use the VFA.

The expectation is that specific cash flows will be included when estimating future cash flows. However, such cash flows may only arise when returns on underlying items are such that the group becomes onerous. The need for such cash flows may be obviated through the choices made in respect of grouping (e.g. a larger and more diverse group is less likely to require cash flows from outside the group as profits from contracts within the group could offset losses from other contracts within the same group).

In the same way that cash flows related to policyholder bonuses include differences between expected bonuses and actual declared bonuses currently held in PRP, mutual cash flows would also include payments to or from PRP which prevent a group from otherwise becoming onerous.

8.5 Risk Adjustment

Q8.23 How should the Risk Adjustment be determined under AASB 17 for contracts eligible for the VFA?

There are no specific carve outs in relation to the Risk Adjustment for contracts eligible for the VFA. The principles that apply to its determination generally still apply.

It is noted particularly that the Risk Adjustment is based on the risk aversion of the entity. It is only needed as compensation for the risks faced by them, and hence is included in the liabilities incurred by them. A Risk Adjustment is therefore not needed for risks borne by the policyholders. Consequently, if the policyholder shares in 80% of the 'profits' then the Risk Adjustment needs to be only 20% of what it would be if the shareholder bore all the risks of varying experience.

It is also noted that the Risk Adjustment is only for non-financial risk - so it might be small for most contracts eligible for the VFA (even for guarantees) where the main risk arises from investments volatility.

In particular, no Risk Adjustment is needed if the risk (particularly that arising from guarantees) is hedged by derivatives – in that case the risk is passed on to the writer of the derivative. It is noted that entities do have a choice for how derivatives are disclosed (see **Chapter 11 Disclosure**).

8.6 Coverage Units

Q8.24 What nuances are there in the calculation of coverage units for contracts eligible for the VFA?

There are differing views as to whether coverage units should be based on Sum at Risk (Insurance Benefit – Value of Investment Component (i.e. surrender Value)) or Insurance Benefit. For contracts with an investment component (i.e. contracts eligible for the VFA) the two will be different. See **Q6.11 What is a coverage unit?** for further general discussion.

If Sum at Risk is to be used then, for contracts eligible for the VFA, it is noted that the actual Sum at Risk could vary as account balance varies. A stochastic projection has been postulated determining the expected Sum at Risk over all scenarios. However, it is questioned how material any difference might be, and a deterministic approach may therefore be acceptable.

Similarly, the Surrender Value may not be the same as the Account Balance where there are surrender fees or penalties.

For Conventional business, the Insurance Benefit will not only include the Sum Assured, but also any bonuses (reversionary or terminal). For this purpose, future bonuses are to be determined in the same way that future cash flows are determined.

8.7 Asymmetry

Q8.25 How is asymmetry treated for contracts eligible for the VFA?

The estimate of future cash flows shall be an estimate of the probability-weighted mean of the full range of outcomes. Hence, any asymmetry in the possible outcomes would be captured within this estimate of future cash flows. Similarly, where the risk of asymmetry is hedged, then the value of any hedging derivatives may be included in the pool of underlying items, offsetting the value of the assets in that pool.

Whilst the standard requires an understanding of the full range of potential outcomes, it acknowledges that a variety of methods of calculation could be suitable for arriving at the estimate. These include stochastic modelling, the use of probability distributions and relatively simple modelling.

Q8.26 How do changes in the impact of asymmetry affect profit?

Because the impact of asymmetry is incorporated into the estimate of future cash flows, its impact on profit is the same as for other FCF.

AASB 17 appears to specifically require changes in the value of options and guarantees for contracts eligible for the VFA to be offset by changes in the value of the CSM, so long as this margin does not become negative. That is, if the risk of asymmetry is not hedged, then the profit to the entity will be reduced by the value of the options and guarantees.

Where derivatives are used to mitigate the impact of options and guarantees, but such derivatives are not in the pool of underlying items, then the movement in value of the options and guarantees does not have to be offset by a change in the CSM. This is to avoid an accounting mismatch, where the movement in the derivatives goes to profit but the movement in the options/guarantees is offset by the CSM.

Q8.27 Is there a material change from current approaches in the treatment of asymmetry?

The required outcomes of both AASB 17 and AASB 1038 are similar and both allow flexibility in the method of calculation. As a result, methods of allowing for options and guarantees that are currently used are expected to remain suitable for AASB 17 purposes.

AASB 17 does not contain the shareholder/policyholder delineation that exists within the Life Act. A reserve for asymmetry is currently held under AASB 1038, but outside the participating environment. Accordingly, treatment under AASB 17 is expected to now be simpler (in as much as asymmetry just requires an adjustment to cash flows and CSM) and may not have a material impact on the profit results.

Similarly, insurers in Australia (being still bound by the Life Act), may not be able to exercise the option under AASB 17 of including derivatives in the pool of underlying items. An issue would be whether policyholders can share in the returns on any derivatives. If so, then it would seem appropriate for them to be included in the pool of underlying items.

It is noted that there has been some difference of opinion amongst practitioners in the past (e.g. does AASB 1038 require a reserve in advance, or is it sufficient to recognise a loss when the guarantee 'bites'?). Different companies therefore approach the reserve for asymmetry differently. However, it would appear that AASB 17 is more definite in terms of the requirement to hold a reserve in advance for asymmetry: i.e. a reserve also needs to be held for the time value of the equivalent option.

The potential for overlap between the risk of asymmetry and the need for a Risk Adjustment is also noted. If the asymmetry is related to financial returns (which in most cases it is), then it affects discount rates and / or cash flows, not Risk Adjustment. Given that the risk of asymmetry is likely to be financial, a Risk Adjustment is unlikely to be needed, unless the risk is deemed to arise from the contract terms – see **Sub-chapter 8.5 Risk Adjustment**.

8.8 Expenses

Q8.28 Is there any difference between the way expenses are treated under AASB 17 and how they are treated in the pool of underlying items?

Under AASB 1038 all costs allocated to participating contracts are included in the VSA, and hence in the liability i.e. the VSA for participating business will include its projected share of indirect expenses, and the policyholder will participate in the cost of these.

The supportable bonus rate reflects all the expenses whether direct or indirect.

For AASB 17, the insurance result will reflect only the directly attributable costs in the FCF, and the indirect costs will flow through as an expense to the shareholders outside the insurance results. The FCF will, however, reflect a bonus rate that includes the policyholder share of all expenses, so the present value of the policyholders' share of indirect expenses will be reflected in the CSM, which will be released as the coverage units are "released". This additional insurance profit (from bonuses being reduced by more than the expenses allowed for in the insurance result) will be available to defray the indirect costs.

To the extent that the "run-off" pattern of coverage units is different to the incurrence of the indirect costs, then there will be a timing difference between the profit (CSM) release and the (indirect costs) cash flow.

Changes in the policyholders' share of the "overhead unit cost" will effectively be spread through the CSM in a similar way.

Example

A one year contract boundary is assumed in this example and the insurance benefit paid (part of the FCF) is the policyholder 'profit' for the year.

It needs to be noted that the 'profit' under the Life Act (which is split 80:20) is not the same as the profit to the shareholder after meeting all payments (including those to policyholders). Under AASB 17 expenses should include **all** directly attributable expenses, even those attributed to policyholders, since bonuses are reduced by them and cash flows should include all those paid by the shareholder. The presentation of results to APRA to demonstrate that the Life Act is being complied with will therefore be an issue.

Table 8.3a: Illustrative example of AASB 1038 Treatment of Expense Allocated to Participating Business

	Insurance Result			Other	Total
	PH	SH	Total	SH	SH
	0.8	0.200		100%	
Expenses					
Direct	56	14	70		
Indirect	24	6	30		
Total	**80**	**20**	**100**	**0**	**20.0**
Benefit Payments (= Bonus)					
Expenses					
FulFilment Cash Flows					
Contractual Service Margin					
Insurance Income					
Insurance Income	800	200	1000		
Expenses	80	20	100		
Profit	**720**	**180**	**900**	**0**	**180.0**
Profit % Total	80%	20%			20%

Table 8.3b: Illustrative example of AASB 17 Treatment of Expense Allocated to Participating Business

	At Inception	Insurance Result			Other	Total
		PH	SH	Total	SH	SH Profit
		80%	20%		100%	
Expenses						
Direct		56	14	70		
Indirect					30	
Total		**56**	**14**	**70**	**30**	
Benefit Payments (= Bonus)	720					
Expenses	70					
FulFilment Cash Flows	**790**					
Contractual Service Margin	210					210
Insurance Income	**1000**					
Insurance Income						
Expenses						(30)
Profit						**180**

8.9 Reinsurance considerations

Q8.29 Are there any special considerations that arise for contracts eligible for the VFA where reinsurance is present?

Although AASB 17 requires cash flows arising from reinsurance to be excluded when estimating cash flows for the underlying gross contracts (AASB 17.B66(b)), if they are part of the underlying items which drive payments to policyholders, then they are to be appropriately included for this purpose as per AASB 17.B65(c). Note that AASB 17.B65(c) allows the net cost of reinsurance (premiums less recoveries) to be included in the measurement of the underlying gross contracts only if this cost is included in the profits shared under the contract – i.e. under the Life Act.

Note that this does not permit:

- the measurement of the underlying liability to be based on net of reinsurance cash flows; or
- the cost of reinsurance to be included for any participating business that is not eligible for the VFA.

See **Chapter 9 Reinsurance and External Risk Transfers** for a general discussion about reinsurance.

8.10 Non-Investment Experience

Q8.30 How is non-investment experience treated for business eligible to use the VFA?

In the VSA under AASB 1038 non-investment experience is explicitly deducted in full (both effects in the current period and resulting differences in future cash flows) and in all circumstances. For AASB 17, the treatment of non-investment experience is different, and relates to the pool of underlying items.

If the **policyholder does not share** in such experience (i.e. all profits go to the shareholder) then the related benefits will be treated as they are under the Core Requirements. Differences between actual and expected cash flows in the current period will be immediately recognised as profit in the P&L. Resulting differences in future cash flows will be absorbed by the CSM, as they would under the Core Requirements – this is elaborated on in **Q6.6 After initial recognition, what changes are recognised in the CSM?** and **Q8.31 What changes in the FCF do not vary based on the returns on underlying items?**).

Through the VFA mechanism this is achieved by increasing the variable fee (which is absorbed into the CSM) by the amount by which the CSM would be adjusted under the Core Requirements for differences in future cash flows. The experience in the current period is then immediately recognised as profit in the P&L, as it would under the Core Requirements.

If the **policyholder does share** in such experience with the shareholder (e.g. if the pool of underlying items includes the total profits from particular contracts) then the related benefits will all be reflected in the pool of underlying items, and hence by the CSM. This includes both differences between actual and expected cash flows in the current period, **and** resulting differences in future cash flows.

Through the VFA mechanism this is achieved by also adjusting the variable fee by the difference between actual and expected cash flows in all periods (as the fair value of the pool is changed by that amount). The experience in all periods is thus absorbed in the CSM and emerges in the future.

Note that resulting differences in future cash flows (from volume changes) should be included in the pool and so absorbed by the CSM (regardless of whether or not profits are shared with policyholders), consistent with the treatment for non-par contracts.

Note that the treatment of non-investment experience for participating business is different from the treatment under AASB 1038, where non-investment experience is deducted from the VSA regardless.

Finally, note that the policyholder share of profit (which includes experience in future periods) needs to be included in bonuses or cash flows – as per contractual requirements – independent of its treatment under AASB 17.

Q8.31 What changes in the FCF do not vary based on the returns on underlying items?

A consequence of the decision that changes in future cash flows from experience during the period should adjust the CSM rather than be recognised immediately, was that a similar adjustment needed to be made for contracts using the VFA where experience did **not** affect the pool of underlying items. The original reference was in paragraph 38 of **AP02 in February 2017**. A similar reference was then made in paragraph 39 of that same paper, and subsequently manifested itself in AASB 17.B113.

However the wording of each of these references is slightly different, such that we have gone from 'cash flows affecting the pool', to 'the pool affecting cash flows'.

In the context of what was intended, the original wording would seem to make more sense. That is, the adjustment for contracts eligible for the VFA should be equivalent to the adjustment required for non-participating business. However, under the VFA, an adjustment to the CSM is already made for experience which **does** affect the pool of underlying items, so a further adjustment – equivalent to that for non-participating business – is only needed where experience does **not** affect the pool of underlying items.

Hence, the interpretation of AASB 17.B113(a) (and the adjustment to CSM which results) is that subsequent recognition through CSM should **not** apply to changes in FCF arising from experience that does not affect the pool of underlying items. The policyholder does not share in the profits or losses from such experience.

8.11 Friendly Societies

Q8.32 How does VFA apply for Friendly Societies?

The Friendly Society products that may be eligible to use the VFA are:

- Capital Guaranteed Investment Account funds
- Capital Guaranteed Funeral Bonds
- Conventional products where all Benefit Fund assets are applied for the benefit of members

How the VFA applies to these products depends on a number of aspects.

It is possible that a friendly society may have no products at all that are subject to AASB 17. (Note that the applicability of AASB 17 generally to Friendly Societies depends on whether they even offer insurance contracts, as investment contracts with discretionary participation features only fall under AASB 17 if the entity also has insurance contracts.) The points in sub-chapter 1.10 about mutuals are also relevant. Also, it is not clear whether the PAA can be used for determining what insurance liabilities they may have.

8.12 Aggregation

Q8.33 How might grouping be different for contracts eligible to use the VFA?

AASB 17 has paragraphs specifically on mutualisation (AASB 17.B68-B71 and AASB 17.B103). These allow that in calculating the value of expected cash flows an allowance can be made for cash flows originating from contracts in other groups, not just cash flows arising solely from contracts in that group. Similarly, when doing this calculation, cash flows implicitly transferred to other groups are to be excluded. Note that this ability assumes that profit from the donor group has not already been released.

The existence of AASB 17.B103, and the examples used in other paragraphs, indicates that this is particularly relevant for some business eligible to use the VFA (where participation traditionally involves sharing by a large group of policyholders, regardless of their profitability or year of issue, and includes both current and future policyholders).

Because of the allowance for cash flows to be transferred between groups, what would otherwise be an onerous group will potentially be profitable. Similarly, if a group is potentially about to become onerous, then a transfer from a profitable group is expected to prevent that. On this basis, unless the whole portfolio is onerous, or becomes onerous (which is very unlikely), there are no groups which at inception would be onerous or likely to become onerous

One might even argue that there is no point in sub-dividing groups by year of issue, because cash flows from a more profitable cohort could be transferred to a less profitable cohort. The ability to transfer between cohorts means that the profitability for business written in separate years should be less differentiated. Certainly, no cohorts are expected to be onerous (although positive profitability might still vary between cohorts).

However, the IASB has stipulated that groups ordinarily be differentiated by year of issue (transition notwithstanding). This is because the IASB expects that profitability would vary over time, and at the extreme one cohort might be onerous while another is profitable. The IASB did not want this information obscured by offsetting onerous contracts in one group with profitable contracts in another (see IFRS 17.BC119 and the last two sentences of IFRS 17.BC136).

The IASB therefore, still felt that subdivision by year of issue was appropriate, even where there were transfers of cash flows between groups (see IFRS 17.BC138). The requirement in AASB 17.22 (an entity shall not include contracts issued more than one year apart) would seem to be unequivocal. However, for the reasons noted above, this issue seems likely to go to the IASB TRG.

Note that none of this argument applies to investment linked business, where transfers of cash flows between groups would not occur.

(Regardless of the above, it is noted that on transition it is not necessary to split existing business by year of issue.)

IFRS 17.BC138 notes that the amounts to be reported for each group are specified, but it is not necessary to calculate amounts at a group level, so calculation could presumably be undertaken at a higher level and the results then allocated to each group – this is important in the context of mutualisation, as AASB 17 assumes that the amount of any transfers will be specifically known, whereas the actual quantification is likely to be vague and not known for certain in advance.

Q8.34 How might the pool of underlying items affect portfolios?

As explained in **Q2.4** (**What is a portfolio of insurance contracts?**) 'portfolios' are defined as contracts subject to similar risks and managed together. It will be up to the entity (with auditor approval) to determine how risks and management are affected by the pool of underling items.

For example, it might be determined that contracts are subject to different risks, and hence be in different portfolios, notwithstanding that they participate in the same pool of underlying items (e.g. if Conventional and Investment Account business share in the same pool). Conversely, it may be that a single portfolio covers contracts that participate in multiple pools of underlying items (e.g. they just represent different bonus series).

Q8.35 What grouping is therefore required for contracts with direct participation features?

For all non-Investment Linked business that uses the VFA and is written in a 12 month period, it is likely that it can be demonstrated all such business is not onerous and possibly even unlikely to become onerous - i.e. in that regard there is only ever 1 group for each 12 month period. Combining cohorts is possible on transition and may be possible (depending on materiality or issue going to the IASB TRG) going forward.

For non-Investment Linked business that uses the VFA where separation by year of issue is required, calculations may be performed for the whole portfolio, with the results then allocated to each group (corresponding to contracts for each year of issue) under IFRS 17.BC. Such allocation is to take account of differences in pricing over time, but note that experience (especially investment experience) is expected to be the same for all contracts in the portfolio, and with approximate transfers of cash flows between cohorts determined accordingly.

9 Reinsurance and External Risk Transfers

9.1 Introduction

Q9.1 What is the scope of this Chapter?

This chapter provides information concerning reinsurance and external risk transfers within the scope of AASB 17. In particular, it covers ceded versus assumed reinsurance, CSM for reinsurance, onerous contracts, counter-party risk adjustment, best estimate assumptions, risk adjustment, contractual options, multi-year covers, contract boundaries and premium allocation.

Q9.2 Which sections of AASB 17 address this topic?

AASB 17.63-70 provide guidance on this topic. IFRS 17.BC296-315 also provides background on the subject.

9.2 Reinsurance

Q9.3 What are Reinsurance Held and Reinsurance Issued?

AASB 17 refers to outwards reinsurance or ceded reinsurance as *reinsurance held* and inwards reinsurance or reinsurance assumed as *reinsurance issued*.

Q9.4 Will a different interpretation for *reinsurance held* versus *reinsurance issued* be required?

Under AASB 17, *reinsurance issued* is effectively treated the same way as insurance issued (see AASB 17.3-4) and treatment and interpretations are the same. However, for *reinsurance held*, the requirements are modified as per AASB 17.4, i.e. any references in AASB 17 to insurance issued do not apply, and the modifications made for reinsurance by AASB 17.60-70 do apply, but only for reinsurance held.

Also the accounting treatment of assets versus liabilities and recognition also can lead to different interpretations for reinsurance held versus reinsurance issued;

- for reinsurance held and the underlying gross insurance contracts; and
- also for the liabilities loss recoveries under ceded reinsurance and the related liabilities under assumed reinsurance will be observed.

This is a practical outworking of portfolios being regarded firstly as gross of reinsurance recoveries, with potential recoveries separately considered. It is quite

predictable that a mismatch between loss recoveries under reinsurance held and liabilities under reinsurance issued will be observed.

This chapter primarily deals with reinsurance held (i.e. ceded).

Q9.5 How is reinsurance held shown on the balance sheet?

Where an entity has entered into reinsurance contracts to cede risk associated with gross assumed policy liabilities, the value of these contracts is shown on the balance sheet as a separate reinsurance held asset or liability (AASB 17.78). The policy liabilities continue to be valued on a gross basis and do not reflect the reinsurance (AASB 17.B66(b)). Refer to **Chapter 11 Disclosure**.

Q9.6 How is the value of the reinsurance held asset determined?

The core requirements for the measurement of insurance contracts are modified for reinsurance contracts as per AASB 17.60 – 70. The reinsurance held asset reflects the cash flows and contract boundaries associated with the reinsurance ceded contract. It is separately determined and de-linked from the valuation of the gross policy liabilities and the underlying cash flows on these gross policy liabilities. (See AASB 17.63)

Thus accounting mismatches can occur between the measurement of the reinsurance held asset and the underlying insurance contracts whose risk is being reinsured for a variety of reasons, for example:

- **Contract boundary** – the gross contracts may be eligible for PAA whereas the treaty is long term and covers the renewal of the underlying gross contracts. This can create significant differences in the impact of assumption changes on the reinsurance ceded and the underlying gross contracts;
- **Discount rates** - the reinsurance ceded uses an inception discount rate based on date of treaty for CSM re-measurement and interest accretion, whereas underlying gross contracts may use either a current discount rate, if eligible for the variable fee approach for valuation, or an inception discount rate based on its inception date. Both would give rise to potential differences in the impact of assumption changes, and the accretion of interest on CSM. Note, neither reinsurance ceded nor reinsurance assumed are eligible to use the variable fee approach (AASB 17.B109).

Q9.7 Does reinsurance held have a CSM?

Yes, a CSM is determined for a reinsurance held using a similar approach to that for other insurance contracts. The difference is that the CSM can both reduce the reinsurance held asset (i.e. present value of reimbursements from the reinsurance contract exceed the present value of reinsurance premiums) and therefore defer recognition of profit from the reinsurance contract, or increase the reinsurance held

asset (i.e. present value of reinsurance premiums exceeds the present value of reimbursements from the reinsurance contract) and therefore recognition of losses from the reinsurance contract would be deferred - see AASB 17.65(a). This means that the concept of an 'onerous' reinsurance ceded contract does not exist - see AASB 17.68. The IASB's rationale is that a net loss from the reinsurance contract would usually represent a commercial expense of purchasing reinsurance and should be spread over the period in which the service is received (IFRS 17.BC312).

The following table shows the measurement of a reinsurance contract where the CSM is negative (i.e. a net cost of purchasing reinsurance - scenario 1) versus when the CSM is positive (i.e. a net gain of purchasing reinsurance - scenario 2). This assumes the risk of non-performance of reinsurer to be negligible.

Table 9.1: Illustrative example of CSM for a Reinsurance Contract

	Scenario 1	Scenario 2
Present value of cash inflows (recoveries)	(500)	(500)
Present value of cash outflows (premiums paid)	750	450
Risk adjustment for non-financial risk	(50)	(50)
Fulfilment cash flows	**200**	**(100)**
CSM	**(200)**	**100**
Reinsurance contract asset on initial recognition	**-**	**-**

Q9.8 Is there an offset in reinsurance held when the underlying gross contracts become onerous?

If a group of underlying contracts becomes onerous (or is already onerous and becomes more or less so) due to changes in assumptions relating to future service, then while ever the underlying contract is onerous, the corresponding change in cash flows for the reinsurance held also does not adjust the CSM of the reinsurance held under AASB 17.66(c) (see also IFRS 17.BC315).

Note, the criteria for not adjusting CSM of reinsurance held, does not require underlying contracts to be or have become onerous. The only requirement under AASB 17.66(c) is that changes in reinsurance FCF results from a change in FCF allocated to a group of underlying insurance contracts that does not adjust the CSM for the group of underlying insurance contracts

In these circumstances it is possible that the offsetting impact on the reinsurance held may exceed that on the underlying contracts, if due to its contract boundary, the reinsurance ceded cash flows include expected renewals on the underlying contracts but the gross does not.

When gross liability is determined using PAA, it is not clear how this applies, and there are number of views on this:

A) **Only when the underlying portfolio is onerous** is the reinsurance CSM not adjusted. The argument for this is that:

(i) This is consistent with the rationale given by IASB that where an underlying group becomes onerous due to changes in estimates for future service then the reinsurance CSM should not be adjusted, creating an offset (IFRS 17.BC315).

(ii) Estimates for future service only occur under PAA when the portfolio is onerous (see AASB 17.57-58).

(iii) Criteria for not adjusting reinsurance CSM under AASB 17.66(c) are that there is a change in underlying FCF for future service which does not adjust the CSM of the underlying group. Such change only occurs under PAA when contracts are onerous, as otherwise underlying FCF are not measured under PAA.

B) **The reinsurance CSM is never adjusted** when the change in reinsurance FCF relates to an underlying portfolio using PAA even when the underlying cash flows are not onerous as:

(i) there is no CSM under PAA, any change to reinsurance cash flows relating to underlying portfolio does not adjust the CSM of the underlying; and

(ii) the criteria in AASB 17.66(c) do not require an actual change in FCF for the underlying, just that the change in FCF of the reinsurance contract that relate to the underlying and do not change the CSM of the underlying group.

Q9.9 Does the existence of reinsurance held impact the determination of the CSM and onerous contract testing of the gross policy liabilities?

No, because the principle of AASB 17 (IFRS 17.BC298 and AASB 17.B66(b)) is to de-link the underlying gross liabilities from any associated reinsurance held, the determination of CSM as well as onerous contract testing of the gross policy liabilities is not impacted by reinsurance ceded.

As an example, a contract which is onerous at inception on a gross basis would still be considered onerous and accounted for as such even where 100% of this risk is ceded to another party on an original terms coinsurance basis. In this example, the reinsurance held asset would not offset the impairment on the gross liability (i.e. asymmetric accounting, with the practical consequence of a day one loss from the gross liability impairment offset by income from the reinsurance ceded asset over the lifetime of the reinsurance contract).

Note if the underlying contract is onerous at inception, then as arises from initial measurement of the underlying contract, there is no change to estimates on the underlying cash flows to trigger the application of AASB 17.66(c). This differs from the

circumstances discussed in **Q9.5 How is reinsurance held shown on the balance sheet?**

Note, this leads to the unexpected outcome that there is no offset due to reinsurance for underlying contracts that are onerous at inception, but there is (possibly) where underlying contracts subsequently go onerous, or get worse.

Q9.10 How is counter-party risk reflected in the reinsurance held?

The estimates for expected values for the cash flows of the reinsurance held need to allow for the effect of reinsurance counter party failure to fulfil the contractual obligations (AASB 17.63). This would include allowances for disputes resulting in reduced payments as well as for potential reinsurance counter party failure due to defaults (i.e. credit events), claims disputes or any other disputes that may affect the reinsurance recoveries.

The allowance should reflect the current financial condition and credit standing of the reinsurance counter party, as well as the potential for these conditions to change over time (IFRS 17.BC308 – 309).

Q9.11 How can a market-based assessment of default of reinsurance held be made?

One approach would be to apply alternate sets of discount rates with respect to valuing reinsurance assets.

Given that debt instruments are graded and priced according to standard credit ratings as issued by the major ratings agencies, it is possible to construct separate sets of discount rates applicable to each band of credit ratings.

Thus, for each reinsurance asset a set of discount rates could be applied based on that reinsurer's own credit rating. Given that debt instruments with a lower credit rating would typically trade at a higher yield, this would imply a market-determined (lower) value for that same reinsurance asset.

Q9.12 Are there special considerations for setting best estimate assumptions for reinsurance held FCF?

The assumptions used for the reinsurance held would normally be consistent with those used for the gross policy liabilities on similar business. That is to say, assumptions related to policyholder behaviour or insured decrements (e.g. mortality rates, morbidity rates) would normally be consistent between the determination of the gross policy liabilities and the reinsurance ceded asset.

Q9.13 How is the reinsurance held risk adjustment determined?

The risk adjustment for the reinsurance held increases the value of the reinsurance held. The quantum of the risk adjustment should reflect the compensation that would make the entity indifferent between entering into reinsurance contract(s) to mitigate these risks and retaining these risks without reinsurance. In AASB 17, the reinsurance risk adjustment should *represent the amount of risk being transferred by the holder of the group of reinsurance contracts to the issuer of those contracts* (AASB 17.64).

The risk adjustment for the ceded asset can usually be determined most easily based on the difference in the risk position of the entity with (i.e. net position) and without (i.e. gross position) the reinsurance asset.

In practice, however, it may be difficult to assess an entity's appetite for gross risk, if that risk is heavily reinsured. It may be necessary to work backward, assessing first the appropriate net risk adjustment, based on an appetite for net risk, and then extrapolating to determine the gross risk adjustment, with the reinsurance risk adjustment determined by difference.

Note that in assessing the entity's appetite for gross risk, it may be argued that the compensation that the entity requires for bearing gross risk reflects the availability and cost of reinsurance in the market.

AASB 17 does not prescribe any particular technique in determining the risk adjustment where it is determined on a principle-based approach.

Q9.14 Will the net risk adjustment equal the gross risk adjustment less the reinsured risk adjustment?

The reinsurance risk adjustment is defined in IFRS 17.64 as the value of the *amount of risk being transferred by the holder of the group of reinsurance contracts to the issuer of those contracts*. This is interpreted as meaning the reinsurance contract risk adjustment is the difference between the gross and net positions. However, that will be challenging if the gross and reinsured contracts are measured on different basis.

The risk adjustment on reinsured business is likely to differ from the cedant to the reinsurer. The example illustrates the case of a quota share arrangement or pandemic/catastrophe treaty and the problems one can get into trying to determine the reinsurance risk adjustment in isolation from the business subject to reinsurance.

Consider the following example where risks up to 250 units are covered under a catastrophe reinsurance treaty. The gross risk adjustment (230 units) less reinsured risk adjustment (219 units) is equal to 11 units. But the net risk adjustment calculated directly using the net exposure is higher at 16 units.

Table 9.2: Illustrative example of asymmetry in the net risk adjustment

Probability	Gross Exposure (Units)	Reinsured Exposure (Units)	Net Exposure (Units)
10%	100	100	0
20%	150	150	0
40%	200	200	0
20%	250	250	0
8%	300	250	50
2%	350	250	100
Mean	**201**	**195**	**6**
Standard Deviation	**57**	**47**	**19**
Risk Adjustment (Mean + ½ Standard Deviation)	**230**	**219**	**16**

Q9.15 Is the risk adjustment for gross policy liabilities impacted by reinsurance held on the same business?

In principle, under IFRS 17, the risk adjustment determined by an entity for the valuation of insurance contracts it has issued (assumed risks) is not impacted by the presence on its balance sheet of reinsurance contracts it has entered into to mitigate these risks (ceded risks), and determined without reference to any reinsurance contracts that mitigate or offset the risks of the issued contracts.

In practice, as outlined in the previous question, if the gross risk is heavily reinsured, it may be necessary to work backward, assessing an appropriate net risk adjustment, based on an appetite for net risk, and then extrapolating to determine the gross risk adjustment.

Q9.16 What use is the net risk adjustment?

There is no mention of a net risk adjustment in AASB 17 because of the theoretical separate determination of the gross risk adjustment and ceded risk adjustment. Conceptually, however, insurers manage their net exposure to risk so, while the net risk adjustment is, in AASB 17 terms, the gross risk adjustment less the ceded risk adjustment, it is the net risk adjustment that has most economic substance.

Therefore, it is an essential control to consider the net risk adjustment, based on the entity's appetite for net risk. If this is not equal to the difference between the assessed gross and reinsurance risk adjustment, then the reinsurance risk adjustment does not properly represent the amount of risk being transferred by the holder of the group of reinsurance contracts to the issuer of those contracts.

Q9.17 How does the reinsurer's ability and willingness to pay claims impact the reinsurance held risk adjustment?

It is important to distinguish between the expected value of any non-performance and the risk of variation around that expected value.

The risk of non-performance of the reinsurer, including losses from disputes, form part of the estimates of the present value of the future cash flows for the reinsurance contracts held (see AASB 17.63 and AASB 17.67).

The net risk adjustment should include allowance for the associated uncertainty. In practice, the impact of uncertainty surrounding non-performance is very unlikely to be material.

Q9.18 Can you provide an illustrative example for proportional versus non-proportional reinsurance?

For proportional contracts, the degree of risk adjustment transfer is measured by the allocation of underlying claims between insurer and reinsurer assuming rates are set at parity.

For non-proportional contracts, the degree of risk transfer is determined by the standard deviation of the distribution of losses (i.e. total contract cash flows). For the insurer, this uses the net loss distribution (after reinsurance) and for the reinsurer this uses the residual loss distribution accepted by it.

Q9.19 How are contractual options such as future new business, recapture, cancellation, reinstatements or commutation treated in developing reinsurance cash flows?

As with all insurance contracts, all contractual cash flows within the contract boundary are included in FCF (see **Chapter 3 Current Estimates**). Particular considerations for reinsurance are:

- the potential inclusion of underlying new business in reinsurance contract cash flows if the treaty binds the reinsurer and they do not fall outside of the contract boundary due to practical ability to reprice;
- when including the impact of contractual options on cash flows, while one would normally reflect experience rather than assume rational economic policyholder behaviour (See AASB 17.B62 and **Q3.22 What needs to be considered in estimating policyholder behaviour?**), for reinsurance it would be more appropriate to assume that the ceding and assuming entities each exercises its control over such options to its economic advantage. Advantage would be determined based on the best estimate assumptions used in the valuation.

Note, this leads to the unexpected outcome that reinsurance FCF could include expected new business covered by the treaty.

Q9.20 How is reinsurance held shown on the AASB balance sheet?

Where an entity has entered into reinsurance contracts to assume risk and obligations, the value of these contracts is shown on the balance sheet as part of the gross policy liabilities.

Q9.21 Are there special considerations for reinsurance issued liabilities?

In general, reinsurance issued business, once classified as insurance risk, is treated consistently in approach with all other gross insurance liabilities assumed. One exception is that reinsurance issued business is not eligible to use the Variable Fee income approach for valuation (AASB 17.B109).

Data issues are frequently more prevalent for reinsurance assumed business, as the reinsuring entity is further removed from the underlying risks, and is reliant on the ceding entity for underlying data on insured risks. This means that there is frequently more use of approximations both in terms of data and modeling approach. Actuaries performing such valuations might therefore ensure that techniques used are appropriate, produce reasonable approximations and are consistent with the entities approach to materiality.

Q9.22 How is the grouping of contracts for CSM impacted by the fact that reinsurance contracts may cover multiple years of underlying policies?

Under AASB 17, entities are prohibited from grouping contracts issued more than one year apart for CSM determination purposes. Reinsurance contracts held are aggregated differently to the underlying contracts (see AASB 17.61), in particular they are treated as a separate portfolio from the underlying and are grouped based on the characteristics and inception dates of the reinsurance contract, not the underlying.

Q9.23 What is the contract boundary for reinsurance issued and held?

The contract boundary for reinsurance contracts issued is assessed in the same way as for any other insurance contracts issued by the reinsurer - see **Chapter 2 Aggregation and Contract Boundary**. Considerations are the same: does the reinsurer have the practical ability to reprice. In the case of reinsurance, the reinsurer's repricing rights are very likely to be more specific and less generic, than is the case for normal insurance contracts.

For reinsurance held, the assessment of the reinsurance contract boundary is based not on the cedant's right to reprice but on the reinsurer's right to reprice or terminate the reinsurance (see **IASB's Feb 18 TRG Summary for AP03 Boundary of reinsurance contracts held**).

As for other insurance contracts, FCF include all contractual cash flows within the contract boundary. For reinsurance assumed, onerous groups of contracts that continue after the balance date can make allowance for unbound risks to continue to be accepted up until the earliest cancellation date after the balance date. Non-onerous contracts should include risks to be accepted and bound after the balance date.

Aggregate reinsurance contracts may cover more than one group of underlying contracts.

Contracts in perpetuity (or subject to automatic renewal) need to be assessed for a contract boundary in accordance with the cancellation provisions applicable, re-pricing rights and reflect a consistent view of the treaty between the insurer and reinsurer.

Facultative business can be treated as ordinary contracts of insurance.

Note, this leads to the following unexpected outcomes:

- the contract boundary for reinsurance held and the underlying contracts can be different; for example, the underlying may qualify for PAA due to the insurer having repricing rights at the portfolio level for the underlying contracts, but not the reinsurance held due to the insurer not having the right to reprice the reinsurance held; and
- reinsurance cash flows from future underlying gross contracts are included in the measurement of reinsurance contract held or issued, if they captured under the terms of the reinsurance contract.

Q9.24 When can PAA be used for reinsurance contracts held?

The entity may also apply the PAA to reinsurance contracts held, if at inception of the group of reinsurance contracts held, it expects:

- that the resulting measurement will provide a reasonable approximation compared to applying the core requirements in full for reinsurance contracts held (AASB 17.69(a) and AASB 17.70); or
- the coverage period for each reinsurance contract held in the group is one year or less (AASB 17.69(b)).

Note, because groups of reinsurance contracts are separate to the underlying insurance contracts and measurement and PAA eligibility criteria modified for reinsurance held, the outcomes of the assessment of whether the underlying

contracts and reinsurance held meet the conditions of applying the PAA may differ from each other.

AASB 17.70 states that an entity cannot meet the materiality requirement if, at inception, an entity expects significant variability in the FCF. This is the same issue that has to be dealt with for direct contracts (see **Q7.6 What is meant by significant variability in AASB 17.54 when considering PAA eligibility?**). Under a non-proportional reinsurance treaty, particularly catastrophe covers, the pattern of risk may differ significantly from pro-rata over time and therefore may not qualify for the PAA if the contracts had coverage periods in excess of one year.

Q9.25 How is reinsurance held measured where underlying contracts are eligible for the VFA?

Reinsurance held on contracts eligible for the VFA is not eligible for VFA (AASB 17.B109) and is measured under either:

- the core requirements as modified for reinsurance held (see **Section B Core Requirements**); or
- the PAA - if it qualifies (see **Chapter 7 Premium Allocation Approach**).

Note, for reinsurance on VFA products, the reinsurance may only apply to the risk component of the underlying contract, not the investment component.

Q9.26 Is it still possible to measure liability and profit on net of reinsurance basis, particularly for VFA business?

While it may still be possible to directly measure insurance contract liability and profit on a net of reinsurance basis, and get the materially same answer as measuring Gross and Reinsured liabilities separately as required by AASB 17, this is likely to be the case only in limited circumstances for the following reasons:

- Where gross business is eligible to use the VFA, as the VFA cannot be used to measure reinsurance, adding reinsurance measured otherwise to net liability measured under the VFA will not result in the same outcome as a gross contract measured directly under the VFA, e.g. the CSM is:
    - accreted effectively at current rates (VFA) versus at inception discount rates (Core Requirements); and
    - unlocked for changes in the entity's share of the fair value of the underlying items relating to future service effectively at current rates (VFA) versus changes in estimates of the present value of the future cash flows in the LRC at inception discount rates (Core Requirements); and
- Loss recognition applies only to the gross contract, e.g. CSM cannot be negative under the gross contract versus reinsurance where CSM can be negative or positive.

Q9.27 What does *managed together* and *subject to similar risks* mean when determining portfolio and groupings for reinsurance?

Refer to **Q2.6 What does *subject to similar risks* mean?** and **Q2.7 What does *managed together* mean?**

Applying AASB 17.14 to reinsurance contracts potentially introduces different considerations given that such contracts can cover multiple classes of business generally associated to different portfolios by a primary insurer.

For example, for property catastrophe, there are multiple perils covered. The contract is underwritten as follows:

- determine the expected loss independently for each peril covered, according to the best available tool / practice of the time;
- aggregate the expected losses;
- determine the appropriate capital allocation, with regard to the overall loss distribution and corporate standards that may relate to specific perils; and
- add loadings specific to the costs of the contract.

The contract here is then bound by each party and regarded as one contract. Should a loss arise, the specifics of the loss (e.g. cyclone or earthquake) dominate the claims management of each party to the contract and actuarial reserving.

Portfolio management would consider the contract as a whole, rather than the specific constituent perils. It is likely that accumulation management may however consider each peril independently.

This extends across contracts written of a similar nature, where the reinsurer may aggregate the contracts by type for management purpose:

- Proportional (Surplus, Quota Share)
- Non-Proportional
- Aggregate Covers (including Stop Loss)
- Contracts with / without Natural Catastrophe exposure.

Therefore, the '*managed together*' concept is likely to be more driven by the contract type and not the underlying class of business exposure, as this is reflective of how contracts are bound and administered / managed prior to a loss occurrence. This conclusion is consistent with the IASB Feb 18 TRG discussion on AP01 where it was observed that the lowest unit of account is the contract.

Q9.28 Will a different interpretation for facultative versus treaty reinsurance be required?

In simple terms, it would be expected that facultative reinsurance would be treated according to the realities of contract types, with a substance over form approach. Facultative covers on a pure "offer-and-acceptance" basis would be treated similar to an insurance portfolio of risks. On the other hand, facultative binding facilities, facultative obligatory covers, and facultative risks that are in reality of a treaty nature may be best regarded as treaty reinsurance.

Q9.29 What are key considerations for regulatory risk equalisation, profit-sharing and pooling mechanisms?

In Australia, there are a number of mechanisms imposed by regulation and schemes used to pool risk across industry participants. Where these take the form of a contract with a statutory body (for example the Australian Reinsurance Pool Corporation for terrorism risks) they should be treated the same as any other type of reinsurance arrangement. Where they take the form of mandatory redirection of premiums, cost of claims or profits amongst insurers (such as the health insurance and NSW CTP risk equalisation systems) treatment will be different as such redirection forms part of the contractual cash flows (see AASB 17.2 and AASB 17.B65(i)).

The objective of AASB 17 is to ensure that entities provide relevant information in a way that faithfully represents those contracts. Risk equalisation and pooling arrangements imposed by regulation add expected costs and benefits, usually linked to writing a policy and paying claims. Such arrangements should be reflected in the net impact they have on the cash flows of the contracts as contractual terms under AASB 17 include those imposed by law or regulation. The costs and benefit cash flows of the pooling arrangements must be captured in a manner consistent with how they are expected to arise and their expected level of cost or benefit. The inflows and outflows can be modelled explicitly or on a combined basis; as is appropriate given the data available, the complexity and the materiality of the risk transfer cash flows.

Where profit sharing mechanisms imposed by regulation and/or schemes exist, then expected cash inflows and outflows from this mechanism should be included in the expected cash flows as well.

Where it takes the form of reinsurance, under AASB 17 the gross cash flows and the reinsurance must be considered separately.

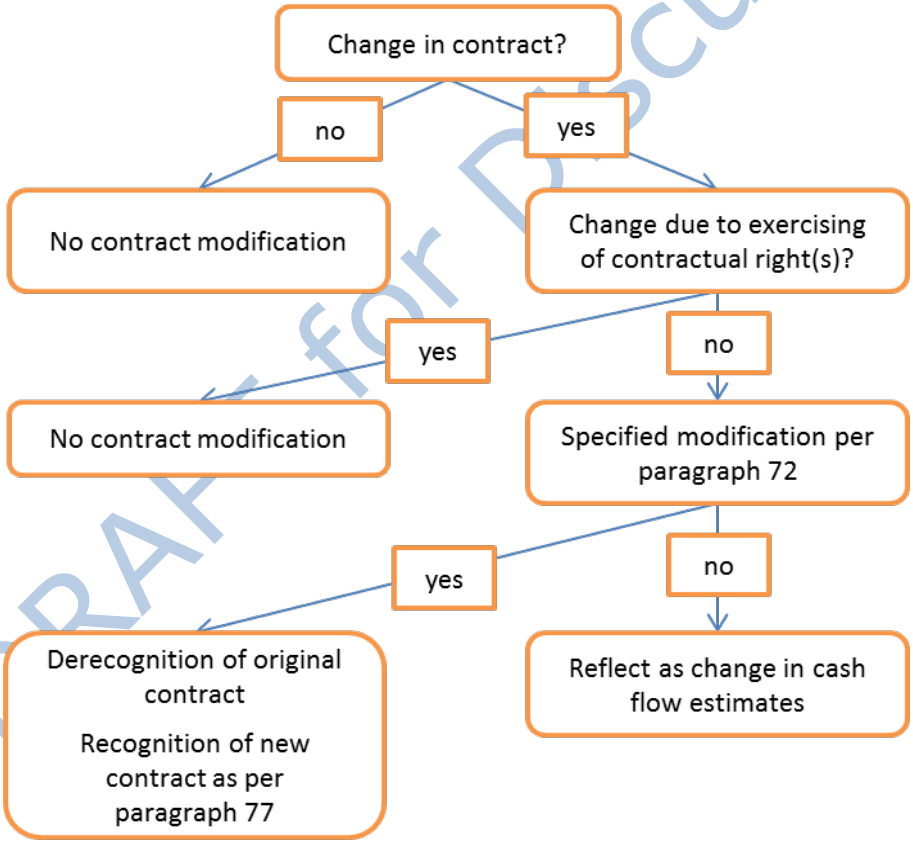
10 Contract Modifications and Derecognition

10.1 Scope

Q10.1 What is the scope of this chapter?

This chapter provides information concerning accounting for modifications to insurance contracts and derecognition of insurance contracts. In particular, it covers: What is a contract modification, Identification and treatment of specified contract modifications, Non-specified contract modifications, Modifications to reinsurance contracts and underlying contracts, and Derecognition – including on transfer to third parties. Figure 10.1 gives an overview.

Figure 10.1: Overview of Contract Modifications and Derecognition



Q10.2 Which sections of AASB 17 address this topic?

AASB 17.72-77 specifically address this topic. IFRS 17.BC316-BC322 also provides background on the subject.

10.2 What is a contract modification?

Q10.3 How does AASB 17 define a Contract Modification?

As a change to the legally enforceable terms of the contract, for example, either by agreement between the parties to the contract or by change in law or regulation. Note that the exercise of any rights or options available under the contract, by one or both parties, are not contract modifications (see AASB 17.72) and form part of the expected cash flows of the original contract.

Q10.4 What is a contract modification?

Examples of what is and is not a contract modification for AASB 17 purposes are given below. Note that these examples are not a complete or exhaustive list.

(a) Considered to be a contract modification (so long as it does not arise from an option available to either the insurer or policyholder under the contract) and hence requires the agreement of both to take effect:

- an increase or decrease in the nature or level of benefits under the contract (note this would include changes to extend or reduce the period of cover under the contract, unless they arise from the exercise of an option under the contract, or they only affect coverage beyond the contract boundary);
- the addition or removal of benefits under the contract;
- the addition or removal of coverages under the contract;
- the addition or removal of options or guarantees available under the contract;
- any change to premiums;
- any change to contractual terms arising from change in regulation.

(b) Considered not to be a contract modification:

- the exercise of any options available to the policyholder under the terms of the contract (or law), within the contract boundary, that does not require the agreement of the insurer (this does not include any requirement to notify the other party in order to exercise). For example:
  - an option to renew the contract under the terms of the contract without further underwriting;
  - an option to surrender the contract or to cease paying premiums while still receiving benefits under the contract;
  - a contractual right to suspend and later resume cover under the contract without a new risk assessment

- an option to increase cover on renewal e.g. with consumer price index or at other times under the contract (e.g. guaranteed future insurance options) without further underwriting;
- guaranteed future insurability options; these form part of the original contract terms and are neither a new contract nor a contract modification (e.g. guaranteed annuitisation option under a deferred annuity contract);

- the exercise of any options available to the insurer under the terms of the contract (or law), within the contract boundary, that do not require the agreement of the policyholder.

  For example, changes to the premium permitted under the terms of the contract, law or regulation. Note that where the insurer has the right or practical ability to change the premium in such a way that that the payment of that premium is outside the boundaries of the contract, then it creates a new contract which is to be measured as such.

  Note, that for this purpose, an option available to either the insurer or policyholder under the contract does not include any requirement to notify the other party in order to exercise the option.

Q10.5 How are changes that are not contract modifications treated?

Changes that are not contract modifications (as per Q10.3(b) above) form part of the expected cash flows under the contract (see **Chapter 3 Current Estimates**) so long as they are within the contract boundary. That is both when:

- measuring it upon initial recognition under AASB 17.32 et. al., AASB 17.B61-B62; and
- upon subsequent measurement under AASB 17.40 etc.

Q10.6 What about the exercise of a contractual option to add features that are outside the contract boundary?

A special case occurs if there is a contractual right to add new features to the original contract which are outside the contract boundary (e.g. because underwriting is carried out for the new feature using the information available when the new feature is added).

AASB 17 treats cash flows outside the contract boundary as relating to future insurance contracts (AASB 17.35) and the new feature could be treated as a new contract. This may not be practicable where the new feature is not distinct (i.e. the cash flows of the new feature and the original contract are highly interrelated).

If not distinct, then addition of new features that are outside the contract boundary (e.g. because they can be underwritten at time of exercise at an appropriate price for the change in insurance risk) could be treated as a contract modification at the time of

addition, as the ability to underwrite the new feature effectively means the consent of both parties is required.

If the contract modification is not specified under AASB 17.72 then AASB 17.73 applies, i.e. the contract is not derecognised and the changes in cash flows caused by the modification are treated as changes in estimates of FCF.

Note that a contractual right (not requiring agreement of the insurer) within the contract boundary (even though it gives rise to cash flows outside the contract boundary) must be modelled, and the exercise of such options is treated like other experience – see **Q3.15 How are contractual rights (e.g. policy loans) handled?**

10.3 Specified Contract Modifications

Q10.7 Which are the specified contract modifications that result in the derecognition of the original and recognition of the modified contract as a new contract?

These are those contract modifications specified in AASB 17.72, hereinafter referred to as "specified contract modifications". The discussion in the Basis for Conclusions (see IFRS 17.BC317 – BC320) indicates that these criteria in AASB 17.72 capture modifications that the IASB sees as resulting in significantly different accounting treatment, e.g. the modified terms would have caused differences in the applicability of AASB 17, or the separation of components, or the contract boundary (only if significantly different) at initial measurement, or the applicability of the measurement model.

The specified criteria are, if the contract had been written at inception as modified, it would:

- not have been classified as an insurance contract, see **Chapter 2 Aggregation and Contract Boundary**;
- have been included in a different group from the one it was included in at initial recognition;
- have had a significantly different contract boundary;
- different components would have been separated, resulting in a different insurance contract for IFRS 17;
- if the PAA was applied to the contract and it no longer qualifies (see **Chapter 7 Premium Allocation Approach**); or
- now qualify (or cease to qualify) for treatment as an insurance contract with direct participation features.

Q10.8 How do contract modifications or the exercise of options available under the contract influence the contract boundary?

The contract boundary is re-assessed in each reporting period (AASB 17.B64) and ends when the criteria of AASB 17.34 are fulfilled (see **Chapter 2 Aggregation and Contract Boundary**).

Q10.9 What qualifies as a significantly different contract boundary?

The intent in setting the criteria in AASB 17.72 was to capture those contract modifications that would result in a significantly different accounting treatment (see IFRS 17.BC317-BC320) and only those modifications (see IFRS 17.BC320).

This indicates that a possible criterion for assessing if the change in contract boundary is substantial could be the impact on accounting treatment.

A contract modification that changes the contract boundary in such a way that the modified contract:

- no longer qualifies for the PAA, when it was being accounted for under the PAA; or
- would have been included in a different group;

are clearly contract modifications that result in a significantly different accounting treatments, as they are captured under the other criteria in AASB 17.72.

Other contract boundary changes that possibly could be considered to result in a significantly different accounting treatment are:

- a change such that the renewal of the contract is now outside the contract boundary (e.g. the modification gives the insurer the right to reprice the contract at renewal) so that the contract becomes eligible for PAA upon renewal; or
- a change to the contract boundary that has a significant effect on the contract's CSM release pattern and hence its accounting treatment.

Note that, if the relevant criterion is the impact of the change in contract boundary of itself, then the impact of any other modifications to the contract on the contract's CSM release pattern would, if material, need to be excluded from this assessment. If the criterion is simply the change in the contract boundary itself, then a change that increased or decreased the contract boundary by 50% or more at inception of the contract, might be a significant change, but one that changed it by 20% or less might not be a significant change, e.g.

- the extension of a contract term from 20 years to 40 years might be significant; and

- the extension of contract that provided coverage from age 60 to age 65 might not be significant

10.4 Accounting for Specified Contract Modifications

Q10.10 How are specified contract modifications accounted for?

The accounting requirements are complex and a spreadsheet example is available on the Institute website to illustrate them.

The entity:

(a) derecognises the contract being modified from the group to which it was allocated at inception by:

- setting the contribution of its fulfilment value (including the risk adjustment and incurred claims) to the group to zero (AASB 17.76(a));
- adjusting the number of coverage units for expected remaining coverage (AASB 17.76(c))
- adjusting the CSM of the group to the extent required by AASB 17.44(c) and AASB 17.45(c) for the difference between:
  - the reduction in fulfilment value of the group from setting that for the contract prior to modification to zero; and
  - the premium it would have charged for a new contract issued at the date of contract modification with equivalent terms, net of any additional premium charged for the modification per AASB 17.77(a)
- according to AASB 17.44(c) and AASB 17.45(c), the CSM can only be adjusted to the extent that the adjustment does not exceed the margin. If there is a loss component already, AASB 17.44(c)(ii), AASB 17.45(c)(iii) and AASB 17.50(b) apply;

and

(b) recognises the modified contract as a new contract as at the date of modification under AASB 17 assuming the net equivalent premium noted above was paid as at the date of modification (AASB 17.77(b)).

Note that this:

- is different from existing treatment under AASB 1023 and AASB 1038 where contract modifications are usually treated as a change in estimates;
- may result in unexpected outcomes – for example, if the additional premium charged for the contract modification is inconsistent with what would be charged for an equivalent new contract, the shortfall or excess impacts the original group and not the measurement of the modified contract in the new group; and
- any incurred claim liability is transferred to the new contract.

Q10.11 If the insurer does not have contracts with equivalent terms, how is the premium determined?

The premium is the price that the entity would have charged the policyholder if it had entered into a contract with equivalent terms at the date of the actual modification (AASB 17.77(a)(iii)). Note that this is not likely to be the same as the fair value of the modified contract, and the premium possibly could differ from fair value as follows:

- it uses entity-specific assumptions for some inputs, including the degree of risk aversion, whereas fair value uses market participant assumptions in all cases;
- it excludes the entity's own non-performance risk, whereas fair value would include the entity's own non-performance risk; and
- it includes the entity's target for CSM, whereas fair value includes no such margin, although fair value implicitly includes a current value for any additional margin that market participants would require.

The assumptions used in determining the premium would usually be consistent with those used in determining the liability arising from the modified contract at the date of actual modification, except for the CSM.

For example, the premium might be determined as the sum of:

- the FCF; and
- any other elements not included in FCF under AASB 17 that the entity would normally include in setting premiums, e.g. general overheads and costs not directly attributable to a portfolio of insurance contracts and charge for capital; and
- a CSM, after allowing for any elements not included in FCF, that reflects the entity's current approach to profit targets when pricing for similar business.

10.5 Other Contract Modifications

Q10.12 What other types of contract modifications are there?

Apart from specified contract modifications, there are other contract modifications. Examples could include:

- addition or removal of benefits, where they don't cause the contract to fall into another group, or another portfolio and hence different group; or
- increase or reduction in benefits, where they don't change grouping; or
- extension of contract term, with no change in benefit levels, provided this does not materially change the contract boundary or change eligibility for PAA.

Q10.13 How are other contract modifications accounted for?

Contract modifications not specified in AASB 17.72 are accounted for by treating the resulting changes in the fulfilment cash flows (i.e. expected cash flows, risk adjustment) as a change in estimates as per of AASB 17.40-52. (see AASB 17.73).

10.6 Derecognition

Q10.14 When can contracts be derecognised?

Only when all obligations under the contract are extinguished. This includes not only the liability for future coverage but also for incurred claims arising from past coverage (as per AASB 17.74).

This can also occur when:

- A specified contract modification occurs (see **Chapter 10 Contract Modifications and Derecognition**), in this case the modified contract is treated as a new contract which assumes all obligations arising from the contract pre and post modification; and
- A contract is transferred to a third party (see AASB 17.77), this applies only when the contract as a whole is transferred, including any obligation for incurred claims arising from past coverage, otherwise the contract in full has not been extinguished and cannot be derecognised as per paragraph 74.

Q10.15 How are contracts transferred to a third party derecognised?

In the similar way to the derecognition of a contract upon a significant contract modification -that is, the contract being transferred is de-recognised from the group to which it was allocated at inception by:

- setting the contribution of its fulfilment value (including the risk adjustment) and incurred claims, to the group to zero;
- adjusting the number of coverage units (AASB 17.76(c))
- adjusting the CSM of the group for the difference between:
  - the reduction in fulfilment value of the group from setting that for the contract prior to modification to zero; and
  - the premium charged by the third party for transfer of the contract.

Q10.16 How are contracts derecognised other than due to a specified contract modification or transfer to a third party?

In the similar way to the derecognition of a contract upon a significant contract modification that is the contract being transferred is derecognised from the group to which it was allocated at inception by:

- setting the contribution of its fulfilment value (including the risk adjustment) and incurred claims to the group to zero;
- adjusting the number of coverage units (AASB 17.76(c))
- adjusting the CSM of the group for the reduction in fulfilment value of the group from setting that for the contract being derecognised.

Q10.17 What if only the obligation for future coverage is transferred to a third party

In this case, the contract does not qualify for derecognition under AASB 17.77, as only part of the contract has been transferred, and is treated as a contract modification.

10.7 Application to Reinsurance and Premium Allocation Approach

Q10.18 How are modifications to reinsurance contracts accounted for?

Reinsurance contracts are insurance contracts and the modifications to them are accounted for in the same way as for other insurance (AASB 17.4), see also **Chapter 9 Reinsurance and External Risk Transfers**.

Q10.19 How do modifications to underlying insurance contracts affect the subsequent measurement of the reinsurance contract?

To the extent that the modifications to the underlying insurance contract change the expected cash flows under the reinsurance contract, they are:

- reflected in the re-measurement of the reinsurance contract (as per AASB 17.40-46 and AASB 17.60-68); and
- not reflected in the CSM of the reinsurance contract to the extent that they do not adjust the CSM of the underlying group of insurance contracts (see AASB 17.66(c)(ii)).

Q10.20 How are contract modifications and derecognition accounted for under the Premium Allocation Approach (PAA)?

Where a contract continues to qualify for PAA following a contract modification the requirements of AASB 17.73, AASB 17.76 and AASB 17.77 are applied as follows:

(a) For non-specified contract modifications, as per the answer to Q10.13, they are still treated as a change in estimates per AASB 17.40-52, but as modified by AASB 17.53-59 (PAA). Under PAA changes in estimates would only impact the LIC

as per AASB 17.44(b) which applies to PAA as well as the Core Requirements. However, if the contract modification were to cause the group of which it is a part to be viewed as onerous, AASB 17.57-58 would apply and LRC would also change as per these paragraphs.

(b) For specified contract modifications, the answer to Q10.10 applies, modified for PAA as follows:

(i) derecognises the modified contract from the group of which it is part by setting the contribution of its carrying value to the group including the LIC to zero, consistent with AASB 17.76 (a); and

(ii) recognises the modified contract as a new contract as at the date of modification under AASB 17 assuming the premium it would have charged for a new contract issued at the date of contract modification with equivalent terms, net of any additional premium charged for the modification AASB 17.77(a) was received as at the date of modification AASB 17.77(b).

(c) When derecognising a contract, the answer to Q10.18 applies, modified for PAA as per (b) (i) above.

(d) When derecognising a contract upon transfer to another party, the answer to Q10.17 applies, modified for PAA as per (b)(i) above.

Q10.21 What if a modified contract was part of an Onerous Group?

If the modification is not specified in AASB 17.72, then AASB 17.73 applies and the changes in estimates of FCF are treated in accordance with AASB 17.50 and AASB 17.51 in the same way as any other subsequent change in FCF under AASB 17.

If the modification is specified in AASB 17.72, then it is treated as per AASB 17.74-76 (see **Q10.13 How are other contract modifications accounted for?**) and there is no CSM to be adjusted in respect of the Onerous Group to which the contract was allocated at inception, but as noted in Q10.10 it needs to be allocated to the loss component as required by AASB 17.44(c)(ii), AASB 17.45(c)(iii) and AASB 17.50(b).

Q10.22 What practical examples are there for when a contract is modified?

Table 10.2: Practical Examples of Contract Modification

Scenario	Modification	Comment
Group Risk scheme renewing at end of rate guarantee period	No	This would be considered an issuance of a new contract.
Customer exercises option to increase sum insured following a life event specified in their policy (e.g. marriage)	No	Exercising an existing option that does not require the consent of the insurer is not a modification

		(see **Q10.3 How does AASB 17 define a Contract Modification?**)
Level premium life products that convert to stepped premium life products at a specified age	No	So long as the insurer does not have the option to underwrite or terminate the cover at the specified age, this is not a modification (see **Q10.3 How does AASB 17 define a Contract Modification?**).
Customer increases sum insured following insurer underwriting. Insurer consents.	Yes	As both parties had to consent, this constitutes a modification.
Add an extra driver to GI	Yes / No	If the insurer has the right to decline coverage for adding the named driver, this would form a modification.
Add a named good to policy	Yes / No	If the insurer has the right to decline coverage for adding the named good, this would form a modification.

Section D. Disclosure and Transition

11 Disclosure

11.1 Introduction

Q11.1 What is the scope of this chapter?

This chapter provides information concerning the new disclosure requirements for IFRS 17 related to actuarial calculations. These requirements are significantly more detailed than current disclosure requirements. This chapter is not meant to provide a comprehensive list of the new disclosure requirements, but is instead focused on highlighting accounting choices and areas where new actuarial calculations or analysis may need to be performed solely to satisfy the disclosure requirements.

Q11.2 Which sections of AASB 17 address this topic?

AASB 17.78-132 provide guidance on this topic. IFRS 17.BC328-BC371 also provides background on the subject.

11.2 OCI versus P&L

Q11.3 What is Other Comprehensive Income and why is it relevant for AASB 17?

Income and expenses are reported in the financial statements in the statement of profit or loss and other comprehensive income for the period. Other comprehensive income is defined in AASB 101 as comprising *items of income and expense (including reclassification adjustments) that are not recognised in profit or loss as required or permitted by other Australian Accounting Standards*. That is, it is income or expenditure items that are presented as "below the line adjustments".

The changes to AASB 17 incorporate the following additional items within AASB 101 that can be included as part of other comprehensive income (refer Appendix D of AASB 17):

- For insurance contracts without direct participating features, a systematic allocation of the total finance income or expenses over the duration of the group of contracts (refer AASB 17.88(b));
- For insurance contracts with direct participating features, an amount that removes accounting mismatches with finance income or expenses between the underlying items held and the insurance contract liability (refer AASB 17.89(b)); and
- For both these items, the entity will be required to make an accounting policy choice about whether to disaggregate the insurance finance income and expenses to separately identify amounts within profit and loss and other comprehensive income or to present the whole amount in the profit and loss. In theory the accounting choice is made separately for each group of contracts and so could vary between groups.

Q11.4 What is included in P&L and OCI under the systematic allocation of insurance finance income and expense in P&L?

Assuming the accounting policy choice is appropriately made, the amount included in other comprehensive income is the insurance finance income and expense on a group of contracts that relates to the change in discount rates at the inception of the group of contracts to those at the end of the current reporting period - the objective being to segregate the effects of underwriting performance from the effects of changes in discount rates.

The systematic allocation applied to the group of contracts is different depending on whether the contracts have cash flows that are substantially affected by financial risk.

Illustrative Example 15 from IFRS 17 Illustrative Examples shows how this could work in practice.

Q11.5 What is included in other comprehensive income for accounting mismatches with income or expenses between the underlying items held and the insurance contract liability?

An insurance contract will be classified as an insurance contract with direct participating features if the policyholder participates in a share of a clearly identified pool of underlying items, for example, traditional participating life insurance business where a percentage of the returns on underlying assets are passed back to policyholders.

In this situation where an entity holds the underlying assets it also includes the disaggregation of the return on the underlying assets so that the finance result on the profit and loss is zero (includes the offsetting items of movements in the insurance contract liability and underlying assets) and the other comprehensive income is zero (also includes the offsetting movements).

Illustrative example 16 from IFRS 17 Illustrative Examples shows the accounting for this.

11.3 Financial Statements / Disclosures

Q11.6 What are the key changes from an actuarial perspective for the financial statements and disclosures?

Overall the detail and complexity of the disclosures has increased considerably from current requirements and additional cuts of data or analysis will be required in order

to meet the disclosure requirements beyond what would be required to calculate the policy liabilities.

Key figures and key reconciliations are a mix of actuarial and accounting cash inflows and outflows. This results in a very complex process, with many more cross reconciliation points that reconcile within the accounts than before.

Success will require very careful detailed planning and co-ordination between accounting and actuarial teams when implementing AASB 17 to ensure that:

- All the components are produced in a way that ensures consistency between actuarial and accounting processes; and
- It enables sources of reconciliation errors to be quickly determined and rectified in a way that ensures consistency across the two reconciliation dimensions.

AASB 17.38 requires the separate disclosure of the groups of contracts that are issued as assets and that are issued as liabilities (although this requirement is being questioned with the TRG). All previous analysis has required the separation and monitoring of groups of contracts that are onerous and not-onerous and the disclosures require a separate consideration as to their asset or liability position.

AASB 17.103 requires the separate disclosure of insurance revenue/service expenses and investment components. Currently for products such as conventional business where a combined premium is charged for investment and insurance components within the contract, it is not necessary to separate that premium into the separate components. Under IFRS 17 this separation will be necessary and we expect that actuaries will need to provide the information necessary to do this.

AASB 17.100 -105 sets out the detailed reconciliations required including:

- The components that made up the total insurance contract liability at the balance date; and
- How these components change from the beginning to the end of the period. The components of the insurance contract liability include items such as
    - Present value of future cash flows
    - Risk adjustment
    - Contractual service margin
    - Liability of remaining coverage (excluding loss component)
    - Loss component of remaining coverage
    - LIC.

AASB 17.119 requires the disclosure of the confidence level used to determine the risk adjustment. Even if the cost of capital method is used to calculate the risk adjustment, the company must determine the equivalent confidence level for the purpose of disclosures.

Q11.7 Are there any illustrative accounts available?

Yes, see **KPMG 2018**.

11.4 Use of Materiality and Judgement

Q11.8 Are there any specific considerations on the use of judgement under AASB 17?

Sub-chapter 1.7 Materiality addresses materiality.

Under IFRS 17.93 all significant judgments and changes to those judgments including the inputs, assumptions and techniques used, need to be appropriately disclosed in the notes to the accounts. The actuary needs to ensure that the nature of any judgment calls are understood and agreed with the preparer who is ultimately responsible for the accuracy of the accounts issued and the disclosures therein.

For example, where an accounting estimate is to be made in absence of suitable data, then, in such a case, the actuary should discuss the nature of the judgment call with the preparer if material or the use of materiality if not material.

12 Transition

12.1 Introduction

Q12.1 What is the scope of this Chapter?

This chapter covers information about transition to AASB 17, including the various possible approaches and the treatment of reinsurance contracts.

Q12.2 Which sections of AASB 17 address this topic?

AASB 17 Appendix C and IFRS 17.BC372- BC407 deal with transition.

12.2 Overview of Transition

Q12.3 What is Required upon Transition to AASB 17?

At the date of transition, AASB 17 is applied retrospectively as if it had always applied, which requires (AASB 17.C2, IFRS 17.BC374):

- the grouping and measurement of existing insurance contracts to be done as if AASB 17 had applied from when they were written; and
- any existing balances relating to existing accounting for insurance contracts, e.g. under AASB 1023 or AASB 1038 to be de-recognised, including some intangibles; and
- any existing balances separated out under AASB 1038 and that cannot be separated out under AASB 17 to be de-recognised and included in insurance contract liabilities, as if AASB 17 had applied from when they were written. As the test for unbundling the deposit component is much tighter under AASB 17.11(b) and AASB 17.B31-32 than it was under AASB1038.2.1-3, it is likely that, for example, for most investment linked contracts that included insurance riders, the investment component can no longer be reported separately as investment contracts under other accounting standards (e.g. AASB 15 and AASB 9); and
- the recognition of any net difference balances in equity and no adjustment to goodwill (IFRS 17.BC374).

Q12.4 What are the Transition Date and Initial Application Date?

The transition date is the start of reporting year prior to adoption (AASB 17.C1) i.e. the start of the comparative year. The initial application date is the start of the reporting year for which AASB 17 is first applied i.e. adoption date. For example, if AASB 17 is first applied for an annual reporting year starting on the 1 January 2021, then the initial application date is 1 January 2021 and the transition date is 1 January 2020.

Q12.5 What are the latest and earliest possible Initial Application dates for AASB 17?

For with-profit entities subject to Australian Accounting Standards (see AASB 17.C1):

- AASB 17 must be applied for annual reporting periods commencing on or after 1 January 2021, which means the latest possible initial application date is 31 December 2021, with a prior annual reporting period commencing on 31 December 2020; and
- Earlier application is permitted if both AASB 9 and AASB 15 are also applied by the initial application date of AASB 17. This means the earliest possible initial application date is 1 January 2018, unless these two Standards are also early adopted.

12.3 Full Retrospective Approach

Q12.6 What does the Full Retrospective Approach Require?

The Full Retrospective Approach requires the application of AASB 17 retrospectively at the transition date as if it had always applied (AASB 17.C2 and IFRS 17.BC374), which means that both the grouping of existing insurance contracts and the measurement of those groups insurance contracts is to be done as if AASB 17 had applied from when they were written.

In practice, the measurement of the fulfilment values, i.e. expected value of future cash flows and risk adjustment, can be estimated at transition date based on the contracts and circumstances existing as at transition date (IFRS 17.BC375-376).

However, the determination of the CSM (or loss component) for a group of insurance contracts remaining as at transition date effectively requires:

- the determination of the CSM of the group as at the date of inception of all the contracts originally in the group (not just those still existing at transition date) based on assumptions that would have been used if AASB 17 had applied at that date;
- updating of the group CSM for events after inception of the group, as follows:
  - accretion of interest;
  - changes in estimates of cash flows and risk adjustment for future service at each reporting period due to changes in composition of the group and assumptions;
  - experience items that would adjust the CSM, e.g. premiums received for future service and investment component;
  - release of the CSM based on coverage provided and expected to be provided at each reporting date.

This is likely to be increasingly impracticable (IFRS 17.BC378) the further back from the transition date the group was initially established as:

- the data required may not have been captured or no longer held; and
- the setting of assumptions for each historic reporting date, where they do not exist, that are free from the influence of hindsight would be extremely challenging.

This is particularly relevant for contracts eligible to use the VFA as much of that business will be legacy business. Even for newer Investment Linked contracts, unbundling may well be possible, which would make such contracts ineligible for the VFA (indeed, the investment component may not even be subject to AASB 17).

Q12.7 What do I also need to do for other comprehensive income at transition?

If the accounting policy choice is made to disaggregate insurance finance income and expense between profit and loss and other comprehensive income, at transition, an entity needs to determine the amount that would have been historically allocated as other comprehensive income as if the accounting standards had always been adopted unless impracticable (see AASB 17.C3-4). This is required due to the cumulative amount in other comprehensive income (OCI) in respect of an insurance contract needing to be run off over the life of the group or reclassified as profit or loss if the contract is transferred or sold to a third party, or a contract modification requires derecognition of an insurance contract.

Q12.8 What does *impracticable* mean?

AASB 108 sets out the general requirements for transition under a new accounting standard and defines it as (AASB 108.5):

> *Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so. For a particular prior period, it is impracticable to apply a change in an accounting policy retrospectively or to make a retrospective restatement to correct an error if:*
>
> *(a) the effects of the retrospective application or retrospective restatement are not determinable;*
>
> *(b) the retrospective application or retrospective restatement requires assumptions about what management's intent would have been in that period; or*
>
> *(c) the retrospective application or retrospective restatement requires significant estimates of amounts and it is impossible to distinguish objectively information about those estimates that:*
>
> *(i) provides evidence of circumstances that existed on the date(s) as at which those amounts are to be recognised, measured or disclosed; and*

(ii) would have been available when the financial statements for that prior period were authorised for issue from other information.

Q12.9 When is the Full Retrospective Approach impracticable?

Although *undue cost and effort* is a criterion for the use of the permitted modifications under the modified retrospective approach, this is not the same as the *making every reasonable eff*ort test for *impracticable* (see IAS 8.BC23-BC24).

The impracticality test is effectively met when hindsight is required, which occurs when:

- assumption(s) need to be made as to what intent would have been (see (b) in the definition above), e.g. determining the appropriate adjustment for risk at time when the entities approach to compensation for risk was at best only implicit in its pricing or risk appetite; or
- evidence of the circumstances needed to make a measurement at a prior time are lacking (see (a) in the definition above) or would not have been available at the time of measurement (see (c) in the definition above).

This will often be the case for most if not all the elements involved in determining and updating the CSM set out in Q12.6 above (see IFRS 17.BC378).

Also, where benefits depend on the entity's discretion, it will be increasingly difficult to say how that discretion would have been applied in the past, particularly for most contracts eligible to use the VFA.

12.4 Alternatives

Q12.10 Are there alternative transition approaches?

If the full retrospective approach is impracticable for a group of insurance contracts, then there is a choice of two alternative transition approaches (AASB 17.C5):

1. the modified retrospective approach; or
2. the fair value approach.

However, if the modified retrospective approach is not possible using reasonable and supportable information, then the fair value approach must be used for that group. The entity also has the option to use the fair value approach, even when the modified retrospective approach is possible, if the full retrospective approach is impracticable.

12.5 Modified Retrospective Approach

Q12.11 What is the Modified Retrospective Approach?

The Modified Retrospective Approach means using the minimum modifications necessary for achieving the closest outcome to the Full Retrospective Approach that is possible using reasonable and supportable information (AASB 17.C6, AASB 17.C8

IFRS 17.BC379). The entity can only disregard such information as is available if it would involve undue cost or effort. If such information is not available, then the Fair Value approach must be used.

Q12.12 What areas are permitted to be modified?

The following areas can be modified (AASB 17.C7-8):

- assessments of insurance contracts or GIC that would have been made at the date of inception or initial recognition;
- amounts related to the CSM or loss component for insurance contracts without direct participation features;
- amounts related to the CSM or loss component for insurance contracts with direct participation features; and
- insurance finance income or expenses.

Q12.13 In which areas is there a choice to make a determination either at the date of inception or at the date of transition?

The following determinations can be made either at the date of inception, if reasonable and supportable evidence exists, or at the date of transition, if such evidence is too costly or does not exist (AASB 17.C910, IFRS 17.BC381-382):

- identifying GIC - GIC can include contracts written more than one year apart;
- whether an insurance contract meets the definition of an insurance contract with direct participation features; and
- how to determine discretionary cash flows for contracts without direct participation features.

Q12.14 How is the CSM or loss component at transition determined for GIC without direct participation features?

In order to determine the CSM or loss component for the group at the date of transition (AASB 17.C11, IFRS 17.BC383), for the reasons noted in Q12.6, the following items at the date of initial recognition of the contracts in the group at inception have to be assessed and adjusted:

- future cash flows;
- discount rates to apply; and
- risk adjustment for non-financial risk.

Q12.15 How is the determination of future cash flows at initial recognition modified?

Future cash flows for a group of insurance contracts at the date of initial recognition can be determined as a combination of:

- future cash flows for contracts in the group at the transition or earlier date (if applicable); and
- the actual past cash flows that are known to have occurred for all contracts originally in that group between the date of initial recognition and the date at which the future cash flows element above is determined.

If future cash flows can be determined retrospectively at a date earlier than the transition date, then that date is used as the cut-off point between future cash flows and past actual cash flows instead of the transition date. Cash flows include cash flows in respect of policies that have ceased to exist prior to the transition date (AASB 17.C12).

Q12.16 How is the determination of the yield curve at date of initial recognition modified?

The cash flows of the group need to be discounted using the yield curve that would have applied at the date of initial recognition of the group of insurance contracts (AASB 17.36, AASB 17.B72-B85). This is modified (AASB 17.C13) by allowing this yield curve to be determined by:

- using an observable yield curve at the date of initial recognition, provided that such a curve can be observed for at least three years immediately prior to the transition date.
- if such an observable yield curve does not exist, then estimating an average spread (over at least three years prior to the transition date) between an observable yield curve and the yield curve as estimated by the General Model approach, and applying that spread to the observable yield curve at the date of initial recognition.

Q12.17 How is the determination of the risk adjustment for non-financial risk at the date of initial recognition modified?

This is determined as a combination of:

- the risk adjustment for non-financial risk at the date of transition; and
- an adjustment for the expected release of risk before the transition date, by referring to release of risk for similar insurance contracts that the entity issues at the transition date (AASB 17.C14).

Q12.18 How is the prior release of risk adjustment determined if similar contracts are no longer currently issued?

If similar contracts are no longer being issued, then there appears to be a number of views on the approach that can be used depending on circumstances and would be appropriate to obtain the perspective of those responsible for issuing the entity's accounts. These are:

- if the risk adjustment is not material to balance sheet and profit at transition, then any reasonable estimate can be used;
- estimate as if similar contracts were currently issued – techniques used to determine risk adjustment at date of transition and subsequent release can be used to determine the prior release from risk adjustment. Note though that AAASB 17.C14 states that the prior release of risk *shall be determined by reference the release of risk for similar insurance contracts that the entity issues at the transition date*;
- full retrospective approach can be used to determine the risk adjustment element, which only requires use of reasonable and supportable information and does not preclude the modified retrospective approach being used for the other elements (AASB 17.C8); or
- the Fair Value Approach would have to be used as determination of the release from risk is only permitted by reference to similar contracts issued at transition date. If reasonable and supportable information for this does not exist then the fair value approach must be used. (see AASB 17.C6(a)).

Q12.19 How is the CSM at the date of transition determined?

If a CSM has been determined as at the date of initial recognition using the above approach, then it is updated to the transition date as follows (AASB 17.C15):

- accrete interest on the CSM using the discount rate at initial recognition (as determined in Q12.16 above); and
- reduce by the amount of CSM recognised before the transition date by comparing the remaining coverage units with the coverage units provided prior to the transition date.

Q12.20 How is the loss component at the date of transition determined?

If a loss has been determined as at the date of initial recognition using the above approach, then the loss component is updated to the transition date as follows (AASB 17.C16) by:

- determining any amounts allocated to the loss component before the transition date using the approach in **Q12.15 How is the determination of future cash flows at initial recognition modified?** to **Q12.18 How is the prior release of risk adjustment determined if similar contracts are no longer currently issued?**; and
- using a systematic basis of allocation for those amounts.

Q12.21 How is the CSM or loss component determined for GIC with direct participation features

AASB 17.C17 sets out the calculation requirements for contracts eligible to use the VFA. Consequently, any modifications allowed for other contracts (in relation to cash

flows, discount rates, risk adjustment and prior release of the CSM) are irrelevant in this context.

The calculation of CSM is effectively in two parts. Firstly the CSM at inception is estimated. The calculation is:

a) Determine the fair value of the pool of underlying items as at the transition date;

b) Subtract the present value of future cash flows as at the transition date – i.e. the present value of future net cash outflows;

c) Subtract the amounts paid before the transition date that didn't come out of the pool of underlying items – either directly or notionally (the amounts that did come out of the pool are already assumed to have depleted the pool and so are reflected in the value of a)) – i.e. the accumulation of past unrecognised cash outflows;

d) Add the amounts deducted from policyholder benefits before the transition date (e.g. asset management charges, policy fees, insurance premiums) which are assumed to be payable to the entity – i.e. the accumulation of past cash inflows to entity and not policyholder; and

e) Subtract a risk adjustment – this is the risk adjustment as at the transition date, grossed up by the way in which the risk adjustment runs-off for similar contracts still issued. (Note that AASB 17.C17 includes the future risk adjustment in the FCF (AASB 17.C17(b)), and so only adjusts (in AASB 17.C17(c)(iii)) for the past risk adjustment, instead of deducting the full risk adjustment at inception. It is presented differently here so that it is clear how cash flows and risk adjustment are treated separately – even though the outcome is the same.) Note that AASB 17.C17(c)(iii) refers to business still being written when determining the size of this risk adjustment – thus, under a literal interpretation, if new business is no longer being written then it may be that AASB 17.C17 cannot be applied and there is no choice but to use the Fair Value Approach (see **Q12.18 How is the prior release of risk adjustment determined if similar contracts are no longer currently issued?**).

This is then adjusted for the release of CSM between inception and transition by multiplying by the remaining coverage units at transition and dividing by the coverage units both before and after transition. (Note that actual decrements between inception and transition do not need to be allowed for in this case, as they will have already been reflected in the current size of the pool.)

If the calculation suggests that there is a loss, then the loss component is assumed to be nil (i.e. there is no scope for future loss reversal, and all subsequent favourable changes will result in a CSM). The liability for future coverage at transition will just be the present value of future cash flows as at the transition date, plus the risk adjustment as at the transition date.

Q12.22 How is Insurance Finance Income and Expenses determined under the Modified Retrospective Approach?

The cumulative difference between the insurance finance income and expense recognised in P&L and that recognised in OCI is equal to the cumulative amount recognised in OCI on the underlying items (i.e. the liability amount recognised in OCI is assumed to be equal to the amount already recognised in OCI on the asset side).

The effect is that the net of the two separately presented items is nil.

12.6 Fair Value Approach

Q12.23 With respect to transition, when is the Fair Value approach to be used?

The Fair Value approach is to be used:

- if full retrospective approach is impracticable and the entity elects to use the fair value approach; or
- if full retrospective approach is impracticable and the entity cannot obtain reasonable and supportable information necessary to apply the modified retrospective approach (AASB 17.C6 (a)).

Q12.24 How is the fair value approach applied at transition?

The fair value approach (AASB 17.C20) is used to determine the CSM or loss component at the transition date as the difference, measured at that date, between the fair value of a GIC and the FCF.

Q12.25 What other transition modifications apply if using the fair value approach?

The following determinations can be made either at the date of inception, if reasonable and supportable evidence exists, or using information available as at the date of transition:

- identify GIC;
- group together contracts that are more than one year apart;
- whether an insurance contract meets the definition of an insurance contract with direct participation features and so is eligible to use the VFA; or
- the discount rates to be used (at the transition date rather than the date of initial recognition or incurred claim).

Q12.26 How is Insurance Finance Income and Expenses determined under the Fair Value Approach?

The cumulative difference between the insurance finance income and expense recognised in P&L and that recognised in OCI is equal to the cumulative amount recognised in OCI on the underlying items (i.e. the liability amount recognised in OCI is assumed to be equal to the amount already recognised in OCI on the asset side).

The effect is that the net of the two separately presented items is nil. This calculation is the same as that under the Modified Retrospective Approach.

Q12.27 What is the Fair Value of a group of insurance contracts?

The fair value of a group of insurance contracts is determined applying AASB 13 *Fair Value Measurement* except the demand floor requirements of AASB 13.47 are excluded (see AASB 17.C20).

As fair value measurement already applies to Life Investment Contracts under AASB 1038.20 and LPS 340.23, the techniques involved should carry across to insurance contracts and be familiar to Australian Actuaries. Accordingly, the details of fair value have not been covered in this information note.

Accordingly, it is arguable that for contracts eligible for the VFA, the fair value of liabilities will be equal to the fair value of the pool of underlying items relevant to the benefits under the contract (excluding what might already have accrued to the shareholder but is still included in the pool).

If unadjusted, it is very likely that the fair value of insurance contract liabilities will be much lower than that produced under either the full transition approach or the modified retrospective approach. Under typical approaches the profit is capitalised (at current wholesale market expectations rather than historic retail margins), which reduces the amount the acquirer needs to receive to take on the liabilities – under AASB 17 those profits are allowed to emerge in the future. If the value under typical approaches is applied directly, then a lower CSM (possibly even zero) would be expected if the Fair Value Approach is used on transition in preference to other approaches.

Q12.28 What are the implications for disclosure?

If the required disclosures for CSM and insurance revenue reconciliations include balances as at the transition date, separate disclosures are required for insurance contracts to which the fair value approach was applied at transition (AASB 17.114). An entity must also include an explanation of how it determined the measurement of insurance contracts at the transition date (AASB 17.115).

12.7 Transition for Reinsurance and Modified Contracts

Q12.29 Can all treaties be included in one group at transition?

Groups may include contracts issued more than one year apart, where:

- fair value approach is used; or
- the modified retrospective is used, if the entity does not have reasonable and supportable information to enable it to group no wider than one year (see **Q12.11 What is the Modified Retrospective Approach?**).

Note, this does not change other criteria for grouping, e.g. that contracts all be in the same portfolio of insurance contracts (AASB 17.16).

For example, for reinsurance assumed, contracts are typically treaties where a treaty may cover particular cohorts or products, be proportional versus non-proportional, quota share versus surplus, coinsurance versus risk premium etc. This does not mean that 'any' treaty which have been issued more than one year apart may be grouped for transition purposes disregarding the nature of the treaty and the risks it covers, as to be in the same portfolio, insurance contracts need to be subject to similar risks and managed together (AASB 17 Appendix A).

Also contract modifications need to be appropriately recognised, assuming that the volume of contract modifications is not material to the amounts determined on transition, a reasonable approach could be to assume modified contracts have always been modified.

Q12.30 How are addendums treated?

Addendums are typically modifications to the 'base' treaty. Addendums may be attached to the 'base' treaty to change the rights for the reinsurer to reprice from a certain effective date (this would be substantial as it may affect contract boundaries) or change the rebate of risk premium rates to name a few. If they require the consent of both parties to the contract, as contract modifications, they would affect the accounting for the treaty, at the time of modification (see **Chapter 10 Contract Modifications and Derecognition**).

For example, if there is a history of price changes (which may not be fully tracked), these need to be considered appropriately in determining future cash flows at initial recognition (see **Q12.5 What are the latest and earliest possible Initial Application dates for AASB 17?**) and whether the modification resulted in the modified contract being treated as a new contract?

Q12.31 What Issues are there in applying the Fair Value Approach to Reinsurance?

Where the fair value approach is used for reinsurance held, care needs to be taken to ensure that that both the fair value and fulfilment value, reflect the contract boundary of the reinsurance held, which may well vary from the contract boundary of the underlying policies.

Q12.32 How is risk of non-performance of reinsurer measured at transition?

Estimates of future cash flows at initial recognition and subsequently for transition purposes for reinsurance held need to include the risk of non-performance, which is part of the future cash flows for reinsurance held (AASB 17.63). The modifications permitted under the modified retrospective approach for the measurement of future cash flows (see Q12.15) can be considered to include this element.

Section E. References and Acronyms

13 References

Australian Accounting Standard Board (2017). AASB 17 Insurance Contracts.

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Australian Accounting Standards Board (2014). AASB 1023: General Insurance Contracts.

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Actuaries Institute (2012). Valuation of Health Insurance Liabilities. Practice Guideline 699.02

https://www.actuaries.asn.au/library/Standards/HealthInsurance/2012/PG699_02Dec2012.pdf

This Practice Guideline is intended to assist actuaries preparing estimates of the health insurance liabilities of Insurers licensed under the Act. Health insurance liabilities include both the Outstanding Claims Liability and the Future Claims Liability. Chapter 10 covers risk margins.

Actuaries Institute (2011). Illiquidity Premiums

https://www.actuaries.asn.au/Library/Submissions/Superannuation/2011/APRA_Illiquidity_Premiums.pdf

A working party of The Actuaries Institute produced a proposal dated 17 November 2011. This provided a large body of information on different methodologies, giving examples of illiquidity premium estimates from historic data for Credit Default Swaps, semi-government bonds and government guaranteed bonds. This was then re-stated as a formula using corporate bond spreads as an input, using least squares regression techniques

Australian Prudential Regulatory Authority (2017). APRA's Approach to AASB 16 Leases and AASB 17 Insurance Contracts

APRA Letter to industry on AASB 16 and 17.pdf

This letter to all general insurers, life insurers and private health insurers set out APRA's planned response to the issuance of AASB 16 Leases and AASB 17 Insurance Contracts.

Australian Prudential Regulatory Authority (2014). Approved alternative method to calculate the illiquidity premium.

http://www.apra.gov.au/lifs/Documents/140310-illiquidity-premium-response-letter-March-2014.pdf

This letter to CEOs and Appointed Actuaries of Life Insurers (including Friendly Societies) set out an approved alternative method to calculate the illiquidity premium using RBA published data (at that time).

Australian Prudential Regulatory Authority (2013). General Insurance Prudential Standard GPS (115): Insurance Risk Charge.

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http://www.apra.gov.au/lifs/PrudentialFramework/Documents/120330_LTI_LA+_LI_illiquidity_premium_consultation.pdf

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Bui. H. And Cummings. B. (2008). R*isk margins for Life Insurers Liabilities*. Presented to the Institute of Actuaries of Australia, 4th Financial Services Forum.

https://www.actuaries.asn.au/Library/Events/FSF/2008/FSF08_5a_part2_hoa%20Buipaper.pdf

This paper provided Australian actuaries practicing in life insurance with an introduction to the consideration, current thinking and techniques involved in

setting risk adjustments under the exit framework that was being considered by the International Accounting Standard Board for insurance contracts. Risk adjustments were calculated based on a Cost of Capital Method and quantile methods, with the key finding that the Cost of Capital Method was easier to apply than the quantile method.

Bu. Di. and Liao. Y. (2013). Structural Credit Risk Model with Stochastic Volatility: A Particle-Filter Approach, NCER Working Party Series

http://www.ncer.edu.au/papers/documents/WP98.pdf

This is an Australian paper that provides a structural approach in calculating an illiquidity premium.

Coulter. B. (2016). PWC. Risk adjustments for life insurers: Using a GI approach in a life insurance context.

https://actuaries.org.nz/wp-content/uploads/2016/07/6-paper-Risk-adjustments.pdf

This paper used the Risk Margin Taskforce (2008) paper to estimate a reasonable range of risk adjustments for a typical yearly renewable term life portfolio in New Zealand.

International Actuarial Association (unpublished). Application of IFRS 17 Insurance Contracts

http://www.actuaries.org/index.cfm?lang=EN&DSP=PUBLICATIONS&ACT=STANDARDS_PRACTICE_GUIDELINES

This soon to be published IAN has been written to assist actuaries in complying with IFRS 17 and ISAP4, by offering practical examples of ways in which actuaries might implement the ISAP and IFRS 17 in the course of their work.

A number of existing IANs will be withdrawn by the IAA as the topics will no longer be applicable under IFRS 17.

International Actuarial Association (unpublished). Risk Adjustments for Financial Reporting of Insurance Contracts under International Financial Reporting Standards No. 17

http://www.actuaries.org/index.cfm?lang=EN&DSP=CTTEES_ACTSTD&ACT=DOCUMENTS

This soon to be published monograph is intended to address the educational needs of practitioners in the insurance field who are involved in the preparation and auditing of financial statements under IFRS 17 Insurance Contracts. It provides

descriptions and illustrative examples of techniques that could be applied in the risk adjustment calculation for various insurance contracts.

International Actuarial Association (2013). Discount Rates in Financial Reporting: A Practitioners Guide.

This monograph provides information on discounting in financial reporting from a practical and conceptual perspective.

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This book presents the mathematical and statistical framework necessary to develop stochastic models in any setting (insurance or otherwise).

International Actuarial Association (2009). Measurement of Liabilities for Insurance Contracts: Current Estimates and Risk Margins.

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This research paper was written by the ad-hoc Risk Margin Working Group (RMWG) in 2009 on behalf of the IAA. It has a detailed discussion on the various approaches to calculating risk margins with an overall preference for the Cost of Capital Method.

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http://www.ifrs.org/issued-standards/list-of-standards/ifrs-17-insurance-contracts/

The IFRS 16 Standard, Basis of Conclusions and Illustrative Examples are available on the website for subscribers.

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http://www.ifrs.org/groups/transition-resource-group-for-insurance-contracts/#meetings

This paper a summary of the 6 February 2018 meeting of the Transition Resource Group discussing submission papers AP01-AP07.

International Financial Reporting Standard – Transition Resource Group for Insurance Contracts (February 2018). AP01: Separation of insurance components of a single insurance contract.

AASB 17 Implementation Task Force

Information Note: AASB 17 Insurance Contracts

http://www.ifrs.org/-/media/feature/meetings/2018/february/trg-for-ic/ap01-separation-of-insurance-components.pdf

This paper provides background and an accounting analysis to support discussion by the TRG in whether IFRS 17 permits the separation of insurance components of a single insurance contract for measurement purposes. Also whether a reinsurance contract held should be separated into components to reflect the underlying contracts covered for measurement purposes when applying IFRS 17.

International Financial Reporting Standard – Transition Resource Group for Insurance Contracts (February 2018). AP02: Boundary of contracts with annual repricing mechanisms.

http://www.ifrs.org/-/media/feature/meetings/2018/february/trg-for-ic/ap02-boundary-of-contracts-with-repricing-mechanism.pdf

This paper provides background and an accounting analysis to support discussion by the TRG in how to determine the contract boundary of insurance contracts with annual repricing mechanisms. In particular, whether those contracts would have a contract boundary of one year (i.e. the first annual repricing date) or longer than one year, depending on which type of risks are relevant in applying IFRS 17.34(b).

International Financial Reporting Standard – Transition Resource Group for Insurance Contracts (February 2018) (February 2018). AP03: Boundary of reinsurance contracts held.

http://www.ifrs.org/-/media/feature/meetings/2018/february/trg-for-ic/ap03-boundary-of-reinsurance-contracts-held.pdf

This paper provides background and an accounting analysis to support discussion by the TRG in how to read the IFRS 17 requirements on cash flows that are within the boundary of an insurance contract when applying them for reinsurance contracts held.

International Financial Reporting Standard – Transition Resource Group for Insurance Contracts (February 2018). AP04: Insurance acquisition cash flows paid on an initially written contract.

http://www.ifrs.org/-/media/feature/meetings/2018/february/trg-for-ic/ap04-insurance-acq-cash-flows-contract-renewals.pdf

This paper provides background and an accounting analysis to support discussion by the TRG in how to account for insurance acquisition cash flows unconditionally paid when a contract is first written by the entity (an initially written contract). The entity (a) expects renewals outside the contract boundary to occur; and (b) has written the new business with that expectation.

International Financial Reporting Standard – Transition Resource Group for Insurance Contracts (February 2018). AP05: Determining quantity of benefits for identifying coverage units

http://www.ifrs.org/-/media/feature/meetings/2018/february/trg-for-ic/ap05-quantity-of-benefit-for-coverage-units.pdf

This paper provides background and an accounting analysis to support discussion by the TRG in how to determine the coverage units of a group of insurance contracts.

International Financial Reporting Standard – Transition Resource Group for Insurance Contracts (February 2018). AP06: Insurance acquisition cash flows when using fair value transition

http://www.ifrs.org/-/media/feature/meetings/2018/february/trg-for-ic/ap06-insurance-acq-cash-flows-fv-transition.pdf

This paper provides background and an accounting analysis to support discussion by the TRG about whether, when the fair value approach to transition is applied, insurance acquisition cash flows that occurred prior to the transition date are recognised as revenue and expense in the statement of financial performance for reporting periods subsequent to the transition date.

International Financial Reporting Standard – Transition Resource Group for Insurance Contracts (February 2018). AP07: Reporting on other questions submitted

http://www.ifrs.org/-/media/feature/meetings/2018/february/trg-for-ic/ap07-reporting-on-other-questions-submitted.pdf

This paper summarises other questions submitted to the TRG and considered as part of the February meeting.

KPMG (2018). Illustrative Disclosures for Insurers. Guide to Annual Financial Statements: IFRS 17 and IFRS 9

https://assets.kpmg.com/content/dam/kpmg/xx/pdf/2018/01/2018-ifs-insurance.pdf

This paper provides an overview of IFRS 17 and how it may affect insurers' financial standards. It includes examples and KPMG insights to assist entities to assess the potential impacts and to prepare for 2021.

KPMG (2017). Insurance Contracts – First Impressions IFRS 17

https://assets.kpmg.com/content/dam/kpmg/xx/pdf/2017/07/ifrs17-first-impressions-2017.pdf

AASB 17 Implementation Task Force

Information Note: AASB 17 Insurance Contracts

This paper provides an overview of IFRS 17 and how it may affect insurers' financial standards. It includes examples and KPMG insights to assist entities to assess the potential impacts and to prepare for 2021.

Life Financial Reporting Sub Committee (2016). Framework for Setting Life Insurance Risk Margins for Regulatory Capital. Information Note.

https://actuaries.asn.au/Library/Standards/LifeInsuranceWealth/2016/LIWMPCINSettinglifeinsuranceriskmarginsMarch2016Final.pdf

This paper presented a framework for setting life insurance risk margins which is similar to, but less complex than, the approach described in the general insurance, Risk Margin Taskforce (2008) paper.

Risk Margin Taskforce (2008). A framework for assessing risk margins. Presented to Institute of Actuaries of Australia 16th General Insurance Seminar, 2008

https://www.actuaries.asn.au/Library/Framework%20for%20assessing%20risk%20margins.pdf

This paper outlined a framework for assessing general insurance liability risk margins and provided practical advice on how to implement it. The key sources of uncertainty were examined and the main quantitative approaches to analysing uncertainty discussed, including commentary on the advantages and disadvantages of each approach.

14 Acronyms

Table 14.1: Acronyms

Abbreviation	Full Description
AAS	**Australian Accounting Standards**
AASB	**Australian Accounting Standards Board**
AASB 17	Accounting Standard AASB 17 *Insurance Contracts*
AASB 1023	Accounting Standard AASB 1023 *General Insurance Contracts*
AASB 1038	Accounting Standard AASB 1038 *Life Insurance Contracts*
APRA	Australian Prudential Regulation Authority
BBA	Building Block Approach
CDS	Credit Default Swap
CoC	Cost of Capital
CPI	Consumer Price Index
CSM	Contractual Service Margin
FCF	Fulfilment Cash Flows
GIC	Group of Insurance Contracts
IAA	International Actuarial Association
IAN	International Actuarial Note
IASB	International Accounting Standards Board
IBNR	Incurred But Not Reported
I-E	Investment less Expenses
IFR	Investment Fluctuation Reserve
IFRS	International Financial Reporting Standard
IFRS 17	International Financial Reporting Standard 17 *Insurance Contracts*
IN	Information Note
LIC	Liability for Incurred Claims
Life Act	Life Insurance Act 1995

LRC	Liability for Remaining Coverage
MoS	Margin on Services
OCI	Other Comprehensive Income
P&L	Profit and Loss
PAA	Premium Allocation Approach
PHI	Private Health Insurance
PRBE	Policyholder Reasonable Benefit Expectations
PRP	Policy Owner Retained Profits
RBA	Reserve Bank of Australia
SRPNP	Shareholder Retained Profits Non Participating
SRPP	Shareholder Retained Profits Participating
TRG	Transition Resource Group
VFA	Variable Fee Approach
VSA	Value of Supporting Assets
YRT	Yearly Renewable Term