

Actuaries Institute

AASB 17 Insurance Contracts

Information Note

Version 2.0

November 2019

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AASB 17 IN Version Control

Version	Key changes	Effective date
1.0	AASB 17 Information Note Version 1.0 - draft for discussion	March 2018
1.1	Version 1.1 is not a draft, but the first operating version. The main changes reflect clarification on various aspects through IASB processes and TRG papers and feedback in Australia. In particular: • More clarity on premium received rather than accrued • Revision of treatment of expense cash flows, including allocation of fixed and variable overheads and acquisition costs • More detail on the level at which diversification benefits apply for risk adjustment purposes • More detail on coverage units • More clarity on treatment of contractual options • More detail on derecognition	July 2018
1.2	Version 1.2 is an update of Version 1.1. A number of refinements and clarifications have been made, following feedback, questions and improved understanding, with the main changes being as follows: • A Preface has been added. This provides more context and amongst other matters explains how areas of uncertainty are being addressed. • To provide ready access to details of areas of uncertainty, a new Chapter 15 (Interpretation Uncertainties) has been added. This includes five tables on: ○ areas where judgement will need to be applied; ○ areas where an accounting choice will need to be made; ○ areas where consequences have been identified, but there is unlikely to be a change; ○ areas where the IASB seems to be open to changing the Standard; and	December 2018

Version	Key changes	Effective date
	○ areas where there is still uncertainty in interpretation, but the Standard is unlikely to change. • Updates which have been made where previously uncertain areas have been clarified (e.g. IASB September TRG); and • Various editorial clarifications have been made.	
Addendum A to Version 1.2	This Addendum A provides changes to what is set out in Version 1.2 of the IN as a consequence of tentative decisions of the IASB at its January and February 2019 meetings.	February 2019
2.0	Version 2.0 captures the changes to IFRS/AASB 17 proposed in the Exposure Draft issued by the IASB/AASB in June/July 2019. It assumes the Exposure Draft proposals are adopted as drafted. Version 2.0 has also been updated where clarity can be provided for matters that in earlier versions of the IN were considered uncertain or where views were still forming. NOTE: Where wording is dependent on the adoption of the proposals in the Exposure Draft, it is highlighted in green.	November 2019

Preface 7

Section A. Background Information 17

1 Introduction 18
1.1 New Accounting Standard for Insurance Contracts 18
1.2 Status of this Document 18
1.3 Accountants and Actuaries 19
1.4 Interpretation of AASB 17 19
1.5 Purpose of this Information Note 20
1.6 Information Note Structure 20
1.7 Materiality 20
1.8 Size of Company 21
1.9 Company and Funds 21
1.10 Mutuals 21
1.11 Practical Considerations 22
1.12 Comparison with Current Accounting Standards 22
1.12.1 Contract not Insurer Liability 23
1.12.2 Contract Boundary 23
1.12.3 Premium Received and Premium Receivable 23
1.13 Prudential Reporting 24
1.14 AASB 17 Overview 25
1.14.1 Scope 25
1.14.2 Key Principles 25
1.14.3 General Measurement Model (GMM) 26
1.14.4 Variations to General Measurement Model 27
1.14.5 Presentation and Disclosures 27
1.14.6 Transition 28

Section B. General Measurement Model (GMM) 29

2 Aggregation and Contract Boundary 30
2.1 Introduction 30
2.2 Identification of portfolios of insurance contracts 30
2.3 Partitioning into GICs 34
2.4 Testing Contract Boundary 38
2.5 Insurance Items Potentially Falling Outside of AASB 17 45

3 Current Estimates 48
3.1 Introduction 48
3.2 General Issues 48
3.3 Issues concerning the definition of cash flows to be included 50
3.4 Inflows 55
3.5 Methods to estimate expected future cash flows 56
3.6 Internal Costs 58
3.7 Changes in Estimates 69

4 Discount Rates 70
4.1 Introduction 70

4.2 Discounting cash flows not dependent on the return of underlying items 76
4.2.1 Overview ... 76
4.2.2 Risk Free Rates ... 78
4.2.3 Extrapolation ... 81
4.2.4 Illiquidity Premium ... 83
4.2.5 Investment Management Expenses ... 86
4.2.6 Grouping ... 87
4.3 Discounting cash flows dependent on the return of underlying items ... 89
5 Risk Adjustment ... 93
5.1 Introduction ... 93
5.2 Calculation steps ... 95
5.2.1 Uncertainty and variability (Step 1) ... 96
5.2.2 Risk aversion (Step 2) ... 99
5.2.3 Diversification benefits (Step 3) ... 103
5.2.4 Quantification (Step 4) ... 106
5.2.5 Communication / disclosure (Step 5) ... 107
5.3 Leveraging the existing framework for setting APRA regulatory risk margins ... 108
5.4 Risk mitigation ... 110
5.5 Estimation techniques ... 111
5.5.1 Confidence level approach ... 111
5.5.2 Cost of capital technique ... 112
6 Contractual Service Margin and Onerous GICs ... 115
6.1 Introduction ... 115
6.2 The CSM ... 115
6.3 Determining the CSM ... 116
6.4 Updating the CSM ... 117
6.5 Releasing the CSM ... 119
6.6 Onerous contracts ... 126
Section C. Variations to the General Measurement Model ... 128
7 Premium Allocation Approach ... 129
7.1 Introduction to Premium Allocation Approach ... 129
7.2 Eligibility for PAA ... 129
7.3 Measurement considerations ... 132
7.4 Onerous GIC Considerations ... 133
7.5 Other PAA considerations ... 135
8 Direct Participation Features ... 138
8.1 Introduction ... 138
8.2 Eligibility to use the Variable Fee Approach ... 138
8.3 Likely VFA eligibility for Australian products ... 144
8.4 Projection of FCF ... 148
8.5 Risk Adjustment ... 151
8.6 Coverage Units ... 152
8.7 Asymmetry ... 152
8.8 Expenses ... 154

8.9 Reinsurance considerations 155
8.10 Experience 156
8.11 Friendly Societies 157
8.12 Aggregation 157
9 Reinsurance and External Risk Transfers 160
9.1 Introduction 160
9.2 Reinsurance 160
10 Contract Modifications and Derecognition 177
10.1 Scope 177
10.2 A contract modification 178
10.3 Specified Contract Modifications 180
10.4 Accounting for Specified Contract Modifications 182
10.5 Other Contract Modifications 184
10.6 Derecognition 184
10.7 Application to Reinsurance and Premium Allocation Approach 186
10.8 Acquired Business 188
11 Disclosure 191
11.1 Introduction 191
11.2 OCI versus P&L 191
11.3 Financial Statements / Disclosures 192
11.4 Use of Materiality and Judgement 195
12 Transition 196
12.1 Introduction 196
12.2 Overview of Transition 196
12.3 Full Retrospective Approach 197
12.4 Alternatives 199
12.5 Modified Retrospective Approach 200
12.6 Fair Value Approach 206
12.7 Transition for Reinsurance and Modified Contracts 208

Section E. Other Useful Information 211

13 References 212
14 Acronyms 227
15 Interpretation Uncertainties 229

Preface

Background to this Information Note

In May 2017, after many years gestation, the International Accounting Standards Board (IASB) released a new international accounting standard for insurance contracts, IFRS 17 *Insurance Contracts* (**IFRS 17**). It also issued a supporting Basis for Conclusions.

The new standard is quite different in many detailed ways from the current accounting standards for life insurance, general insurance and health insurance in Australia although there are many similar principles between the current accounting for Australian general and health insurers and IFRS 17. The standard is complex and there are many challenges to fully understand its implications and to be able to provide definitive guidance, and there will be numerous changes to actuarial and accounting practices.

Following representations from various parties, including industry and professional bodies, the IASB considered a series of proposed changes to IFRS 17, ahead of the standard being implemented. At a series of meetings in 2018 and 2019, these were considered and the IASB tentatively agreed a number of changes to the standard. This culminated in the release in June 2019 of an Exposure Draft (ED) containing the proposed changes. A consultation period ended in late September 2019, and the IASB is expected to finalise the standard in the first half of 2020. A marked-up version of IFRS 17 showing the proposed changes is here. The Basis for Conclusions for the ED is here.

The new standard relies heavily on the work of actuaries, and so in 2017 the Actuaries Institute established a task force (TF) to help actuaries prepare for its implementation. The TF decided that the most useful way of providing support initially would be through an Information Note (IN) – that is, this document.

The International Actuarial Association is preparing an International Actuarial Note (IAN), which is expected to be released as an exposure draft in late 2019. Members of the Australian TF have contributed significantly to the development of the IAN also.

Development of IFRS 17 and AASB 17

The new standard is now expected to apply for reporting periods starting on 1 January 2022 or later. (The IASB agreed to propose a one-year deferral from its current date of 1 January 2021 at the IASB meeting in November 2018, in response to industry concerns.) There is provision for early adoption.

The IASB engaged in extensive consultation in the development of IFRS 17, and to help support the implementation of the new standard, it set up a Transition Resource Group (TRG). The IASB explains the purpose of the TRG is to:

- provide a public forum for stakeholders to follow the discussion of questions raised on implementation; and
- inform the Board in order to help the Board determine what, if any, action will be needed to address those questions. Possible actions include providing supporting materials such as webinars, case studies and/or referral to the Board or Interpretation Committee.

The IASB further advised that implementation questions brought to the TRG should meet the following criteria:

a. must be related to, or arise from, IFRS 17;

b. may result in possible diversity in practice; and

c. are expected to be pervasive, i.e. relevant to a wide group of stakeholders.

The TRG meets regularly. The meetings in 2018 and 2019, with links to relevant papers, were as follows:

- 6 February 2018 (**here**);
- 2 May 2018 (**here**); and
- 26-27 September 2018 (**here**).
- 4 April 2019 (no tentative decisions)

In July 2017, the Australian Accounting Standards Board (AASB) released AASB 17 *Insurance Contracts* (**AASB 17**). It is almost identical to the international standard (the principal exception is that it does not apply for not-for-profit entities). In July 2019, the AASB issued an Exposure Draft for changes to AASB 17, which mirrors the ED for IFRS 17.

As with the IASB, the AASB established a TRG. It has the same objectives as the IASB TRG, being a forum to discuss Australian implementation issues and feed these through to the IASB TRG where appropriate. In practice, it considers interpretive questions and issues in the context of the Australian insurance industry, its specific regulatory environment, product features and market context. The AASB 17 TRG provides a public forum for individuals and entities to bring interpretative questions to a panel of industry representatives for discussion and debate, and to support submissions to the IASB TRG. The AASB 17 TRG is chaired by the Australian representative on the IASB TRG, who provides input to the IASB discussions on behalf of the AASB TRG.

Clarification and Residual Uncertainty

It is important to note the distinction between authoritative and persuasive interpretations. Only what is in IFRS 17 itself and decisions of the IFRS Interpretations Committee (should they formally issue any) are authoritative. Also note that:

- the various Bases for Conclusions do not form part of the Standard and are by their nature persuasive and not authoritative;
- staff views in the TRG papers, like the bases for conclusions, are by their nature persuasive but not authoritative;
- alternative interpretations put forward by TRG members are also persuasive but not authoritative; and
- where a topic has been further considered in the ED Basis for Conclusions (ED.BC), this has been considered by the IASB itself and is therefore more persuasive.

There have been various international and Australian forums for gathering industry views and issues, and then making submissions to the IASB (either via the TRG or directly) and to the AASB 17 TRG in Australia. Key international groups include the European Financial Reporting Advisory Group[1] (EFRAG), and the European CFO Forum[2].

In addition to the AASB 17 TRG and the Actuaries Institute TF in Australia, the Accountants and Actuaries Liaison Committee (AALC) is an informal group of actuaries and accountants which meets regularly to discuss topical issues, including IFRS 17.

Other international organisations that have actively contributed to the discussion and debate surrounding IFRS 17 include the Association of British Insurers (ABI), the European Insurance and Occupational Pensions Authority (EIOPA), the European Securities and Markets Authority (ESMA) the European Banking Authority (EBA), the International Actuarial Association (IAA) and a number of representatives from the international analyst community. Generally, the correspondence from these groups to the IASB is publicly available and can be found online.

In Australia, both the Australian Prudential Regulation Authority (APRA) and the Insurance Council of Australia (ICA) have made public pronouncements and submissions on IFRS 17 and these can also be found online. Appropriate links are provided in Chapter 13 (**References**).

[1] EFRAG – European Financial Reporting Advisory Group – is a private association established in 2001 with the encouragement of the European Commission to serve the public interest. Its Member Organisations are European stakeholders and National Organisations having knowledge and interest in the development of IFRS and how they contribute to the efficiency of capital markets.

[2] The European Insurance CFO Forum ('CFO Forum') is a high-level discussion group formed and attended by the Chief Financial Officers of major European listed, and some non-listed, insurance companies. Its aim is to influence the development of financial reporting, value based reporting, and related regulatory developments for insurance enterprises on behalf of its members, who represent a significant part of the European insurance industry. The CFO Forum was created in 2002.

Where there is more than one interpretation, entities have an accounting choice and the requirements of IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors apply. It is then a matter of judgement for the entity as to which interpretation provides the most useful information to users of its financial statements and the entity should apply its approach consistently for similar transactions and over time.
To help the readers of this IN to appreciate the current position, Chapter 15 (**Interpretation Uncertainties**) includes five tables:

1. Areas where judgement will need to be applied;
2. Areas where an accounting choice will need to be made (e.g. use of the PAA);
3. Areas where consequences have been identified, but there is unlikely to be a change (or the IASB has decided that there will be no change);
4. Areas where the IASB seems to be open to changing the Standard; and
5. Areas where there is still uncertainty in interpretation, but the Standard is unlikely to change.

Proposed and Possible Changes to IFRS 17

Prior to the issue of the ED, there had been 25 areas of possible change considered by the IASB in its various meetings in 2018 and 2019. The ED proposes changes in eight of these areas (as well as some minor amendments). The ED poses a series of questions in respect of the various changes.

In September 2019, the AASB made a submission to the IASB on the ED. Through participation in the AASB TRG, members of the task force that produced this IN were involved in helping draft the submission. The Institute issued a letter of support to the IASB for the AASB submission.

The position taken by the AASB on the various areas of possible change are shown in the table below.

Summary of Issues raised including AASB Response to June 2019 Exposure Draft Proposals

Topic	Exposure Draft Proposals	AASB TRG Submission on ED	Reference in this IN
ED Q 1 **1** – Scope of IFRS 17 | Loans and other forms of credit that transfer insurance risk	Exclude such risks	Support	0 Chapter 15, Table 4
2 – Level of aggregation of	No change	Support	Chapter 15, Table 3

Topic	Exposure Draft Proposals	AASB TRG Submission on ED	Reference in this IN
insurance contracts			
ED Q 2 **3** – Measurement | Acquisition cash flows for renewals outside the contract boundary	Must defer, but optional under PAA if < 1 year boundary	Support with some modifications: • Ability to not defer • Asset on transition • The number of assets to be held	Q3.31 Chapter 15, Table 4 Chapter 7, Q7.12
4 – Measurement | Use of locked-in discount rates to adjust the CSM	No change	Disagree. Propose change to avoid locked-in discount rates; if not change so discount rate for reinsurance held is based on discount rate for underlying contracts.	Chapter 15, Table 3
5 – Measurement | Subjectivity| Discount rates and risk adjustment	No change	Support	Chapter 15, Table 3
6 – Measurement | Risk adjustment in a group of entities	No change	Support	Q5.19 Chapter 15, Table 3
ED Q 3 **7** – Measurement | Contractual service margin: coverage units in the general model	Include investment return service and for VFA investment-related service; disclose quantitative info re timing	Support with some modifications: • Notion of positive investment return • Tax payments attributable to policyholders	Q6.12 Chapter 15, Table 4
ED Q 6 **8** – Measurement | Contractual service margin: limited applicability of risk mitigation exception	Include reinsurance used for financial protection in VFA	Support	Q8.27 Chapter 15, Table 3
9 – Measurement | Premium allocation approach: premiums received	No change	Support	Chapter 15, Table 3
10 – Measurement | Business combinations: classification of contracts	Assessment should be based on terms and conditions at the acquisition date	Support	Q10.24 Chapter 15, Table 3

Topic	Exposure Draft Proposals	AASB TRG Submission on ED	Reference in this IN
11 – Measurement | Business combinations: contracts acquired during the settlement period	No change	Disagree	Q10.23 Chapter 15, Table 3
ED Q 4 **12** – Measurement | Reinsurance contracts held: initial recognition when underlying insurance contracts are onerous	Change to allow reinsurance offset if strictly proportionate	Support with some modifications: • Scope of reinsurance contracts too narrow	Q9.9 Chapter 15, Table 4
13 - Measurement | Reinsurance contracts held: ineligibility for the variable fee approach	Not addressed	Support	Q8.14 Chapter 15, Table 3
14 - Measurement | Reinsurance contracts held: expected cash flows arising from underlying insurance contracts not yet issued	No change	Disagree	Chapter 15, Table 3
ED Q 5 **15** – Presentation in the statement of financial position | Separate presentation of groups of assets and groups of liabilities	Change: aggregate now at portfolio level	Support with some modifications: • Portfolio better than group but still too low a level	Q11.6 Chapter 15, Table 4
16 – Presentation in the statement of financial position |	No change	Support	Q7.11 Chapter 15, Table 4

Topic	Exposure Draft Proposals	AASB TRG Submission on ED	Reference in this IN
Premiums receivable			
17 – Presentation in the statement(s) of financial performance | OCI option for insurance finance income or expenses	No change	Support	Section 11.2 Chapter 15, Table 3
18 – Defined terms | Insurance contracts with direct participation features	No change	Support	**Error! Reference source not found.** Chapter 15, Table 3
19 – Interim financial statements | Treatment of accounting estimates	No change	Disagree. Permit final reporting to be independent of interim reporting.	Chapter 11 Chapter 15, Table 3
ED Q 7 **20** – Effective date | Date of initial application of IFRS 17	Defer to 1 January 2022	Support	Section **1.1 Q12.5** Chapter 15, Table 4
21 – Effective date | Comparative information	No change - issue addressed via topic 20	Support	Chapter 15, Table 3
ED Q 7 **22** – Effective date | Temporary exemption from applying IFRS 9	Exemption now to 1 January 2022	Support	Chapter 15, Table 4
23 – Transition | Optionality	No change apart from topics 24 & 25.	Support	Chapter 12 Chapter 15, Table 3
ED Q 8 **24** – Transition | Modified retrospective approach: further modifications	Primarily, only allowed change for contracts acquired in settlement period & risk mitigation	Support allowed change with modifications: • Extend concession at transition to include contracts acquired at any time	Section 12.5 Chapter 15, Table 3
25 – Transition | Fair value	No change	Support	Section 12.6

Topic	Exposure Draft Proposals	AASB TRG Submission on ED	Reference in this IN
approach: OCI on related financial assets			Chapter 15, Table 3
ED Q 9 Minor Amendments		Support	Q6.10, Q10.24,
ED Q 10 Terminology	*replace 'coverage' with 'service' in the terms 'coverage* units', *'coverage period' and 'liability for remaining coverage'*	Support	Q6.12

APRA

APRA issued a letter on 16 November 2018 to all life and general insurers providing an update on APRA's planned approach to integrating AASB 17 into the capital and reporting frameworks by the first quarter of 2021. The letter provides details on the intended principles of the review, its scope, process and indicative timelines. An initial discussion paper is due for release by third quarter of 2019 and draft regulatory standards by second quarter of 2020. A link to the roadmap letter is **here**.

APRA also issued a letter on 16 November 2018 to all private health insurers (PHI) outlining its planned approach to reviewing the capital framework applicable to PHI, including the impacts of AASB 17, as part of Phase Three of the PHI Policy Roadmap released in August 2016. This followed completion of Phase One (Risk) and Phase Two (Governance) in 2018. Future PHI capital standards are intending to be built off AASB 17. A link to the PHI roadmap letter is **here**.

The Task Force has been working closely with APRA to provide advice on the impact of AASB 17 on the APRA reporting and capital frameworks. Consistent with its mandate to achieve sound prudential outcomes, APRA is assessing balance sheet implications to ensure that industry regulatory capital levels continue to be robust. APRA will also look to ensure that it has ongoing access to granular information to monitor the emergence of profit over time, given this can be an early indicator of emerging risks and future capital strength.

On 27 September 2019, APRA issued a letter to all insurers providing guidance on its approach to AASB 17 to assist insurers in determining their own implementation approach to AASB 17. The letter outlines APRA's indicative directions for integrating AASB 17 into the capital and reporting frameworks for insurers and outlines a revised timeframe for APRA's approach to integrating AASB 17. The indicative directions cover AASB 17 components that relate to APRA reporting and regulatory capital, including timeframes for prudential adoption, product groups,

discount rates, deferred acquisition costs, reinsurance and risk adjustment. APRA seeks feedback from stakeholders on the indicative directions and will accept written submissions until 22 November 2019.

The letter includes APRA's revised timeframes for integration of AASB 17. APRA's intention is for all insurers, regardless of their financial year-end, to commence reporting to APRA (for quarterly and annual reports) and determining regulatory capital requirements from an AASB 17 base from 1 July 2023. This would mean that until 1 July 2023, insurers would need to report to APRA under the existing reporting and prudential standards regardless of the adoption of AASB 17 for preparing general purpose financial reports. APRA is also considering seeking transition information from insurers before 1 July 2023 to assist with understanding the capital impact of the revised capital standards. APRA is yet to determine the specifics of the approach to collecting transition information. However, as an example, APRA may request additional information from insurers to make sure it has full visibility of the capital impact on transition and the adequacy of capital buffers on a forward-looking basis.

Over the coming years, APRA plans to provide progressive updates to stakeholders as well as release discussion papers, and Quantitative Impact Studies. APRA expects to release a first discussion paper in Q2 2020, with an aim to release the final revised prudential and reporting standards in Q2 2022.

The letter also highlights that insurers should step-up their preparations and implementation efforts for AASB 17, given that the implementation is expected to significantly heighten operational risk. In this regard, together with the letter, APRA has released an information request to all insurers to gather information on their preparedness for AASB 17. Responses to the information request are due by 8 November 2019.

APRA's consultation material on AASB 17 is here.

Through its engagement with the Task Force, APRA has indicated that there is no intention to systematically adjust industry capital levels, although idiosyncratic impact is expected for individual entities. While APRA's preference is to align its requirements with the accounting standards, regulatory adjustments will be implemented where necessary to ensure LAGIC remains fit for purpose.

For private health insurers, APRA continues to work on a revised capital framework, which will be based on AASB 17, and will reflect LAGIC principles. APRA's consultation on the private health insurer capital framework review is here.

The APRA timeframes for both reviews have dependency on the timeframes for overall implementation of AASB 17. In this context, APRA is monitoring the International Accounting Standards Board (IASB) process, and the outcome may impact APRA's view on integration of AASB 17 into the reporting and capital framework.

Tax

On 5 November 2018, the Federal Government released a paper for public consultation on taxation of insurance companies under AASB 17. A link to the consultation paper is **here**. The Government is seeking information and comments from interested parties on the tax impacts of implementing the new accounting standard. Consultation is open until 31 January 2019.

As part of the consultation process, Treasury convened a roundtable discussion involving interested parties, as an opportunity to ask us questions on the consultation process and to convey any preliminary views in advance of providing written submissions. The Task Force had two members attend, and it will take an active role in the consultation process into the future.

Public Sector Insurance entities (government and statutory insurers)

In November 2017 the AASB released a Discussion Paper on the application of AASB 17 to government entities. A link to the consultation paper is **here**. The Discussion Paper suggested that entities performing insurance-like activities would be required to use AASB 17 for accounting purposes. Mandatory and non-mandatory criteria were provided to test whether or not an entity's activities were insurance-like.

The Discussion Paper provided examples where it found that specific CTP schemes, workers compensation schemes, lifetime care and support schemes and the NDIS may all be insurance-like arrangements and covered by AASB 17. However, the example of a Medicare-like arrangement was not an insurance-like arrangement.

The paper also discusses discount rates, risk adjustments, contract boundaries and captive arrangements for public sector entities covered by AASB 17.

Submissions to the Discussion Paper were due by 28 February 2018 and those received have been published. The AASB's status is "Work in progress – pending"; no other updates have been provided by the AASB.

Updates to this IN

The Task Force intends to update this IN every three to six months or so, together with other improvements considered necessary as accounting 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 it issued AASB 17 *Insurance Contracts*.

In June 2019, the IASB issued an Exposure Draft (ED) of IFRS 17 which addressed a range of matters considered by the IASB over the period since IFRS 17 was released. Changes that might flow from the ED are not expected to be finalised until the first half of 2020. In July 2019, the AASB issued an ED for AASB 17, which mirrored the ED for IFRS 17.

See the Preface for more details of these changes.

This document assumes the changes proposed in the ED are adopted as drafted. It also highlights in green these changes.

AASB 17 does not apply to superannuation entities applying AASB 1056 Superannuation Entities or 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 2022 (the ED proposed a one-year deferral from its current date of 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.

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 (i.e. firstly insurance revenue and insurance service expenses as per AASB 17.103 and secondly release of CSM and risk adjustment per AASB 17.104).

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 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 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. In particular, the IN will be revised after IASB consideration of the ED feedback and for the final standard; 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. Accordingly, the word 'materiality' is only used in this document to refer to the accounting concept - -in other cases, an alternative word is used.

AASB 101 *Presentation of Financial Statements* and AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors* define materiality (see AASB 101.7 and AASB 108.5)

There are a number of other 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 primarily from the perspective of reporting for for-profit entities. This Information Note deals with the application of AASB 17 in the context of reporting for for-profit entities.

It is not entirely clear for a mutual how the member's interest should be handled in financial reporting under AASB 17. This applies predominantly to life insurance mutuals but may also be relevant for general insurance and health insurance mutuals.

IFRS17.BC265 notes that *the fulfilment cash flows of an insurer that is a mutual entity generally include the rights of policyholders to the whole of any surplus of assets over liabilities. This means that, for an insurer that is a mutual entity, there should, in principle, normally be no equity remaining and no net comprehensive income reported in any accounting period*.

However, IFRS17.BC269 notes that *an insurer that is a mutual entity can distinguish between … the liability attributable to policyholders in their capacity as policyholders from the liability attributable to policyholders with the most residual interest in the entity*. For for-profit entities, the latter would be the owner's equity.

The ED adds a footnote to IFRS 17.BC265 to explain that not all mutual entities have the feature that the most residual interest of the entity is due to a policyholder. In the ED.BC217-BC220, the IASB also notes that, if the member's implied share of the mutual is included in the measurement of the contract, stakeholders have advised that this could result in no equity and no comprehensive income in any accounting period. Notwithstanding this, the IASB reaffirmed its decision not to make any exception for mutuals where policyholders have a residual interest.

The May 2019 IASB TRG meeting points out that:

- the BC accompanies, but is not part of, IFRS 17; and
- that there should not be separate requirements for mutual entities for the reason that *(b) if a mutual entity that issues an insurance contract accounted for that contract in one way and a non-mutual entity that issues the same insurance contract accounted for that contract in a different way, comparability across entities would be reduced*.

This indicates that where contracts are issued by mutual entities on the same basis as for-profit entities (e.g. the Australian health insurance industry), the accounting for the policy should not incorporate any of the implicit value the policyholder may have in the mutual entity.

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. Some 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 the resulting liability of the insurance company. 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 insurance contracts (GIC), 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 (which are not attributable to the portfolio) 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).

1.12.3 *Premium Received and Premium Receivable*

Under AASB 1023 and AASB 1038, premiums are recognised on an accruals basis and a separate receivable is held for premiums due but not received. The timing of premium receipt does not affect the calculation of unearned liabilities or the earning of insurance premium revenue.

AASB 17 requires premium to be recognised as received, both when applying the Premium Allocation Approach (Chapter 7) and when adjusting the Contractual Service Margin (CSM) under the General Measurement Model (Chapter 4). This does not affect the earning of insurance revenue, and so does affect the Liability for Remaining Coverage. The LRC therefore will be negative under some circumstances.

See **paper AP06 for IASB May 18 TRG** for a discussion on the implementation challenges. Note in particular paragraph 10 in that paper:

> *The receipt of premiums during each reporting period affects the measurement of the liability for remaining coverage, as follows:*
>
> *(a) applying the general model in paragraphs 33–37 of IFRS 17, the liability for remaining coverage of each group is measured using the fulfilment cash flows, which reflects the current estimate of future cash flows, and the contractual service margin (CSM) for each group. In other words, the measurement excludes the premiums already received and includes premiums that are due but that have not been received.*
> *(b) applying the PAA, the liability for remaining coverage is measured based on the premiums received less those that have been recognised as revenue.*

Note also that:

- It is unclear how any premiums paid in advance of the insurance contract being recognised should be treated, as AASB 17 precludes any asset or liability being held for future insurance contracts. Initial recognition is only based on premium received date if there is no premium due date; otherwise it is based on the earlier of date coverage commences and premium due date - see AASB 17.25-28.
- For premium receivable but not yet due and that is in respect of coverage already provided, AASB 17 is potentially contradictory on whether this should be included in the Liability for Incurred Claims (General Measurement Model, where paragraph 40(b) specifies that all fulfilment cash flows in respect of past service should be included) or the Liability for Remaining Coverage (PAA, where paragraph 59(b) specifies that the Liability for Incurred Claims relates only to incurred claims). Note that for PAA, paragraph 55 makes no distinction for premiums in the LRC between past and future service. The issue was considered at the July 2019 Australian TRG meeting, where Members considered that although IFRS 17.40 and IFRS 17.59(b) do not use the same specific terms, given that the PAA was intended to be an approximation to the general model, it may be inferred that the LIC under the general model should be measured using the same approach that is applied under the PAA. Applying this interpretation will result in a consistent treatment between the two measurement models.

1.13 Prudential Reporting

Australian Prudential Regulation Authority (APRA) has indicated that it does not intend to adopt AASB 17 as the basis for its prudential capital and performance

reporting framework until 1 July 2023 (see **APRA 2017** and **APRA 2018** and **APRA 2019**). This means that there will be misalignment between AASB 17 and APRA's requirements for the period from adoption of AASB 17 to 1 July 2023, and depending on APRA's approach potentially after that.

This Information Note is not intended to assist in:

- assessing capital under APRA standards;
- the preparation of APRA reports; or
- 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[3], 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 (or the components thereof) 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 of the investment component is only permitted and required if they are distinct. The primary criterion for this is that 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.

3 Note that the term "issued" could cause confusion. It should be read in some places as "on issue" to distinguish from the act of issuing. That is, the entity has policies on issue and reinsurance policies held.

(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 *General Measurement Model (GMM)*

The terms “Core Requirements” and “General Measurement Model” (neither of which are defined terms) in practice are being used interchangeably, with the latter gaining more favour over time. “General Measurement Model” has been used in this IN. (Earlier versions used “Core Requirements”.)

The General Measurement Model was also referred to as the building block approach (BBA) by the IASB during development of IFRS 17.

Under the GMM:

- 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 their 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 a number of items including changes in FCF relating to future service.
- The LIC is measured as the FCF relating to coverage already provided.

1.14.4 *Variations to General Measurement Model*

Variations to the GMM include:

- At the insurer's option, shorter 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 (i.e. the CSM – which for reinsurance held could be either positive or negative) 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 recognised as coverage and expected service is provided; less
  - Insurance service expenses (incurred claims, amortisation of acquisition expenses, loss recognition and reversal, 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;
- 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 GIC, in respect of:
   - the cash flows that have occurred for that GIC including cash flows in respect of those contracts that were in the GIC but are no longer in force;
   - the yield curve for the GIC 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. General Measurement Model (GMM)

2 Aggregation and Contract Boundary

2.1 Introduction

Q2.1 What is the scope of this chapter?

AASB 17 deals purely with insurance contracts and is applicable to all entities accounting for those contracts. 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 of insurance contracts***, 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 GMM covered in this chapter is addressed in AASB 17.2-24, AASB 17.34-35 and AASB 17.B61-B71. IFRS 17.BC69-70 and IFRS 17.BC115-139 also provide 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?

A portfolio is defined in AASB 17 as a set of 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?

A ***group of insurance contracts*** (GIC) is a further partition of a portfolio according to when written and expected profitability (AASB 17.16 and AASB 17 Appendix A).

Hence a "group of insurance contracts" is a set of contracts which incept no more than 12 months apart, to be measured together. It is a sub-set of a “portfolio”. Furthermore, each GIC is the primary 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 (IFRS 17.BC) contain several sections related to this question. The relevant wording in IFRS 17.BC 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.BC 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 GICs. 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.BC in isolation, given that it reflects the IASB’s journey in developing IFRS 17.

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 GICs as historical GICs do not change and GICs are a sub-set of the portfolios.

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

Peril aggregation is a common feature of (general) insurance products. Benefit combination is also a common feature of life insurance products. If the contracts are *subject to similar risks and managed together,* then it could be concluded that multi-perils (or multi-benefit) contracts can be aggregated into portfolios.

Also relevant may be the following references and TRG guidance relating to the separation and combination of insurance contracts:

- **Paper AP01 for IASB Feb 18 TRG** and subsequent discussion which provide guidance on when it may be appropriate to separate components of insurance contracts.
- AASB 17.9 and **Paper AP01 for IASB May 18 TRG** and subsequent discussion which provide guidance on the combination of insurance contracts.

Additionally, it is noted that:

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

This supports the bundling of perils within GICs and therefore portfolios from a practical standpoint, however if the contracts cover multiple perils or benefits then separation of these components may first be required. 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 GICs are onerous, which would not be in the spirit of the Standard.

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 GICs; or

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

Following deliberations by the **February 2018 TRG** and **May 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 or where a set or series of insurance contracts with the same or a related counterparty can be treated as a single contract. This will require careful consideration 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 GICs 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 GICs 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 GICs

Q2.13 When is an issued contract grouped?

A contract is grouped at the earlier of the date when insurance coverage commences or the date 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 GIC at initial recognition and shall not reassess the composition of the GICs 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 GIC, or the GIC 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 GIC (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 existing 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). Thus "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 GIC 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 GIC.

It is worth noting that GICs 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 GICs on a more granular level than prescribed?

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

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

The establishment of a GIC can be a process that spans up to a year. The original classification of the GIC determines the allocation of new contracts during that period. If the expected profitability of an open GIC changes during that period, it might be appropriate to close the open GIC 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 GIC?

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 GIC to which the contracts belong by considering individual contracts.

Reasonable and supportable information for this purpose could be considered to be readily available internal management and reporting information. Examples may include policy disclosure statements, valuation reports, pricing reports, profit testing results or other key profitability metrics. It would be appropriate for actuaries to consider the relevance of documentation supporting the basis for determination in

order to satisfy themselves that they are indeed indicative of profitability of all contracts in the set.

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* GIC. The approach is likely to vary across entities, given the judgemental 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 GIC (portfolio, underwriting year, level of onerousness)?

AASB 17.40 stipulates that:

> *The carrying amount of a GIC 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 GIC 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 GICs, 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 GICs 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 GICs. 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 insurance contract services.*

AASB 17.34 explains that

> *a substantive obligation to provide insurance contract 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:

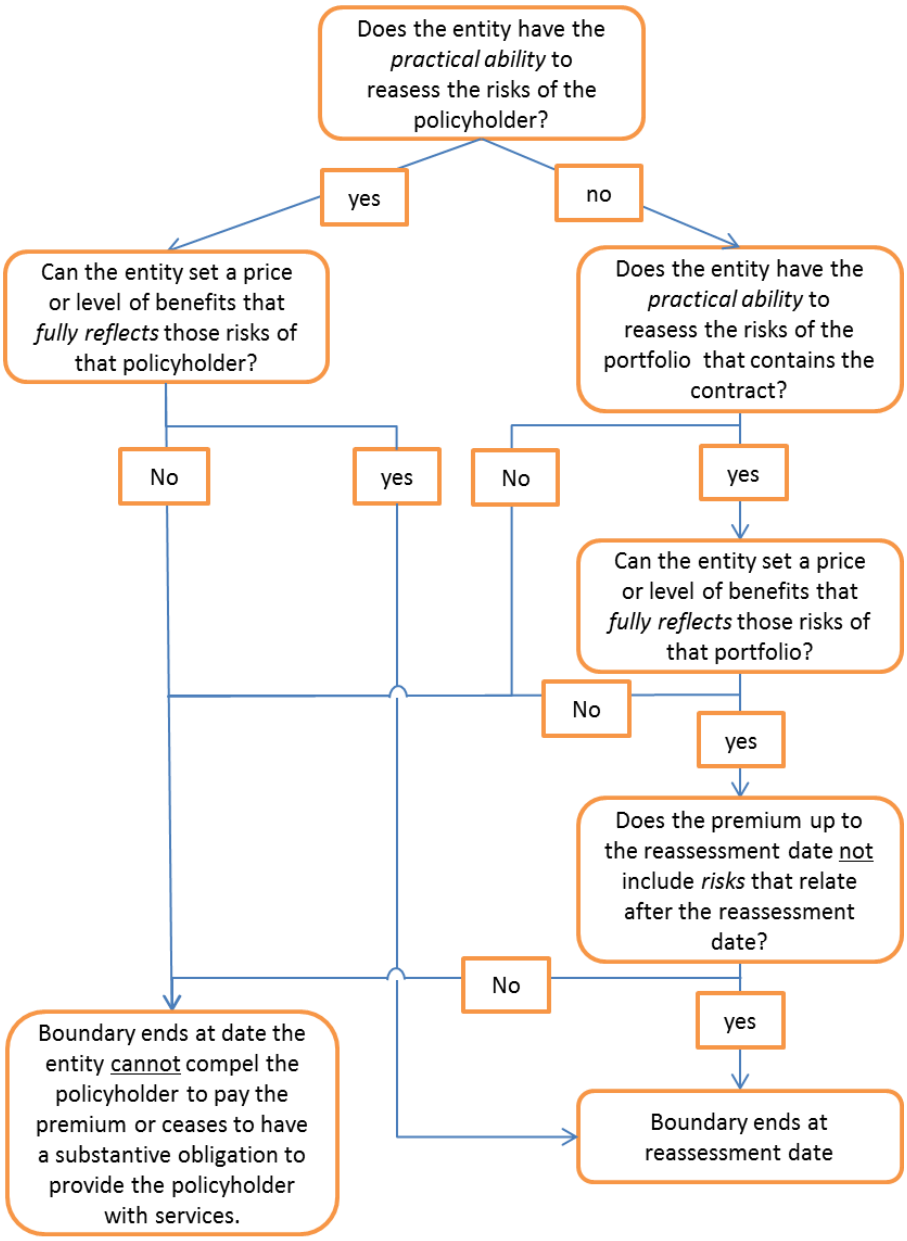
(i) the entity has the practical ability to reassess the risks of the portfolio of insurance contracts that contains the contract and, as a result, can set a price or level of benefits that fully reflects the risk of that portfolio; and

(ii) the pricing of the premiums 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 steps to consider when determining the contract boundary for insurance contracts issued. (See Q9.27 **What is the contract boundary for reinsurance issued and held?** for contract boundary considerations for reinsurance held).

Figure 2.1: Overview of Contract Boundary Decision Points



Q2.24 What is the relationship between contract boundary and coverage period?

AASB 17 Appendix A defines coverage period as:

> *The period during which the entity provides insurance contract services. This period includes the services that relate to all premiums within the boundary of the insurance contract.*

Generally, contract boundary and coverage period can be used interchangeably, but they are different, because:

- contract boundary defines what is included in FCF;

- coverage period defines how CSM is released (via coverage units).

There are various circumstances where coverage period may not align with contract boundary. This is explored in more detail in **Q6.13 When does the coverage period start and end?**

Q2.25 What constitutes a *practical ability* to set a price or benefit level?

As specified in AASB 17.B64 and discussed in the **IASB May 18 TRG paper AP03**, 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. This issue is further discussed in the **IASB May 18 TRG paper AP03** and the **AASB submission to the TRG on Contract Boundary**.

Q2.26 What is the contract boundary 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 or cancel products (and migrate customers) 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 contract boundary would be on the next 1st April with coverage period of at most 12 months. As a result, the contracts in these cases 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.

Q2.27 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 AASB 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.

Q2.28 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 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. Refer to Q2.27 **What risks are to be considered when assessing when a substantive obligation ends?** for details of related February 2018 TRG deliberations on this topic.

AASB 17.34 (b)(ii), unlike AASB 17.34 (b)(i), makes no reference to practical ability. However, the **IASB Feb 18 TRG paper AP02** indicates that it is the actual pricing process that matters when assessing the contract boundary. More specifically, the underlying principle of the contract boundary is that a contract renewal with the same premium that would be available to a new contract should be treated as a new contract because the existing contract does not confer on the existing policyholder any further substantive rights. This is important, in particular for what is known as Yearly Renewable Term (YRT) life insurance with annual stepped premium rates.

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.

Q2.29 What is the contract boundary for long-term policies which contain annual or more frequent pricing or underwriting review features?

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 more complex and requires a careful consideration of the features of the assessed contracts.

The contract boundary definition outlined in Q2.28 **What does pricing of premiums for coverage only for risks up to the reassessment date mean?** is critical. It is subject to the insurance risks (which do not normally include lapse and expense risks), 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 identification of portfolios. More granular portfolios 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 portfolio (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 (underlying principle discussed in Q2.28 **What does pricing of premiums for coverage only for risks up to the reassessment date mean?**) This underpins the contract boundary definition in respect of whether repricing can be carried out at contract or portfolio level.

Q2.30 Is the contract boundary impacted if an incurred claim results in insurance risk for the insurer that would not exist if no claim were made?

This question was deliberated in **paper AP01 for IASB Sep 18 TRG** following a number of submissions. Such insurance risk is referred to as consequential insurance risk. Two examples were included: a disability income policy where a claim was made with a long-term (e.g. to age 65) benefit period and a house insurance policy where there is a possibility for a significant period of time before the policy is reinstated. Different interpretations of the definitions in AASB 17 lead to the consequential insurance coverage being either part of the liability for incurred claims or the liability for remaining coverage.

The paper indicates that it is a matter of judgement for the entity as to which interpretation provides the most useful information about the insurance service provided by the entity to the policyholder. Judgement will be influenced by the relative complexity of the two approaches and comparability with other products available in the market. Furthermore, the entity should apply an approach consistently for similar transactions and over time.

Q2.31 How is the contract boundary determined for group insurance policies?

This question was discussed in **paper AP08 for IASB Sep 18 TRG**, in the context of an arrangement between an insurer and an association or bank (referred to as a "group association policy") under which the insurer provides insurance to members of the association or customers of a bank (referred to as "certificate holders"). The TRG observed that for group association policies, the insurer should consider whether:

- the policyholder is the association/bank or the certificate holders. AASB 17 defines a policyholder by their right to compensation if adversely affected by an insured event. This is the case regardless of whether that compensation is received directly or indirectly (by payment of amounts on the policyholder's behalf);
- the arrangement reflects a single insurance contract or multiple insurance contracts (i.e. with each certificate holder). Noting that, rebutting the presumption that the contract is a single contract by separating components involves judgement and careful consideration of all facts and

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

For the group association policies described in paper AP08, the TRG observed that the following facts and circumstances are indicative that the arrangement reflects multiple insurance contracts for AASB 17:

- the insurance coverage is priced and sold separately;
- other than being members of the association or customers of the bank, the individuals are not related to one another; and
- the purchase of the insurance coverage is an option for each individual.

The TRG further observed that the insurer needs to assess the contract boundary, which for group association policies described in AP08, ends at the point at which the insurer can terminate the policy. The certificate holders' expectation that the group association policy will not be terminated earlier than the end of the contract term is not relevant to the assessment of the contract boundary applying AASB 17.34.

The TRG also noted that:

- the analysis and their observations are specific to the fact patterns of AP08, and there are in practice many different contracts of these types with different terms; and
- the assessment of whether a group association policy reflects a single insurance contract or multiple insurance contracts should be applied to such policies carefully considering all relevant facts and circumstances.

2.5 Insurance Items Potentially Falling Outside of AASB 17

Q2.32 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.

Q2.33 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. AASB 17.7 provides specific examples of contracts outside 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 (i.e. annuities where the payment does not depend on the continuation of human life) and non-participating investment accounts.

Within general insurance, credit card contracts when not priced for individual customer risk are an example of excluded contracts. A further potential example is claim salvage activities as discussed in Q2.32 **Once the rights have been acquired by the insurer, do salvage and subrogation recoveries fall outside of AASB 17?**.

AASB 17.8 and AASB 17.8A provide entities with the choice of applying AASB 9 or AASB 15 instead of AASB 17 to contracts under specific circumstances e.g. loans with death waivers. Once a selection has been made as to which standard is to be applied, however, the choice is irrevocable.

Q2.34 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.

However, under AASB 17 separation of components is only permitted and required if they are distinct. The primary criterion for this is that the components are both able

to lapse without the other component also lapsing (AASB 17.11 and AASB 17.B31-32). Otherwise, the components will need to be treated in their entirety as a single insurance contract. See also sub-chapter 1.14.1

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 17.28A-28D, AASB 17.33-35 and AASB 17.B35A-B71 provide guidance on this topic. IFRS 17.BC146-184 and IFRS 17 ED.BC31-49 also provide 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 or other beneficiaries 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; and
9. Costs incurred in providing an investment-return service or investment-related service that forms part of the insurance contract services.

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 GICs so that the appropriate amounts are included in the measurement of the GIC's FCF for future service and incurred claims as per Q3.5 **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 GIC, 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 analyse 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 GICs 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 favourable and unfavourable 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 favourable 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 17 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 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 GICs 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 or effort (see AASB 17.B54).

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.

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 GIC, but only if it is the regulatory pricing constraints that would cause them to fall into a different GIC. 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.

Q3.13 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 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

Q3.14 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 **Chapter 2 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.

Q3.15 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 before the GIC to which they relate is first recognised. In the same way as insurance acquisition cash flows arising before recognising the GIC are an asset according to AASB 17.28B(b), liabilities arising from prepaid premiums might be recognised as a non-insurance liability, until the insurance contract is recognised.

Q3.16 How are premium adjustments relating to past earned periods treated?

By its nature, the calculation of fulfilment cash flows under GMM allows explicitly for any expected differences between when premiums are earned and when they are paid. Where the PAA applies, paid (or expected) premiums are earned in line with the passage of time or, if significantly different, in line with the expected timing of incurred insurance service expenses.

There are, however, circumstances in which the premium payable is adjusted after the period to which it relates. This might be because actual data is available to replace a previous estimate (such as actual wage data for workers compensation insurance) or because the premium contractually responds in some way to actual claims experience (such as a formal experience adjustment mechanism). In this case, the insurance revenue will be changed by the amount of the premium adjustment *not* relating to future service. For example, an extra CU100 premium received as a result of a true-up in relation to exposure in the current period (or earlier) would add CU100 to insurance service revenue (see AASB 17.B124(d)).

Q3.17 How are overdue premiums treated?

Under AASB 17, the expected future receipt of overdue premiums is not treated as an asset but forms part of fulfilment cash flows. By deducting earned premium from received premium, the PAA methodology achieves a similar outcome. Refer to **1.12.3 Premium Received and Premium Receivable** and **Q7.11 What are key considerations relevant to *premiums received* per AASB 17.55 when applying PAA?**

Q3.18 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.

Q3.19 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 or effort. 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.

Q3.20 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.

Q3.21 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).

Q3.22 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.

Q3.23 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

Q3.24 How are expense cash flows treated?

In considering what expenses are included in FCF, distinction is made between:

(i) expenses clearly directly attributable at the individual contract level;

(ii) expenses that are directly attributable at the portfolio level; and

(iii) other expenses.

The first two sets of expenses are included in FCF. The third set are general expenses of the entity and are not considered in measurement of the expected cash flows of the contracts. Rather, they are recognised in profit or loss when incurred.

AASB 17.B65 states (emphasis added) that:

> *Cash flows within the boundary of an insurance contract are those that relate directly to the fulfilment of the contract, including cash flows for which the entity has discretion over the amount or timing. The cash flows within the boundary include:*
>
> *...*
>
> *(l) an allocation of fixed and variable overheads (such as the costs of accounting, human resources, information technology and support, building depreciation, rent, and maintenance and utilities) directly attributable to fulfilling insurance contracts. Such overheads are allocated to groups of contracts using methods that are systematic and rational, and are consistently applied to all costs*

AASB17.B66 sets out cash flows that are to be excluded, and in particular those specified under AASB 17.B66(d) (emphasis added):

> *d) cash flows relating to costs that cannot be directly attributed to the portfolio of insurance contracts that contain the contract, such as some product development and training costs. Such costs are recognised in profit or loss when incurred.*

IFRS 17.BC181-182, and in particular IFRS 17.BC182(b) make clear that the IASB's intent for acquisition cash flows was to include expenses if they are incremental at the portfolio level, and not just at the contract level (emphasis added):

> *(b) an entity typically prices insurance contracts to recover not only incremental costs, but also other direct costs and a proportion of indirect costs incurred in originating insurance contracts—such as costs of underwriting, medical tests and inspection, and issuing the policy. The entity measures and manages these costs for the portfolio, rather than for the individual contract. Accordingly, including insurance acquisition cash flows that are incremental at the portfolio level in the fulfilment cash flows of the insurance contracts would be consistent with identification of other cash flows that are included in the measurement of the contracts.*

It is possible to take a fairly narrow view of what costs are directly attributable as per AASB 17.B65 and AASB 17.B66. If such a view is taken, then it may be difficult to support the attribution of many fixed and variable overhead costs to the FCF. However, the predominant view is that indirect expenses such as fixed and variable overheads are generally included, except those that are **clearly not directly attributable at the portfolio level**.

There are various sources of support for this position, as set out below.

The IASB's 2010 Insurance Contracts exposure draft in B63 stated (emphasis added):

> *"Some costs relate directly to insurance contracts or contract activities but are the result of activities that cover more than one portfolio (e.g. salaries of staff of a claims handling department working on more than one portfolio).*

> *An insurer shall allocate those costs, other than acquisition costs (see paragraph B61(f)), on a rational and consistent basis to individual portfolios of insurance contracts. Even though such costs are allocations, they are still incremental at the portfolio level."*

The IASB's 2013 Insurance Contracts re-exposure draft also treated fixed and variable overheads as being included if they related to insurance contracts and included a very similar version to AASB 17.B65(l). This draft AASB 17.B66(l) stated that:

> *"fixed and variable overheads (such as the costs of accounting, human resources, information technology and support, building depreciation, rent and maintenance and utilities) that are directly attributable to fulfilling the portfolio that contains the insurance contract and that are allocated to each portfolio of insurance contracts using methods that:*
> *(i) are systematic and rational, and are consistently applied to all costs that have similar characteristics; and*
> *(ii) ensure that the costs included in the cash flows that are used to measure insurance contracts do not exceed the costs incurred."*

The re-exposure draft also explicitly included the following in the cash flow measurement (2013 ED.B66(c)):

> *"directly attributable acquisition costs that can be allocated on a rational and consistent basis to the individual portfolios of insurance contracts. Acquisition costs include costs that cannot be attributed directly to individual insurance contracts in the portfolio."*

As the treatment of expenses was not a topic of discussion at the IASB board following the issuing of the re-exposure draft, it can be reasonably inferred that the subsequent removal of the above paragraph from the final standard does not reflect a change of intent, and hence directly attributable to the portfolio can be read as including fixed and variable overheads directly related to insurance contracts, but not other overheads.

It is also noted that IFRS 15.97(c) prescribes that the following is included in costs relating directly to fulfilling a contract:

> *"allocation of costs that relate directly to the contract or contract activities (for example, costs of contract management and supervision, insurance and depreciation of tools and equipment used in fulfilling the contract)."*

At its most wide application, such an interpretation of AASB 17 suggests that for an entity that exclusively provides insurance services **all** expenses involved in the **daily running** of the business would be considered directly attributable - provided that the business is run efficiently, with no *abnormal amounts of wasted labour or other resources* (AASB 17.B66(e)). This would mean that only expenses which fall outside of the usual business activities would be considered to be not directly attributable. AASB 17.B66(d) – see above – gives examples of costs to be excluded, being **some**

product development and training costs. Thus the vast majority of an insurer's expenses, including marketing, production of product disclosure materials, relationship management costs and the related share of overheads, would be directly attributable to portfolios.

Q3.25 How are investment expenses treated?

When investment administration expenses are estimated, only expenses that are required by the contract are included and 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.

However, investment expenses **would** be allowed for if they were expected to be incurred in providing an investment-return service or investment-related service that forms part of the insurance contract services. It may be possible to allow for these expenses implicitly, by adjusting the discount rate, provided that the FCF is correct and the CSM is correctly adjusted for change in estimates for investment expenses. (see Q8.23 **Are investment administration expenses reflected in the discount rates**).

Q3.26 What methods are appropriate to estimate expected future internally incurred costs?

AASB 17 is silent with respect to techniques to be used for estimating cash flows; therefore, no special techniques are required to determine the allocation of fixed and variable overhead expenses. The customary methods used for pricing or other types of reporting can also be used for the purposes of AASB 17.

Estimates of future management costs will usually make use of any forecasts the entity makes, including budgets and business plans. Those future 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.

Q3.27 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.

Q3.28 How are fixed and variable costs allocated to cash flows treated

After identifying fixed and variable overhead costs that can be directly attributed to portfolios of insurance contracts (see Q3.24 **How are expense cash flows treated?**), they need to be differentiated regarding their function in fulfilling the insurance contracts.

IFRS 17.BC113 makes it clear that other IFRS (and hence AASB) standards are relevant (emphasis added):

> *IFRS 17 requires that cash outflows should be allocated to their related component, and that cash outflows not clearly related to one of the components should be systematically and rationally allocated between components. Insurance acquisition cash flows and some fulfilment cash flows relating to overhead costs do not clearly relate to one of the components. A systematic and rational allocation of such cash flows is consistent with the requirements in … other IFRS Standards for allocating the costs of production—the requirements in IFRS 15 and IAS 2 Inventories, for example.*

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

1) Exclude fixed and variable overhead costs that are not directly attributable to a portfolio of insurance contracts. (AASB 17.B66 (d)).
2) Allocate the remaining fixed and variable overhead costs – those that are considered directly attributable - 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)).

Q3.29 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 that are incremental at the portfolio of contracts level (see Q3.24 **How are expense cash flows treated?**).

Q3.30 How are insurance acquisition costs considered if paid prior to initial recognition of the related GIC?

Under the definition in AASB 17 Appendix A, insurance acquisition cash flows only include those that are directly attributable to the portfolio of insurance contracts. Hence, those that aren't should be expensed as per other standards – probably immediately.

An asset is recognised for any insurance acquisition cash flows paid prior to initial recognition of the GIC to which they relate. This asset is derecognised when the related GIC is recognised, and the insurance acquisition cash flows are then gradually expensed over the coverage period. (See AASB 17.28B(b) and 17.28C)

However, where the option under AASB 17.59(a) is exercised, the costs are immediately expensed when they are incurred and not deferred.

Q3.31 Can insurance acquisition costs be allocated beyond the contract boundary?

When using the PAA, and provided that the contract boundary is no longer than one year, there is an option to immediately expense the acquisition costs when incurred under AASB 17.59(a).

Otherwise, insurance acquisition cash flows must be allocated on a systemic and rational basis (see AASB 17.28A-B) to the GIC to which the insurance contracts are initially allocated and to any future GICs expected to include renewals of these insurance contracts. The allocation of acquisition costs follows a sequential process:

1) Determine the acquisition costs that are directly attributable to the portfolio to which the GIC belongs.
2) Allocate these acquisition costs to current and future GICs.
3) Determine the share of acquisition costs for each current GIC in the portfolio.
4) For each current GIC, allocate this share *on a systematic and rational basis* between the current GIC and any future GICs expected to include the renewals arising from the current GIC. Subject to impairment tests, any acquisition costs allocated to future GICs will be recognised as an asset until those GICs are recognised. The recoverability of this asset is assessed if facts and circumstances indicate that the asset may be impaired, in which case the asset is adjusted accordingly. This may be subject to subsequent loss reversal.
5) When a future GIC is recognised (i.e. becomes current), its allocated share of the deferred acquisition cost asset is recognised as acquisition cost of that GIC. Where only some of the renewing contracts expected

to be included in that GIC have been recognised at a reporting date, only a proportion of the costs allocated to that GIC need be recognised at the reporting date.

Q3.32 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 (e.g. if there is claw back of initial commission or renewal commission), 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.

If the payments are contingent on the policy continuing outside the contract boundary (e.g. trailing commissions in year two of a PHI policy that only apply if the policy doesn't lapse) then those cash flows would be linked to the future policies that give rise to those cash flows.

Q3.33 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.

Q3.34 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 and 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; and

- overhead of underwriting units if not directly attributable to a portfolio of insurance contracts.

Q3.35 Are any taxes included in cash flows?

AASB 17.B65 lists several examples of what is included in cash flows. The specific references to taxes are:

- 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); and
- AASB 17.65(j) – taxes paid on behalf of the policyholder by the insurer in a fiduciary capacity to meet tax obligations incurred by the policyholder.

Wage-based taxes (payroll taxes, social security taxes and similar items) would also be included to the extent that the wages they are based on are included. In addition, AASB 17.B65(m) brings in *any other costs specifically chargeable to the policyholder under the terms of the contract*.

It seems reasonable to conclude that taxes paid on behalf of policyholders are included in cash flows:

- As Division 320 of the Australian Income Tax Assessment Act 1997 specifically identifies and segregates complying superannuation asset pool (CSAP, formerly known as 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'.
- For ordinary business, where the corporate tax rate applies with no distinction between policyholder and insurer, it seems unlikely that tax paid on behalf of policyholders will qualify as 'fiduciary' – while the same principles are implicit in Division 320, there is no separately identified pool of policyholder assets. However, AASB 17.65(m) should capture taxes paid on behalf of ordinary business policyholders.

Note that, apart from transaction specific taxes, taxes paid in a 'fiduciary' capacity or taxes specifically chargeable to the policyholder, 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*.

Q3.36 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 Q9.34 **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 that 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 that 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 GICs. Note that it is possible for profit / loss share arrangements to change whether a GIC is onerous or not when two or more underlying contracts are grouped. An entity might be required to apportion or calculate the profit share separately for each portfolio 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.

Q3.37 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.

Q3.38 How are policyholder dividends or bonuses projected for traditional participating contracts?

See **Chapter** 8 **Direct Participation Features**.

Q3.39 How are delayed benefits, benefits which are expected never to be paid, or 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.

Q3.40 How are interest credits paid to policyholders projected?

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

Q3.41 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.

Q3.42 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.

Q3.43 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 yet 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 only.

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 some 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

Q3.44 How often are estimates re-evaluated?

According to 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 that 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 implicitly or explicitly in the discount rate (AASB 17.B90). See **Chapter 5 Risk Adjustment** for a discussion on the risk adjustment for non-financial risks.

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:

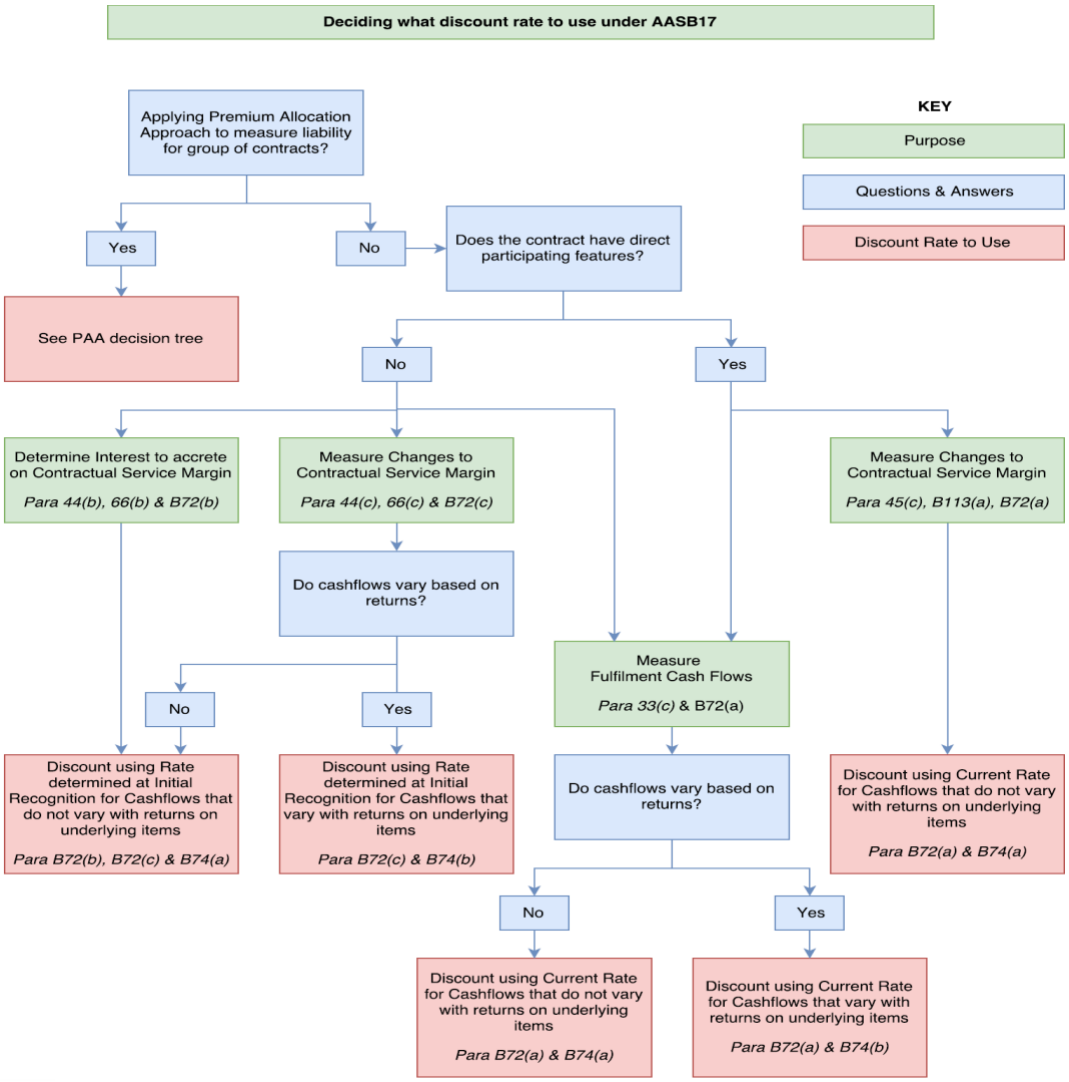
- cash flows that do not vary based on the returns on any underlying items shall be discounted at rates that do not reflect any such variability; and
- cash flows that vary with returns on any financial items shall be discounted using rates reflecting that variability, to the extent that the variability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

Q4.5 Which discount rates should be applied under the GMM?

Discount rates to use under the GMM (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 GMM

Discount Rates	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 GIC 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 rates should be applied under the VFA?

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

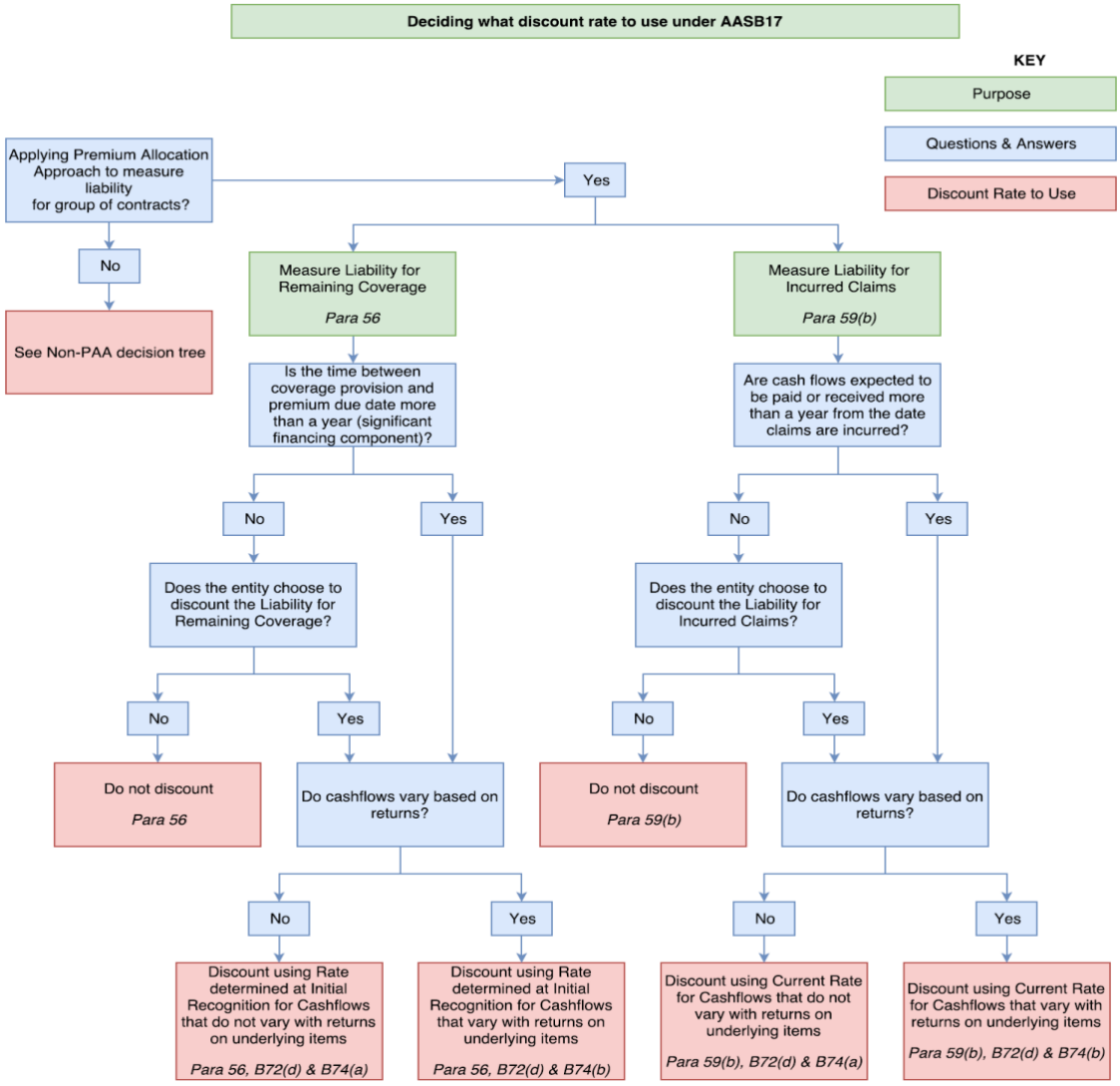
- No explicit interest is accreted on the CSM since it is remeasured when it is adjusted for changes in financial risks; and
- Changes in FCF arising from time value of money and financial risks is regarded as part of the variable fee and recognised in the CSM unless the changes exceed the CSM or the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

Q4.7 Which discount rates 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 GIC becomes onerous (as per AASB 17.57(b)), the difference between the carrying amount of the liability using PAA (AASB 17.55) and the GMM (applying AASB 17.33-37 and AASB 17.B36-B92) is calculated. The calculation of liability values under the GMM is conducted at either the current rate or the locked in rate depending on the purpose for which discounting is required.

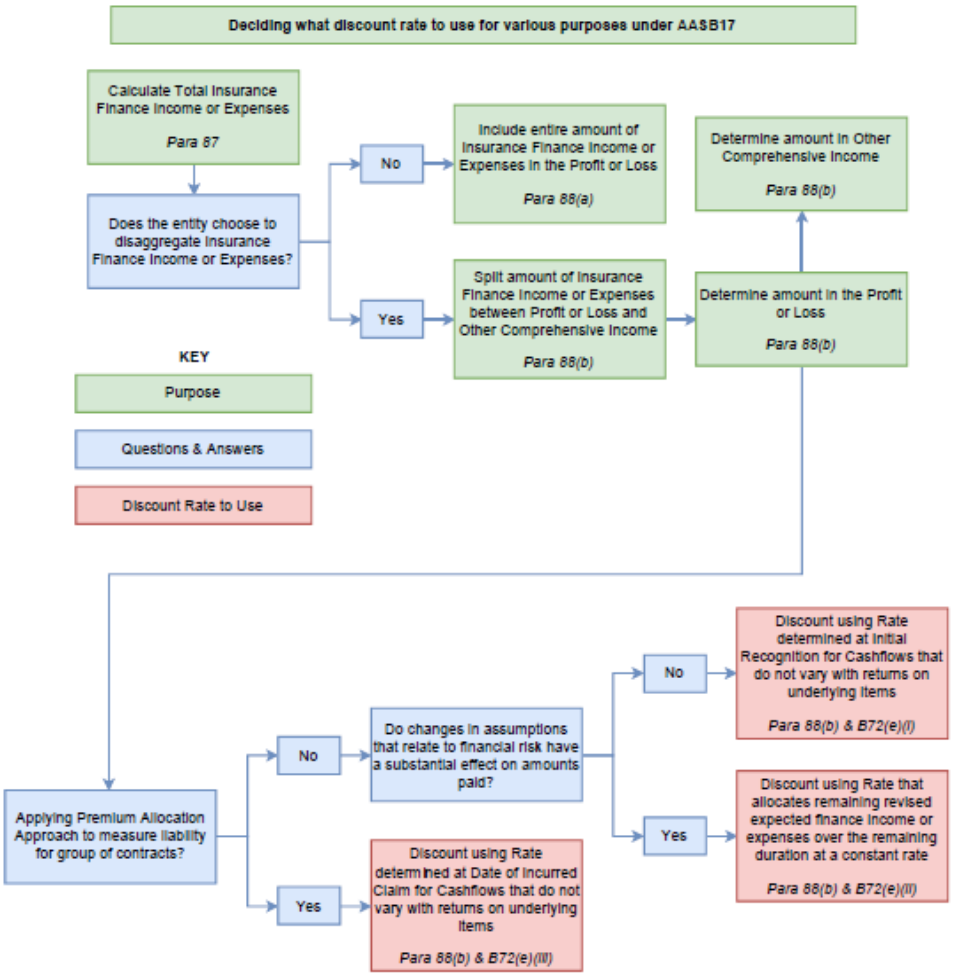
Q4.9 What is included in P&L and OCI under the systematic allocation of insurance finance income and expense in P&L?

For GICs 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 GIC (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 GIC. 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.*

Although AASB 17.B81 does not require the entity to adjust the yield curve for differences in liquidity characteristics of the insurance contracts and the reference portfolio, **paper AP02 for IASB Sept 2018 TRG** meeting suggests that the assets in the reference portfolio would be selected (where available) so that they have similar liquidity characteristics to the insurance contracts.

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. Although most insurers seem likely to choose one approach across the Group, an insurer might use different approaches in different jurisdictions and for business with different durations.

It is understood that the selected approach is an accounting estimate (rather than an accounting policy), which might change over time as circumstances suit. Any changes would therefore be treated in the same way, and be subject to the same requirements and consequences, as other assumption changes.

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, it is noted 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 will need to exercise judgement to determine whether it's reasonable in the circumstances to use (or continue to use) the APRA illiquidity premium without adjustment.

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. The most likely conclusion is that the use of debt instruments in the reference portfolio is more practical.

4.2.5 *Investment Management Expenses*

Q4.27 Are investment administration expenses reflected in discount rates or cash flows?

AASB 17.B65 sets out examples of cash flows included within the FCF. While this list is not necessarily exhaustive, the level of detail means that it will be hard to justify allowing for an element not included in the list.

Under AASB 17.B65(la), the cash flows include *costs the entity will incur in providing an investment-related service (for insurance contracts without direct participation features) or an investment-related service (for insurance contracts with direct participation features)*. By implication, investment expenses are not part of cash flows included within the FCF in other cases, such as risk business.

Investment expenses are not included amongst the relevant factors permitted to be considered when determining discount rates (see AASB 17.B78). However, VFA is an

exception (see Q8.23 Are investment administration expenses reflected in the discount rates).

Overall:

- for VFA business (providing an investment-related service), investment administration expenses can be allowed for either in the discount rate or in the cash flows;
- for non-VFA business providing an investment-return service, investment administration expenses should be allowed for in the cash flows; and
- for contracts not providing an investment service, investment administration expenses can't be allowed for in either the discount rates or the cash flows (so they fall into profit for the period in the same way as other non-attributable expenses).

4.2.6 *Grouping*

Q4.28 How is the discount rate for a GIC 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 GIC, noting that this period cannot exceed one year. This enables a single yield curve at initial recognition to be applied to the entire GIC, rather than recording discount rates at initial recognition for each contract. A separate yield curve may be required for GICs that are onerous at recognition, GICs 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 GIC.

For contracts that are largely denominated in a particular currency (e.g. a contract might be denominated in New Zealand Dollars but parts of the expenses could still be incurred in AUD), all of the future cash flows should be converted into that single currency before discounting so that a single discount curve in that currency can be applied to all cash flows for that contract.

Q4.29 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.

Q4.30 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.

Q4.31 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?

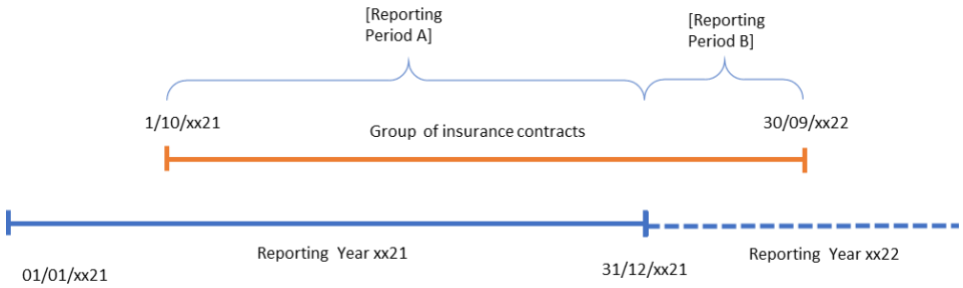
An entity may add contracts to a GIC, as long as they are not issued more than one year apart from any other contracts in the GIC.

As contracts are added to a GIC, this may result in a change in the weighted-average discount rates at the date of initial recognition for the GIC. 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 GIC.

As an example, if a GIC 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 GIC are based on weighted average coverage units provided in Reporting Period [A] (i.e. over nine months) by the contracts added to the GIC during the nine months; and
- the discount rates at initial recognition in Reporting Period xx22 for the GIC 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 GIC during the twelve months.

Figure 4.4: Non-Aligned Group Year and Financial Year



Note that the locked-in discount rates for the GIC are those found in the second calculation above.

Q4.32 Does the discount rate move along (i.e. ride) the locked-in discount curve over time?

The discount rate curve is locked in at inception. The rate to be used at a point in time depends on where you are on the curve at that particular point in time.

4.3 Discounting cash flows dependent on the return of underlying items

Q4.33 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.

Q4.34 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 items 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.

Q4.35 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.

Q4.36 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.

Q4.37 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 items that is passed to the policyholder 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.

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.

The risk adjustment for reinsurance is not defined by AASB 17.37 but rather AASB 17.64 and covered in **Chapter** 9 **Reinsurance and External Risk Transfers**.

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).

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.*

The risk adjustment is intended to inform users of the financial statements about the amount charged by the entity for the uncertainty arising from non-financial risk about the amount and timing of cash flows (AASB 17.B87). The purpose of the risk adjustment therefore differs from a solvency objective of having adequate capital to cover adverse deviation in more unusual circumstances. Note that the use of the word 'charged' might convey the impression it is referring to an amount included in the premium to the customer. It is understood from the May TRG that this is not the interpretation to be applied (see **IASB May 18 TRG APO2**).

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.*

But AASB 17 does provide examples of "non-financial' risk. Paragraph AASB 17.B42 states:

> *IFRS 17 identifies two types of variables:*
>
> *(a) market variables—variables that can be observed in, or derived directly from, markets (for example, prices of publicly traded securities and interest rates); and*
>
> *(b) non-market variables—all other variables (for example, the frequency and severity of insurance claims and mortality).*

Similarly, AASB 17.B43 states "non-market variables will generally give rise to non-financial risk (for example, mortality rates)".

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:

- mortality, morbidity, longevity, catastrophe and latent claims;
- uncertainty in claim occurrence, amount, timing and development;
- lapse, surrender and other policyholder actions;
- expense risk associated with the costs of servicing the contract; and
- external developments and trends, to the extent that they affect insurance cash flows. Examples include genetic testing, litigation prevalence.

Inflation risk might be a financial risk or non-financial risk depending on how the entity derives the inflation assumption (AASB 17.B128):

- Assumptions about inflation based on an index of prices or rates or on prices of assets with inflation-linked returns are assumptions that relate to financial risk.
- Assumptions about inflation based on an entity's expectation of specific price changes are not assumptions that relate to financial risk.

The risk adjustment only includes the uncertainty due to operational risk that impacts the timing or amount of cash flows associated with servicing the insurance contracts. It does not include 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. The following are three examples.

1. 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.
2. 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. (Note that it is the discretionary nature of the crediting rates which makes it a non-financial risk.)
3. 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**). In contrast, the uncertainty in timing and amount of cash flows that arise from non-financial risks is covered by the risk adjustment (AASB 17.37).

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. It is noted, 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, including reinsurance, 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, number of motor claims, value of property damage, 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 options 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 servicing the in-force policies.	Insurance Risk	✓	Other non-financial risk	✓
Market risks	Impact on balance sheet arising from adverse fluctuations in investment market variables	Asset Risk	✓	Financial risk	×

	including interest rates, inflation (directly only – see distinction as per Q5.6), exchange rates, equities and property values.				
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	✓	Financial risk	×
	Risk of mis-estimation of the non-performance by the issuer of the reinsurance contract		✓	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,	Operational Risk	✓	Business risk	×

	including internal and external fraud.				

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 of Directors' 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.

Area	Comments
	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.
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 of Directors 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

Area	Comments
	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 of Directors 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?

The risk adjustment differs from what might be used for market-consistent fair value transfer valuations, settlement value, market model valuations, or valuations based on specific entity costs. This is because it is based on the entity's view of risk aversion and not tied to a market view.

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	The risk adjustment relates to the uncertainty of future cash flows (which may be related to past, current or future service).

Measurement basis of capital			Relevance for risk adjustment
		purpose of the risk adjustment.	
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. However, it is unlikely that the confidence level would differ in an entity's risk aversion unless there is good reason.

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.

5.2.3 *Diversification benefits (Step 3)*

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

Because the risk adjustment reflects the compensation the entity would require for bearing non-financial risk arising from the uncertain amount and timing of the cash flows, the risk adjustment also reflects *the degree of diversification benefit the entity includes when determining the compensation it requires for bearing that risk* (AASB 17.B88(a)).

The allowance for diversification is expected to be consistent with the entity's risk management framework.

Q5.18 At what level of an entity should diversification be considered when determining the risk adjustment?

The level of an entity at which diversification is considered in determining the risk adjustment is specific to the entity's perception of the economic burden of its non-financial risks. It is not prescribed by AASB 17.

Applying AASB 17.B88, an entity should only reflect diversification benefits in the risk adjustment to the extent that the diversification benefit has been included when determining the compensation the entity would require for bearing non-financial risk.

The level of diversification might have been set at the portfolio or GIC level where the only risk diversification benefits would be those achievable at that portfolio or GIC level. If adopted, it is:

- likely to produce the least diversification benefit for the entity; and
- likely to require an enterprise 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.

Alternatively, the level of diversification might be set at the enterprise level incorporating all risk diversification benefits in the entity aggregated across all of its portfolios. That diversification benefit would then be allocated down to each of its portfolios and GICs. If adopted, it is:

- likely to produce the highest amount of diversification benefit for the entity; and
- likely to produce the smallest risk adjustment.

Q5.19 At which level is the risk adjustment required to be determined in the individual financial statements of entities that are part of a consolidated group?

The **IASB May 18 TRG paper AP02** discusses this question and the IASB staff views are as follows:

- The degree of risk diversification that occurs at a level that is higher than the entity level is required to be considered in the determination of the risk adjustment if, and only if, it is considered when determining the compensation the entity would require for bearing non-financial risk related to insurance contracts issued by the entity.
- Equally, risk diversification that occurs at a level that is higher than the entity level must not be considered in the determination of the risk adjustment if it is not considered when determining the compensation the entity would require for bearing non-financial risk related to insurance contracts issued by the entity.

The **May 2018 TRG paper** and subsequent discussion confirmed the IASB staff's view that the risk adjustment would not differ based on an individual entity's perspective or risk appetite. That is, the risk adjustment for a specified GIC would not differ at different reporting levels in a group structure, even if different entities within the group had different appetites for non-financial risk. TRG members generally did not agree with the IASB staff's view on this matter and it is likely to be further debated at subsequent TRG meetings.

Q5.20 Can the risk adjustment at a Group level be more or less than the addition of subsidiary risk adjustments – that is, can there be consolidation adjustments in respect of risk adjustments?

This question is discussed in the **IASB May 18 TRG paper AP02.** The staff's view outlined is as follows.

- Determining the compensation that the entity would require for bearing non-financial risk related to insurance contracts issued by the entity is a single decision that is made by the entity that is party to the contract (i.e. the issuer of the insurance contract).
- In making that decision the entity chooses what factors to consider, including whether or not to consider the degree of risk diversification benefit available to the group of entities.
- Therefore, for a GIC, the risk adjustment at the consolidated group level is the same as the risk adjustment at the individual entity level.

Q5.21 Another view is that the Group level risk adjustment need not be the aggregate of subsidiary risk adjustments but would reflect the Group's view of the risk adjustment, which may be different from the aggregate of subsidiary risk adjustments. Further discussion is expected on this issue at the TRG. Can the risk adjustment be negative?

It is not consistent with the intention of the risk adjustment (gross and net of reinsurance) if its application results in a positive impact on the balance sheet.

Q5.22 What is the impact of statutory funds (or benefit funds for Friendly Societies) on the risk adjustment?

Statutory funds (or benefit funds for Friendly Societies) are a regulatory construct rather than an accounting one. There is no impact for accounting purposes, other than if the existence of statutory funds (or benefit funds for Friendly Societies) impacts the compensation an entity requires for bearing the uncertainty that arises from non-financial risk and so influences the risk adjustment.

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 GIC, it will need to be allocated down to the GIC level for purposes of computing the CSM.

Q5.24 Does the existence of reinsurance have an impact on the risk adjustment for the gross insurance?

The impact on the risk adjustment of actual or potential reinsurance is not specifically addressed in AASB 17. However, in assessing the entity's appetite for gross risk, it is generally accepted that the compensation that the entity requires for bearing gross risk reflect any applicable reinsurance.

One way to do this would be to calculate the compensation required for bearing the net risk and to add the net cost of reinsurance. This is one method suggested in a **discussion paper** on this topic, issued by the AASB TRG. Refer also to **Q9.12 Does the existence of reinsurance held impact the determination of the CSM or onerous contract testing of the gross policy liabilities?**.

Q5.25 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)*

It is important that the entity does not double-count the risk adjustment by, for example, also including the risk adjustment implicitly when determining the estimates of FCF or the discount rates (AASB 17.B90).

Q5.26 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.

Q5.27 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;
- practicality 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.

Q5.28 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**.

Q5.29 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.

Q5.30 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.

Q5.31 Could the pricing profit margin be used 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

Q5.32 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	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.

Areas of Consideration	APRA Regulatory Risk Margin	AASB 17 Risk Adjustment
	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-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

Areas of Consideration	APRA Regulatory Risk Margin	AASB 17 Risk Adjustment
		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.**

Q5.33 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.

Q5.34 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

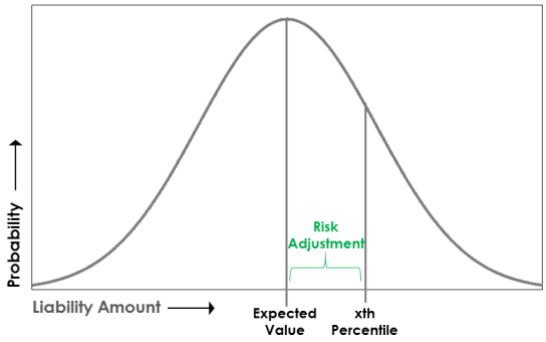
5.5.1 *Confidence level approach*

Q5.35 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 GIC.

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

Q5.36 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*

Q5.37 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.

Q5.38 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.

Q5.39 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 but may need to be modified, 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.

Q5.40 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.

Q5.41 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**);
- might introduce 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**).

Q5.42 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 GICs

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, AASB 17.B96-B100 and AASB17.B119 provide guidance on this topic. IFRS 17 ED.BC50-BC66, IFRS 17.BC218-BC226, IFRS 17.BC228-BC237, IFRS 17.BC270-BC275, and IFRS 17.BC277-BC287 also provide background on the subject.

6.2 The CSM

Q6.3 What is the contractual service margin?

The CSM is a component of the Insurance Contract Liability for a GIC. 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 GIC as the excess (if any) of the present value of expected cash inflows over cash outflows within the boundary of the contract (including acquisition costs), after adjustment for non-financial risk.

If the present value of expected net cash flows is negative at inception, the contract is onerous, no CSM is established and a loss is recognised at time of issue.

Thereafter, the CSM of the GIC is simply rolled forward with interest based on the yield curve applying at inception of the GIC, 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 GIC 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 GIC that an entity issues, AASB 17 specifies that the CSM can never be negative and, if the expected present value of all cash flows from the GIC at inception is negative after adjustment for non-financial risk, the GIC is treated as onerous (see **Sub-chapter** 6.6 **Onerous contracts**) and has no CSM. However, AASB 17 makes an exception for GICs 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 risk adjustment for non-financial risk) of all contracts in the GIC as they would be determined in the normal measurement at initial recognition 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 GIC based on estimation at the GIC level or even higher level, provided they can be appropriately allocated to the GIC (see **Chapter** 2 **Aggregation and Contract Boundary**).

Q6.5 What are pre-coverage cash flows and how are they treated?

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 GIC includes all contractual cash flows including pre-coverage cash flows, including that part of any insurance acquisition cash flows for which an asset or liability is held and which is allocated to the GIC prior to the recognition of the GIC (see AASB 17.27 and AASB 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.

Other than when they are expensed under AASB 17.59(a), insurance acquisition cash flows must be allocated on a systematic and rational basis (see AASB 17.28A-B) both to the GIC to which the insurance contracts are initially allocated and to any future GICs to which the insurance contracts are expected to be allocated upon future renewals. See also Q3.31 Can insurance acquisition costs be allocated beyond the contract boundary?

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 GIC;
- The date when the first payment from a policyholder in the GIC becomes due; and
- For a GIC of onerous contracts, when the GIC 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 released from CSM as revenue for services that were provided in the period (see Q6.12 **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 GMM:

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 (excluding exceptions below)	No
Change in present value of cash flows and risk adjustment related to future coverage due to	
Assumptions changes	Yes
Experience differences (premium and investment component)	Yes

Item	Unlock CSM?
Contract holder info changes (ex: age, sex)	Yes
Contract feature changes (premium pattern, face amount, etc.)	Yes
Change in market variables	No
Change in VUI, 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 are the premium and investment component experiences that adjust CSM?

An experience adjustment is included in CSM for premiums received in the period that relate to future service. As this experience adjustment relates to premiums for future service, it can also cause an offsetting change in the present value of future cash flows for future service, which also adjusts the CSM. For example, if a premium for future period coverage was expected to be paid in a future period, it would be in the expected value of future cashflows at the end of the period. If it was paid early, i.e. in the current period, then it would result in:

- that premium being excluded from the expected value of future cash flows;
- an adjustment to the CSM for this change in expected value of cash flows that relate to future service i.e. the CSM would reduce by the amount of premium paid early; and
- positive premium experience equal to the amount of the premium paid early, which increases the CSM by this amount

The overall net result is no impact to CSM due to premiums for future period being paid early (i.e. profitability is unchanged), but liability increases (due to the increase in FCF).

The same logic applies for the investment component.

Q6.9 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 in all circumstances, regardless of whether an insured event occurs.*

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. 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.

Q6.10 How are risk adjustment changes reflected in CSM?

The CSM should be adjusted for changes in risk adjustments relating to services provided in **future** periods (LRC). Note, if the entity elects to disaggregate this change between non-financial risk and time value of money, then the change in the risk adjustment in the LRC relating to the change in time value of money is excluded when adjusting the CSM (see AASB 17.B97(a)), subject to the condition that the margin should not be negative. Changes in the risk adjustments relating to coverage and other services provided in the **current or past** periods (LIC) should be recognised in profit or loss.

The entity has the option for disclosure purposes (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
- the change in the time value of money (discount rates) in the current period.

6.5 Releasing the CSM

Q6.11 How is the CSM released?

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

(a) The amount of the CSM for the GIC 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 the quantity of insurance contract services provided in the current period over the sum of the quantity of the insurance contract services provided in the current period and expected to be provided for future periods (within the contract boundary)

where quantity of service is based on coverage units (see Q6.12 **What is a coverage unit?** below).

Q6.12 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 service 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 period.*

Service as per the first sentence of AASB17.B119, refers to ***insurance contract services*** which is defined in AASB 17 Appendix A as:

> *The following services that an entity provides to a policyholder of an insurance contract:*
>
> *(a) coverage for an insured event (insurance coverage);*
>
> *(b) for insurance contracts without direct participation features, the generation of an investment return for the policyholder, if applicable (investment-return service); and*
>
> *(c) for insurance contracts with direct participation features, the management of underlying items on behalf of the policyholder (investment-related service).*

The interpretation of insurance coverage was discussed initially at the **IASB's Feb 18 TRG paper AP05** and considered further and in more depth at the **IASB's May 18 TRG paper AP05** and **May TRG Meeting Summary**). It was observed that:

- IFRS 17 established principle, not detailed requirements, and detailed requirements would not work appropriately in all cases;
- determination of coverage units is not an accounting policy choice, but requires application of careful judgement and consideration of the facts and circumstances to best achieve the principle of reflecting the services provided in each period;
- the analysis of the examples in paper AP05 reflects the fact pattern of each example and does not necessarily apply to other fact patterns;
- in considering how to achieve the principle, it was observed by the TRG members that:
  - lapse expectations are included to the extent they affect expected duration of coverage;
  - the different levels of service across periods needs to be reflected in determination of coverage units;
  - the quantity of benefits is determined from the policyholder perspective not the quantity of benefits expected to be incurred by the insurer;
  - a policyholder benefits from the insurer standing ready to meet valid claims should the insured event occur, hence the quantity of benefits relates to amounts that can potentially be claimed;

- different probabilities of insured events across periods do not of themselves affect the stand-ready quantity of benefit provide to a policyholder, but where there are different types of insured events, their different probabilities might affect the stand-ready benefit provided by the insurer;
- particular method or methods are not specified by IFRS 17 and different methods may achieve the objective of reflecting the service provide in each period;
- the following methods may be reasonable proxies depending on the facts and circumstances:
  (i) straight line allocation over time but reflecting the number of contracts in the GIC;
  (ii) use of maximum contract cover in each period;
  (iii) use of expected valid claim amounts each period should the insured event occur;
  (iv) use of premiums, but not if they:
    - are receivable in different periods to the insurance services; or
    - reflect different probabilities of claim for the same insured event in different periods rather than different levels of stand-ready service; or
    - different levels of profitability in contracts rather than the stand-ready service.
  (v) use of expected cash flows, but not if they result in no allocation of CSM to periods in which the insurer is standing ready.

The IASB's TRG papers and discussion noted above also covered:

- the treatment of investment-related service for VFA, which all agreed was appropriate because these are substantially investment-related service contracts, although there were some doubts that IFRS 17 permitted this (ED.BC54); and
- whether there were circumstances where this might also be appropriate for some non-VFA insurance contracts.

Paragraph (c) of the definition of ***insurance contract services*** (quoted above) clarifies the inclusion of investment-related services in VFA coverage. As result of (b) above, there can also be an investment-return service present for non-VFA contracts.

AASB 17.B119A further clarifies that these investment services do not include mutualisation cash flows relating to future policyholders, and end no later than when all amounts due to current policyholders have been paid.

An investment-return service may exist for non-VFA contracts (AASB 17.B119A), if and only if, there is an:

- investment component or policyholder can withdraw an amount;
- expectation that this will include a positive investment return; and

- expectation that investment activity will be performed to generate the positive investment return.

The criteria above are an aid to identifying if an investment-return service is present, but not determinative and it is a matter of judgement as to whether an investment return service exists when these criteria are met (ED.BC60). For example:

- where the service was of a purely custodial nature, an investment-return service would not exist; but
- an investment-return service would exist, for example, where a deferred annuity contract provided the right to surrender the investment linked balance during the accumulation phase, but not once it was converted to an immediate annuity at the end conclusion of the accumulation phase.

Where coverage includes both insurance and investment services, the entity is required to disclose the approach used to determine the relative weighting of the benefits provided by each.

The Basis of Conclusions (IFRS 17.BC279-BC282 and IFRS 17 ED.BC50-66) sets out the IASB's original thinking and rationale for the release of the CSM and the use of coverage units for this purpose. 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 (Last sentence of IFRS 17.BC280)

The appendices of the **IASB's May 18 TRG paper AP05** contain a large number of examples and IASB staff's analysis of potential views of what coverage unit means in the context of specific facts and circumstances. These can be helpful in understanding the principles noted above.

Often where a contract has a range of insurance covers (e.g. reinsurance treaty), a common view of coverage is necessary.

A potential common unit of coverage across different types of insurance cover are**;**

- where 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 valid amount payable if a claim were to occur for all covers under each contract in the GIC, e.g:
  - Maximum valid lump sum payable upon claim (gross or net of any investment component depending upon interpretation);

- sum of the maximum valid 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 it could be based on the expected level of cover (e.g. expected maximum valid claim), subject to the limit of indemnity (where applicable) or maximum probable loss – e.g. for property insurance the full limit of indemnity might only be paid if the property is written off, but most claims are for much less.

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 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, especially for contracts with longer benefit payment periods; and
  - later recognition of CSM for mortgage insurance both life and lender's insurance, where expected claims potentially decline much faster than coverage.

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.

Q6.13 When does the coverage period start and end?

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

> *The period during which the entity provides insurance contract services. This period includes the services that relate to all premiums within the boundary of the insurance contract.*

For insurance service, coverage starts from the point in 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, insurance coverage may:

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

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.

For investment-related or investment-return service, coverage starts from the point in time from which the service is provided, which is likely to be at the receipt of the first premium.

For insurance service, coverage normally 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 insured 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, unless the insurer takes the view that the insurance is comprised of two separate elements, i.e. the occurrence of a valid claim and development of the claim amount ultimately payable (see September IASB TRG paper AP01), these are part of the incurred claim liability and do not represent the provision of further coverage. However, if the insurer does take that view, then coverage for claim development continues until all amounts payable under the claim are ultimately determined, and the insurance coverage period only ends once that has occurred.

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, unless the alternative view is taken 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.

As noted above, the September 18 TRG paper AP01 discussed the question of whether uncertainty during an incurred claim can create insurance risk. The examples in that paper were:

- an annuity that becomes payable upon disablement of the insured until recovery occurs; or
- fire insurance which covers the cost of rebuilding

IASB staff analysis, with which the TRG agreed, was that there are two valid views:

i) The payment of amounts after claim being incurred is part of the incurred claim and does not represent insurance risk and provision of further insurance cover; or

ii) The payment of amounts after claim being incurred does represent insurance risk and provision of insurance cover - not only for the initial event (disablement or fire) but also for the uncertainty the insured has (e.g. how long recovery from disablement will take or how much it will cost to rebuild after the fire has occurred) once initial insured event occurred.

The implications of the two views are also covered in Table 1 of Chapter 15.

For an investment-related or investment-return service, coverage ends when this service ends for the policyholder, which may be:

- before the insurance coverage ends, e.g. in the case of a deferred annuity or life annuity with term certain period;
- after the insurance coverage ends, e.g. in case of investment contract with insurance riders which cease before the investment component is payable, or an investment-return accrues on the insurance claim amount until paid out.

Q6.14 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 Q6.11 **(How is the 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.

Q6.15 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 subsequent favourable changes (see **Sub-chapter** 6.6 **Onerous contracts**).

6.6 Onerous contracts

Q6.16 What is an onerous GIC and how are they treated?

A GIC 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).

Q6.17 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 GIC is fully unwound by the end of their coverage (see AASB 17. 52)

Q6.18 When are onerous contracts recognised?

A GIC of onerous contracts needs to be recognised when the GIC 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, which for business combination falling under AASB 3 is deemed to be fair value) can be classified as either goodwill for contracts acquired in a business combination falling under AASB 3 or otherwise as a loss for contracts acquired in a transfer.

Q6.20 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 the loss component is extinguished.

- allocating the remaining change in the FCF of the GIC 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 GIC. This can be done for example by:

- using the same release method that would have been applied to the GIC 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))

Section C. Variations to the General Measurement Model

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 GICs 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 GMM is the default model for measuring insurance contracts under AASB 17. However, AASB 17.53 allows an entity to simplify the measurement of a GIC 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 determines the liability for remaining coverage based on premiums received and appropriate allowance for acquisition costs. The LRC then reduces as revenue is 'earned' over the coverage period. While some of the principles underlying the PAA are similar to current approaches, there are some significant differences. This is discussed in more detail 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 only be used if, at inception of the GIC, the LRC for the GIC would not differ materially from the LRC determined based on the GMM.

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 GIC. 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 GMM. This implies that, whilst the assessment is performed at the inception of the GIC,

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 GMM 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 GMM are materially different then the PAA could not be used.
- Differences between PAA and GMM that may affect the assessment of PAA eligibility for a GIC includes the expected pattern of revenue recognition over time. The CSM under GMM is allocated based on *coverage units* reflecting the expected quantity of benefits and duration of contracts in the GIC (AASB 17.B119). Revenue under the PAA is based on *the passage of time* or *the expected timing of incurred insurance service expenses* (AASB 17.B126) if the expected pattern of release of risk during the coverage period differs significantly from the passage of time.
- 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.

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 GIC, 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.

It is possible to conceive of situations where View 1 may prevail and other situations where View 2 prevails.

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 GIC 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 GIC 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 were to lapse or claim, the risk adjustment relating to coverage would release and any offset in incurred claim risk adjustment is outside the AASB 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 necessarily contradict view 1.

If View 1 is held, then it 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 GIC?

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 include:

- 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
- the composition of insurance service expenses, including incurred claims, other incurred insurance service expenses and other amounts (as described in 17.103(b)).

7.4 Onerous GIC 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.

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*.

Facts and circumstances is likely to refer to management information available to the key decision makers in the business 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 relevant information that is known to the entity or easily ascertained, 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. Note that acquisition costs would not be relevant in assessing whether a GIC is onerous if the entity has elected to recognise insurance acquisition cash flows as expenses when it incurs those costs, in accordance with AASB 17.59(a).

Other examples could be if the insurer deliberately ignores a significant rating variable (e.g. gender) in pricing when it is entitled to use it (and hence may be aware of less profitable segments) or where historic GICs are loss making, possibly indicating a deterioration in profitability for more recent GICs as well.

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.

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 GIC 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 GIC, 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 GIC 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 GICs 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 GIC 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 GIC 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 GIC is deemed not to have a significant financing component when the period between premiums being due and the provision of insurance contract services 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 service 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, if any* at initial recognition and subsequently for the purpose of liability measurement, however
- AASB 17.B126 refers to *expected premium receipts* (including premiums already 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 $600 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.
- No expectation that the premium will not be paid, hence in this case expected premium equals contractual premium.

AASB 1023 balance sheet

Inception:

Liability for remaining coverage:	*600*
Premium receivable asset	*600*
Net asset position	*0*

At 31 January

Liability for remaining coverage: *550 (i.e. 11/12ths of premium still to be earned)*

Premium receivable asset:	*600*
Net asset position:	*50*

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:	*500 (i.e. 10/12ths of premium still to be earned)*
Premium receivable asset:	*0*
Cash:	*600*
Net asset position:	*100*

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 31 January

Liability for remaining coverage:	*-50 (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:	*50*

At 28 February

Liability for remaining coverage:	*500 (i.e. -50 opening liability + 600 received – 50 additional revenue recognised)*
Cash	*600*
Net asset position	*100*

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

This approach also applies to all life insurance and health insurance policies valued under PAA.

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, per AASB 17.59(a)) or amortise acquisition costs.

If the option to recognise insurance acquisition costs immediately under AASB 17.59(a) is not taken then AASB 17.28A specifies that the allocation of insurance acquisition cash flows to a GIC is made on a systematic and rational basis by applying AASB 17.B35A. (Also refer **to Q3.31 Can insurance acquisition costs be allocated beyond the contract boundary?)**

Insurance acquisition cash flows are recognised in accordance with AASB 17.28B, which specifies that:

- For insurance acquisition cash flows the entity expects to pay after the related GIC is recognised, insurance acquisition cash flows are part of the fulfilment cash flows for the GIC (or liability for remaining coverage when measuring using PAA) (AASB 17.28B(a)).
- For insurance acquisition cash flows paid before a related GIC is recognised, an asset is recognised for insurance acquisition cash flows relating to future GICs (AASB 17.28B(b)).

The implication of AASB 1728B(b) is that acquisition costs expected to be recovered from future contract renewals can be deferred through the explicit recognition of an asset. Regular testing for impairment of this asset is required based on the expected net inflows from the related GIC, as specified in AASB 17.B35B.

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 (particularly AASB 17.B119 – B119B). IFRS 17.BC238-BC269 also provide background on the subject (and IFRS 17 ED.BC50 – BC56).

Q8.3 What is the VFA?

The variable fee approach (VFA) is a modification of the GMM that is **only applicable** to life insurance contracts with direct participation features. The entity's interest in the investment portfolio underlying these products ("underlying item" – see **Q8.6 What is a clearly identified pool of underlying items?**) is viewed as "equivalent" to a "variable fee" that is charged to policyholders, and can be expressed as the entity's share of the underlying item, adjusted for other shareholder funded obligations (such as the cost of providing guaranteed benefits). The fee could be, for example, a percentage of funds under management, or a share of profits.

(The VFA 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. However, IASB staff have continued using the term – e.g. in TRG meeting papers.)

8.2 Eligibility to use the Variable Fee Approach

Q8.4 How does the VFA differ from the GMM?

On inception, there is no difference between the VFA and the GMM. All of the building blocks are calculated in the same way. The difference arises in subsequent periods where the adjustments to the CSM are determined differently. In summary, the interest accretion component of the change in the CSM is replaced with changes in the entity's share of the underlying item. Like the GMM, changes in estimates of fulfillment cash flows relating to future service adjust the CSM, but current rates rather than locked-in discount rates are used.

See **Section B General Measurement Model (GMM)** for a detailed discussion of the GMM.

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.

Note that within products of the same type, some contracts will be eligible to use the VFA while others won't, depending on whether the above criteria are met. For example, there may be differences due to the level of expected benefits relative to any guarantees. This would affect the extent to which changes in amounts to be paid to the policyholder vary with changes in the fair value of the underlying items. See also Q8.9 **What is a substantial share of the fair value returns from the underlying items?**, Q8.11 **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?**, and **Q8.12 How does having a minimum guarantee affect the assessment of eligibility for VFA?**

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).

The composition of the underlying items and their fair value must be disclosed (AASB 17.111).

Q8.7 What is the variable fee?

The entity's obligation to the policyholders under the VFA must be able to be expressed as the fair value of the underlying items less a variable fee (AASB 17.B104).

The variable fee has two components being:

- the entity's share of the fair value of the underlying items (for example, the fees that the entity will collect as a % of the underlying item); less
- fulfillment cash flows that do not vary based on the returns on the underlying items (for example, guaranteed benefits provided by the shareholder in excess of the underlying items)

Changes in the first component are considered to relate to future service and therefore adjust the CSM (AASB17.B112).

Changes in the second component comprise:

- changes in the time value of money (i.e. changes in discount rates and/or accretion of interest) which are considered future service and therefore adjust the CSM (AASB17.B113(b));
- changes in financial risk not arising from the underlying items, such as the effect of financial guarantees, which are considered future service and therefore adjust the CSM (AASB17.B113(b)); and
- other changes in estimates of fulfillment cash flows, which, as for the General Model, adjust the CSM only to extent that they relate to future service. Unlike the General Model, the adjustments are measured using current discount rates (AASB17.B113(a)).

On the assumption that, under the Life Act, the policyholder is entitled to an 80% share of Operating Profit (and the shareholder the remaining 20%), the variable fee can be determined as follows:

Obligation to policyholders	= BEL + 80% x (VSA – BEL) + PRP
	= 80% x VSA + 20% x BEL + PRP
	= VSA + PRP +SRPP – 20% x (VSA – BEL) - SRPP
	= VUI – Variable Fee

Where:

VUI	= VSA + PRP + SRPP
and	
Variable Fee	= 20% x (VSA – BEL) + SRPP
	= 20% x (VSA + PRP + SRPP) – 20% x BEL
	= portion that varies with the underlying item
	less
	portion that does not vary with the underlying items (assuming SRPP = 25% x PRP)

Note that the 'Obligation to policyholders' is the obligation over the life of the contract (which is why it includes PRP and already declared bonuses in BEL). Accordingly, the 'variable fee' also includes shareholder profits already allocated but yet to be distributed (SRPP), as well as what the shareholder will receive in future (20% x (VSA – BEL)).

Q8.8 Does the entity need to hold the underlying items?

No. The entity 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.

Q8.9 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. Judgement is required to determine whether the share of the fair value returns on the underlying items expected to be passed on to the policyholder during the life of the contract is "substantial".

Q8.10 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.

Conversely, in some contracts, the amount paid to the policyholder may be at the discretion of the entity, yet the contract is not eligible to use the VFA (because it does not meet the criteria, or there is no defined pool of underlying items, or the link is not enforceable). Such contacts are deemed to be 'indirect participating', and are subject to the GMM.

The entity must identify at inception the basis on which it expects to determine its commitment under the contract – e.g. the commitment might be based on specified asset returns. The entity must distinguish between the effect of changes in assumptions that relate to financial risk on that commitment (e.g. variations in the asset return - which do not adjust the CSM – profits from variations in investment will offset losses from variations in policyholder benefits) and the effect of discretionary changes to that commitment (which adjust the contractual service margin – profits to the shareholder from discretionary changes in policyholder benefits will be spread over future periods). Also, any subsequent changes in the commitment will be absorbed into the CSM. See AASB 17.B98 – B99.

See also Q8.21 **How should other discretionary cash flows be treated?**

Q8.11 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 change in expected returns on the underlying items compares with the resultant change in expected payments to policyholder over the life of the contract.

Q8.12 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 (i.e. where the level of bonuses is sufficiently low), the product would not be subject to VFA treatment.

Also, the variable fee needs to be a sufficiently small portion of the underlying items such that a "substantial share" of the fair value returns from the underlying items is passed on to the policyholders. If a minimum guarantee is too great then the variable fee might similarly be too great, such that the share of the fair value returns from the underlying items passed on to the policyholder is not considered sufficiently "substantial".

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.

For insurance contracts acquired in a future transfer or business combination, AASB 17.39, AASB 17.B93 and AASB 3.17 (as modified by AASB 17.D64N), means that this assessment is done as at the date of acquisition for:

- Insurance contracts acquired in a business combination under AASB 3 after the date of adoption of AASB 17; and
- Insurance contracts acquired that do not form a business.

For insurance contracts acquired in a business combination not under AASB 3 (i.e. under common control) AASB 17.B93 is silent and the entity needs to develop an accounting policy for these as per AASB 108.10 – in which case it might be considered appropriate to apply the same treatment as for business combinations falling under AASB 3. Note, transfers under Part 9 of the Life Insurance Act are likely to be considered as business combinations under common control and hence not fall under AASB 3.

If assessment for VFA eligibility needs to be done at the date of acquisition, then there may be significant consequences for products that are close to maturity when acquired, as there may be little in the way of expected benefit variability in the future, and so the contract would fail the criterion in AASB 17.B101(c). It might not then be eligible to use the VFA, even though it might have been eligible if assessment had been done at inception.

Similarly, at transition, to the extent that the entity does not have reasonable and supportable information to make the assessment as at contract inception, then the assessment for VFA eligibility is done using information available at the transition date (see AASB 17.C9(b) & AASB 17.C22).

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 contract 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 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 underlying items?	P/H share of pool experience is substantial?	Substantial proportion of changes in policyholder 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	Non-Par	Yes	Yes	Yes	Yes

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 underlying items?	P/H share of pool experience is substantial?	Substantial proportion of changes in policyholder cash flow comes from pool experience?
be separated by the policy owner.					
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 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	Non-Par	No	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 underlying items?	P/H share of pool experience is substantial?	Substantial proportion of changes in policyholder cash flow comes from pool experience?
contracts no profit share.					
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
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 need 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 underlying items can be viewed as the ring-fenced assets backing the obligations to policyholders (and in which the shareholders also have a stake). In the case

Product	Underlying Items
	of participating business, the underlying items would typically be the assets backing the Value of Supporting Assets (VSA), Policy Owner Retained Profits (PRP) and Shareholder Retained Profits Participating (SRPP). Note also that some of the assets backing the VSA may change – e.g. some policy loans may no longer be treated as assets. Even though policyholders in these products usually share in profits from sources other than investment returns, the current underlying items are still as above. Also, while support may be provided by Shareholder Retained Profits Non Participating (SRPNP), this would not be considered part of the underlying item, as the returns on these assets are not shared with the policyholder.
Investment linked contracts with term riders that cannot be separated by the policy owner.	Invested assets.
Non-Participating Investment account contracts.	Invested assets.
Participating annuity contracts	Similar to participating traditional (above)

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).

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?**). It is considered that group risk business as currently written in Australia is not eligible for the VFA, and so such business is not included in the above table.

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 GMM of AASB 17. As such, all the components of a liability (future cash flows, risk adjustment, discounting, CSM - see AASB 17.32) theoretically exist under the VFA, and generally operate as they would under the GMM. However, the specifics of that operation may differ under the VFA.

Under the VFA, it is possible to construct the obligations to policyholders as the underlying items less the variable fee (AASB 17.B104). This construction is equivalent to the projection of future cash flows under the GMM, and can therefore be used in the place of the present value of future cash flows in the construction of the liability as a means of quantifying the variable fee.

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.

That said, the future cash flows need to be the full cash flows under the contract. So, if expenses were, say, 100, then the full 100 needs to be included in the P&L. The policyholder benefits include negative 80 - i.e. the shareholder incurs the whole expense of 100, but then pays 80 less in bonuses to the policyholder. (See also Q8.20 How are policyholder bonuses to be treated?) The profit attributable to the entity only is then reduced by the net amount of 20.

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 on 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 – i.e. the bonus cash flow should include that supported by the PRP – which is equivalent to PRP being included in the liability.)

Note that it may not be necessary in the actual measurement to include specific bonus cash flows if it can be shown that these are equivalent in value to other items (e.g. the value of the pool of underlying items less the value of fixed benefits) – the value of these other items would be included instead.

The outcome of this is that the CSM is essentially only 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 (i.e. CSM plus risk adjustment should equal 20% of the investment returns on the underlying items). The pattern of release of that profit (i.e. through P&L) will depend on AASB 17 (i.e. in proportion to coverage units and release of the risk adjustment) rather than currently (in proportion to bonuses). Accordingly, the recognition of profit over time may differ under AASB 17 from currently – the balance of unrecognised shareholder 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 risk adjustment, and CSM and risk adjustment are not necessarily 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.

In summary, as it is expressed from a shareholder perspective only, the liability under AASB17 reflects full obligations to policyholders, including bonuses yet to be declared; the liability will therefore implicitly include the equivalent of both the VSA and PRP.

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 otherwise fixed policyholder benefits, such discretionary cash flows need to be quantified as currently determined, separately from the liability calculation under AASB 17 (although, in measuring the liability under AASB 17, it might be possible to use the value of other items in lieu of projecting specific future discretionary cash flows). The extent to which these cash flows impact the variable fee will depend on the extent to which the discretionary cash flows are funded by the shareholder as opposed to being funded from the underlying item.

Q8.22 What discount rate is used for measurement?

The discount rate used for cash flows that vary based on the returns on underlying items should be based on current rates reflecting that variability (unless cash flows themselves are adjusted for that variability – see AASB 17.B74 – B76). This is the case regardless of whether the entity actually holds the underlying items or not and whether the variation is set out in the contract terms or a matter of discretion.

Where minimum guarantees exist, the return is not solely dependent on the return on underlying items and the discount rate is adjusted to allow for the impact of the guarantee, even if the guarantee is lower than the expected return on the underlying items.

The discount rate used for cash flows that do not vary based on the returns on underlying items should be based on current rates that do not reflect that variability (see AASB 17.B74(a))).

The standard does not require entities to divide cash flows into those that vary based on the return on underlying items and those that do not. If a split is not carried out, the discount rates reflect the impact on the combined cash flows.

See also Q4.5 **Which discount rates should be applied under the GMM?** and Q4.6 **Which discount rates should be applied under the VFA?**

Subsequently, when investment returns are earned on the assets, the relationship between insurance finance income or expenses and the investment returns must be explained (AASB 17.110).

Q8.23 Are investment administration expenses reflected in the discount rates?

Where cash flows vary based on the returns on underlying items then, as above, there are two ways investment administration expenses can be reflected:

- The discount rate used should be based on current rates reflecting the actual investment administration expenses associated with the underlying items – i.e. the discount rate is net of investment administration expenses; or
- The investment administration expenses can be explicitly included in the cash flows to be discounted (cash flows themselves are adjusted for the variability so that the discount rate is as determined under the GMM).

Where cash flows do not vary based on the returns on underlying items, the discount rate should only allow for investment administration expenses associated with assets consistent with the nature of the liability cash flows – for which the investment administration expenses are effectively nil.

Q8.24 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 mutual cash flows will be included when estimating future cash flows. However, such cash flows might only arise when returns on underlying items are such that the GIC is likely to become 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 GIC is less likely to require cash flows from outside the GIC as profits from contracts within the GIC could offset losses from other contracts within the same GIC).

8.5 Risk Adjustment

Q8.25 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. (Note that this

ignores the possibility of guarantees, such that the shareholder takes more than 20% of the risk – see **Chapter** 8.7 **Asymmetry** . The point here is that no risk adjustment is needed for risk borne by the policyholder.)

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.

8.6 Coverage Units

Q8.26 What nuances are there in the calculation of coverage units for contracts eligible for the VFA?

Coverage units should be determined by considering both insurance coverage and any investment-related service provided to the policyholders of the contract (not future policyholders).
The inputs, assumptions and estimation techniques used to determine the relative weighting of the benefits provided by insurance coverage and investment related services (or investment return services) need to be disclosed.

It is therefore expected that coverage units will be based on the Insurance Benefit, which will not only include the Sum Assured, but also any bonuses (reversionary or terminal). The Insurance Benefit includes both insurance coverage (represented by the Sum at Risk (Insurance Benefit – Surrender Value or Account Balance)) and investment-related service (represented by the Surrender Value or Account Balance, which grows as premiums are paid (less that used to provide insurance coverage) and bonuses are added). For this purpose, future bonuses are to be determined in the same way that future cash flows are determined.

8.7 Asymmetry

Q8.27 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. The ED of proposed changes to IFRS 17 expands the scope of the risk mitigation exception for insurance contracts with direct participation features to apply not just when an entity uses a derivative but also a reinsurance contract held to mitigate financial risk. Where the risk of asymmetry is hedged, then the value of any derivatives or reinsurance contract held may be included in the pool of underlying items, offsetting the value of the assets in that pool. (However, where the value of such derivatives or reinsurance contract held is not in the pool of underlying items, then the movement in value of the risk mitigants does not have to be offset by a change in the CSM - see Q8.28 **How do changes in the impact of asymmetry affect profit?**).

Whilst AASB 17 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.

Q8.28 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.

Under AASB 17, risk mitigants are included in the pool of underlying items if they are shared with policyholders. This would allow the change in the fair value movement in derivatives to offset the movement in other assets.

AASB 17 appears to specifically require changes in the value of options and guarantees under 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 under the contracts.

Where the impact of options and guarantees under the contracts is hedged, (see Q 8.27) but such risk mitigants are not in the pool of underlying items, then the movement in value of the options and guarantees under the contracts 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.

Note, the risk mitigation option is available even when risk mitigation is inside the underlying items. Careful consideration is needed of the implications of this on the CSM.

If risk mitigation is used and the CSM is not adjusted for some changes in the fulfilment cash flows then the impact of this on the CSM must be disclosed (AASB 17.112).

Q8.29 Is there a significant 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 under the insurance contracts that are currently used are expected to remain broadly 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.

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

Q8.30 Is there any difference between the way expenses are treated under AASB 17 and how they were treated under AASB 1038?

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 all expenses, including overheads and other indirect expenses, and the policyholder will participate in the cost of these. The supportable bonus rate reflects all the expenses whether direct or indirect.

Under AASB 17, the result is effectively the same. The FCF will reflect:

- the directly attributable costs (which are likely to be less than direct expenses previously identified under AASB 1038), and 'any other costs specifically chargeable to the policyholder under the terms of the contract' (see AASB 17.B65(m) – this will capture the remainder of the direct expenses and all the indirect expenses);
- a bonus rate that includes the policyholder share of all expenses, so the present value of the shareholders' share of costs will be reflected in the CSM, which will be released as the coverage units are "released".

Example

Note that the purpose of this example is to show that the results are the same, even though the presentation, and the way they are obtained, is different under AASB 17.

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 include those attributed to both policyholders and shareholders.

Table 8.3a: Illustrative example of AASB 1038 Treatment of Expense Allocated to Participating Business

	Insurance Result

	PH	SH	Total	Total SH Profit
	80%	20%		
Income	**800**	**200**	**1000**	
Expenses				
Direct	56	14	70	
Indirect	24	6	30	
	80	**20**	**100**	
Profit	**720**	**180**	**900**	**180**
Profit % Total	80%	20%		20%

Table 8.3b: Illustrative example of AASB 17 Treatment of Expense Allocated to Participating Business

			Total SH Profit
Insurance Income	**1000**		
Insurance Expenses			
Benefit Payments (= Bonus)	720	(as currently = 800-80)	
Directly attributable	60		
Other (specifically chargeable)	40		
	820		
Profit	**180**		**180**

8.9 Reinsurance considerations

Q8.31 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 Experience

Q8.32 How is experience treated for business eligible to use the VFA?

AASB 17 doesn't differentiate between investment and non-investment experience. Rather, it refers to cash flows that do, or do not, vary based on returns on the underlying items. Consequently, the differentiation, and treatment of experience, under AASB 17 is different.

If experience derives from cash flows that **do not** vary based on the returns on underlying items then experience emerges in the same way that it would under the GMM. The shareholder share of differences between actual and expected cash flows relating to past or current service will be immediately recognised as profit in the P&L. The shareholder share of resulting differences in cash flows that relate to future service will be absorbed by the CSM – this is elaborated on in Q6.6 **After initial recognition, what changes are recognised in the CSM?**

(The policyholder share is theoretically reflected in the value of cash flows, although in practice it may be represented as the value of the underlying items less the variable fee.)

Through the VFA mechanism this is achieved by adjusting the CSM by the amount by which the CSM would be similarly adjusted under the GMM (i.e. for the shareholder share of differences in cash flows relating to future service). This is in addition to other adjustments to the CSM for investment returns and assumption changes. The experience in the current period is then immediately recognised as profit in the P&L, as it would under the GMM.

If experience derives from cash flows that **do** vary based on the returns on underlying items then the shareholder share of the full difference will be absorbed by the CSM. This includes the shareholder share of both differences between actual and expected cash flows relating to past or current service, **and** resulting differences in cash flows that relate to future service.

Through the VFA mechanism this is achieved by adjusting the CSM by the shareholder share of the full amount of the experience. The shareholder share of experience thus emerges in the future.

Thus, for example, the shareholder share of the effect of investment returns on the underlying items would be absorbed by the CSM. (The policyholders' share of investment returns will all be reflected in future bonuses or other cash flows – as per contractual requirements – independent of its treatment under AASB 17.) The

shareholder share of those investment returns would then be recognised in future periods as CSM is released.

By contrast, expenses do not vary based on returns on the underlying items. Consequently, the difference between actual and expected expenses in the current period, less the amount reflected in future policyholder benefits as per contractual requirements, will be recognised immediately in the P&L.

Finally, the treatment of surrenders, lapses and other benefit payments, will depend on the reasons for the experience. To the extent that differences arise from changes in the underlying items then the shareholder share of the whole effect will be absorbed by the CSM to then be recognised in future periods as CSM is released. However, to the extent that differences arise from the number of benefits (i.e. the rate of decrement, unrelated to changes in the underlying items) then the shareholder share of differences between the actual payment and that expected within the current period will be recognised immediately in the P&L, with the balance (due to changes in cash flows relating to future service from changes in the volume of business remaining in force) absorbed by the CSM.

8.11 Friendly Societies

Q8.33 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.

8.12 Aggregation

Q8.34 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 policyholder cash flows originating from contracts in other GICs, not just cash flows arising solely from contracts in that GIC. Similarly,

when doing this calculation, cash flows implicitly transferred to other GICs are to be excluded. Note that this ability assumes that profit from the donor GIC 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 GICs, it may be assumed that what would otherwise be an onerous GIC will potentially be profitable. Similarly, if a GIC is potentially about to become onerous, then a transfer from a profitable GIC is expected to prevent that. On this basis, unless the whole portfolio is onerous, or becomes onerous (which is very unlikely), it might be assumed that there are no GICs which at inception would be onerous or likely to become onerous.

One might even argue that there is no point in sub-dividing GICs 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 GICs 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 GIC 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 GICs (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.

Furthermore, it must be noted that the provision only allows for the transfer between GICs of **policyholder** cash flows. The provision does not allow for the transfer of other cash flows, and particularly no change in the CSM. Consequently, whether a GIC is onerous, or likely to become onerous, is unaffected by the potential transfer of policyholder cash flows.

Notwithstanding all of these arguments, aggregation will therefore be the same as it is under the GMM.

Note that none of the above applies to investment linked business, where transfers of cash flows between GICs would not occur.

In addition, IFRS 17.BC138 notes that the amounts to be reported for each GIC are specified, but it is not necessary to calculate amounts at a GIC level, so calculation could presumably be undertaken at a higher level and the results then allocated to each GIC. Such allocation should take account of differences in pricing over time, but note that experience (especially investment experience) is expected to be the same for all contracts that share in the same pool of underlying items. Approximate transfers of cash flows between cohorts should be determined accordingly. 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.

This issue was discussed at the September 2018 meeting of the IASB TRG (see **AP10 for September 2018 meeting of the IASB TRG**) but the original IASB staff conclusion was that this would really only be possible where policyholders received 100% of the returns on the pool of underlying items. The TRG took a broader view than this and so it may be possible that an interpretation, and hence practice, along these lines is possible.

Q8.35 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).

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 17.62-70 and AASB 17.B119C-F provide guidance on this topic. IFRS 17.BC296-315 and IFRS 17 ED.BC67-90 also provide 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)). This is because an entity that holds a reinsurance contract does not normally have a right to reduce the amounts it owes to the underlying policyholder by amounts it expects to receive from the reinsurer (IFRS 17.BC298).

Refer to **Chapter 11 Disclosure**.

Q9.6 How is the value of the reinsurance held asset determined?

The measurement of insurance contracts under the GMM is 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:

- **Assessment of the Contract boundary** – could result in the reinsurance treaty being split into a series of "contracts" for AASB 17. This may be due to the ability of the reinsurer to cease accepting new business. The fulfilment cash flows considered in each one of those cohorts are long term and cover the renewal of the underlying gross contracts falling within the cohort, notwithstanding that the underlying contract could be short term in its own right. 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 issued 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 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 defer recognition of losses from the reinsurance contract - 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. Also, in this example it is assumed that the underlying GIC is profitable.

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 subsequently become onerous?

Consider the situation where a change in the FCF of a GIC of underlying contracts does not adjust the CSM of the underlying GIC either to some extent or fully (e.g. becomes onerous or is already onerous and becomes more or less so). This could occur due to changes in assumptions relating to future service. In this case, the corresponding change in cash flows for the reinsurance held does not adjust the CSM of the reinsurance held under AASB 17.66(c)(ii) (see also IFRS 17.BC315). Thus, the net effect on the profit or loss in the period reflects the offsetting release from the reinsurance held. This applies regardless of the nature of the reinsurance, i.e. whether it is proportionate or non-proportionate.

Note that this provision only applies **after** inception of the underlying insurance contracts. For discussion on the treatment of reinsured GICs that are onerous on initial recognition, see Q9.9 and Q9.10 below.

AASB 17.66(c) applies to the extent the cash flows related to the underlying GIC does not adjust the CSM of the underlying GIC. A question then arises when the underlying GIC does not currently have a CSM:

- due to it being measured using PAA; or
- because it relates to the underlying expected future new business or renewals that falls within the boundary of the reinsurance contract, and hence currently does not have a CSM.

For discussion on the PAA case, see Q9.9 and 9.10 below

In the second instance, it is possible that the impact on the reinsurance held may exceed that on the underlying contracts if, due to its contract boundary, the reinsurance ceded cash flows include new business as well as expected renewals on the underlying contracts but the gross does not. However, the rationale for excluding the impact of future renewals and new business from the capitalisation calculation is that to the extent no underlying GIC fulfilment cash flows exist, there cannot be a related recognition of reinsurance cash flows in the Income Statement.

Q9.9 Is there an offset in reinsurance held when the underlying gross contracts are onerous at inception?

Under AASB 17.66A, an offsetting capitalised reinsurance profit (by reduction of the reinsurance CSM) may be determined in the Income Statement on initial recognition of an onerous underlying GIC, as long as the reinsurance held is proportionate (see Q9.10). The amount of the adjustment is calculated by multiplying (AASB 17.B119D):

- the amount of loss recognised on the underlying onerous GIC, and
- the fixed percentage recovery applicable from the GIC of reinsurance treaties held.

Therefore, in particular, this provision would allow for initial losses on new GICs created by renewal under the PAA method to be offset by proportionate reinsurance cover. The initial version of the standard did not have an allowance for reinsurance offset on initial recognition. This still does not address the issue of GICs using the PAA method but with longer contract boundaries, e.g. group risk insurance contracts with 3 year boundaries, as AASB 17.66A only applies on initial recognition.
In addition, this offset is only applicable to reinsurance that is strictly proportionate.

Q9.10 What qualifies as proportionate?

Proportionate reinsurance is defined as reinsurance treaties providing the right to recover a fixed percentage of all claims incurred on a GIC, which implies the same

percentage applying to each individual underlying risk. However, cash flows other than claim recoveries do not have to be proportionate; for instance, premium due to the reinsurer might not be proportionate to the premiums due from the policyholders. (AASB 17.B119C).

This appears to be a strict definition, that would exclude surplus reinsurance subject to a retention, even if the recovery above the retention is proportionate and known. Quota share reinsurance which does not cover all benefits also falls outside the criteria. Further submissions will be made to the IASB to suggest changes to these anomalies.

Q9.11 How is the Loss Recovery component determined and subsequently remeasured?

Under AASB 17.66B (and AASB 17.B119E) a loss-recovery component of the reinsurance asset for remaining coverage is set up after initial recognition of an onerous GIC with proportionate reinsurance coverage. The loss-recovery component is adjusted at remeasurement as follows under AASB 17.B119F to:

- Reflect changes in the loss component of the GIC as a result of AASB 17.50-52 with respect to releases from the underlying GIC LRC as revenue is recognised,
- Allocate subsequent changes in fulfilment cash flows arising from onerous underlying GICs until the loss-recovery component is reduced to zero.

Q9.12 Does the existence of reinsurance held impact the determination of the CSM or onerous contract testing of the gross policy liabilities?

AASB 17 (IFRS 17.BC298 and AASB 17.B66(b)) requires a reinsurance contract held to be accounted for separately from the underlying insurance contracts (see **Q9.5 How is reinsurance held shown on the balance sheet?**). Thus, the risk adjustment for the underlying insurance is assessed at a gross level.

However, the entity should then consider the impact on its appetite for non-financial risk, and hence on its gross risk adjustment, due to any applicable reinsurance. This may or may not result in a change in gross risk adjustment, depending on the level and type of reinsurance, its pricing, and the methodology for determining any change to the gross risk adjustment. As mentioned in **Q5.24 Does the existence of reinsurance have an impact on the risk adjustment for the gross insurance?**, this **discussion paper** issued by the AASB TRG explores methodologies for assessing changes in the gross risk adjustment to allow for reinsurance.

Any change in the gross risk adjustment as a result of reinsurance would flow through to the CSM and onerous contract testing of the gross policy liabilities.

Q9.13 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).

Q9.14 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.

Q9.15 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.

Q9.16 How is the reinsurance held risk adjustment determined?

The risk adjustment for the reinsurance held is required to adjust 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 non-financial 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 reinsurance held 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 held.

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 is generally accepted 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.

The AASB TRG reinsurance working group has produced a useful **note** on this issue.

Q9.17 Will the net risk adjustment equal the gross risk adjustment less the reinsured risk adjustment?

The reinsurance risk adjustment is defined in AASB 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.

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**
Estimated 75th percentile (Mean + ½ Standard Deviation)	**230**	**219**	**16**
Risk adjustment	**29**	**24**	**10**

There is a range of gross outcomes, some below 250 units that are fully reinsured and some above 250 units that are beyond the reinsurance limit. The 75th percentile under both cases has been approximated by the mean plus half a standard deviation (as per APRA GPS 320).

The gross risk adjustment (29 units) less reinsured risk adjustment (24 units) is equal to 5 units. However, the net risk adjustment calculated directly using the net exposure is higher at 10 units. This shows that when there is an asymmetric distribution of reinsurance recoveries that AASB 17 may result in a difference in the risk adjustment on the balance sheet compared to current practice where risk margins are determined on a net of reinsurance basis.

In examples provided by the IASB, the risk adjustment for reinsurance held is represented by the reinsured percentage multiplied by the gross risk adjustment. This should be considered as one possibility under the circumstances of the simplified examples provided. However, this relationship may not necessarily hold under particular facts and circumstances – for example due to asymmetry in recoveries as illustrated above or differences in contract boundary (see **Q9.27 What is the contract boundary for reinsurance issued and held?**

Q9.18 Is the risk adjustment for gross policy liabilities impacted by reinsurance held on the same business?

AASB 17 does not provide guidance on whether the risk adjustment determined by an entity for the valuation of insurance contracts it has issued should take into account reinsurance contracts it has entered into to mitigate these risks. See Q9.12 **Does the existence of reinsurance held impact the determination of the CSM or onerous contract testing of the gross policy liabilities?**

Q9.19 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 reinsurance 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 reinsurance 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 may not properly represent the amount of risk being transferred by the holder of the GIC of reinsurance contracts to the issuer of those contracts.

Q9.20 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.

Q9.21 What is 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.

Q9.22 How are commissions and reinstatement premiums in reinsurance contracts shown?

AASB 17.86 gives the reporting entity two choices, for reinsurance held, for how the cost of reinsurance is shown in the insurance service result. This is covered in Chapter 11 Disclosure (see Q11.7 **How should ceding commissions and reinstatement premiums be disclosed?**.

Q9.23 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 Q3.23 **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.

Q9.24 How is reinsurance issued 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.

Q9.25 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 issued 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 entity's approach to materiality.

Q9.26 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.

Q9.27 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**.

AASB 17.34 states:

> *Cash flows are within the boundary of an insurance contract if they arise from substantive rights and obligations that exist during the reporting 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.*

For reinsurance, the contract boundary continues while either the policyholder (in the case of reinsurance, the cedant) is compelled to pay premiums to the reinsurer or the reinsurer has substantive obligations to provide the cedant with services. This is consistent with the February 2018 TRG conclusion that the "entity" to be considered is the reinsurer and the "policyholder" is the cedant (see **IASB's Feb 18 TRG Summary for AP03 Boundary of reinsurance contracts held**).

The May 2018 TRG explored an example where the substantive obligation of the reinsurer to provide service ends (because of the ability to reprice to fully reflect risk) but the policyholder is compelled to pay premiums (except in circumstance beyond its control). The contract boundary in this case is the full contractual term, because the policyholder (cedant) does not have the unilateral right to cancel the contract (see **IASB's May 18 TRG AP04 Boundary of reinsurance contracts held with repricing mechanisms**).

Based on the above, **both** of the following conditions are required to end the reinsurance contract boundary:

- the policyholder (cedant) must have unilateral rights to terminate the contract (i.e. not be compelled to pay premiums), or, arguably, unilateral rights to reprice (which would economically equivalent to terminating the existing contract and establishing a new one with different terms); **and**
- the reinsurer must have the unilateral right to either terminate or fully reprice the contract.

Unless both of these conditions are met, the contract boundary runs for the contractual term.

As for other insurance contracts, FCF include all contractual cash flows within the contract boundary.

Aggregate reinsurance contracts may cover more than one GIC 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 be regarded as short term (hence it 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.

Q9.28 How is underlying new business treated when measuring reinsurance contracts?

It is common for a reinsurance treaty to automatically cover:

- changes to existing contracts, including increases to underlying cover; and
- new underlying contracts, unless prior notice is given by either party.

For such a treaty, a careful assessment of the contract boundary is needed and may lead to the conclusion that cash flows arising from the provision of such coverage must be included in the measurement of the reinsurance treaty, even if they are excluded from measurement of the underlying contracts.

In these circumstances, it may be that reinsurance cash flows arising from new business expected to be written up to the end of the notice period would be included within the boundary and measurement of the reinsurance contract.

AASB 17.35 states that insurance contract cash flows outside the contract boundary relate to future insurance. This implies, for example, that if the reinsurance notice period is six months, then at the start of an annual reporting period:

- new business that is expected to be written in the second six months is outside the contract boundary of the reinsurance treaty; and
- any reinsurance cash flows arising from such new business being written in the second six months relate to future insurance and would be needed to be treated as creating a separate reinsurance contract under AASB 17 .

However, if no notice is given and the reinsurance contract boundary is reassessed at the end of the annual reporting period, then it would appear that all reinsurance cash flows arising from new business written within the reporting period would now fall within the contract boundary.

AASB 17.B64 requires reassessment of the contract boundary at the end of each reporting period *to include the effect of changes in circumstances on the entity's substantive rights and obligations*. This gave rise to uncertainty as to whether reinsurance cash flows arising from new business that was outside the reinsurance contract boundary at the start of the reporting period, as per the example above, give rise to new reinsurance contract as per AASB 17.35 or fall under existing reinsurance treaty in light of AASB 17.64

This was the subject of staff paper AP05 *Cash flows that are outside the contract boundary at initial recognition* to the September 2018 IASB TRG, which noted that:

- AASB 17.35 and AASB17.B64 are not in conflict because they address different circumstances.
- AASB 17.35 applies to the treatment of cash flows that are outside the contract boundary and that relate to future contracts. When AASB 17.35 applies, *additional cash flows will be recognised as a new contract when the recognition criteria of a new group of contracts are met*.
- AASB 17.B64 expands upon AASB 17.34 concerning the practical ability to reprice a contract, in particular, the absence or presence of constraints on that ability and, needs to be read in that context.
- When AASB 17.B64 does apply, the FCF are updated to reflect changes in cash flows arising from the (revised) contract boundary. When the changes relate to future service, they adjust the CSM of the GIC to which the contract belongs.

In the context of the example above, the probability of the notice being given to close the treaty to new business was not a consideration in assessing the practical ability to

reprice under AASB 17.B64, when initially assessing the contract boundary. Hence subsequent exercise or not does not trigger reassessment of the contract boundary under AASB 17.B64.

As a consequence, any reinsurance cash flows arising from new business written in the second half of the reporting period give rise to a new reinsurance contract under AASB 17.

Q9.29 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 GIC of reinsurance contracts held, it expects:

- that the resulting measurement will provide a reasonable approximation compared to applying the GMM 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 GIC is one year or less (AASB 17.69(b)).

Note, because GICs 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.

Q9.30 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 GMM as modified for reinsurance held (see **General Measurement Model (GMM)**); 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.

Q9.31 Is it still possible to measure liability and profit on net of reinsurance basis, particularly for VFA business?

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. However, 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 (GMM); 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 (GMM); 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.

Q9.32 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 purposes:

- proportional (surplus, quota share);
- non-proportional;
- aggregate covers (including stop loss); and
- 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.

Q9.33 How will facultative reinsurance be treated?

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.

Q9.34 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.

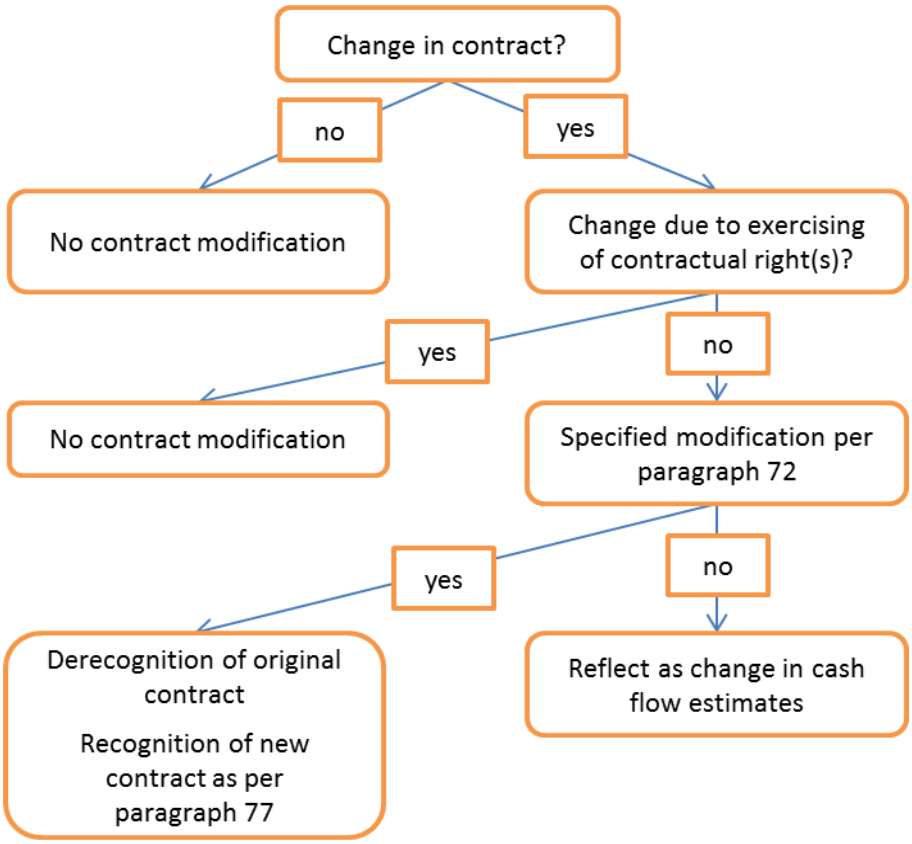
10 Contract Modifications and Derecognition

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. Examples are provided **in Q10.22 What practical examples are there for when a contract is modified?** below.

10.2 A contract modification

Q10.3 How does AASB 17 define a Contract Modification?

Contract modification is defined 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?

A contract modification involves the consent of both parties or a change due to regulation. 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:

- 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 underwritten option under the contract (see Q10.6), 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. 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 **How does AASB 17 define a Contract Modification?**) 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 may occur if there is a contractual right to add new features to the original contract which could be outside the contract boundary because the entity is able to reprice the contract for the additional feature added at the time it is added.

AASB 17 treats cash flows outside the contract boundary as relating to future insurance contracts (AASB 17.35) and such a new feature might be eligible to be treated as a new contract.

The treatment of contractual options and their interaction with the contract boundary was discussed at the IASB May 2018 TRG meeting (see **AP03** *Cash flows within the contract boundary* and the **IASB Summary of the May TRG Meeting**).

It was observed by the TRG, that unless the contractual option of itself, even before exercise, qualifies as a separate contract (see **IASB Feb 18 TRG paper AP01** *Separation of insurance components of a single insurance contract* and IASB TRG summary for the limited circumstances in which this may apply), then it is a contractual feature of the insurance contract. In that case it is included in measurement of the original contract to the extent it is within the contract boundary.

The staff view was that:

- as the unit of account is the contract as a whole, the contract boundary depends on the substantive rights and obligations as a whole; and
- the ability to reprice a part (e.g. the feature being added on exercise of the option) does not mean that part has a different contract boundary.

Several TRG members disagreed with this view and considered that if the addition on exercise of the option was able to be repriced at exercise, then it should be considered to be outside the contract.

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 appropriately modelled, and the exercise of such options is treated like other experience – see Q3.13 **How are contractual rights (e.g. policy loans) handled?**

10.3 Specified Contract Modifications

Q10.7 Which are the specified contract modifications?

Those contract modifications specified in AASB 17.72, are 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, if they had applied at inception, would have caused differences in the applicability of AASB 17, or the separation of components, or the contract boundary (only if significantly different), 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**;
- it would have been included in a different GIC from the one it was included in at initial recognition;
- it would have had a significantly different contract boundary;
- it would have had different components separated, resulting in a different insurance contract for IFRS 17;

- if the PAA was applied to the contract and it would not have qualified (see Chapter 7 Premium Allocation Approach); or
- it would qualify (or ceased 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**). Options and contract modifications form part of the reassessment in each reporting period.

Q10.9 What qualifies as a substantially 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, if it had occurred at inception, the impact on accounting treatment at that point.

Contract modifications that change the contract boundary in such a way that, if the contract had been written at inception as modified, the modified contract:

- if it was being accounted for under the PAA, would not have qualified for PAA; or
- would have been included in a different GIC;

are clearly contract modifications that result in a significantly different accounting treatment, as they are included in the criteria for specified contract modifications under AASB 17.72.

Other contract boundary changes that 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 upon renewal is treated as a new contract and becomes eligible for PAA ; or
- a change to the contract boundary that has a significant effect on the GIC's CSM release pattern and hence its accounting treatment.

When assessing whether a certain modification results in a substantially different contract boundary, the impact of any other modifications to the contract on its GIC'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 a contract that provided coverage from age 30 up to age 60 to now provide coverage up 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 GIC to which it was allocated at inception by:

- setting the contribution of its fulfilment value (including the risk adjustment and incurred claims) to the GIC 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 GIC to the extent required by AASB 17.44(c) and AASB 17.45(c) for the difference between (AASB 17.77(a)):
  - the reduction in fulfilment value of the GIC from setting that for the contract prior to modification to zero (AASB 17.77(a)(i)); 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)(iii)
- 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 reduce the CSM below zero, except in the case of reinsurance held. 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 GIC and not the measurement of the modified contract in the new GIC; 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 net equivalent premium determined?

The net equivalent premium is the price that the entity would have charged the policyholder if it had entered into a new contract with equivalent terms at the date of the actual modification (AASB 17.77(a)(iii)), less any additional premium charged for the modification.

The assumptions used in determining the equivalent 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, other than profit targets, 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.

Note that the equivalent premium is not likely to be the same as the fair value of the modified contract, and could possibly 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.

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 GIC, or another portfolio and hence different GIC; or
- increase or reduction in benefits, where they don't change grouping; or
- changes to what is covered, e.g. an extension or renovation under home insurance, or a new car under motor insurance; 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?

Contracts can be derecognised only when:

- A specified contract modification occurs (see Q10.7 **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; or
- A contract is transferred to a third party (see Q10.15 **How are contracts which are transferred to a third** party derecognised? and 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 AASB 17.74; or

- All obligations under the contract are extinguished (see Q10.16 **How are contracts derecognised other than due to a specified contract modification or transfer to a third party?**). This includes not only the liability for future coverage but also for incurred claims arising from past coverage (as per AASB 17.74).

Q10.15 How are contracts which are transferred to a third party derecognised?

This is similar to the derecognition of a contract upon a specified contract modification - that is, the contract being transferred is derecognised from the GIC to which it was allocated at inception by:

- setting the contribution of its fulfilment value (including the risk adjustment) and incurred claims, to the GIC to zero (AASB 17.76(a));
- adjusting the number of coverage units (AASB 17.76(c))
- adjusting the CSM of the GIC (AASB 17.76(b)) for the difference between:
  - the reduction in fulfilment value of the GIC 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?

When all obligations under the contract are extinguished, the contract is derecognised from the GIC to which it was allocated at inception by:

- setting the contribution of its fulfilment value (including the risk adjustment) and incurred claims to the GIC to zero (AASB 17.76(a));
- adjusting the number of coverage units (AASB 17.76(c))
- adjusting the CSM of the GIC for the reduction in the fulfilment value relating to future service for the contract being derecognised (AASB 17.76(b)).

Q10.17 What if a modified contract was part of an Onerous GIC?

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 GIC to which the contract was allocated at inception (since this GIC is by prerequisite of the question onerous and hence there is no CSM). However, if the modified contracts contained the ones that finally caused the GIC to be onerous, a CSM might re-appear.

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).

Q10.18 What if only the obligation for future coverage is transferred to a third party?

In this case, if there is any remaining obligation for coverage already provided, 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. However, if there is no remaining obligation for coverage already provided, then it would qualify for derecognition.

10.7 Application to Reinsurance and Premium Allocation Approach

Q10.19 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**.

Q10.20 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 held, they are:

- reflected in the re-measurement of the reinsurance contract held (as per AASB 17.40-46 and AASB 17.60-68); and
- not reflected in the CSM of the reinsurance contract held if they do not adjust the CSM of the underlying GIC and relate to future service (see AASB 17.66(c)(ii)).

Q10.21 How are contract modifications and derecognition accounted for under the PAA?

The requirements of AASB 17.73, AASB 17.76 and AASB 17.77 presume that the contract is being measured under the GMM. Where PAA applies to a contract (and in the case of a contract modification the contract continues to qualify for PAA), AASB 17 provides no definite guidance on the applicability of these requirements and the entity would have to develop an appropriate accounting policy as per AASB 108.10-12.

For example, one possible but unlikely interpretation might be that they have no effect for PAA contracts.

Another possible approach (arguably a literal interpretation) might be to apply the requirements of AASB 17.73, AASB 17.76 and AASB 17.77 appropriately modified for PAA, e.g.

1. For non-specified contract modifications (because a change in estimates under PAA only impact the LIC as per AASB 17.44(b)) only this element would reflect the change if appropriate. However, if the contract modification were to:

   (i) cause the GIC of which the contract is a part of to be viewed as onerous, then AASB 17.57-58 would also apply and LRC would also change as per these paragraphs; or

   (ii) cause the premiums received to change then this would be reflected in the liability for remaining coverage as per AASB17.55.

2. For specified contract modifications the answer to Q10.10 applies modified for PAA as follows:

   (i) derecognise the modified contract from the GIC of which it is part by setting the contribution of its carrying value to the GIC including the LIC to zero, consistent with AASB 17.76 (a); and

   (ii) recognise the modified contract as a new contract as at the date of modification assuming the premium the insurer would have charged for a new contract issued at the date of contract modification with equivalent terms. This would be done net of any additional premium charged for the modification (AASB 17.77(a)) which was received as at the date of modification (AASB 17.77(b)).

3. When derecognising a contract upon transfer to another party, the answer to Q10.15 applies, modified for PAA as per (b)(i) above.

4. When otherwise derecognising a contract, the answer to Q10.16 applies, modified for PAA as per (b) (i) above.

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.

10.8 Acquired Business

Q10.23 How are transferred Insurance contracts treated?

If the insurance contracts are acquired in a transfer within the scope of AASB 3 Business Combinations or the insurance contracts transferred do not form a business, then the insurer shall identify and group the contracts as if it entered into the insurance contracts as at the date of the transfer, and;

- for transfers within the scope of AASB 3, use the fair value of the insurance contracts transferred, determined in accordance with AASB 13 excluding only paragraph 47 (the deposit floor), as the premium for the insurance contracts transferred; and
- for transfers that do not form a business, use the consideration received or paid for the insurance contracts transferred as premiums received for the insurance contracts transferred.

Note that any liabilities for settlement of claims incurred before date of acquisition, are reclassified as a liability for remaining coverage (e.g. insurance for adverse claims development - see IFRS 17 ED.BC120).

Q10.24 Can insurance contracts transferred form a business that is not within scope of AASB 3 and how are these treated?

Yes, AASB 3 excludes business combinations under common control from its scope. For example, if the insurer's parent acquired another insurer and subsequently transferred all the insurance contracts into its primary insurer, then:

- In the parent's accounts, the insurance contracts acquired through the acquisition of the other insurer are a transfer within the scope of AASB 3; and

- In the primary insurer's accounts, the insurance contracts acquired are a business combination under common control, as the parent owned both businesses prior to consolidation of the purchased insurance business into the primary insurer.

As AASB 17 is largely silent on the treatment of insurance contracts acquired in a business combination under common control, the insurer has to set an appropriate accounting policy for the acquired contracts under AASB 108. For this, there are effectively two choices:

- The acquisition method – that is, account for the acquired insurance contracts as if AASB 3 did apply; or
- The pooling of interest method – that is if the assets and liabilities relating to the insurance contracts acquired are transferred to the primary insurer, the classification and accounting for them could also be carried across.

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 AASB 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 and IFRS 17 ED.BC46, ED.BC62, ED.BC91-96, ED.BC153 and ED.BC155 also provide 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 GIC (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 GIC and so could vary between GICs.

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 GIC that relates to the change in discount rates at the inception of the GIC 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 GIC 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.

AASB 17 17.78 requires the separate disclosure of the portfolios of contracts issued that are assets and that are liabilities.

AASB 17.103 requires the separate disclosure of insurance revenue/service expenses and investment components. For products such as conventional life insurance business where a combined premium is charged for investment and insurance components it is necessary to separate that premium into the separate components. It is expected that actuaries will need to provide the information needed to do this.

AASB 17.100 -105C 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 including:
  - Present value of future cash flows
  - Risk adjustment
  - Contractual service margin
  - Liability of remaining coverage (excluding loss component)
  - Loss component of remaining coverage
  - LIC.

- The movement in the value of the opening to closing balance of assets for insurance acquisition cashflows over the period if the company has an asset arising from insurance acquisition cashflows under AASB 17.28B(b) including recognition of impairment losses and reversals of impairment losses.

AASB 17 also requires the disclosure by time-bands of when:

- (AASB 17 105B) a company expects to derecognise an asset arising from insurance acquisition cashflows under AASB17.28C.
- (AASB 17 109) a company expects to recognise the remaining profit or loss in the CSM.

AASB 17.105B requires the disclosure of the time-bands when a company expects to derecognise an asset arising from insurance acquisition cashflows under AASB 17.28C.

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.

Where the company has insurance risk consequent to an incurred claim as discussed earlier in Q2.30 **Is the contract boundary impacted if an incurred claim results in insurance risk for the insurer that would not exist if no claim were made?**, the company must disclose the interpretation of the standard which the company has adopted.

Q11.7 How should ceding commissions and reinstatement premiums be disclosed?

For reinsurance held, AASB 17.86 gives the reporting entity, the choice of showing the cost of reinsurance in the insurance service result:

- as simply a net cost; or
- as two separate lines:
    - the amounts recovered from the reinsurer; and
    - an allocation of the premiums paid to the reinsurer.

Note that these exclude the effects of time value of money and financial risk relating to reinsurance which must be shown separately from the insurance service result in insurance finance income and expenses.

For reinsurance held when presenting the amounts recovered and the premiums paid to reinsurer separately, AASB 17.86 requires:

(a) that only reinsurance cash flows that are contingent upon claims be treated as part of the amounts expected to be recovered; and

(b) other amounts it expects to receive from the reinsurer that are not contingent upon claims (e.g. some types of ceding commissions) be treated as a reduction in the premiums payable to the reinsurer.

For reinsurance issued, AASB 17.86 also has implications even though it refers only to reinsurance held. These implications were discussed at the September 2018 TRG.

The TRG observed that:

- the requirements of AASB 17.86 are based on the economic effect of exchanges between the reinsurer and the cedant; and
- that it would be appropriate to also apply assessment based on economic effect to the treatment of reinsurance held.

As a consequence, the TRG noted that for reinsurance held:

- amounts exchanged between the reinsurer and cedant that are not dependent on claims are equivalent to adjusting the premium and should be recognised as part of revenue;

- amounts dependent upon claims are equivalent to adjusting the claims and should be recognised as part of insurance service expenses, unless they are repayable to the cedant in all circumstances, in which case they should be treated as an investment component;
- a ceding commission is not an acquisition cost for the reinsurer, unless the cedant provides a distinct service to the reinsurer for selling, underwriting and starting a GIC of reinsurance contracts that the reinsurer issues.

Q11.8 Are there any illustrative accounts available?

Yes, for examples see **KPMG 2018, EY 2018** and **PWC 2018**

11.4 Use of Materiality and Judgement

Q11.9 Are there any disclosure considerations on the use of judgement under AASB 17?

Sub-chapter 1.7 **Materiality** addresses materiality.

Under AASB 17.93 and AASB 17.117 all significant judgements and changes to those judgements including the inputs, assumptions and techniques used, need to be appropriately disclosed in the notes to the accounts. In particular, AASB17.117 requires this for:

- processes for estimating inputs;
- determination of risk adjustment, discount rates and investment components; and
- for contracts with investment and insurance services, the relative weighting of the benefits provided by the services.

It is important that the nature of any judgement call (for example, where an accounting estimate is to be made in the absence of suitable data) is understood and agreed with the preparer, who is ultimately responsible for the accuracy of the accounts issued and the disclosures therein.

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, IFRS 17.BC372-BC407 and IFRS 17 ED.BC119-BC146 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.C4, 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
- for life insurance, 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 2022, then the initial application date is 1 January 2022 and the transition date is 1 January 2021.

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 2022 (as noted, the ED proposes a one-year deferral from its original date of 1 January 2021), which means the latest possible initial application date is 31 December 2022, with a prior annual reporting period commencing on 31 December 2021; 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 GICs 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 GIC remaining as at transition date effectively requires:

- the determination of the CSM of the GIC as at the date of inception of all the contracts originally in the GIC (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 GIC CSM for events after inception of the GIC, 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 GIC 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 GIC 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 GIC 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 'impracticable' 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 or 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 effo*rt test for *impracticable* (see IAS 8.BC23-BC24).

The impracticability 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 and 17.BC382).

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?

The fair value approach may be used for VFA contracts, even if full retrospective is practicable (AASB 17.C5A), if and only if:

- the risk mitigation option in AASB 17.B115 is applied prospectively to that GIC of VFA contracts; and
- derivatives or reinsurance has been used to mitigate financial risk arising from that GIC of VFA contracts before transition;

Otherwise, only if the full retrospective approach is impracticable for a GIC, is there 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 GIC. 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;
- classification as a liability for incurred claims for claims incurred (but not settled) before an insurance contract was acquired;
- 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;
- amounts related to the loss-recovery component for proportionate reinsurance held; 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.C9-10, 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 classification of acquired claims modified?

Insurance contracts acquired either under a transfer of business or business combination to which AASB 3 applies (i.e. all business combinations except those under common control) are required to be classified as at date of acquisition (AASB 17.39 and AASB 17.B93-B95 and ED.BC120). Any liabilities for settlement of claims incurred before date of acquisition, is reclassified as a liability for remaining coverage (e.g. insurance for adverse claims development). Refer also to **Q10.23 How are transferred Insurance contracts treated?**

However, at transition, Liabilities for settlement of incurred claims incurred before the insurance contract was acquired are able to be classified as a liability for incurred claims if the entity does not have reasonable and supportable information to enable them to be classified as a liability for remaining coverage (AASB 17.C9A and ED.BC120-BC124).

Q12.15 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 GIC 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 GIC at inception have to be assessed and adjusted:

- future cash flows;
- discount rates to apply; and
- risk adjustment for non-financial risk.

Q12.16 How is the determination of future cash flows at initial recognition modified?

Future cash flows for a GIC at the date of initial recognition can be determined as a combination of:

- future cash flows for contracts in the GIC 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 GIC 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).

Q12.17 How is the determination of the yield curve at date of initial recognition modified?

The cash flows of the GIC need to be discounted using the yield curve that would have applied at the date of initial recognition of the GIC (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.

Q12.18 Are there other modifications to discount rates when modified retrospective is applied?

The following modifications are also permitted in respect of GICs that include contracts issued more than one year apart:

- the discount rate as at the date of transition may be used instead of the discount rates at the date of initial recognition for:
  - accreting interest on the CSM;
  - determining the impact on CSM of changes in expected cash flows; and
  - adjusting LRC for significant financing component under PAA.

For additional modifications that apply when using OCI, see **Q12.24** below

Q12.19 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).

Q12.20 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 AASB 17.C14 states that the prior release of risk *shall be determined by reference to 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)).

Q12.21 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.

Q12.22 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 Q12.16 **How is the determination of future cash flows at initial recognition modified?** To Q12.20 **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.

Q12.23 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 Q12.20 **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.

Q12.24 How is Cumulative Amount of OCI determined under the Modified Retrospective Approach?

For GICs that include contracts issued more than one year apart, and if the entity chooses to use OCI, it may determine the cumulative amount of insurance finance income or expenses recognised in OCI at the transition date as follows:

(i) as per the transition approaches allowed for GICs that include contracts issued no more than one year apart below; or

(ii) nil, except for VFA insurance contracts for which it holds the underlying item. For these VFA insurance contracts it is determined as 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.

For GICs that include contracts issued more than one year apart, that are measured under PAA, the discount rate at the date of transition may be used instead of the discounts at dates of incurred claim to determine the amount of insurance finance income or expense included under OCI.

For GICs that only include contracts issued no more than one year apart, and if the entity chooses to use OCI, it may determine the cumulative amount of insurance finance income or expenses recognised in OCI at the transition date as follows:

(i) for insurance contracts for which changes in financial risk assumptions do not have a substantial impact on policyholder amounts, using the inception discount rate determined under the modified approach (see **Q12.17**);

(ii) for insurance contracts for which changes in financial risk assumptions do have a substantial impact on policyholder amounts as nil;

(iii) for incurred claims under PAA, using the discount rate as at the date of incurred claim, determined under the modified approach (see **Q12.17**), where applicable; or

(iv) for insurance contracts to which VFA applies, as equal to the amount recognised in OCI on the underlying items.

Q12.25 How is the Loss-Recovery Component for Reinsurance determined under the Modified Retrospective Approach?

For a GIC of proportionate reinsurance contracts held, the loss recovery component is determined (AASB 17.C15A) as the result of multiplying:

- the loss component for each underlying GIC covered by the proportionate reinsurance held

by

- the fixed percentage of claims recoverable from that underlying GIC.

12.6 Fair Value Approach

Q12.26 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)).

Q12.27 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.

Q12.28 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).

Other transition modifications are:

- for amounts related to the loss-recovery component for proportionate reinsurance held; or
- at the entity's option, claims incurred (but not settled) before an insurance contract was acquired may be classified as a liability for incurred claims.

Q12.29 How is the cumulative amount for OCI determined under the fair value approach?

For insurance contracts, the cumulative amount recognised in OCI may be determined either:

- retrospectively, if the entity has reasonable and supportable information to do so; or
- as nil, except for VFA insurance contracts. For these contracts, it is determined as 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.

Q12.30 How is the Loss-Recovery Component for Reinsurance determined under the Fair Value Approach?

For a GIC of proportionate reinsurance contracts held, the loss recovery component is determined (AASB 17.C20A) as the result of multiplying:

- the loss component for each underlying GIC covered the proportionate reinsurance held

  by

- the fixed percentage of claims recoverable from that underlying GIC.

Q12.31 How is classification of acquired claims modified?

Insurance contracts acquired either under a transfer of business or business combination to which AASB 3 applies (i.e. all business combinations except those under common control), are required to be classified as at date of acquisition (AASB 17.39 and AASB 17.B93-B95 and ED.BC120). Any liabilities for settlement of claims incurred before date of acquisition, is reclassified as a liability for remaining coverage (e.g. insurance for adverse claims development).

Liabilities for settlement of incurred claims incurred before the insurance contract was acquired may be classified by the entity as a liability for incurred claims (AASB 17.C22A and ED.BC120-BC124).

Q12.32 What is the Fair Value of a GIC?

The fair value of a GIC 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 determination of fair value has not been covered in detail in this IN.

For contracts eligible for the VFA, the fair value of liabilities may be equal to the fair value of the pool of underlying items adjusted for the time value of guarantees and different timing of release of shareholder margins that are still included in the underlying items.

It is very likely that the fair value of insurance contract liabilities could be different to that produced under either the full transition approach or the modified retrospective approach. Actual outcomes will depend on a range of factors including:

- margins observed in any recent on-market transactions;
- the treatment of those margins in forming fair value and their recognition and release (if any) under AASB 17; and
- differences in market and entity specific assumptions (e.g. adjustment for non-financial risk and expenses).

This may result in a lower CSM under the fair value approach for business with high historic margins. Conversely, for business with low or no margins, the use of the fair value approach is likely to reinstate or improve those margins and so produce a higher CSM.

Q12.33 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

Q12.34 Can all treaties be included in one GIC at transition?

GICs may include contracts issued more than one year apart, where:

- fair value approach is used; or
- the modified retrospective approach 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 issued, 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' treaties which have been issued more than one year apart may be grouped for transition purposes disregarding the nature of the treaties and the risks they cover, 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.

Q12.35 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?

Q12.36 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.

Q12.37 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 Q12.16) can be considered to include this element.

Section E. Other Useful Information

13 References

Australian Accounting Standard Board (2017). AASB 17 Insurance Contracts.

http://www.aasb.gov.au/admin/file/content105/c9/AASB17_07-17.pdf

Australian Accounting Standard Board (2019). AASB Exposure Draft Amendments to AASB 17 (based on IFRS 17 Exposure Draft)

https://www.aasb.gov.au/admin/file/content105/c9/ACCED292_07-19.pdf
See International Accounting Standard Board below also.

Australian Accounting Standards Board (2019). Submission on IFRS 17 Exposure Draft

http://eifrs.ifrs.org/eifrs/comment_letters/544/544_25959_HelenSimkovaAustralianAccountingStandardsBoardAASB_0_AASB_Response_to_ED20194.pdf

Australian Accounting Standards Board (2014). AASB 1023: General Insurance Contracts.

http://www.aasb.gov.au/admin/file/content105/c9/AASB1023_07-04_COMPoct10_01-11.pdf

Australian Accounting Standard Board (2014). AASB 1038: Life Insurance Contracts.

http://www.aasb.gov.au/admin/file/content105/c9/AASB1038_07-04_COMPdec13_01-14.pdf

Australian Accounting Standard Board Transition Resource Group for Insurance Contracts

https://www.actuaries.asn.au/Library/Miscellaneous/2019/AASB17DiscussionNote.pdf

AASB TRG – Reinsurance working group report

https://www.aasb.gov.au/Hot-Topics/Transition-Resource-Group-for-Insurance-Contracts/Meeting-Minutes.aspx

Collection of AASB TRG minutes, supporting papers and IFRS 17 submitted papers
http://www.aasb.gov.au/admin/file/content105/c9/ACCDP_Aus_Specific_Insurance_Issues_11-17.pdf

Australian Accounting Standard Board Discussion Paper: Australian-specific Insurance Issues – Regulatory Disclosures and Public Sector Entities.

http://www.aasb.gov.au/admin/file/content102/c3/IASB_TRG_Submission-Contract_boundary_for_Australian_insurance_products.pdf

Australian Accounting Standard Board Transition Resource Group for Insurance Contracts: Submission to the IASB 17 TRG – Contract Boundary for Australian Insurance Products.

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

Actuaries Institute (2019). Submission on IFRS 17 Exposure Draft

http://eifrs.ifrs.org/eifrs/comment_letters/544/544_25972_LindaMcMasterTheInstituteofActuariesofAustralia_0_2019_09_25_Letter_IASB_reComments_ED_2019_4_Amendment_IFRS17IC_Fnl.pdf

Australian Prudential Regulatory Authority (2018, a). Update on New Accounting Standards – AASB 16 and AASB 17

Letter_to_industry_new_accounting_standards_aasb_16_aasb_17.pdf

This letter to all general insurers, life insurers and private health insurers provides an update to APRA's planned response to the issuance of AASB 16 Leases and AASB 17 Insurance Contracts. In particular, it provides the results of the 2017 survey of insurers regarding the impacts of AASB 17.

Australian Prudential Regulatory Authority (2018, b). Roadmap for integration of AASB 17 Insurance Contracts into the Capital and Reporting frameworks for Insurers

https://www.apra.gov.au/sites/default/files/aasb_17_roadmap_letter.pdf

This letter updates stakeholders on APRA's planned approach to integrating AASB 17 into the capital and reporting frameworks applicable to life insurers and general insurers, and outlines the next steps.

Australian Prudential Regulatory Authority (2018, c). Roadmap for APRA's Review of the Private Health Insurance Capital Framework

https://www.apra.gov.au/sites/default/files/phi_capital_roadmap_letter.pdf

This letter updates stakeholders on APRA's planned approach to reviewing the capital framework applicable to private health insurers, and outlines the next steps.

Australian Prudential Regulatory Authority (2019). Information request and consultation on directions for integration of AASB 17 insurance contracts into the capital and reporting framework for insurers

https://www.apra.gov.au/sites/default/files/letter_-_information_request_and_consultation_on_directions_for_integration_of_aasb_17_insurance_contracts_into_the_capital_and_reporting_framework_for_insurers.pdf

This letter provides guidance on APRA's approach to AASB 17 to assist insurers in determining their own implementation approach to AASB 17. The letter outlines APRA's indicative directions for integrating AASB 17 into the capital and reporting frameworks for insurers and outlines a revised timeframe for APRA's approach to integrating AASB 17.

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 [link unavailable due to website update]

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.

GPS-115-Capital-Adequacy-Insurance-Risk-Charge-January-2013.pdf

Australian Prudential Regulatory Authority (2013). Life Prudential Standard LPS (115): Insurance Risk Charge.

LPS-115-Capital-Adequacy-Insurance-Risk-Charge-January-2013.pdf

Australian Prudential Regulatory Authority (2012). Illiquidity Premium.

https://www.apra.gov.au/sites/default/files/120330_LTI_LAGIC_LI_illiquidity_premium_consultation.pdf

This letter to CEOs (or equivalent) and Appointed Actuaries of Life Insurers set out a proposed methodology to calculate the illiquidity premium using RBA published data (at that time)

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.

Commonwealth of Australia (2018). Taxation of Insurance Companies: Consultation paper on the tax impacts of AASB 17, recognition of outstanding claims and tax provisions for health insurers

https://static.treasury.gov.au/uploads/sites/1/2018/11/c2018-t338423.pdf

This paper is seeking information and comments from interested parties on the tax impacts of implementing AASB 17. This will inform the Government's consideration of whether and what changes may be needed to the tax law as a consequence of the move to the new accounting standard.

CFO Forum

http://cfoforum.eu/ifrs_letters.html
The CFO Forum have published various papers on IFRS 17, to provide EFRAG with case study testing information on implementation issues and complexities, and proposed solutions.

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 YRT life portfolio in New Zealand.

European Financial Reporting Advisory Group.

https://www.efrag.org/Activities/289/IFRS-17---Insurance-Contracts?AspxAutoDetectCookieSupport=1#

EFRAG has established a project on IFRS 17 which has published several papers to provide simplified information on controversial areas of IFRS 17, to enable constituents to understand the issues and for constituents to be in the position to comment on EFRAG's draft endorsement advice to the European Union.

EY (2018). Selected Illustrative disclosures for IFRS 17 Insurance Contracts (general model), IFRS 9 Financial Instruments and IFRS 7 Financial Instruments

https://asia-pac.ey-vx.com/34/12004/landing-pages/ifrs-ey-000076726-01-good-life-insurance-2018-pd—oct-2018.pdf

International Actuarial Association (unpublished). Application of IFRS 17 Insurance Contracts

https://www.actuaries.org/IAA/Documents/Publications/IANs/IAN_100_Consultation/IAN100_ED_17January2019.docx

This draft 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 (2018). Risk Adjustments for Insurance Contracts under IFRS 17

https://www.actuaries.org/iaa/IAA/Publications/ImportTemp/Overview.aspx?hkey=67474917-32f8-4e02-8e12-c88b53420cdc

This 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.

https://www.actuaries.org/iaa/IAA/Publications/ImportTemp/Overview.aspx?hkey=67474917-32f8-4e02-8e12-c88b53420cdc

This monograph provides information on discounting in financial reporting from a practical and conceptual perspective.

International Actuarial Association (2010). Stochastic Modeling — Theory and Reality from an Actuarial Perspective.

https://www.actuaries.org/iaa/IAA/Publications/ImportTemp/Overview.aspx?hkey=67474917-32f8-4e02-8e12-c88b53420cdc

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.

http://www.actuaries.org/LIBRARY/Papers/IAA_Measurement_of_Liabilities_2009-public.pdf

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.

International Accounting Standard Board (May 2017). IFRS 17 Insurance Contracts

http://www.ifrs.org/issued-standards/list-of-standards/ifrs-17-insurance-contracts/

The IFRS 17 Standard, Basis of Conclusions and Illustrative Examples are available on the website for subscribers.

International Accounting Standard Board (2019). Exposure Draft - Amendments to IFRS 17 Insurance Contracts

https://www.ifrs.org/-/media/project/amendments-to-ifrs-17/ed-amendments-to-ifrs-17.pdf

A marked-up version of IFRS 17 showing the proposed changes is here. The Basis for Conclusions for the ED is here.

International Accounting Standards Board, Staff Paper (October 2018) – AP2D Concerns and Implementation Challenges

https://www.ifrs.org/-/media/feature/meetings/2018/october/iasb/ap02d-ifrs17.pdf

This paper provides an overview of the main concerns and implementation challenges that have been raised by stakeholders about the requirements in IFRS 17.

International Accounting Standards Board, Staff papers

December 2018
AP2: Cover Note. **https://www.ifrs.org/-/media/feature/meetings/2018/december/iasb/ap2-insurance-contracts.pdf** This cover note provides: (a) background information about the tentative decisions made by the Board at its recent meetings; (b) a list of the papers for this meeting with a table of concordance of the topics discussed at the October 2018 Board meeting; and (c) an outline of the next steps.
AP2A: Presentation of insurance contracts on the statement of financial position. **https://www.ifrs.org/-/media/feature/meetings/2018/december/iasb/ap2a-insurance-contracts.pdf** This paper discusses the following topics: (a) the need to allocate premium cash flows and the liability for incurred claims to each GIC; and (b) separate presentation and measurement of premiums receivable and claims payable.
AP2B: Discount rates, risk adjustment and OCI option. **https://www.ifrs.org/-/media/feature/meetings/2018/december/iasb/ap2b-insurance-contracts.pdf** This paper discusses the following topics: (a) the use of locked-in discount rates to adjust the contractual service margin; (b) the risk adjustment in a group of entities; (c) the subjectivity in the determination of discount rates and risk adjustment; and (d) the OCI option for insurance finance income or expenses.
AP2C: Variable fee approach. **https://www.ifrs.org/-/media/feature/meetings/2018/december/iasb/ap2c-insurance-contracts.pdf** This paper discusses the following topics: (a) the definition of an insurance contract with direct participation features (which sets the scope for the variable fee approach); and (b) the limited applicability of the risk mitigation exception.
AP2D: Business combinations.

https://www.ifrs.org/-/media/feature/meetings/2018/december/iasb/ap2d-insurance-contracts.pdf This paper discusses the following topics: (a) business combinations: classification of acquired contracts as insurance contracts; and (b) business combinations: identification of insured event for acquired insurance contracts.
AP2E: Future cash flows in the measurement of reinsurance contracts held. **https://www.ifrs.org/-/media/feature/meetings/2018/december/iasb/ap2e-insurance-contracts.pdf** This paper provides: (a) an overview of the requirements in IFRS 17 Insurance Contracts; (b) a summary of the Board's rationale for setting those requirements, including an overview of the Board's previous discussions; (c) an overview of the concerns and implementation challenges expressed since IFRS 17 was issued; and (d) the staff analysis, recommendation and a question for Board members.
AP2F: The treatment of accounting estimates in interim financial statements **https://www.ifrs.org/-/media/feature/meetings/2018/december/iasb/ap2e-insurance-contracts.pdf** This paper provides (a) an overview of the requirements in IFRS 17 Insurance Contracts; (b) a summary of the IASB's rationale for setting those requirements, including an overview of the Board's previous discussions; (c) an overview of the concerns and implmentations challenges expressed since IFRS 17 was issued; and (d) the staff analysis, recommendation and a questions for Board members.

International Accounting Standards Board, Staff papers – Transition Resource Group for Insurance Contracts

February 2018
Summary of the Transition Resource Group for IFRS 17 Insurance Contracts meeting held on 6 February 2018 **http://www.ifrs.org/groups/transition-resource-group-for-insurance-contracts/#meetings** This paper provides a summary of the 6 February 2018 meeting of the Transition Resource Group discussing submission papers AP01-AP07.
AP01: Separation of insurance components of a single insurance contract. **http://www.ifrs.org/-/media/feature/meetings/2018/february219/trg-for-ic/ap1-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 AASB 17.

AP02: Boundary of contracts with annual repricing mechanisms.

http://www.ifrs.org/-/media/feature/meetings/2018/february/trg-for-ic/ap2-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 AASB 17.34(b).

AP03: Boundary of reinsurance contracts held.

http://www.ifrs.org/-/media/feature/meetings/2018/february/trg-for-ic/ap3-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.

AP04: Insurance acquisition cash flows paid on an initially written contract.

http://www.ifrs.org/-/media/feature/meetings/2018/february/trg-for-ic/ap4-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.

AP05: Determining quantity of benefits for identifying coverage units

http://www.ifrs.org/-/media/feature/meetings/2018/february/trg-for-ic/ap5-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 GIC.

AP06: Insurance acquisition cash flows when using fair value transition

http://www.ifrs.org/-/media/feature/meetings/2018/february/trg-for-ic/ap6-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.

AP07: Reporting on other questions submitted

http://www.ifrs.org/-/media/feature/meetings/2018/february/trg-for-ic/ap7-reporting-on-other-questions-submitted.pdf

This paper summarises other questions submitted to the TRG and considered as part of the February meeting.

May 2018

Summary of the Transition Resource Group for IFRS 17 Insurance Contracts meeting held on 2 May 2018.

http://www.ifrs.org/groups/transition-resource-group-for-insurance-contracts/#meetings

This paper provides a summary of the 2 May 2018 meeting of the Transition Resource Group discussing submission papers AP01-AP07.

AP01: Combination of insurance contracts

https://www.ifrs.org/-/media/feature/meetings/2018/may/trg-for-ifrs-17/ap01-combination-of-insurance-contracts.pdf

This paper provides background and an accounting analysis to support discussion by the TRG about when it may be necessary to treat a set or series of insurance contracts as a whole applying IFRS 17.9.

AP02: Determining the risk adjustment for non-financial risk in a group of entities

https://www.ifrs.org/-/media/feature/meetings/2018/may/trg-for-ifrs-17/ap02-risk-adjustment-in-a-group-of-entities.pdf

This paper provides background and an accounting analysis to support discussion by the TRG about at which level the risk adjustment is required to be determined (a) in the individual financial statements of entities that are part of a consolidated group and (b) in the consolidated financial statements of the group of entities.

AP03: Cash flows within the contract boundary

https://www.ifrs.org/-/media/feature/meetings/2018/may/trg-for-ifrs-17/ap03-cash-flows-within-the-contract-boundary.pdf

This paper provides background and an accounting analysis to support discussion by the TRG about the cash flows within the boundary of an insurance contract.

AP04: Boundary of reinsurance contracts held with repricing mechanisms

https://www.ifrs.org/-/media/feature/meetings/2018/may/trg-for-ifrs-17/ap04-boundary-of-reinsurance-held-with-repricing.pdf

This paper provides background and an accounting analysis to support further discussion by the TRG about how the boundary of a reinsurance contract held. In particular, how should the boundary be determined when the reinsurer has the right to reprice remaining coverage prospectively. See also paper AP03 for IASB Feb 18 TRG.

AP05: Determining the quantity of benefits for identifying coverage units

https://www.ifrs.org/-/media/feature/meetings/2018/may/trg-for-ifrs-17/ap05-quantity-of-benefits-for-identifying-coverage-units.pdf

This paper provides background and an accounting analysis to support further discussion by the TRG on coverage units. See also paper AP05 for IASB Feb 18 TRG.

AP06: Implementation challenges outreach report

https://www.ifrs.org/-/media/feature/meetings/2018/may/trg-for-ifrs-17/ap06-implementation-challenges-outreach-report.pdf

This paper provides background and an accounting analysis to support discussion by the TRG on the implementation challenges in applying the requirements of IFRS 17 in (a) the presentation of GIC in the statements of financial position, (b) premiums received applying the PAA and (c) subsequent treatment of insurance contracts acquired in their settlement period.

AP07: Reporting on other questions submitted

https://www.ifrs.org/-/media/feature/meetings/2018/may/trg-for-ifrs-17/ap07-reporting-on-other-questions-submitted.pdf

This paper summarises other questions submitted to the TRG and considered as part of the May meeting.

September 2018
Summary of the Transition Resource Group for IFRS 17 Insurance Contracts meeting held on 26-27 September 2018. **https://www.ifrs.org/-/media/feature/meetings/2018/september/trg-insurance/trg-for-ic-meeting-summary-september-2018.pdf** This paper provides a summary of the 26-27 September 2018 meeting of the Transition Resource Group discussing submission papers AP01-AP11.
AP01: Insurance risk consequent to an incurred claim **https://www.ifrs.org/-/media/feature/meetings/2018/september/trg-insurance/ap01.pdf** This paper provides background and an accounting analysis to support further discussion by the TRG under which an incurred claim results in insurance risk for the issuer that would not exist if no claim were made.
AP02: Determining discount rates using a top-down approach **https://www.ifrs.org/-/media/feature/meetings/2018/september/trg-insurance/ap02.pdf** This paper provides background and an accounting analysis to support further discussion by the TRG about how an entity applies a top-down approach to determine the discount rates for insurance contracts with cash flows that do not vary based on the returns on underlying items.
AP03: Commissions and reinstatement premiums in reinsurance contracts issued **https://www.ifrs.org/-/media/feature/meetings/2018/september/trg-insurance/ap03.pdf** This paper provides background and an accounting analysis to support further discussion by the TRG about amounts exchanged between the issuer of a reinsurance contract (the reinsurer) and the holder of a reinsurance contract (the cedant). The paper discusses how to in the financial statements of the reinsurer: (a) common types of commissions due to the cedant; and (b) reinstatement premiums charged to the cedant following the occurrence of an insured event.
AP04: Premium experience adjustments related to current or past service **https://www.ifrs.org/-/media/feature/meetings/2018/september/trg-insurance/ap04.pdf** This paper provides background and an accounting analysis to support further discussion by the TRG about how differences between expected premiums and

actual premiums (ie premium experience adjustments) which relate to current or past service should be accounted for
AP05: Cash flows that are outside the contract boundary at initial recognition **https://www.ifrs.org/-/media/feature/meetings/2018/september/trg-insurance/ap05.pdf** This paper provides background and an accounting analysis to support further discussion by the TRG about the accounting for cash flows that are outside the boundary of an insurance contract at initial recognition
AP06: Recovery of insurance acquisition cash flows **https://www.ifrs.org/-/media/feature/meetings/2018/september/trg-insurance/ap06-recovery-of-insurance-acquisition-cash-flows.pdf** This paper provides background and an accounting analysis to support further discussion by the TRG about whether insurance acquisition cash flows and the related revenue are recognised in the statement(s) of financial performance applying paragraph B125 of IFRS 17 if those cash flows cannot be recovered from the cash flows of the portfolio of contracts.
AP07: Premium waivers **https://www.ifrs.org/-/media/feature/meetings/2018/september/trg-insurance/ap07-premium-waivers.pdf** This paper provides background and an accounting analysis to support further discussion by the TRG on whether terms in an insurance contract that waive premiums in specified circumstances create insurance risk.
AP08: Group insurance policies **https://www.ifrs.org/-/media/feature/meetings/2018/september/trg-insurance/ap08-group-insurance-policies.pdf** This paper provides background and an accounting analysis to support further discussion by the TRG about the boundary of a contract for an arrangement between an entity and an association or a bank under which the entity provides insurance coverage to members of an association or to customers of a bank.
AP09: Industry pools managed by an association **https://www.ifrs.org/-/media/feature/meetings/2018/september/trg-insurance/ap09-industry-pools-managed-by-an-association.pdf** This paper provides background and an accounting analysis to support further discussion by the TRG about the level at which the risk adjustment for non-financial

risk should be determined for insurance contracts that are within industry pools managed by an association.
AP10: Annual cohorts for contracts that share in the return of a specified pool of underlying items **https://www.ifrs.org/-/media/feature/meetings/2018/september/trg-insurance/ap10-annual-cohorts.pdf** This paper provides background and an accounting analysis to support further discussion by the TRG about annual groups of contracts with policyholders that all share in the return on a specified pool of underlying items, with some of the return contractually passing from one group of policyholders to another.
AP11: Reporting on other questions submitted **https://www.ifrs.org/-/media/feature/meetings/2018/september/trg-insurance/ap11-reporting-on-other-questions-submitted.pdf** This paper summarises other questions submitted to the TRG and considered as part of the September meeting.

EY (2018). Good Life Insurance (International) Limited Selected Illustrative disclosures for IFRS 17 Insurance Contracts (general model), IFRS 9 Financial Instruments and IFRS 7 Financial Instruments: Disclosures

https://asia-pac.ey-vx.com/34/12004/landing-pages/ifrs-ey-000076726-01-good-life-insurance-2018-pd--oct-2018.pdf

The purpose of this publication is to provide illustrative disclosures to meet the requirements of IFRS 17 Insurance Contracts and IFRS 9 Financial Instruments related to groups of insurance contracts accounted for under the default measurement model described in IFRS 17 (the general model).

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 (now 2022).

PWC (2018) IFRS 17, Insurance Contracts: An illustration

https://www.pwc.com/id/en/publications/assurance/ifrs-17-insurance-contracts.pdf

This publication (the Illustration) demonstrates the presentation and disclosure requirements of IFRS 17, Insurance Contracts (IFRS 17), as issued

by the International Accounting Standards Board (IASB) in May 2017, as well as the new disclosures introduced or modified by IFRS 9, Financial Instruments (IFRS 9), through consequential amendments to IFRS 7, Financial Instruments: Disclosures (IFRS 7).

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*
AALC	Accountants and Actuaries Liaison Committee
APRA	Australian Prudential Regulation Authority
BC	Basis of Conclusions
BBA	Building Block Approach
BEL	Best Estimate Liability
CDS	Credit Default Swap
CoC	Cost of Capital
CPI	Consumer Price Index
CSM	Contractual Service Margin
DAC	Deferred Acquisition Cost (being acquisition costs allocated to future GICs which are deferred as an asset until they are recognised)
DLR	Disabled Lives Reserve
ED	Exposure Draft (of the IASB's proposed changes to IFRS 17)
ED.BC	Basis of Conclusions behind the ED
FCF	Fulfilment Cash Flows
GIC	Group of Insurance Contracts
GMM	General Measurement Model
IAA	International Actuarial Association
IAN	International Actuarial Note
IASB	International Accounting Standards Board
IBNR	Incurred But Not Reported

I-E	Investment less Expenses
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
LPS	Life Prudential Standard
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
VUI	Value of Underlying Items
YRT	Yearly Renewable Term

15 Interpretation Uncertainties

This chapter is intended to help the reader by highlighting those areas where there are uncertainties with respect to the implementation of the standard.

It is important to note the distinction between authoritative and persuasive interpretations. Only what is in IFRS 17 itself and decisions of the IFRS Interpretations Committee (should they formally issue any) are authoritative. Also note that:

- the Basis for Conclusions do not form part of the Standard and are by their nature persuasive and not authoritative;
- staff views in the TRG papers, like the Basis for Conclusions, are by their nature persuasive but not authoritative; and
- alternative interpretations put forward by TRG members are also persuasive but not authoritative. This means, for example, in the context of the May TRG discussion paper on the treatment of risk adjustment, there were now two valid interpretations.

This chapter includes five tables:

1. Areas where judgement will need to be applied;
2. Areas where an accounting choice will need to be made (e.g. use of the PAA);
3. Areas where consequences have been identified, but there is unlikely to be a change;
4. Areas where the IASB has decided that a change should be made; and
5. Areas where there is still uncertainty in interpretation, but the Standard is unlikely to change.

Even though it is yet to be confirmed, it is assumed for the purpose of this Information Note that the standard will be finalised as proposed in the ED. However, where various parties (e.g. the AASB) have suggested further changes in their submissions, these are noted as areas of uncertainty.

Note that these tables are not necessarily comprehensive, but contain the best estimate of issues at the current time, and their status.

Table 1: Areas where judgement will need to be applied

Issue	Description and Implications	References	Related IN Question
Risk Adjustment on Consolidat-ion	**How is the risk adjustment at a Group level determined?** The IASB staff view outlined in AP02 of the May 2018 TRG is that risk adjustments are based on the issuing entity view encompassed in pricing when the contract was written. The alternative supported by a number of IASB TRG members is that IFRS 17 should be interpreted as requiring a reporting entity view of compensation required for bearing uncertainty about the amount and timing of the cash flows that arises from non-financial risk and, therefore, accommodate circumstances in which that compensation would vary between the subsidiary and Group levels. The ED makes no change in this area, and makes clear that both views are valid, and the entity will have to choose what approach to adopt.	AALC June meeting AP4b **AASB TRG July 2018 meeting – AP02** **IASB October 2018 meeting – AP02d** **ED.BC189-192**	Q5.19 and Q5.20
Level of Aggregation - portfolio	**What are 'similar risks', 'managed together'?** This will particularly affect the extent to which multiple risks covered by a single contract can be segregated into separate groups. (Note that current GI interpretation – where a similar aggregation is required for the liability adequacy test – is very broad; will entities look to do something similar under AASB 17?)	AASB 17.14 and IFRS 17.BC115 -BC139	Q2.6 – Q2.9
Level of Aggregation - group	**How likely is a contract to become onerous?** The division for grouping between contracts that are likely to become onerous, and groups of contracts that have no significant possibility of becoming onerous, is very subjective.	AASB 17.16, AASB 17.19, AASB 17.24 and IFRS 17.BC115 -BC139	Q2.15 and Q2.20
Contract Boundary	**What is the boundary of a contract?** In many cases the boundary of a contract remains uncertain, and is to be determined by the entity (based on the principles in AASB 17). In particular:	AASB 17.33 – 35 and AASB 17.B61 – B66 **IASB TRG September**	Q2.23– Q2.31

Issue	Description and Implications	References	Related IN Question
	• it is not categorical whether YRT products are short-term or long-term (although the issue is less significant if some acquisition cash flows can be allocated to future groups); and • the boundary of health insurance products is uncertain as they have no end date	**2018 meeting – AP01** **ED**	
Expenses	**What expenses can be included in the projection of cash flows, and what must be expensed immediately?** What expenses are regarded as 'directly attributable' remains a matter of judgement. There is still some uncertainty which is mentioned in this IN, but it is unlikely that this will be further clarified.	AALC June 2018 meeting – AP4c). AASB 17.B65 – B66 and IFRS 17.BC175 – BC184.	Q3.24
Taxes	**What taxes are considered 'fiduciary'?** Taxes that are paid by the entity in a 'fiduciary' capacity can be included in the projection of cash flows. But what 'fiduciary' is needs to be determined by the entity. Note that AASB 17.B65(m), which is effectively a 'catch all', may not resolve this. The AASB submission in relation to the ED (endorsed by the Actuaries Institute) seeks for costs associated with tax payments attributable to the policyholder that arise from investment services to be also included in the fulfilment cash flows.)	AALC June 2018 meeting – AP4d) AASB 17.B65(j) and B65(m) **AASB Submission on ED**	Q3.35
Risk Adjustment Generally	**How is the risk adjustment to be quantified and what method is to be used for its calculation?** Entities will need to determine the compensation they require for bearing non-financial risk.	AASB 17.37, AASB 17.B86 – B92, and IFRS 17.BC206 – BC217.	Chapter **5**
Coverage Units	**How are coverage units determined for particular contracts?** The coverage units for particular contracts will need to be determined by the entity (based on the principles in AASB 17). Particular issues of uncertainty will be similar to those for determining the boundary of contracts. In addition, entities will need to decide if coverage units are to be discounted.	AASB 17.B119 and IFRS 17.BC279 – BC283. **ED**	Q6.12, Q6.14, **Q6.13, Q8.26**

Issue	Description and Implications	References	Related IN Question
	An entity is required to identify coverage units considering the quantity of benefits and expected period of both insurance coverage and investment services. An entity is also required to disclose information about the approach used to determine the relative weighting of the benefits provided by insurance coverage and investment services. Entities will therefore need to determine how the provision of investment services is to be reflected in coverage units, including particularly the weighting between insurance coverage and investment services.		
Loss Component	**How is the Loss Component to be amortised?** The amount of the Loss Component to be amortised each period is to be determined on a 'systematic' basis; what is systematic needs to be determined by the entity (based on the principles in AASB 17).	AASB 17.47 – 52 and IFRS 17.BC284 – BC287.	Q6.20
Coverage Period – LIC	**What is the coverage period if LIC is instead included as LfRC?** In AP1 for the September 2018 IASB TRG meeting, the IASB staff concluded that a claim could be deemed to occur: • when the uncertain event occurs; or • when the claim amount is determined. This will determine when the coverage period ends. One example used was fire insurance where the benefit in the event of fire was reconstruction of the destroyed property. Coverage could cease when the fire occurred with the claim amount depending on the cost of reconstruction, and being treated as LIC. Alternatively, coverage could extend to finalisation of the claim amount (even though the claim event has occurred). The other example relates to Disabled Lives Reserves (DLR). If DLR is treated as LIC then there are no requirements to establish a CSM on DLR - the CSM remains in the in-force portfolio. Entities will need to determine themselves what the coverage period is in these cases – i.e. whether	**IASB TRG September 2018 meeting – AP01**	Q2.30

Issue	Description and Implications	References	Related IN Question
	payment amounts are to be treated as LIC or part of LfRC. This is likely to have an impact on whether contracts qualify as PAA with a boundary of no more one year.		
Eligibility to use the PAA	**Can the PAA be used?** To use the PAA, the entity needs to show that either: • the coverage period is 1 year or less, or • at inception, the results are not materially different from those that would have been produced by the GMM. Accordingly, the entity will need to decide if the PAA can be used, and, if so, should it be used.	AASB 17.53 – 54 and IFRS 17.BC288 – BC295.	Q7.4 – Q7.6
Eligibility to use the VFA	**Can the VFA be used?** There are a number of determinations that the entity must make for the VFA to be used (and if so, it must be used) for a particular contract. These are: • the contractual terms must specify that the policyholder participates in a share of a clearly identified pool of underlying items; • the entity expects to pay to the policyholder an amount equal to a substantial share of the fair value returns on the underlying items; 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. In particular, what is 'substantial' needs to be determined by the entity.	AASB 17.B101 – B108 and IFRS 17.BC238 – BC269.	Q8.4 - Q8.14
Specified Contract Modifications	**When is a contract modification considered to be a 'specified' contract modification?** The treatment of contract modifications specified in AASB 17.72 is different from other contract modifications. To assess if AASB 17.72 applies, the entity will need to determine if the contract as modified would have been assessed differently at the date of inception in respect of: • whether AASB 17 would not apply to it, e.g. is no longer insurance;	AASB 17.72 – 73, AASB 17.77 and IFRS 17.BC317 – BC319.	Q10.9

Issue	Description and Implications	References	Related IN Question
	• the grouping of the contract (including changes to the likelihood of it becoming onerous); • the contract boundary, i.e. has a substantial change occurred; and • eligibility for a particular method (e.g. PAA or VFA). In particular, what a substantially different contract boundary actually is needs to be determined by the entity. For a specified contract modification, the entity will also need to determine the premium that would have been charged for the modification.		
Deferral of Acquisition Cash Flows	**How are acquisition costs to be allocated to future groups in respect of contract renewals?** Paragraphs 28A-28D and B35A-B35C require that an entity allocate, on a systematic and rational basis, insurance acquisition cash flows that are directly attributable to a group of insurance contracts to that group and to any groups that include contracts that are expected to arise from renewals of the contracts in that group. It is not entirely clear what acquisition costs can be deferred – acquisition cash flows are defined as those directly attributable to the portfolio, but the proposed change implies that only costs directly attributable to the group can be deferred. The entity will need to determine if the standard allows a single DAC asset (as opposed to multiple DAC assets – one for each future group) and the basis on which this allocation is done.	ED	Q3.31
Amortisation of Acquisition Costs for disclosure	**How are acquisition costs to be amortised for inclusion in disclosure of insurance revenue and insurance expenses?** Paragraph B125 requires that the part of premium which recovers acquisition expenses be included in insurance revenue and the same amount be included in insurance expenses (so that profit is unaffected). This is despite acquisition expenses allocated to the group being effectively expensed fully at inception of the group under the GMM and the CSM being the	AASB 17.B120 – B125 and IFRS 17.BC175 – BC184.	

Issue	Description and Implications	References	Related IN Question
	profit on the contract after that. The pattern of amortisation is to be determined by the entity.		
Value of the Investment Component to be Excluded from Presentation	**Investment Components are to be excluded from presentation (and reconciliations are to be on that basis) – how is the amount excluded to be determined?** The entity will need to determine the value of the investment component in both premiums and claim payments. For products with a clear account balance this may be straightforward (as is currently done) but it is not clear what the value of the investment component is for traditional contracts or annuities. Interpretation is firming that for traditional contracts the value of the investment component is the surrender value. Life annuities generally – whether immediate or deferred – are considered to have no investment component, unless certain payments are guaranteed, in which case the value of the investment component is the value of the remaining guaranteed payments. Fixed annuities are not considered to be insurance contracts. But even if this resolves the issue in relation to claim payments an entity still needs to determine the value of the investment component in premiums.	AASB 17.84 – 85, AASB 17.103 and AASB 17.B120	Q11.6
Amortisation of Premiums where the PAA is used	**Under the PAA, premiums are to be recognised based on the passage of time, unless the pattern of release of risk is 'significantly' different – how is that determined?** Current practices require similar judgement in this area and may suffice for this purpose.	AASB 17.B126 – B127 and IFRS 17.BC290.	Q7.7
Transition Liabilities	**How are liabilities (including FCF, RA, CSM and OCI) to be determined at transition?** Entities will need to determine the liabilities (and their components) at transition. In particular, entities will need to determine when retrospective application is impracticable, what reasonable and supportable information exists and hence which method can be used or what	AASB 17.C3 – C24 and IFRS 17.BC374 – BC389.	Chapter 12

Issue	Description and Implications	References	Related IN Question
	approximations can be applied, in the transition calculations.		
Discount Rates	**How are discount rates to be determined?** There are many aspects in the determination of discount rates where the entity will have to exercise judgement. These include: • whether to use a top-down or bottom-up approach; • how rates are to be extrapolated when the term of the cash flows is longer than the term of existing assets; • how rates or curves are to be averaged when contracts in a group incept at different dates, or where contracts in a group relate to different currencies; • what replicating assets are appropriate for the cash flows? • what is the risk-free rate? • what allowance should be made for inflation? • what allowance should be made for investment administration expenses?; and • how is the illiquidity premium determined? There is a particular issue around the illiquidity premium. Unlike for life insurance, there is little guidance on the liquidity aspects of general and health insurance contracts. There are very divergent arguments on the relative liquidity aspects depending on the aggregation level of the contracts.	AASB 17.36, AASB 17.B78 – B85 and IFRS 17.BC193 – BC196	Chapter 4

Table 2: Areas where an accounting choice will need to be made

Issue	Description and Implications	References	Related IN Question
Options under the PAA	**How might options be used under the PAA?** There are several options available under the PAA where it is up to the entity to decide which to use. These are: • no discounting of LfRC cash flows if there is no 'significant' investment component and time between	AASB 17.56, AASB 17.59 and IFRS 17.BC288 – BC295.	Q7.10 and Q7.12

	provision of coverage and premium is no more than one year; • immediate expensing of acquisition costs (if coverage is a year or less); and • no discounting of LIC cash flows if the expectation is that they will be settled within the year.		
Options to use OCI	**Can OCI be used?** The ability to use OCI (i.e. to disaggregate total insurance finance income and expenses between P&L and OCI) is an accounting policy choice to be determined by the entity. There are a number of options that flow from this choice.	AASB 17.88 – 90, AASB 17.B128 – B136 and IFRS 17.BC340 – BC342.	Q11.3 – Q11.5

Table 3: Areas where consequences have been identified, but there is unlikely to be a change (or the IASB has decided that there will be no change)

Issue	Description and Implications	References	Related IN Question
Discount rates – 'dangling debit'	The use of a locked in discount rate for the CSM in the GMM. The impact of assumption updates is absorbed in the CSM at the locked-in rate. The FCF is measured at the current rate. The difference between the locked-in and the current rate is reflected in the P&L. The current period result is significantly distorted by the discount rate components of the impact of assumption changes that are reflected in the P&L. In particular, in the situation where the FCF component of the insurance liability is an asset and the CSM component is a liability, inconsistencies arise due to the different discount rates for FCF (current rate) and CSM (locked-in rate). The P&L and/or OCI is then distorted by the use of different discount rates for different components of the insurance liability. The AASB TRG supports this change (although it is not raised in the AASB submission on the ED). However, the IASB in the ED did not propose any change.	**AASB TRG July 2018 meeting – AP3** **CFO Forum October 2018 letter** **ED.BC193-197**	Q4.5
Discount rates – reference portfolio when using top-down	There is currently uncertainty regarding whether changes in asset mix will result in changes to the discount rate when the discount rate is determined top down using actual assets as a reference portfolio. An interpretation of the reference portfolio that appropriately reflects the asset/liability matching strategy is key to avoid significant levels of spurious volatility. No view has been expressed on this by either the IASB or the AASB TRG.	**AASB TRG July 2018 meeting – AP3**	Q4.10

Issue	Description and Implications	References	Related IN Question
Discount Rates and Risk Adjustment - subjectivity	Some users have expressed concerns that the principle-based nature of IFRS 17 could limit comparability between insurance entities. This is because the accounting for insurance contracts relies on assumptions and IFRS 17 requires entities to use judgement to determine key factors for the measurement of insurance contracts, such as the discount rates and the risk adjustment for non-financial risk. The AASB TRG agrees that no change is needed. The IASB in the ED did not propose any change.	**IASB October 2018 meeting – AP2D** **ED.BC186-188**	**Chapters** 4 and 5
Risk Adjustment on Consolidation	**Can the risk adjustment at a Group level be more or less than the addition of subsidiary entity risk adjustments – that is, can there be consolidation adjustments in respect of risk adjustments?** The IASB staff view outlined in AP02 of the May 2018 TRG is that risk adjustments are based on the issuing entity view encompassed in pricing when the contract was written. Some TRG members believe that IFRS 17 can be interpreted as allowing a reporting entity view of compensation required for bearing uncertainty about the amount and timing of the cash flows that arises from non-financial risk and, therefore, accommodate circumstances in which that compensation would vary between the subsidiary and Group levels. As confirmed in the ED Basis for Conclusions, both interpretations are possible. The AASB TRG agrees that no change is needed, on the basis that two views seem to be allowed. The IASB in the ED did not propose any change.	AALC June meeting AP4b **AASB TRG July 2018 meeting – AP2** **IASB October 2018 meeting – AP2D** **ED.BC189-192**	Q5.19 and Q5.20
Unbundling Investment Components	Certain life contracts contain both investment and insurance components, which are unbundled under the current standard. Including these products in the scope of IFRS 17 is inconsistent with the treatment of similar products in other industries. The prohibition on unbundling will mean that contracts that should ostensibly be accounted for as	AASB 17.10 – 13, AASB 17.B31 – B35 and IFRS 17.BC98 – BC114.	1.14.1, Q2.8, Q2.9 and Q2.32

Issue	Description and Implications	References	Related IN Question
	investments, will instead be accounted for as insurance. No view on this has formally been expressed.		
Unbundling Insurance Components with Different Terms	Certain contracts consist of several insurance components of different terms, etc. Treating them as effectively one component (with one set of coverage units) will distort the results. No view has been expressed on this by either the IASB or the AASB TRG.	AASB 17.10 – 13, AASB 17.B31 – B35 and IFRS 17.BC98 – BC114.	1.14.1, Q2.8, Q2.9 and Q2.32
Scope of the VFA model vs GMM and PAA	Results are very different depending on the measurement model applied, whilst there is a continuum in the nature of insurance products. Insurance contracts that are economically similar will be accounted for very differently if different methods are used, which does not reflect economic reality. The significant differences between the models create 'cliff effects' that are very dependent on the interpretation of the scope definitions of the different models. Some members of the IAA have expressed strong support for change. The AASB TRG has not expressed a view on this. As all Australian participating business (except group risk) is expected to qualify for VFA, this is not seen as a material issue for Australian Life Insurers. The IASB in the ED did not propose amy change.	**AASB TRG July 2018 meeting – AP3** **IASB October 2018 meeting – AP2D** **ED**	Q7.4 – Q7.6 and Q8.4 - Q8.14
Business Combinations	Areas that add to complexity include: • the requirement to assess classification at the acquisition date instead of the original inception date; and • the treatment of claims in payment at the acquisition date. There will be significantly different accounting treatment between the group and subsidiary financial statements. Additional capability may be needed only if a future acquisition takes place.	**AASB TRG July 2018 meeting – AP3** **CFO Forum October 2018 letter** **IASB October 2018 meeting – AP2D** **IASB December**	

Issue	Description and Implications	References	Related IN Question
	Some members of the IAA have expressed strong objection to a change in treatment of claims in payment on acquisition. The AASB TRG does not support changing when classification is assessed, but does support a change in the treatment of claims in payment. At their December 2018 meeting, the IASB tentatively decided that there would be no change in respect of either of these issues. However, the IASB proposed in the ED that an entity would be required to classify as a liability for incurred claims a liability for settlement of claims incurred before an insurance contract was acquired, if the acquisition occurred before transition. Numerous submissions to the IASB on the ED have suggested that this be extended to all acquisitions, not just acquisitions prior to transition.	**2018 meeting – AP2C** **ED**	
Level of Aggregation	Aggregation is highly subjective, unduly complex and not in line with how the business and risks are managed. Particular requirements include: • separation into annual cohorts; • separation of the second profitability bucket (i.e. no significant possibility of becoming onerous); and • the requirement to - in principle – group contracts in their entirety (rather than, say, separating the host contract and individual riders). The CFO Forum believes that to minimise complexity and costs, such granularity should be replaced by a principle according to which the insurer determines (based on its internal business and risk management) the way it defines its cohorts. This determination should reflect mutualisation effects when they exist. The requirement to report on an underwriting year basis (including analysis of change) is not aligned with management of reserves which is typically on an accident year basis. The AASB TRG agrees that no change is needed. The IASB in the ED did not propose any change.	**AASB TRG July 2018 meeting – AP3** **CFO Forum October 2018 letter** **IASB October 2018 meeting – AP2D** **ED**	Q2.9, Q2.14 – Q2.15, and Q2.20

Issue	Description and Implications	References	Related IN Question
De-recognition	Unlike current approaches where the liability for a contract is fully released on de-recognition of the contract (to meet expected payments for which that liability exists), AASB 17 requires that the value of the FCF be effectively absorbed in the CSM of the group. This has potential consequences relating to: • discount rate to be used for CSM adjustment – the discount rates for FCF valuation and CSM adjustment are likely to be different (see comment above re 'dangling debit'); • de-recognition of LIC; • de-recognition of other liabilities needed for payment; • differences in de-recognition process between GMM and PAA; and • differences in de-recognition process between GMM and other IFRSs. However, if it is assumed that the de-recognition paragraphs in IFRS 17 only specifically apply to significant contract modifications, and that liabilities are otherwise calculated as stipulated elsewhere (with contracts not being specifically de-recognised) then these consequences may be ameliorated. No view has been expressed on this by either the IASB or the AASB TRG.	AALC June 2018 meeting – AP4e, August 2018 meeting – Appendix 3, and October 2018 meeting – AP4c.	Q10.14 – Q10.17 and Q10.21
Timing of CSM release	AASB 17 indicates that CSM released should be determined **after** all other adjustments, but it is arguable that CSM should be released based on expectations at the start of the year. The current approach could result in profit relating to the current period being reported in other periods. In particular, some of the effect of assumption changes (which only affects future cash flows) is reported in the current period. This differs from results if the PAA is used. The usefulness of results is depleted. No view on this has formally been expressed by the AASB TRG.	AALC June meeting – AP4f	Q6.11

Issue	Description and Implications	References	Related IN Question
Costs charged to policyholders	Do costs and tax charges to VSA, etc., qualify as costs charged to policyholders under AASB 17.65(m)? There are two views: • AASB 17.65(m) allows all expenses and taxes to be charged to the fair VUI; or • AASB 17.65(m) generally does not allow expenses and taxes to be charged to the fair VUI. Insurers are likely to adopt View A. No view on this has formally been expressed by the AASB TRG. However, to absolutely confirm this, the AASB has suggested changes to clarify that costs relating to taxes which are incurred for, or on behalf of, the policyholder due to the provision of investment services be included in the fulfilment cash flows.	AALC June meeting – AP4e AASB Submission on ED	Q3.35 and Q8.28
Reinsurance – other	In addition to the issue at inception: • Reinsurance held cannot be accounted for under the VFA, even if the VFA is applied to the underlying insurance contracts; • Contract boundaries for reinsurance could be inconsistent with those of the underlying insurance contracts. In particular, reinsurance treaties may cover underlying contracts that have not yet been written; • For reinsurance treaties, there could be several benefit types within the same treaty - to what extent are these treaties considered to be "similar risks"? • Changes in FCF estimates for future service don't adjust CSM if they don't adjust CSM of underlying; • The financial statements do not appropriately reflect the net risk position after reinsurance and, as a consequence, a distorted profit recognition pattern could be presented; • Inconsistent contract boundaries mean that reinsurance accounting requires including an estimate of underlying insurance business that is not yet written/recognised; and • Where the underlying contracts use the PAA, changes in future reinsurance fulfilment cash flows are	EFRAG letter to IASB 3/9/2018 AALC August 2018 meeting – Appendix 4, and AALC October 2018 meeting – AP4b) CFO Forum October 2018 letter IASB October 2018 meeting – AP02D ED	Q9.8 and Q9.27

Issue	Description and Implications	References	Related IN Question
	recognised immediately in P&L. The same occurs where future new business is allowed for in the projection of the reinsurance contract as the underlying contracts do not exist. Profit volatility will therefore be amplified. Some members of the IAA have expressed strong support for change. The AASB TRG strongly supports this change. However, at their December 2018 meeting, the IASB tentatively decided that there would be no change, and no such changes are proposed in the ED.		
Premium Received vs Receivable	Primarily, there is the requirement that premiums and claims be measured on a cash paid/received basis. Ordinarily, cash flows are measured on an accrual basis, and systems have been constructed accordingly. One suggestion was to amend the requirements in IFRS 17 to allow insurance contracts to be measured at a higher level than a group of contracts (i.e. no need to identify premiums received for each group of contracts) under the PAA. However, the IASB is not amenable to such a change, and it is believed that not having to separate groups which are assets from groups which are liabilities will largely resolve the issue. The AASB TRG does not see it necessary to support this change. The IASB in the ED did not propose any change (the change in presentation of contracts that are assets or liabilities being considered sufficient – see Table 4).	**IASB October 2018 meeting – AP2D** **ED**	1.12.3 and Q7.11
Options to use OCI	The ability to use OCI (i.e. to disaggregate total insurance finance income and expenses between P&L and OCI) is an accounting policy choice to be determined by the entity. Some users have suggested that this optionality be curtailed, to improve comparability. But the IASB is not amenable to a change. The AASB TRG agrees that no change is needed.	AASB 17.88 – 90, AASB 17.B128 – B136 and IFRS 17.BC340 – BC342.	Q11.3– Q11.5

Issue	Description and Implications	References	Related IN Question
	The IASB in the ED did not propose any change.	**IASB October 2018 meeting – AP2D** **ED**	
Transition - OCI	The option to set OCI to nil under the fair value approach is not available to assets accounted at fair value through OCI. Setting OCI on the liabilities to nil at transition, whilst maintaining the historical OCI on related assets, will significantly distort equity at transition and results going forward. The AASB TRG agrees that no change is needed. The IASB in the ED did not propose any change.	**EFRAG letter to IASB 3/9/2018** **CFO Forum October 2018 letter** **IASB October 2018 meeting – AP2D** **ED**	Q12.7, Q12.24, and Q12.29
Transition - Options	Some users are concerned that the availability of the transition options could reduce comparability of the entities' performance going forward, potentially for a number of years. The AASB TRG agrees that no change is needed. The IASB in the ED did not propose any change (other than those mentioned elsewhere in relation to business combinations and the risk mitigation option).	**IASB October 2018 meeting – AP2D** **ED**	Q12.10
Transition – Modified Retrospective Approach	The modified retrospective approach is very restrictive and will not provide the simplifications that make retrospective application possible in practice. Insurers will be forced into the fair value approach for many portfolios. Whilst the fair value approach is a helpful practical expedient in some cases, it may not provide an appropriate profit recognition pattern in all cases. Additional approximations (yet to be specified) are therefore needed under the Modified Retrospective Approach. The AASB TRG supports this change. However, the IASB in the ED did not propose any change (other than those mentioned elsewhere in relation to business combinations and the risk mitigation option).	**EFRAG letter to IASB 3/9/2018** **ED**	Q12.11 - Q12.24

Issue	Description and Implications	References	Related IN Question
Comparative Information	Some users have suggested that the IASB can address the concerns expressed about the effective date by permitting entities not to present adjusted comparative information when applying IFRS 17. They are concerned that financial statements that restate comparative information about insurance contracts, but not about financial assets, could distort users' understanding of those entities' economic circumstances and transactions both in prior periods and the current period. This is because the comparative period might show accounting mismatches between insurance contracts and related financial assets, and the net financial position and profit reported by entities in the comparative period would not be comparable to that reported in the current reporting period. However, comparatives are seen as important, and the proposed implementation delay largely negates this objection. The AASB TRG agrees that no change is needed. The IASB in the ED did not propose any change.	**IASB October 2018 meeting – AP2D** **ED**	
Interim Statements	Some stakeholders believe that requirements relating to interim statements should be extended to other types of interim reports, such as monthly management reports. In particular, should final statements be built upon previous interim statements, or previous final statements? It is noted that if CSM is "locked-in" at interim reporting then any differences in external reporting frequency between group and subsidiary entities would result in different CSMs. Currently, final statements are built upon previous final statements. The AASB TRG does not believe that any change to current practices is needed. The IASB proposed in the ED that the requirements in relation to interim statements would not be extended to internal interim reports. However, the IASB also confirmed in the ED that an entity would be required to build final statements upon previous interim statements. The AASB in their submission	**IASB October 2018 meeting – AP2D** **ED** **AASB Submission on ED**	

Issue	Description and Implications	References	Related IN Question
	has suggested that this exemption from IAS 34.28 be permitted, not required.		

Table 4: Areas where the IASB has decided that a change should be made

Issue	Description and Implications	References	Related IN Question
Implementation Date of AASB 17	Some international users have expressed the view that there is insufficient time to implement IFRS 17 before its effective date, and have suggested that the Board should postpone the effective date of IFRS 17, by one, two or three years, for the following reasons. Entities need more time to prepare than they originally expected. Potential delays to the European Union endorsement process might mean that entities around the world will not initially apply IFRS 17 at the same time. A successful implementation of IFRS 17 requires dependence on internal or third-party experts, particularly actuaries and IT systems providers - some stakeholders are concerned that limitations in the availability of those resources will make it difficult for them to implement IFRS 17 on time. There is insufficient lead time for some stakeholders to inform and prepare investors, analysts and other users of financial statements about the significant changes in reported information that will arise from the implementation of IFRS 17. Other elements, outside the control of entities, relating to resources, education, operational change management, regulatory capital and supervision, and taxation, might not be realistically complete before 1 January 2021.	**IASB October 2018 meeting – AP2D** **ED**	1.1

Issue	Description and Implications	References	Related IN Question
	The IASB proposed in the ED that there would be a one-year deferral, resulting in an implementation date of 1 January 2022.		
Temporary Exemption From Applying IFRS 9	Some users are concerned that if the IASB were to defer the mandatory effective date of IFRS 17, preparers and users of financial statements will experience two sets of major accounting changes in a short period of time resulting in significant cost and effort for preparers and users of financial statements. Those users suggested that if the IASB were to defer the mandatory effective date of IFRS 17, the IASB should also revise the fixed expiry date of the temporary exemption from IFRS 9 in IFRS 4 to allow entities to continue applying the temporary exemption from IFRS 9 until the newly determined effective date of IFRS 17. The IASB proposed in the ED that there would be a one year extension of this exemption.	**IASB October 2018 meeting – AP2D** **ED**	
Multi-component Contracts	Certain contracts exposing the issuer to credit risk that are in substance loans (for example equity release mortgages in the UK) contain a small insurance element which causes the entire contract to be subject to insurance accounting under IFRS 17. Including these products in the scope of IFRS 17 is inconsistent with the treatment of similar products in other industries. This will also apply to the No Negative Equity Guarantee on Reverse Mortgages in Australia. Also, certain products change significantly in nature during their life due to the execution of an option by the policyholder. (E.g. if a participating contract becomes paid-up without any participation. Yet assessment of which model to use is done at inception.) (Also see earlier comment re investment components and multiple insurance components, for which no change is proposed.) The IASB proposed in the ED that:	**AASB TRG July 2018 meeting – AP3** **CFO Forum October 2018 letter** **IASB October 2018 meeting – AP2D** **ED** **AASB Submission on ED**	Q2.8 – Q2.9 and Q2.32

Issue	Description and Implications	References	Related IN Question
	• credit card contracts providing insurance, but the entity does not reflect an assessment of the insurance risk associated with an individual customer in setting the price of the contract with that customer; and • (loan) contracts that limit the compensation for insured events to the amount required to settle the policyholder's obligation created by the contract (i.e. waiver of the loan), would be out of scope of IFRS 17. The AASB supported this change in their submission, endorsed by the Actuaries Institute.		
Deferral of DAC	Acquisition cash flows on new business that is expected to renew couldn't be allocated to future periods (e.g. if YRT life contracts are short term under AASB 17). This was inconsistent with other industries which capitalise acquisition costs over multiple contracts. This also results in incorrect matching of income and expenses over time. The implications are intensified if the inability to allocate acquisition costs to future periods results in contracts being onerous in accounting (but not in economic reality). The IASB proposed in the ED that: • Paragraphs 28A-28D and B35A-B35C require that an entity allocate, on a systematic and rational basis, insurance acquisition cash flows that are directly attributable to a group of insurance contracts to that group and to any groups that include contracts that are expected to arise from renewals of the contracts in that group; • An entity is also required to assess the recoverability of such an asset if facts and circumstances indicate the asset may be impaired; and • Disclosures about such assets are required. Note that only costs that are directly attributable to the contract (like initial commission) are able to be	**EFRAG letter to IASB 3/9/2018** **CFO Forum October 2018 letter** **IASB October 2018 meeting – AP2D** **ED** **AASB Submission on ED**	Q2.24–Q2.29

Issue	Description and Implications	References	Related IN Question
	deferred – other acquisition costs will still need to be expensed immediately. The AASB supported this change in their submission, endorsed by the Actuaries Institute.		
Reinsurance – calculation at inception	There was an inability under AASB 17 to recognise profits at inception on reinsurance held covering onerous underlying direct contracts. The implications of this were that it: • creates accounting mismatches where none exist in economic terms; • is inconsistent with the principles applied in other IFRS standards; • misrepresents the relationship between the underlying contracts and the corresponding reinsurance/retrocession contracts; and • might affect the ability to use the PAA for the reinsurance business. The IASB proposed in the ED that an entity adjust the contractual service margin of a group of reinsurance contracts held that provides proportionate coverage when the entity recognises a loss on initial recognition of an onerous group of underlying insurance contracts, or on addition of onerous contracts to that group. The AASB strongly supported this change in their submission, endorsed by the Actuaries Institute, but has suggested that it be extended to include all reinsurance where there is direct link between the expected recoveries and the claims recognised on underlying contracts, not just 'proportionate' reinsurance.	AALC June 2018 meeting – AP4a) AASB TRG July 2018 meeting - AP01 **CFO Forum October 2018 letter** **IASB October 2018 meeting – AP2D** **ED** **AASB Submission on ED**	Q9.7 to Q9.9
Coverage Units	The requirements on coverage units to be used for the CSM amortisation were not considered appropriate for all types of contracts. A key issue was that the CSM (the initial amount of which is impacted by investment spreads) could not be amortised over the period in which investment services are provided. For certain contracts, profit recognition was strongly frontloaded or	**EFRAG letter to IASB 3/9/2018** **CFO Forum October 2018 letter**	Q6.12

Issue	Description and Implications	References	Related IN Question
	backloaded. (E.g. on a simple annuity contract profit was not appropriately recognised in the accumulation and deferral phases.) The IASB proposed in the ED that: • An entity is required to identify coverage units considering the quantity of benefits and expected period of both insurance coverage and investment services; and • An entity is required to disclose information about the approach used to determine the relative weighting of the benefits provided by insurance coverage and investment services. The AASB broadly supported this change in their submission, endorsed by the Actuaries Institute.	**IASB October 2018 meeting – AP2D** **ED** **AASB Submission on ED**	
Scope of Risk Mitigation	Whilst IFRS 17 (before the proposed changes in the ED) includes a specific risk mitigation adjustment, its use is limited to specific circumstances: • It is only available for contracts in scope of the VFA. • It cannot be applied retrospectively from the date of initial application. • It can only be used when derivatives are used as hedging instruments. Mismatches will result if the fair value changes on hedging instruments are not recognised in the same category (P&L, OCI or CSM) as the changes on the hedged items. This will significantly distort the net result and create misalignment between accounting results and risk management. Paradoxically, a perfect hedge would cause greater volatility in the higher income statement than a partial hedge. The AASB TRG believed that no change was needed. While not addressing all the concerns, the IASB proposed in the ED that: • applicability of the risk mitigation approach in the VFA model would be extended to hedging arrangements using reinsurance contracts;	**AASB TRG July 2018 meeting – AP3** **CFO Forum October 2018 letter** **IASB October 2018 meeting – AP2D** **ED**	Q8.25 - Q8.27

Issue	Description and Implications	References	Related IN Question
	• on transition an entity be permitted to apply the risk mitigation option prospectively from the transition date, rather than the date of initial application where risk mitigation relationships were designated at or before the date it applies the option; and • on transition an entity be permitted to apply the fair value approach to a group if it meets specified criteria relating to risk mitigation.		
Various Presentational Issues	These include the requirement that: • a group of contracts be presented as asset or liability based on its entirety; and • premiums receivable be absorbed in the insurance liability and not be separately identified on the balance sheet. These requirements, that impact only presentation, would require major system changes and result in a deterioration in relevance of the financial statements. In reality, cash flows are reflected on an accrual basis and payments/receipts are managed and administered separately. The separate recognition of cash flows not yet paid / received may lead to amounts that would otherwise be liabilities becoming assets, or vice versa. The IASB proposed in the ED that the presentation of contracts as assets or liabilities should be at portfolio level, rather than groups. However, it decided that there would be no change re the issue of presentation of premiums and claims (the change in presentation of contracts that are assets or liabilities being considered sufficient). The AASB strongly supported this change in their submission, endorsed by the Actuaries Institute.	**EFRAG letter to IASB 3/9/2018** **IASB October 2018 meeting – AP2D** **ED** **AASB Submission on ED**	Q7.11 and Q11.6

Table 5: Areas where there is still uncertainty in interpretation, but the standard is unlikely to change

Issue	Description and Implications	References	Related IN Question
Transition – Fair Value Approach	The calculation of 'fair value of liabilities' is yet to be determined. Depending on the final interpretation of the fair value of liabilities, there may not be an appropriate profit recognition for portfolios with significant in-force and significant new business.	**EFRAG letter to IASB 3/9/2018**	Q12.26 - Q12.33
Annual Cohorts	If measuring the contractual service margin at a higher level than an annual cohort, such as a portfolio level, in what circumstances would the accounting outcome be the same as measuring the contractual service margin at an annual cohort level. In particular, are cash flows to par policyholders able to be 'mutualised' across cohorts? AASB 17.B68-B71 allows cash flows to be 'mutualised' between groups. However, there is doubt over whether such mutualisation can take place across cohorts (i.e. between businesses written in different years). In particular, the IASB staff conclude that the CSM calculated at portfolio level may be different from that calculated at group level (unless policyholders share in 100% of experience – hence there is no CSM) so CSM for annual cohorts can't be calculated at the portfolio level.	**EFRAG letter to IASB 3/9/2018** **IASB TRG September meeting – AP10**	**Q8.33** and Q8.35
Treatment of Experience for VFA business	**How is treatment of experience for VFA business to be treated?** The exact requirement is not clear, and may be open to interpretation. The answers in this IN are the best currently available interpretation.		Q8.30 - Q8.31
Treatment of Friendly Societies	**How are liabilities to be determined for Friendly Societies?** The application of AASB 17 to, and the calculation of liabilities for, friendly societies is not clear. For example, it is possible that a friendly society may have no products at all that are subject to AASB 17. Also, mutualisation is particularly relevant for friendly societies.		**Q8.32**