Australian Government
Australian Accounting Standards Board

XRB EXTERNAL REPORTING BOARD Te Kāwai Ārahi Pūrongo Mōwaho | NZ ACCOUNTING STANDARDS BOARD

# Staff paper

| | | | |
|---|---|---|---|
| **Project** | **Insurance Activities in the Public Sector** | **Meeting** | AASB (M181)/NZASB June 2021 |
| **Topic** | Eligibility for the PAA under AASB 17 / NZ IFRS 17 for public sector entities | **Agenda item** | AASB 14.3<br>NZASB 8.3 |
| | | **Date** | 7 June 2021 |
| **Contacts** | Angus Thomson<br>athomson@aasb.gov.au<br>Vanessa Sealy-Fisher<br>vanessa.sealy-fisher@xrb.govt.nz<br>Patricia Au<br>pau@aasb.gov.au | **Project priority** | Medium |
| | | **Decision-making** | High |
| | | **Project status** | Addressing specific technical issues for board deliberation |

## Objective of this paper

The objective of this paper is for the AASB and the NZASB to **decide** whether public-sector-specific modifications or guidance is needed in AASB 17/PBE IFRS *17 Insurance Contracts* regarding the eligibility for application of the 'premium allocation approach' to measuring liabilities for remaining coverage.

## Note about terminology

AASB 17/PBE IFRS 17.53 refers to the 'premium allocation approach' (**PAA**), which is a simplified approach to measuring a liability for remaining coverage for an eligible group of insurance contracts. The 'unsimplified' measurement approach has no official name, but insurance industry stakeholders typically refer to the 'general measurement model', 'general model' or 'fulfilment cash flows model'. This paper uses the abbreviation '**GMM**'.

Abbreviations for Standards identified in this paper are referenced in full in Appendix B.

## Structure of this paper

This staff paper is set out in five sections:

- Section 1 compares the GMM and the PAA in AASB 17/PBE IFRS 17
- Section 2 compares the PAA in AASB 17/PBE IFRS 17 with the (unearned premium) approach in AASB 1023/PBE IFRS 4
- Section 3 sets out the eligibility criteria for applying the PAA
- Section 4 provides background on coverage periods among public sector entities
- Section 5 analyses issues relevant to PAA eligibility in the public sector.

**Staff are recommending the following.**

PAA1 It would be appropriate to provide guidance to the effect that an entity's practical ability to fully price for risks/benefits also includes the ability of its controlling government (Minister) to decide on pricing/benefits [paragraph 5.15].

PAA2 It would be appropriate to provide guidance to the effect that an entity's monopoly status (and obligation to stand-ready to insure future participants/policyholders), of itself, does not affect the coverage period [paragraph 5.21].

PAA3 It would be appropriate that public sector entities:

(a) apply AASB 17/PBE IFRS 17.34(b)(i) alone in assessing their eligibility for the PAA (that is, 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);

(b) need not also meet the condition in AASB 17/PBE IFRS 17.34(b)(ii) (that is, 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) [paragraph 5.35].

PAA4 Assuming PAA3 = 'yes', public sector entities should be required to disclose information about the manner in which long-run pricing is determined when that pricing takes into account risks relating to future coverage periods [paragraph 5.36].

## Background

Under AASB 17/PBE IFRS 17, the GMM must always be applied to measure a liability for incurred claims. However, for eligible groups of contracts, an insurer can apply either the GMM or the PAA to measure a liability for remaining coverage.

Liabilities for remaining coverage (relative to liabilities for incurred claims) are of less significance in the public sector compared with the private sector (please see Appendix 1). Nonetheless, the measurement of liabilities for remaining coverage is still a material matter for many public sector entities.

# 1. Comparison of the GMM and the PAA

1.1 Table 1-1 provides a high-level comparison of the initial measurement requirements of the GMM and the PAA in AASB 17/PBE IFRS 17. Costs of acquiring insurance contracts are ignored for the sake of simplicity and, in any case, they are not typically a material feature of public sector arrangements.

| Table 1-1 – initial measurement of insurance contracts | | |
|---|---|---|
| **GMM** | **PAA** | **Comments** |
| An insurer estimates:<br>• an unbiased expected value for cash inflows (premiums, levies, etc.) and cash outflows (claims, attributable expenses, | An insurer defers as a liability any cash (premiums, levies, etc.) actually | Under the PAA, the insurer needs to consider whether the amounts received and deferred as a liability are expected to be |

| Table 1-1 – initial measurement of insurance contracts | | |
|---|---|---|
| **GMM** | **PAA** | **Comments** |
| etc.) related to the contract PV of future cash flows<br>• an adjustment for the time value of money<br>• a risk adjustment.<br>Any expected profit (excess of inflows over outflows and the risk adjustment) is 'contractual service margin' (CSM) which must be separately identified and recognised over the coverage period [AASB 17/PBE IFRS 17.44].<br>Any expected loss (deficiency of inflows over outflows and the risk adjustment) is a 'loss component' (negative CSM) which is recognised immediately in profit or loss. However, the loss component needs to be tracked to address the ongoing accounting for the liability and possible subsequent adjustments to the loss component [AASB 17/PBE IFRS 17.49 & 50]. | received[1] [AASB 17/PBE IFRS 17.55].<br>It is assumed the insurer has priced a risk adjustment into the premium – so no additional amount is provided for risk, unless the contracts are onerous.<br>It is assumed the insurer has priced a profit into the premium – but there is no need for it to be separately identified. | sufficient to meet the cash outflows.<br>If they are not, the insurer would immediately recognise a loss. Although this means the insurer needs to also apply aspects of the GMM, most contracts are sold with a view to profit. Accordingly, typically, it will be clear when an onerous contact assessment is needed. |

1.2 Table 1-2 provides a high-level comparison of the subsequent measurement requirements of the GMM and the PAA AASB 17/PBE IFRS 17. Costs of acquiring insurance contracts are ignored.

| Table 1-2 – subsequent recognition of insurance contracts | | |
|---|---|---|
| **GMM** | **PAA** | **Comments** |
| **Liability components – liability run-off and revenue recognition** | | |
| For the purposes of subsequent recognition, there are potentially different components of a liability for remaining coverage.<br>The liability for remaining coverage reduces over the coverage period (and revenue is recognised) based on provision of 'promised services' [AASB 17/PBE IFRS 17.B121-B124]. | There is essentially only the one component (leaving aside acquisition costs, which are not addressed in this Table).<br>The liability for remaining coverage reduces over the coverage period (and revenue is recognised) based on the passage of time, or the | Under the GMM versus the PAA, the liability components might be run off (and revenue recognised) in different patterns.<br>For example, the provision of 'promised services' might be related to bearing risk, while 'coverage units' used to |

1 IFRS 17 Transition Resource Group May 2018 Agenda Paper 6 *Implementation challenges outreach report* includes a response on what 'premiums received' means. Paragraph A.5 of Agenda Paper 6 says: "Response – 'Premiums, if any, received' as included in paragraphs 55(a)(i) and 55(b)(i) of IFRS 17 means premiums **actually received** at the reporting date. It does not include premiums due or premiums expected".

| Table 1-2 – subsequent recognition of insurance contracts | | |
|---|---|---|
| **GMM** | **PAA** | **Comments** |
| **Liability components – liability run-off and revenue recognition** | | |
| CSM (profit) is recognised over the coverage period based on 'coverage units', which represent the quantity of insurance contract services provided [AASB 17/PBE IFRS 17.B119]. | pattern of expiry of risk, if that is materially different [AASB 17/PBE IFRS 17.B126]. | recognise the CSM are based on the number of employees at risk (in a workers' compensation contract).<br>The IASB has made clear that coverage units are not related to the expiry of risk [IFRS 17.BC279(a)].<br>Accordingly, under the GMM, it is often necessary to run off each component separately.<br>The PAA does not present the same complications. |
| **Liability discounting – and expense recognition** | | |
| The liability changes due to the unwinding of the impact of discounting are presented separately within 'insurance finance income or expense' [AASB 17/PBE IFRS 17.41(c)].<br>The discount rate applying to fulfilment cash flows is a current rate [AASB 17/PBE IFRS 17.36].<br>The discount rate applying to the CSM is a historical rate as at initial contract recognition date [AASB 17/PBE IFRS 17.B72(b)]. | There is no need for discounting of cash flows (unless there is a significant financing component, which would rarely be the case [AASB 17/PBE IFRS 17.56]). | If the GMM is applied to measure the liability for remaining coverage, an insurer needs to track multiple discount rates – the current rate[2] and the historical rates (for the CSM) relevant to each annual generation of contracts. When an insurer has multiple generations of contracts in-force, it must track multiple generations of discount rates. |

1.3 There is widespread recognition in the general insurance industry that, for most types of insurance contracts, the GMM is more complex and more costly to implement and maintain than the PAA. The GMM applies to measuring liabilities for incurred claims, regardless of whether it (or the PAA) is applied to measuring liabilities for remaining coverage. However, many of the complications in the GMM stem from the accounting for the CSM, which only arises in liabilities for remaining coverage.

## 2. Comparison of the PAA and AASB 1023/PBE IFRS 4 approach

2.1 Table 2-1 provides a high-level comparison of the PAA under AASB 17/PBE IFRS 17 and the AASB 1023/PBE IFRS 4 unearned premium (UEP) approach.

2 The same current rate is applied to the liability for incurred claims.

<table>
<tr><th colspan="3">Table 2-1</th></tr>
<tr><th>PAA</th><th>UEP</th><th>Comments</th></tr>
<tr><td colspan="3">Initial recognition</td></tr>
<tr><td>An insurer defers as a liability any cash (premiums, levies, etc.) actually received<br>[AASB 17/PBE IFRS 17.55].</td><td>An insurer defers as a liability any premiums, levies, etc. received or receivable<br>[AASB 1023/PBE IFRS 4.4.2].</td><td rowspan="2">AASB 1023/PBE IFRS 4 involves recognising all the expected contracted premiums as a liability (not only those ‘actually received’).<br>Premium receivables are recognised under AASB 1023/PBE IFRS 4, but not under AASB 17/PBE IFRS 17.</td></tr>
<tr><td colspan="2">It is assumed the insurer has priced a risk adjustment into the premium – so no additional amount is provided for risk, unless the contracts are onerous.<br>It is assumed the insurer has priced a profit into the premium – but there is no need for it to be separately identified.</td></tr>
<tr><td colspan="3">Subsequent recognition</td></tr>
<tr><td>The liability for remaining coverage reduces (and revenue is recognised) over the coverage period based on the passage of time, or the pattern of expiry of risk, if that is materially different [AASB 17/PBE IFRS 17.B126].<br>At any given time, the liability represents premium received, adjusted for premium recognised as revenue.</td><td>The liability reduces (and revenue is recognised) over the contract period based on the passage of the incidence of risk<br>[AASB 17/PBE IFRS 17.4.3].<br>At any given time, the liability represents ‘unearned premium’.</td><td>In practice, the revenue recognition requirements are effectively the same.<br>However, the use of ‘premiums received’ versus ‘unearned premiums’ means that the liabilities can be very different. In particular, when coverage is provided in advance of receiving premiums, AASB 17/PBE IFRS 17 results in assets for remaining coverage, which do not arise under AASB 1023/PBE IFRS 4.</td></tr>
</table>

2.2 Insurers’ balance sheets are expected to be ‘smaller’ under AASB 17/PBE IFRS 17 than under AASB 1023/PBE IFRS 4 because applying AASB 17/PBE IFRS 17 does not result in recognising premium receivable assets or premium liabilities relating to cash not yet received.

2.3 This impact on the balance sheet of moving from the UEP approach to the PAA is likely to be less significant for most public sector entities that currently apply AASB 1023/PBE IFRS 4, compared with private sector insurers in Australia and New Zealand because:

(a) liabilities for remaining coverage are typically a much smaller proportion of the total balance sheet for public sector entities – see Appendix A; and

(b) public sector entities tend to receive most of their premiums/levies before coverage is provided.

# 3. Eligibility criteria for applying the PAA

3.1 Provided the contracts meet the relevant eligibility criteria, an entity can choose to apply the PAA, rather than the GMM. In practice, most insurers plan to apply the PAA whenever feasible and, given the choice, are not intending to apply the GMM.[3]

3.2 AASB 17/PBE IFRS 17.53 outlines the eligibility criteria:

> 53 An entity may simplify the measurement of a group of insurance contracts using the premium allocation approach set out in paragraphs 55–59 if, and only if, at the inception of the group:
>
> (a) the entity reasonably expects that such simplification would produce a measurement of the liability for remaining coverage for the group that would not differ materially from the one that would be produced applying the requirements in paragraphs 32–52; or
>
> (b) the coverage period of each contract in the group (including insurance contract services arising from all premiums within the contract boundary determined at that date applying paragraph 34) is one year or less.

The same eligibility criteria apply to reinsurance contracts held [AASB 17/PBE IFRS 17.69].

3.3 AASB 17/PBE IFRS 17.53(a) is based on materiality. AASB 17/PBE IFRS 17.53(b) is a 'practical expedient' that means an entity need not do the work needed to establish there is no material difference between the PAA and GMM liabilities for remaining coverage when contracts have coverage periods of a year or less.

3.4 For contracts with coverage periods longer than a year, it is necessary to (at least periodically) forecast the likely PAA and GMM liabilities for remaining coverage for the life of the coverage period.

> For example, assume a domestic builder contract with a six-year coverage period.
>
> The liabilities for remaining coverage for each of the next six years would each need to be estimated under both approaches.
>
> Those estimated liabilities in each period would need to be materially the same to be eligible for the PAA.
>
> The choice is made when a group of contracts is initially recognised. Accordingly, if the PAA has been chosen at inception, it is not relevant if the liabilities for remaining coverage subsequently prove to be materially different. However, this would indicate that future groups of similar contracts would not be eligible for the PAA.

## Unit of account

3.5 The PAA accounting policy choice is applied on a group of contracts basis. AASB 17/PBE IFRS 17.16 requires an entity to divide a portfolio of insurance contracts issued into a minimum of three categories:

(a) a group of contracts that are onerous at initial recognition, if any;

(b) a group of contracts that at initial recognition have no significant possibility of becoming onerous subsequently, if any; and

---

3 A possible exception might be a private sector insurer that must apply the GMM to determine most of its liabilities for remaining coverage and does not wish to maintain two separate systems of measurement.

(c) a group of the remaining contracts in the portfolio, if any.

However, there is a lack of clarity around what (b) means. Accordingly, most entities are assuming that all the contracts not captured within (a) are either within (b) or (c), with the result that only two classifications are being identified (onerous versus non-onerous).

3.6 The diagram below is a simple representation of the units of account used in AASB 17/PBE IFRS 17.

| | | |
|---|---|---|
| Portfolio = insurance contracts subject to similar risks and managed together | Group of contracts issued in year 1 | Non-onerous contracts |
| | | Onerous contracts |
| | Group of contracts issued in year 2 | Non-onerous contracts |
| | | Onerous contracts |

3.7 It is possible that a group of 'contracts' with a coverage period longer than a year that is issued between 1 July 2021 and 30 June 2022 is eligible for the PAA, while a subsequent group issued between 1 July 2022 and 30 June 2023 is ineligible for the PAA. However, it would be expected that, provided there are no siginificant changes to the nature of the coverage, that groups of contracts would consistently (year after year) either be eligible or ineligible for the PAA.

# 4. Background on coverage periods among public sector entities

## Arrangements between public sector entities and their 'policyholders'

4.1 Table 4-1 shows the 'contractually-stated' coverage periods of arrangements across a selection of public sector entities.

**Table 4.1**

| *Entity* | *Coverage* | *Comments* |
|---|---|---|
| Accident Compensation Commission (NZ) | one year | Some standardised periods apply, such as 1 April to 31 March for earners' coverage and 1 July to 30 June for motor vehicle coverage |
| Earthquake Commission (NZ) | one year | The period is tied to the underlying (private sector) householders' insurance contracts, which are typically for one year |

| Table 4.1 | | | |
|---|---|---|---|
| ***Entity*** | | ***Coverage*** | ***Comments*** |
| iCare (NSW): | Dust Diseases Care | one year | |
| | Lifetime Care | one year | |
| | Construction risks | up to ten years | Depends on the nature of the projects |
| | Home Building Compensation | six years | From the time work is completed |
| | Workers' Insurance | one year | |
| | Sporting Injuries Scheme | one year | |
| | Building Insurers' Guarantee | seven years | |
| | Self-insurance Corp. | one year | |
| WorkSafe (QLD) | | one year | |
| WorkSafe (VIC) | | one year | |
| WorkCover [RiskCover Fund] (WA) | | one year | |
| ReturnToWorkSA (SA) | | one year | |
| ComCare (Australia) | | one year | |
| Victorian Managed Insurance Authority (VIC) | | various | Mostly one year, but domestic building insurance is seven years and construction risks up to ten years |
| South Australian Finance Authority (SA) [SAicorp Division] | | mainly one year | Domestic building insurance is seven years under a three-year fronting arrangement with a private sector insurer |
| Insurance Commission (WA) | Risk Cover Fund | one year | There are also three-year dust diseases contracts, but they are not material |
| | Third Party Insurance Fund | one year | |
| | Motor Vehicle Catastrophic Injury | one year | |
| Transport Accident Commission (VIC) | | one year | |
| Motor Accident Insurance Board (TAS) | | one year | |
| Nominal Defendant (QLD) | | one year | |
| National Injury Insurance Agency (QLD) | | one year | |
| Queensland Building & Construction Commission | | six years | |
| Lifetime Support Authority (SA) | | one year | |

| Table 4.1 | | |
|---|---|---|
| ***Entity*** | ***Coverage*** | ***Comments*** |
| Australian Reinsurance Pool Corporation | one year | The period is tied to the underlying (private sector) commercial property insurance contracts, which are typically for one year |

4.2 Most of the above arrangements would, based on the contractually-stated coverage period (please refer to Section 5), automatically be eligible to be accounted for using the PAA.

4.3 For arrangements that have coverage periods longer than a year, an assessment would need to be made to determine eligibility.

## Arrangements between public sector entities and reinsurers

4.4 Table 4-2 shows the 'contractually-stated' coverage periods of reinsurance contracts held by a selection of public sector entities. Please note that most of the relevant stakeholder entities periodically review their circumstances to determine whether holding reinsurance contracts is worthwhile. However, fewer than a quarter of the relevant stakeholder entities typically hold reinsurance contracts at any given time.

| Table 4.2 | | |
|---|---|---|
| ***Entity*** | ***Coverage*** | ***Comments*** |
| Earthquake Commission (NZ) | up to five years | |
| iCare Self Insurance Corporation | various | Can be longer than one year when they relate to multi-year projects |
| Victorian Managed Insurance Authority (VIC) | various | Can be longer than one year when they relate to multi-year projects |
| Insurance Commission (WA) Risk Cover Fund | one year | |
| Queensland Building & Construction Commission | one year | |

## A note on reinsurance contract coverage periods

4.5 There are various ways in which types of reinsurance contracts held can be classified. In relation to coverage periods, it is important to distinguish between:

(a) risks-attaching reinsurance; and

(b) losses occurring (or claims incurred) reinsurance.

4.6 The following example helps to illustrate the distinction.

| | ***Risks attaching basis*** | ***Claims incurred basis*** |
|---|---|---|
| Contract period | 1 July 2020 to 30 June 2021 | 1 July 2020 to 30 June 2021 |
| Insured events/losses covered | Events/losses on contracts incepting any time between 1 July 2020 to 30 June 2021 | Events/losses occurring any time between 1 July 2020 to 30 June 2021 |
| Event/loss occurs 31 March 2021 under contract incepting 15 Sept 2020 | Covered | Covered |
| Event/loss occurs 31 July 2021 under contract incepting 15 Sept 2020 | Covered | Not covered |
| Event/loss occurs 31 March 2021 under contract incepting 15 May 2020 | Not covered | Covered |

4.7 Using the example above, for the reinsurance contract held covering **risks attaching** in a particular year and assuming all the underlying (reinsured) contracts are annual:

(a) the first contract covered by the reinsurance contract could be written on 1 July 2020 and an insured event might occur on 1 July 2020

(b) the last contract covered by the reinsurance contract could be written on 30 June 2021 and an insured event might occur on 30 June 2022.

Accordingly, the reinsurance contract covers **insured events spanning two years**, which means **the coverage period is two years** – **even though all the underlying reinsured contracts have one-year coverage periods**.

4.8 Using the example above, for a reinsurance contract covering **claims incurred** in a particular year:

~ the first insured event covered by the reinsurance contract could occur on 1 July 2020; and

~ the last insured event covered by the reinsurance contract could occur on 30 June 2021.

Accordingly, the reinsurance contract held covers **insured events spanning only one year**.

# 5. Analysis of issues relevant to PAA eligibility in the public sector

5.1 As noted above, contracts with a coverage period of a year or less can automatically be accounted for using the PAA. For longer coverage periods, an assessment is needed of whether the PAA liability for remaining coverage would be materially different from the GMM liability for remaining coverage.

5.2 The longer the coverage period, the more likely it is that the two liabilities might differ and AASB 17/PBE IFRS 17.54 says:

> 54 The criterion in paragraph 53(a) is not met if at the inception of the group an entity expects significant variability in the fulfilment cash flows that would affect the measurement of the liability for remaining coverage during the period before a claim is incurred. Variability in the fulfilment cash flows increases with, for example:

(a)[4] the extent of future cash flows relating to any derivatives embedded in the contracts; and

(b) the length of the coverage period of the group of contracts.

The same guidance applies to reinsurance contracts held [AASB 17/PBE IFRS 17.70].

## Coverage period and 'contract boundary'

5.3 AASB 1023/PBE IFRS 4 presumes that the contractually-stated coverage period is the relevant period of the contract for accounting purposes.

5.4 AASB 17/PBE IFRS 17 does not make this same presumption. Instead, there are contract boundary requirements for determining the cash flows within a contract that have a number of possible implications, including implications for determining coverage periods.

> 34 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 insurance contract services (see paragraphs B61–B71). 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.

5.5 A key issue is whether the 'contractually-stated' coverage periods (please refer to Section 4) are the same as the coverage periods that would be determined applying the requirements of AASB 17/PBE IFRS 17.

5.6 AASB 17/PBE IFRS 17.34(a) relates to individual policyholders and would usually only be applicable for large risks that are individually underwritten. This might be relevant for large construction risks underwritten by some public sector entities.

5.7 AASB 17/PBE IFRS 17.34(b) relates to portfolios of contracts. Most of the public sector arrangements being addressed in this project would involve pricing risks/benefits on a portfolio basis.

5.8 Based on AASB 17/PBE IFRS 17.34, a coverage period could be either longer or shorter than the contractually-stated term, as illustrated in the following examples.

(a) A contract with a stated term of one year and a $100 premium is accompanied by an option for a second year of coverage for another $100 premium. The initial contract would be regarded as a contract for two years of coverage because the insurer does not have the practical ability to fully reprice the risk/benefits for the second year.

---

4 Staff are not are that sub-paragraph (a) would apply to any relevant public sector arrangements in Australia or New Zealand.

(b) A contract with a stated term of ten years involves ten annual premiums that are reset each year to reflect current expected risks/benefits. Although the insurer is obliged to keep accepting premiums and providing coverage for ten years, each year (up to a possible ten years) would be regarded as a separate coverage period because the insurer has the practical ability to reprice risk/benefits each year.

5.9 It is important to note that an entity might have the 'practical ability' to fully price for risks/benefits, but choose not to use that ability. In the private for-profit sector, insurers routinely choose to:

(a) under-price in order to gain, or maintain, market share;

(b) over-price when market conditions permit.

The requirement in AASB 17/PBE IFRS 17.34 is based on the existence of the insurer's practical ability to fully price for risks/benefits, not the manner in which the insurer might choose to use that ability.

5.10 The pricing of levies/premiums for many public sector entities is based on achieving a break even result over the long-term. Accordingly, the actual amounts charged in any given period will often be less than, or more than, the expected present value of the risks being borne and likely benefits to be paid. Depending on the circumstances, the entity might be regarded as:

(a) not having the practical ability to fully price for risks/benefits each year; or

(b) having the practical ability to fully price for risks/benefits each year, but choosing not to exercise that ability.

## Who holds the 'practical ability'?

5.11 The price/levy decision-making power may reside with the entity itself, or it might reside with the government (for example, the relevant Minister).

(a) Literally, if the entity does not have the price/levy decision-making power, it could be interpreted that the entity does not have the practical ability to fully price for risks/benefits each year and has contracts with multi-year coverage periods. These multi-year coverage periods may result in the entity's arrangements being ineligible to be accounted for using the PAA.

(b) Alternatively, the entity and its controlling government[5] (Minister) might be considered collectively to have the price/levy decision-making power and any failure to fully price for risks/benefits each year would be regarded as a choice made by the entity and not a lack of a practical ability to fully price for risks/benefits each year.

5.12 Even when the entity and its controlling government (Minister) are considered collectively to have the price/levy decision-making power, there may be cases when the government (Minister) is constrained politically. Staff note that the 'practical ability' benchmark is effectively modified by AASB 17/PBE IFRS 17.B64, which says (in part):

B64 … **An entity has that practical ability in the absence of constraints that prevent the entity from setting the same price it would for a new contract with the same**

5 Under existing (or substantively enacted) legislation.

**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. …

5.13 That is, provided the constraints (political or commercial) apply to new (current) as well as existing arrangements, they are not regarded as constraints that affect an insurer's practical ability to fully price for risks/benefits in relation to the existing arrangements.

***Staff view on long-run pricing and decision-making power***

5.14 Staff consider that, for the avoidance of doubt, it would be appropriate to provide guidance to the effect that an entity's practical ability to fully price for risks/benefits also includes the ability of its controlling government (Minister) to decide on pricing and benefits. Staff support this approach for the following reasons.

(a) The approach seems reasonable given that the government (Minister) is the sole 'owner' and controller of the public sector entity and users of the financial statements would know, when relevant, that the ultimate decision-making power lies with the government (Minister).

(b) Without guidance:

(i) entities might need to engage in costly analysis in consultation with their auditors to determine how long-run pricing affects the entity's 'practical ability'; and

(ii) inconsistent determinations about 'practical ability' might be made by different entities in similar circumstances.

***Question PAA1***

5.15 Do the Boards agree that it would be appropriate to provide guidance to the effect that an entity's practical ability to fully price for risks/benefits also includes the ability of its controlling government[6] (Minister) to decide on pricing/benefits?

## Monopoly status, long-run pricing and future risks

***The impact of monopoly status (alone)***

5.16 It seems reasonable to presume that the IASB developed IFRS 17 largely with competitive markets in mind [IFRS 17.BC167 & BC168(a)].

5.17 All of the public sector entities that are the subject of the joint AASB/NZASB project are monopolies or near monopolies,[7] and are not able to withdraw from the market they serve without a change of legislation.

6 Under existing (or substantively enacted) legislation.

7 The reference to 'near monopoly' relates mainly to schemes such as the workers' compensation schemes that operate in most Australian states, from which 'approved' large employers can be excluded on meeting certain conditions.

5.18 For a not-for-profit public sector entity, a monopoly position can mean:

(a) the power to charge above-market levies/premiums; but

(b) the responsibility to keep insuring participants/policyholders in perpetuity, or at least until there is legislative change and/or structural changes to the markets served.

5.19 The responsibility to keep insuring participants/policyholders might have consequences for the 'contract boundary'; and the 'coverage period' of the public sector entities arrangements.

(a) One view is that this responsibility means the contract boundary (and coverage period) extends over multiple years, even though the contractually-stated coverage period might be, for example, one year.

(b) An alternative view is that this year's participants/policyholders may or may not continue to be participants/policyholders next year and, accordingly, the responsibility to maintain the scheme over the long term is not relevant to determining coverage periods.

***Staff view on the impact of monopoly status (alone)***

5.20 Staff consider that, for the avoidance of doubt, it would be appropriate to provide guidance to the effect that an entity's monopoly status (and obligation to stand-ready to insure future participants/policyholders), **of itself**, does not affect the coverage period. Staff support this approach for the following reasons.

(a) The approach seems reasonable under the principles in AASB 17/PBE IFRS 17 given that typically there is turnover among participants/policyholders over successive years, even though it may be limited. For example, in respect of compulsory third party (personal injury) insurance, at the margin, some motor vehicles registered and insured in the current year may be deregistered and uninsured in the following year.

(b) Without guidance:

(i) entities might need to engage in costly analysis in consultation with their auditors to determine how monopoly status affects the entity's 'practical ability'; and

(ii) inconsistent determinations about 'practical ability' might be made by different entities in similar circumstances.

***Question PAA2***

5.21 Do the Boards agree that it would be appropriate to provide guidance to the effect that an entity's monopoly status (and obligation to stand-ready to insure future participants/policyholders), of itself, does not affect the coverage period?

***The impact of monopoly status and long-run pricing (together)***

5.22 The pricing of levies/premiums for many public sector entities is based on achieving a break even result over the long-term. Accordingly, in some cases, the actual amounts charged in any given period might be regarded as being the result, in part, of taking into account the risks that relate to periods after the current contract period. In these cases, the criterion in AASB 17/PBE IFRS 17.34(b)(ii) would not be met and the arrangements would involve a multi-year coverage period, even though the contractually-stated coverage period might be one year.

5.23 The long-run focus of pricing for many public sector entities might be based solely on past experience and not be influenced by projections of risk relating to future periods. This is likely to be the case for entities providing coverage for risks that evolve only slowly over time in their nature and level of severity. For example, typically this would be expected to include Worker's Compensation and Transport Accident risks.

5.24 The long-run focus of pricing for other public sector entities might be based, at least in part, on projections of risk relating to future periods. For example, this might be the case for entities providing coverage for risks that are scheduled to change, and possibly when an entity insures for losses arising from infrequent severe events.

5.25 Table 5-1 outlines two possible (highly-simplified) examples where the contract boundary might be regarded as being longer than the explicit contractual term due to monopoly status.

**Table 5-1**

| ***Example*** | ***Comment*** |
|---|---|
| A legislative change has been made to significantly increase benefits relating to certain types of injuries that occur after July 2025, and the entity is gradually increasing levies/premiums over the 2022 to 2024 financial years in order to establish reserves to help fund the higher benefits. | In this case, the current-year pricing is taking into account risks that relate to periods after the current period. Accordingly, the contract boundary (and coverage period) could be determined as extending from 2022 until 2025 and possibly beyond. |
| An entity insures against losses from what is projected to be a one-in-20-year event and charges levies/premiums for one-year contracts each year over a 20-year period that are designed to meet the expected benefits that will need to be paid. | In a competitive (private sector) market context, the entity would not be regarded as taking into account the risks that relate to periods after the current contract period because the entity would be regarded as considering the risk of loss for each one-year period. Policyholders could obtain the same coverage from a different insurer in a subsequent year. Accordingly, the contract boundary (and coverage period) would be determined as being one year.<br>In a monopoly public sector context, the current-year pricing could be regarded as taking into account risks that relate to periods after the current period. Accordingly, the contract boundary (and coverage period) could be determined as being 20 years. |

5.26 The Boards could choose to override this feature of AASB 17/PBE IFRS 17.34 and deem the coverage periods for cases such as those outlined in Table 5-1 to be the contractually-stated term.

5.27 Alternatively, the Boards could choose to not override this feature of AASB 17/PBE IFRS 17.34 and either:

(a) allow entities to make their own interpretation without further guidance; or

(b) provide guidance to assist public sector entities in a monopoly position in applying AASB 17/PBE IFRS 17.34 in relation to long-run pricing and future risks.

5.28 The implications of not overriding this feature of AASB 17/PBE IFRS 17.34 for the examples noted in Table 5-1 above might be as follows.

(a) Public sector entities may need to estimate the average time that a participant/policyholder is expected to keep participating in the scheme to determine a coverage period for the purposes of AASB 17/PBE IFRS 17.

(b) The estimated coverage periods may be sufficiently long that they introduce a level of cash flow volatility that makes the arrangements ineligible to be accounted for using the PAA.

(c) The level of uncertainty around the estimated coverage periods may be, of itself, sufficiently large that it introduces cash flow volatility that makes the arrangements ineligible to be accounted for using the PAA.

5.29 Staff note that the monopoly or near monopoly status of public sector entities, coupled with their inability to withdraw from the markets they serve without a change of legislation, is a set of circumstances unique to the public sector. Accordingly, it would be within the Boards' policy frameworks[8] to make modifications to address the issues arising from these circumstances.

### *Staff view on monopoly status and long-run pricing (together)*

5.30 Staff consider that, by providing some direction to the affected public sector entities, the Boards could have a cost-beneficial impact on the application of AASB 17/PBE IFRS 17.34(b)(ii) on the basis of the following.

(a) The costs of having public sector entities:

(i) estimating average times that a participant/policyholder is expected to keep participating in the scheme to determine a coverage period; and/or

(ii) estimating coverage periods based on expectations about whether the relevant insured event is, for example: (i) a one-in-ten-year event or (ii) a one-in-twenty-year event;

seem likely to exceed any potential benefits.

(b) The accounting information that would result from applying the GMM in these circumstances may not be useful and would be costly to implement, particularly if all the other arrangements conducted by the entity are eligible for the PAA.

5.31 In relation to paragraph 5.30(a), it seems highly likely that the relevant public sector entities' estimates would prove to be different from the actual coverage periods, which could trigger a need to consider the contract modification requirements in AASB 17/PBE IFRS 17. If this were the case, the entity would need to consider whether the extent of change to the originally-determined coverage periods results in 'a modification of an insurance contract' under AASB 17/PBE IFRS 17.72 and 73. For example, if actual events establish that the arrangements have a substantially different contract boundary than the originally-determined boundary, the

8 *AASB Not-for-Profit Entity Standard-Setting Framework* and *New Zealand Accounting Standards Framework*.

existing arrangements would need to be derecognised and new arrangements recognised using the revised boundary [AASB 17/PBE IFRS 17.72(a)(iii)].

5.32 In relation to paragraph 5.30(b), if a public sector entity had to apply the GMM the following simple example attempts to illustrate some possible implications.

| |
|---|
| Assume, for example, an entity determines that it expects (on average) to provide coverage to participants for 20 consecutive one-year periods. Under the GMM, the public sector entity would measure its liability for remaining coverage based on a 20-year coverage period. |
| In theory, the entity would need to estimate all the fulfilment cash flows for the next 20 years – including levies/premiums and claims/benefits (and other claim/benefit-related costs) in order to apply the GMM. |
| AASB 17/PBE IFRS 17.22 requires, as a minimum, contracts issued within a year to be a separate ‘group of contracts’. That is, as a minimum, annual cohorts of contracts are the basic unit of account [AASB 17/PBE IFRS 17.22].<br>In the **first year** that an entity applies AASB 17/PBE IFRS 17, the entity would need to, as a minimum, identify the contracts issued in that **year-one cohort**.<br>In the **second year** the entity applies AASB 17/PBE IFRS 17, it would need to identify whether participants acquiring a contract are:<br>• ‘renewing’ from the previous year and should be included in the **year-one cohort**; or<br>• are ‘new’ participants and should be included in the **year-two cohort**.<br>The same process would need to be applied in each of the subsequent 18 years, unless the estimated coverage period changes.<br>This is likely to be a significant departure from the way in which the entity manages the business. While it may not produce very different financial reporting outcomes compared with accounting at a portfolio level (that incorporates all the annual cohorts), there seems unlikely to be much benefit for users of the financial statements to justify the additional cost. |

5.33 Staff consider that public sector entities should be able to apply AASB 17/PBE IFRS 17.34(b)(i) alone to be eligible for the PAA (that is, 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 not need to also meet the condition in AASB 17/PBE IFRS 17.34(b)(ii).

5.34 In cases such as those outlined in Table 5-1, the coverage period uncertainties might be best addressed via disclosures. By way of illustration, in the context of the (highly-simplified) examples outlined in Table 5-1, the entity could disclose information about the following.

(a) A decision has been made to significantly increase benefits relating to certain types of injuries that occur after July 2025, and the entity is gradually increasing levies/premiums over 2022 to 2024 financial years in order to establish reserves to meet the higher benefits on a sustainable basis.

(b) The entity sets charges levies/premiums based on a 20-year timeframe with a view to insuring against losses from what is projected to be a one-in-20-year event.

***Question PAA3***

5.35 Do the Boards agree it would be appropriate that public sector entities:

(a) apply AASB 17/PBE IFRS 17.34(b)(i) alone in assessing their eligibility for the PAA (that is, 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);

(b) need not also meet the condition in AASB 17/PBE IFRS 17.34(b)(ii) (that is, 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)?

***Question PAA4***

5.36 Assuming the Boards concur with PAA3, do the Boards agree that public sector entities should be required to disclose information about the manner in which long-run pricing is determined when that pricing takes into account risks relating to future coverage periods?

# Appendix A
# Coverage versus incurred claims liabilities

The table below compares some typical cases among public sector entities with two private sector New Zealand insurers, the three largest listed Australian general insurers, and the largest listed Australian health insurer.

| ***Entity reports 2020*** | ***Coverage liability (A)*** | ***Claims liability (B)*** | ***A/A+B*** |
|---|---|---|---|
| Accident Compensation Comm | NZD 3,482 million | NZD 61,463 million | 5.4% |
| Earthquake Commission | NZD 265 million | NZD 1,263 million | 17.3% |
| ComCare | nil[9] | AUD 2,867 million | 0.0% |
| Lifetime Care (iCare NSW) | nil[10] | AUD 7,354 million | 0.0% |
| Transport Accident Comm (VIC) | AUD 783 million | AUD 21,374 million | 3.5% |
| WorkCover Queensland | AUD 12 million | AUD 3,487 million | 0.0% |
| Southern Cross Group | NZD 139 million | NZD 13 million | 91.4% |
| FMG | NZD 179 million | NZD 93 million | 65.8% |
| Insurance Australia Group | AUD 6,276 million | AUD 10,584 million | 37.2% |
| QBE Group (half-year) | AUD 7,799 million | AUD 20,836 million | 27.2% |
| SunCorp | AUD 5,219 million | AUD 10,598 million | 33.0% |
| Medibank Private | AUD 746 million | AUD 639 million | 54.0% |

# Appendix B – Abbreviations

PBE IFRS 4 *Insurance Contracts* [PBE IFRS 4]

PBE IFRS 17 *Insurance Contracts* [PBE IFRS 17]

AASB 4 *Insurance Contracts* [AASB 4]

AASB 1023 *General Insurance Contracts* [AASB 1023]

AASB 17 *Insurance Contracts* [AASB 17]

9 The levies received by ComCare are typically all expired by the balance date of 30 June, because 'policies' run from 1 July to 30 June each year.

10 The levies received by Lifetime Support are typically all expired by the balance date of 30 June, because 'policies' run from 1 July to 30 June each year.