Australian Government
Australian Accounting Standards Board

Risk adjustments – emerging practice in the public sector

Objectives of this agenda paper

1. Consider emerging practices in the public sector with respect to identifying and measuring risk adjustments under AASB 17/PBE IFRS 17 *Insurance Contracts*.[1]
2. In the context of measuring liabilities for incurred claims (LIC) (and any assets for incurred claims recoveries (AIC)), the Group is asked to discuss the following questions:
   (a) Are you (or your clients) planning to have a risk adjustment above zero?
   (b) If you (or your clients) are planning to have a risk adjustment above zero, what basis of measurement are you (or your clients) contemplating?
   (c) If you (or your clients) are planning to have a risk adjustment of zero, what justification(s) are you (or your clients) contemplating?
   (d) Are you (or your clients) planning to have the same or different risk adjustments for LIC and for (onerous contract testing for) liabilities for remaining coverage (LRC)?

Disclaimer and assumptions

3. This paper has been prepared for discussion purposes only.[2]
4. It is evident that most (and possibly all) public sector entities will be applying the Premium Allocation Approach to measure their LRC and any assets for reinsurance coverage held (ARC). Accordingly, the discussion on risk adjustments in this paper is largely only relevant in the context of recognising and measuring LIC and any AIC and for any onerous contract testing (which, when relevant, public sector entities are expected to do at the portfolio level).

Background

5. AASB 1023[3] required a 'risk margin' based on the inherent uncertainty in the cash flows, which meant all entities applying the Standard had a 'positive' risk margin within their claim liabilities and when applying the liability adequacy test (that is, in terms of AASB 17, determining whether a portfolio of contracts is onerous).
6. AASB 17.37 requires the estimate of the present value of the future cash flows to be adjusted to reflect the compensation that the entity requires for bearing the uncertainty about the

1 This paper references AASB 17 *Insurance Contracts* and AASB 2022-9 *Amendments to Australian Accounting Standards – Insurance Contracts in the Public Sector*, but is intended to apply equally in the context of the New Zealand XRB's PBE IFRS 17 *Insurance Contacts* and XRB's *Insurance Contracts in the Public Sector (Amendments to PBE IFRS 17)*.

2 The AASB and the authors of this paper do not guarantee, and accept no legal liability whatsoever arising from or connected to, the accuracy, reliability, currency or completeness of any material contained in this paper. This paper is not a substitute for independent professional advice and users should obtain any appropriate professional advice relevant to their particular circumstances. The views in this paper do not necessarily reflect the views of the AASB, or indicate its commitment to a particular course of action.

3 This paper references AASB 1023 *General Insurance Contracts*, but is intended to apply equally in the context of the New Zealand XRB's PBE IFRS 4 *Insurance Contacts*.

amount and timing of the cash flows that arises from non-financial risk. In theory, an entity that does not require such compensation would have a zero risk adjustment.

7. Some entities transitioning to AASB 17 have previously treated claims liabilities as provisions and applied AASB 137[4], which is generally interpreted as not requiring a risk margin/adjustment.

Australia/New Zealand implementation

8. Indications are that some public sector entities transitioning from AASB 1023 and AASB 137 to AASB 17 are planning to have zero risk adjustments and some are not. In addition, some public sector entities with more than one line of business are planning to have zero risk adjustments for some lines and 'positive' risk adjustments for others – that is, their decision is based on the nature and terms of the insurance contracts and is not necessarily an entity-wide judgement.

9. Relevant factors being considered in determining a public sector entity's risk adjustment appear to be the following:

   (a) break-even pricing, on the basis that it may be indicative of public sector entities that do not seek to be compensated for risk [AASB 2002-9.BC151(e)], while pricing for a margin above break-even may be indicative of public sector entities that do seek to be compensated for risk;

   (b) similar to (a), an entity's status might be relevant – some entities identify as 'not-for-profit' (which may be indicative of public sector entities that do not seek to be compensated for risk) and some entities identify as 'for-profit' (which may be indicative of public sector entities that do seek to be compensated for risk);[5]

   (c) level of responsibility shouldered by the governing body for capital management and the entity maintaining solvency (independent of government's intervention) on the basis that it may mean the entity might be less or more risk averse than would otherwise be the case;

   (d) the extent to which the entity has the capacity (legal and practical or political) to price future contracts to recover losses from existing/past contracts;

   (e) the existence of explicit government guarantees and the conditions under which these might be triggered; for example, as indicated in legislation or through customary practice.

Liability for remaining coverage and liability for incurred claims

10. In developing AASB 2022-9, the Boards[6] noted there may be public sector entities that have circumstances which would lead them to having a zero risk adjustment in recognising and measuring their LRC, but having a risk adjustment above zero in recognising and measuring

4 AASB 137 *Provisions, Contingent Liabilities and Contingent Assets*; or the New Zealand XRB's PBE IPSAS 19 *Provisions, Contingent Liabilities and Contingent Assets*.

5 Note that the IASB developed IFRS 17 *Insurance Contracts* to apply to both 'for-profit' and 'mutual entities'. In principle, there is no equity (and no profits) in a mutual entity [IFRS 17.BC265]. However, the IASB envisaged policyholders in a mutual entity acting in two capacities – one as a conventional policyholder and one as a policyholder with a residual interest in the mutual entity [IFRS 17.BC269].

6 The Australian Accounting Standards Board and the New Zealand Accounting Standards Board.

their LIC. For example, when claims are related to infrequent large-scale events and the uncertainties around the amounts and timing of cash flows from those events are particularly difficult to estimate [AASB 2022-9.BC151(d)].

11. It is evident that most (and possibly all) public sector entities will be applying the Premium Allocation Approach in measuring all liabilities for remaining coverage. Accordingly, the impact of the risk adjustment (zero or 'positive') on LRC measurement is generally only relevant in determining whether a portfolio of contracts is onerous.

12. Entities with a positive risk adjustment are more likely (all other things being equal) to have onerous contracts and onerous contract losses than entities with a zero risk adjustment.

13. In contrast, there is a direct impact on the measurement of LIC of a decision on risk adjustments.

14. Indications are that some entities transitioning to AASB 17 are planning to have zero risk adjustments for both LRC and LIC, while others are having positive risk adjustments for both LRC and LIC.

Documentation

15. In any case, an entity's rationale for the basis of its selected risk adjustment would be expected to be well-documented.

Canada

16. The provincial workers' compensation Boards in Canada adopted IFRS 17 (unmodified by the Canadian standard setter) for their annual reporting for 1 January to 31 December 2023. They have all applied the Premium Allocation Approach in measuring LRC.

17. All have reported zero risk adjustments for LIC,[7] based on similar reasoning – the following are extracts from 2023 annual reports of Canadian provincial workers' compensation Boards.

> **Ontario** [FY23, page 66]: Due to the not-for-profit nature of the WSIB's operations, the WSIB does not require compensation for bearing uncertainty from any non-financial risk. Therefore, the WSIB's risk adjustment is determined to be de minimis and corresponds to a 50% confidence level.
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> **Manitoba** [FY23, page 109]: Due to the non-profit nature of the WCB's operations and in accordance with the funding policy (note 18), the WCB does not require compensation for bearing uncertainty for any non-financial risk. The WCB has assessed the risk adjustment at near zero and corresponds to a 50 per cent confidence level.
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> **British Columbia** [FY23, page 128]: WorkSafeBC uses judgment to determine the risk adjustment to be zero, which corresponds to approximately a 50 percent confidence level. This is because WorkSafeBC is an entity created by statute and can fully transfer non-financial risk by applying legislation and policy.
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> **Alberta** [FY23, page 50]: The WCB insurance and funding models do not require compensation, as defined in IFRS 17, for assuming non-financial risk; therefore, the risk adjustment is zero at transition to IFRS 17 and for all prior periods. A risk adjustment of

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7 It is implied in some of the explanatory text and actuarial statements that the provincial workers' compensation Boards in Canada also used a zero risk adjustment for assessing whether, in respect of LRC, insurance contracts are onerous.

> zero corresponds to a confidence level of approximately 50%. This means that the total liability represents WCB's best estimate of expected future cash flows.
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> **PEI** [FY23, page 14] As the Board generates sufficient premiums and income from investments to fully fund the operations of the insurance business and other administrative activities, there is no compensation required or earned by the Board for such risk and as such, the risk adjustment was determined to be approximately nil or negligible.

18. None of the Canadian provincial workers' compensation Boards appear to reinsure.

19. Canadian Institute of Actuaries Education Note *Application of IFRS 17 Insurance Contracts to Public Personal Injury Compensation Plans* (June 2022) notes:

> To establish the RA, the compensation the board requires for the uncertainty in estimates of future cash flows needs to be identified through understanding of the board's risk tolerance, pricing and funding policies. The ability to recover deficits through pricing of future contracts may or may not be a relevant factor determining the compensation the board requires. If it is, then the RA could be nil even if the contract boundary is short. [pages 19-20]

Reinsurance held

20. In considering whether a public sector insurer might have a zero risk adjustment, regard would need to be had to any non-proportionate reinsurance contracts held.[8] Logically, an insurer that cedes risk would do so because they have an aversion to that risk and are prepared to pay compensation to a reinsurer to relieve them of (at least) that risk.

21. Accordingly, in principle, it seems logical that a public sector insurer with reinsurance contracts held could not have a zero risk adjustment for its (underlying) issued insurance contracts. Its risk adjustment on issued insurance contracts would be presumed to be, at a minimum, based on the risk ceded. This is consistent with the view expressed in the Canadian Institute of Actuaries Education Note *IFRS 17 Risk Adjustment for Non-Financial Risk for Property and Casualty Insurance Contracts* (August 2024) [page 15].

22. Therefore, a public sector entity might have a net zero risk adjustment after reinsurance – with a 'positive' risk adjustment in its LIC that equates to a 'negative' risk adjustment in its AIC.

Disclosure and presentation

23. In relation to risk adjustments, AASB 17 has no public sector modifications, including for presentation and disclosure. The Boards noted that public sector entities might arrive at different reporting outcomes in regard to risk adjustments when compared to their private sector counterparts, but that the same presentation and disclosure requirements should apply.

Significant judgements

24. The Boards expected that the (existing) AASB 17 requirements for disclosure about significant judgements are likely to trigger useful disclosure that reveals a public sector entity's approach to risk adjustments – in particular AASB 17.93 and 117 (emphasis added).

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8 Reinsurance held by public sector entities is likely to always be non-proportionate, given the nature of their business models.

93 The objective of the disclosure requirements is for an entity to disclose information in the notes that, together with the information provided in the statement of financial position, statement(s) of financial performance and statement of cash flows, gives a basis for users of financial statements to assess the effect that contracts within the scope of AASB 17 have on the entity's financial position, financial performance and cash flows. To achieve that objective, an entity shall **disclose qualitative and quantitative information about**:

(a) the amounts recognised in its financial statements for contracts within the scope of AASB 17 (see paragraphs 97–116);

(b) the **significant judgements**, and changes in those judgements, made when applying AASB 17 (see paragraphs 117–120); …

117 An entity shall **disclose the significant judgements and changes in judgements made in applying AASB 17**. Specifically, an entity shall disclose the inputs, assumptions and estimation techniques used, including:

(a) the methods used to measure insurance contracts within the scope of AASB 17 and the processes for estimating the inputs to those methods. Unless impracticable, an entity shall also provide quantitative information about those inputs. …

(c) to the extent not covered in (a), the approach used: …

(ii) **to determine the risk adjustment for non-financial risk**, including whether changes in the risk adjustment for non-financial risk are disaggregated into an insurance service component and an insurance finance component or are presented in full in the insurance service result; …

25. In applying AASB 17.93 and 117, public sector entities would be expected to disclose significant judgements made in determining risk adjustments, including whether they have a zero or 'positive' risk adjustment. This is consistent with the Focus Group discussion in February 2024 in respect of Risk adjustments and skewed distributions (February 2024 Agenda paper 3).

Reconciliation (roll-forward) tables

26. AASB 17 also requires the presentation of reconciliation (roll-forward) tables for the LRC and LIC and any reinsurance held equivalents (ARC and AIC). These include showing the amounts of risk adjustments, and movements in risk adjustments [AASB 17.100(c)(ii)].

27. Technically, a zero risk adjustment is still a risk adjustment. For an entity with a zero risk adjustment, a judgement would need to be made about whether the reconciliation (roll-forward) table(s) should:

(a) not include columns or line items for risk adjustments, but include an explanation about risk adjustments being zero; and/or

(b) include columns or line items showing zero balances and zero movements in a reconciliation (roll-forward) table for risk adjustments.