Australian Government
Australian Accounting Standards Board

AASB Transition Resource Group for AASB 17 *Insurance Contracts*

Implementation question discussed by the Private Health Insurers (PHI) focus group – Risk Equalisation

Submission date	01/06/2021
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Potential implementation question

The purpose of this paper is to discuss the treatment of the Risk Equalisation Scheme (Scheme) operating in the Australian Private Health Insurance Industry under AASB 17 Insurance Contracts.

Paragraph of IFRS 17 *Insurance Contracts*

AASB 17.2, AASB 17.32-34, AASB 17.B65, AASB 17.40, AASB 17.B36-92.

Analysis of the question
The analysis of the question should include a detailed description of the different ways the new Standard may be applied, resulting in possible diversity in practice.

Refer to appendix A for paper drafted and discussed by the PHI industry

Is the question pervasive?
Explain whether the question is expected to be relevant to a wide group of stakeholders.

The question is relevant for all PHI's and may also impact others in similarly regulated insurance industries in Australia.

Appendix A – Risk equalisation considerations for Australian PHI

A.1. Background

Under legislation, all private health insurers (PHI) must participate in the Risk Equalisation Special Account (RESA) in which all private health insurers share the cost of the eligible claims of members aged 55 years and over, and claims meeting the high cost claim criteria. The requirements of the Scheme are set out in the Private Health Insurance (Risk Equalisation) Rules 2015.

The purpose of risk equalisation is to support the community rating principal. Insurers are not allowed to risk rate premiums and risk equalisation partially compensates insurers with a riskier demographic profile by redistributing money from those insurers paying less than average benefits to those paying higher than average benefits

The Risk Equalisation Scheme operates as follows:

Gross Deficit (GD)	less	Calculated Deficit (CD)	=	Net RE receipt / (payment)
The insurer's eligible claims allocated to the (i) Age Based Pool and (ii) High Cost Claimants Pool *Age Based Pool (ABP)* The proportion of paid claims shared varies from 15% for a 55 year old to 82% for someone over 85 years old. *High Cost Claims Pool (HCCP)* For claims incurred by a policyholder that exceed $50k in a year (after any recoveries from the ABP), 82% of the amounts above $50k are allocated to the HCCP		The insurer's share of the pooled costs based on hospital market share Insurers calculate their market share based on Single Equivalent Units (SEUs). Single policies count as 1 SEU and a couple or family policies count as 2 SEUs.		

Separate calculations are performed for each State. And only eligible benefits are included in the pools, including hospital benefits, hospital substitute benefits and chronic disease management programs.

The Scheme is administered by Australian Prudential Regulation Authority (APRA) and the net amount due to, or receivable by, PHIs is calculated and invoiced by APRA quarterly in arrears generally within 2 months of quarter end, e.g. for 30 June 2020 quarter amount, the net amounts per PHI were invoiced by APRA in August 2020.

A.2. Accounting Analysis

Current Accounting

PHI's currently account for risk equalisation as follows:

Income Statement:	Balance Sheet:
▪ Recognise the net risk equalisation amount (both for incurred and outstanding claims) on an accruals basis in the Income Statement within the Insurance Underwriting Result (given that amounts are settled in net, they are accounted for on a net basis as allowed under current offsetting rules in AASB 101.32.	▪ Recognise a receivable or payable in the Balance Sheet for claims paid in the preceding quarter (e.g. at 30 June, a receivable or payable is recognised in the balance sheet for the Apr-Jun quarter). ▪ Estimate a receivable or payable amount within the Outstanding Claims Liability in relation to unpresented and outstanding claims.

AASB 17 Accounting

Regulatory based risk equalisation schemes such as this are not explicitly addressed in AASB 17. In determining the appropriate accounting treatment for them under AASB 17 the following areas are considered:

Question 1: Should this arrangement be considered to be a reinsurance contract?

AASB 17, Appendix A defines an **insurance contract** as

- *"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, Appendix A defines a **reinsurance contract** as

- "*An **insurance contract** issued by one entity (the reinsurer) to compensate another entity for claims arising from one or more insurance contracts issued by that other entity (underlying contracts)."*

In order to be considered a reinsurance contract, it must first be an insurance contract. Therefore consideration of the key terms for an insurance contract are further analysed below.

Contract

While PHIs hold underlying insurance contracts with policyholders, the risk equalisation scheme is a construct of law, and does not take the form of a contract between a PHI and the government, nor a contract between all the PHI's.

Transfer of significant risk

Under the risk equalisation scheme, the insurers share collectively in claims experience, however there is no assumption by other PHI's of a specific insurer's risk and no additional compensation provided into the Scheme – both the CD and GD amounts for the whole Scheme net to zero.

Summary of discussion:

The PHI focus group consensus was that the scheme does **not** meet the definition of an insurance contract and therefore should **not** be separately accounted for as a reinsurance contract.

Question 2: Should the CD and GD amounts be considered as part of fulfillment cashflows?

AASB 17.2 states that "*An entity shall consider its substantive rights and obligations, whether they arise from a contract, law or regulation, when applying IFRS 17*."

AASB 17 para32-34 requires an entity to include in the measurement of a group of insurance contracts all the future cash flows within the boundary of each contract in the group. AASB 17.B65 goes on to state that cash flows within the boundary of an insurance contract are those that relate directly to the fulfilment of the contract and include:

i) transaction-based taxes (such as premium taxes, value added taxes and goods and services taxes) and levies (such as fire service levies and guarantee fund assessments) **that arise directly from existing insurance contracts**, or that can be attributed to them on a reasonable and consistent basis.

k) potential cash inflows from **recoveries** (such as salvage and subrogation) on future claims covered by existing insurance contracts and, to the extent that they do not qualify for recognition as separate assets, potential cash inflows from recoveries on past claims.

- The net cash flow arising from the CD and GD calculation results from legislation, connected to the issuance of private health insurance contracts within the scope of AASB 17.
- The CD that is 'paid' into the Scheme is directly linked to SEUs and therefore linked to private health insurance contracts issued, which are in the scope of AASB 17. Payments into the Scheme are noted by legislation as "risk equalisation levies".

- The GD that is recovered from the Scheme relates directly to recoveries on benefits paid by PHIs and can be linked to both past claims as well as future claims.

Summary of discussion:
The PHI focus group consensus was that the nature of the CD and GD cash flows relate to insurance contracts within the scope of AASB 17. The cash flows are directly attributable to the issuance of insurance contracts and settlement of related claims. The amounts should be considered part of fulfilment cash flows within the boundary of an insurance contract.

Question 3: how should they be disclosed and accounted for when the PAA is applied?

Balance Sheet:
Per AASB 17.40 the carrying amount of a group of insurance contracts at the end of each reporting period shall include the liability for incurred claims (LIC), comprising the fulfilment cash flows related to past service allocated to the group at that date, measured applying paragraphs 33–37 and B36–B92.

AASB 17, Appendix 2, defines the LIC as "an entity's obligation to investigate and pay valid claims for insured events that have already occurred, including events that have occurred but for which claims have not been reported, and **other incurred insurance expenses**."

Amounts recognised at the balance sheet date for the Scheme include:
- The net CD and GD for claims paid in the preceding quarter (i.e amounts included in the latest risk equalisation survey); and
- An estimate for the net CD and GD in relation to claims that have been incurred but not yet paid at balance sheet date.

In both instances, any amounts payable or receivable under the Scheme relate to a past service provided and therefore relate to fulfilment cash flows of the LIC at balance sheet date.

Income statement:
AASB 17.80 notes that the amounts recognised in the income statement are disaggregated into **an insurance service result** (comprising **insurance revenue** and **insurance service expense**) and insurance finance income or expenses.

AASB 17.83 states that **Insurance revenue** shall depict the provision of coverage and other services arising from the group of insurance contracts at an amount that reflects the consideration to which the entity expects to be entitled in exchange for those services with AASB 17.B126 further stating that insurance revenue is calculated based on expected premium receipts adjusted for a financing effect and excluding investment components.

AASB 17.84 defines **insurance service expenses** as those arising from a group of insurance contracts issued, comprising incurred claims (excluding repayments of investment components), other incurred insurance service expenses and other amounts as described in paragraph 103(b).

AASB 17.103 requires an entity to separately disclose the following items (where applicable):
(a) insurance revenue
(b) insurance service expenses, showing separately:
   i. **incurred claims (excluding investment components) and other incurred insurance service expenses**;
   ii. amortisation of insurance acquisition cash flows;
   iii. changes that relate to past service, ie changes in fulfilment cash flows relating to the liability for incurred claims; and
   iv. changes that relate to future service, ie losses on onerous groups of contracts and reversals of such losses.

Amounts relating to insurance contracts are recorded through the income statement as either insurance revenue or insurance service expense (excluding discounting).

Given that the CD is effectively a levy charged (or received) on PHI contracts issued, and is calculated based on the claims experience of the scheme as a whole it would be appropriate to recognise the amounts as an **insurance service expense**.

The GD recoverable from the Scheme is a recoverable based on incurred claims, therefore it would also meet the definition of an **insurance service expense**.

Alternative views of the treatment in the income statement include:

- Recognising the CD and GD on a net basis – per the discussion above, both the GD and CD would form part of the calculation of the LIC, with movements flowing through insurance service expense. As such, treating the GD and CD as individual gross amounts, or as a net amount would result in the same presentation in the financial statements. AASB 17 does not contain any further disclosure requirements specific to insurance service expense or LIC that would require further disclosure of the GD/CD on a gross basis. As such, it would be up to insurers to whether they believe it is useful to users of the financial statements to provide additional separate disclosure as to the impact of the Scheme on their results.

- Recognising a net CD/GD amounts as revenue, however it would not meet the definition of insurance revenue under AASB 17.83.

The proposed treatment as insurance service expense is supported by AASB 17.86 which, whilst applicable to reinsurance held, does reference a basic principle that cash flows that are 'contingent on claims' are adjusted against claims (i.e. insurance service expense) and cash flows that are 'not contingent on claims' are adjusted against premium (i.e. insurance revenue).

Summary of discussion:

- Given that any amounts payable or receivable under the scheme relate to past service for contracts, at the reporting date they should be included in the LIC.
- Both the GD and CD meet the definition of an insurance service expense and should be accounted for as such in the income statement.

A.3. Summary of discussions

Based on the above analysis, it is proposed that the risk equalisation scheme be accounted for as follows under AASB 17:

- The nature of the CD and GD cash flows relate to insurance contracts within the scope of AASB 17. The cash flows are directly attributable to the issuance of insurance contracts and settlement of related claims. The amounts should be considered part of **fulfilment cash flows within the boundary of an insurance contract**.

- Given that any amounts payable or receivable under the scheme relate to past service for contracts in issue at the reporting date they should be **included in the LIC**.

- Both the GD and CD meet the definition of an **insurance service expense** and should be accounted for as such in the income statement.