AASB Transition Resource Group for AASB 17 *Insurance Contracts*

Submission form for potential implementation question

In addition to the form, attachments (such as memos) may be included with the submission.

Any public discussion of issues submitted will be without the identification of the submitter's name. Although the submission forms will remain private, please do not include any confidential information in your submission.

Email a PDF of the completed (including any attachments) form to standards@aasb.gov.au.

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Do you wish to present to the TRG?	Yes

Potential implementation question

Contract boundary of reinsurance contracts held with the ARPC for cyclone risks

Paragraph of IFRS 17 *Insurance Contracts*

AASB 17.34 and AASB 17.B64

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.

Please see the Appendix

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

Yes – all insurers accepting cyclone risks will be required to reinsure through the Australian Reinsurance Pool Corporation (ARPC)

ARPC reinsurance contract held contract boundary

December 2022

A Background & Purpose

A.1 From 1 July 2022 the Australian Reinsurance Pool Corporation (ARPC) established a reinsurance pool for cyclones and related flood damage. Similar to the terrorism pool, the cyclone pool is designed to lower insurance premiums for households and small businesses with high cyclone and related flood damage by reducing the cost of reinsurance. Large insurers[1] must join the pool before 31 December 2023, and insurers can progressively transfer eligible cyclone policies up to this date.

A.2 The way the scheme works is that insurers will pay the eligible reinsurance premium[2] into the pool and for the first 3 years (1 July 2022-1 July 2025) the pool will cover all eligible cyclone and related flood damage above the policyholder excess. From 1 July 2025 the pool will operate on a risk sharing arrangement with insurers. The aim is to provide insurers with affordable reinsurance, which, in turn, is expected to influence (reduce) premiums charged to policyholders.[3]

A.3 Consistent with the terrorism pool, when a cyclone event is declared the pool will cover claims for the duration of the event. In the context of the cyclone pool the Bureau of Meteorology (BoM) will declare the start and end of the cyclone event for which the pool will cover cyclone and related flood damage for the period of the cyclone plus 48 hours after.

A.4 When an event occurs, the claim recoveries under the reinsurance contract are unlimited (above the underlying policyholder's retention limit[4]) and backed by Government guarantee. Insurers can purchase other reinsurance covers to cover the post 48 hrs risk and any additional risk as they see fit.

A.5 The ARPC may cancel the reinsurance contract between insurer and ARPC based on the following [Clause 1(f)]:

(i) Insured has failed to comply with its material obligations and non-compliance is not rectified within 90 days

(ii) Insured has committed fraud in connection with the reinsurance agreement

(ii) Repeated failure of compliance with obligations over at least 6 months

(iv) Failure to remit reinsurance premium within 30 days

(v) If the Corporation reasonably considers termination/ repeal/ amendment of the Act is necessary.

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1 That issue policies with GWP of $300m or more cyclone related premium

2 Set by the ARPC and reviewed by the reviewing actuary using property level data such as geography, building characteristics (e.g.: date of construction) and mitigation (e.g.: retrofitted to current building standards)

3 Note, however, the ACCC will monitor policyholder outcomes resulting from the implementation of the Cyclone reinsurance pool

4 In relation to the contract issued from the insurer to the policyholder. There is no retention limit under the reinsurance contract.

A.6 In the above cases it generally needs to be approved by majority of ARPC members to terminate with 6 months' notice (except for (ii) which is immediate).

A.7 An insurer can cancel based on the following Clause 1(e):

> The reinsured may terminate this Agreement by giving the Corporation not less than 6 months' written notice of its decision to terminate the Agreement. The Agreement shall terminate with effect from the next 1 January that is at least 6 months after the written notice is given if the Reinsured is a *Lloyd's underwriter*, otherwise the Agreement shall terminate at the date and time specified in the written notice given pursuant to this sub-clause.

B Distinguishing features of the ARPC Cyclone Loss Reinsurance Arrangement and possible accounting implications

B.1 Two key features distinguish the ARPC Cyclone Loss Reinsurance Arrangement from conventional commercial reinsurance arrangements:

1. it is mandatory to have ARPC reinsurance contract held coverage for the relevant underlying insurance contracts providing cyclone coverage; and
2. pricing and benefits are set by the ARPC – there is no facility for insurers to negotiate.

B.2 The *Terrorism and Cyclone Insurance Act 2003*, section 8A(1) says:

> If a general insurer carries on insurance business that includes undertaking liability, under pool insurance contracts, in respect of eligible cyclone losses, the insurer must maintain contracts of reinsurance with the Corporation that:
>
> (a) cover the insurer's liability, under all pool insurance contracts that it enters into, in respect of all eligible cyclone losses; and
>
> (b) insure against 100% of the insurer's liability, under each of those pool insurance contracts, in respect of all eligible cyclone losses.

B.3 The *Terrorism and Cyclone Insurance Act 2003*, section 8D says:

> When setting premiums that reinsureds are to pay under cyclone reinsurance contracts, the Corporation is to seek:
>
> (a) to ensure that, over the longer term, premiums paid under such contracts are sufficient to cover or offset:
>
> (i) the amounts paid in meeting the Corporation's liabilities under such contracts (including payments by the Commonwealth under section 35A in respect of such liabilities); and
>
> (ii) all other amounts applied by the Corporation as mentioned in subsection 34(1), in so far as those amounts may reasonably be regarded as connected with the cyclone reinsurance scheme; and
>
> (b) in so far as those premiums are for reinsuring liability under pool insurance contracts that involve medium to high levels of exposure to eligible cyclone losses—to keep the premiums as low as possible while maintaining incentives to reduce and mitigate the risk of eligible cyclone losses; and
>
> (c) in so far as those premiums are for reinsuring liability under pool insurance contracts that involve lower levels of exposure to eligible cyclone losses—to keep those premiums at levels comparable to what would be charged by other reinsurers.

B.4 Accordingly, although the ARPC is a monopoly, it is intended to price at levels that are comparable to, but hopefully lower than, levels that would be charged by private sector reinsurers.

C Relevant extracts from AASB 17 and the IFRS 17 Basis for Conclusions

C.1 Under AASB 17.34, the contract boundary for the purposes of identifying cash flow under an insurance contract issued or reinsurance contract held, ends when the insurer/cedent has the practical ability to reprice the relevant risks and benefits.

> 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

C.2 Under AASB 17.B64, an insurer/cedent is identified as having the practical ability to reprice in the absence of constraints that prevent the entity from setting the same price as for a new contract (emphasis added).

> B64 Paragraph 34 refers to an entity's practical ability to set a price at a future date (a renewal date) that fully reflects the risks in the contract from that date. **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 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. Similarly, an entity has that practical ability to set a price 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. 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 service. In determining the estimates of future cash flows at the end of a reporting period, an entity shall reassess the boundary of an insurance contract to include the effect of changes in circumstances on the entity's substantive rights and obligations.

C.3 The IFRS 17 Basis for Conclusions notes that estimates of future cash flows included in measuring reinsurance contracts relate to insurance contracts the entity expects to be covered by the reinsurance.

> BC309A **Estimates of future cash flows included in the measurement of a group of reinsurance contracts held include future cash flows that relate to insurance**

contracts an entity expects to be covered by the reinsurance contracts held in the group. Such cash flows include cash flows related to insurance contracts the entity expects to issue in the future if the entity has a substantive right to receive reinsurance coverage for those insurance contracts. The Board considered a suggestion from entities implementing IFRS 17 to amend IFRS 17 to exclude from the measurement of the group of reinsurance contracts held cash flows that relate to underlying insurance contracts that are yet to be issued.

BC309B The Board noted that the suggestion in paragraph BC309A, which is consistent with feedback during the development of IFRS 17, would achieve an outcome similar to the practice often used applying IFRS 4 whereby an entity measured reinsurance contracts held based on the measurement of existing underlying insurance contracts

BC309C The Board reaffirmed its view that the accounting for a reinsurance contract held should be consistent with the accounting for insurance contracts issued (see paragraph BC298). Consistent accounting includes measuring the expected value of all the entity's rights and obligations arising from a contract. When an entity holds a reinsurance contract that provides the entity with a substantive right to receive reinsurance coverage for insurance contracts it expects to issue, cash flows arising from that substantive right are included in the measurement of the reinsurance contract held (that is, those cash flows are within the boundary of the reinsurance contract held applying paragraph 34 of IFRS 17). …

D Possible contract boundary implications of ARPC Cyclone Loss Reinsurance Arrangements

D.1 For the purposes of discussion, three possible views are considered in this paper – the contract boundary for ARPC reinsurance contracts held is:

1. perpetual;
2. determined by reference to the insurer's foreseeable commercial expectations for issuing insurance contracts that cover cyclone risks; or
3. determined by reference to the contract boundaries of the insurer's underlying in-force insurance contracts issued plus those that would be expected to be issued during the six-month notice period under Clause 1(e) of the ARPC reinsurance contract.

View 1: perpetual contract boundary

D.2 The ARPC is a monopoly reinsurance provider and, based on current legislation, stands ready to reinsure all cyclone risks, meaning an insurer is entitled to receive reinsurance coverage from the ARPC, and similarly is obligated to pay reinsurance premiums from the ARPC for as long as the current legislation remains in place.

D.3 A possible implication of the features of an ARPC reinsurance contract held under AASB 17 would be a contract boundary that is perpetual because insurers may have no option to cease the obligation to pay premiums under AASB 17.34 into the scheme (unless they cease writing eligible cyclone risks/policies).

D.4 The cash flows associated with an ARPC reinsurance contract held would be all the expected cash flows from substantive rights and obligations under the contract with the ARPC based on the expectations at the reporting date.

View 2: determined by reference to insurer's foreseeable commercial expectations

D.5 The ARPC is a monopoly reinsurance provider and, based on current legislation, stands ready to reinsure all cyclone risks for so long as an insurer expects to be issuing insurance contracts covering cyclone risks.

D.6 An ARPC reinsurance contract held contract boundary would be determined by reference to an insurer's commercial expectations about issuing insurance contracts covering cyclone risks for the foreseeable future.

D.7 The foreseeable future period may be based on the insurer's corporate business plans and forecasts, which, for example, could span three or five years. Alternatively, an insurer might re-assess annually whether it will retain the cyclone coverage within its insurance contracts – that is, while an insurer might continue to issue contracts in cyclone-affected areas, it may annually review whether to exclude cyclone risks.

D.8 Therefore, if an insurer were to review its decision to continue writing eligible cyclone risks on an annual basis, the expected cashflows (and therefore contract boundary[5]) would be based on the annual business written.

View 3: determined by reference to in-force underlying issued insurance contract boundaries

D.9 The alternative view is that an ARPC reinsurance contract held contract boundary would be determined by reference to the contract boundaries of the insurer's underlying in-force insurance contracts issued plus those that would be expected to be issued during the six-month notice period under Clause 1(e) of the ARPC reinsurance contract on one or both of two possible bases:

- having to reinsure with the ARPC is a constraint that applies to both new and existing contracts; and/or
- the insurer can exit the market for cyclone risks once its existing in-force contracts expire.

Basis for View 3 is that the same constraint applies to both new and existing contracts

D.10 IFRS 17 Transition Resource Group [May 2018] agenda paper 3 notes that:

> 26 A constraint that equally applies to new contracts and existing contracts would not limit an entity's practical ability to reprice existing contracts to reflect their reassessed risks. This is because, as explained in paragraph B64 of IFRS 17, the entity could either:
>
> (a) set the same price for an existing contract and a new contract with the same characteristics (see paragraph 34(a) of IFRS 17); or
>
> (b) reprice an existing contract to reflect overall changes in the risks in a portfolio, even if the price set for each individual policyholder does not reflect the change in risk for that specific policyholder (see paragraph 34(b) of IFRS 17).

D.11 AASB 17.B64 is probably intended to apply to constraints such as competitive market pressures that, for example, compel an insurer to under-price risk and is emphasising that the insurer nonetheless retains its practical ability to fully price for risk but might choose to under-price based on those constraints. Provided new contracts would be subject to the same competitive market pressures and result in a similar under-pricing of risk, the end of the contract would be the end of the in-force contract boundary.

5 Noting that the reinsurance is written on a risks-attaching basis, so likely a 24 month contract boundary on the assumption that the underlying policies are annual and written on an equal frequency throughout the year.

D.12 AASB 17.B64 was probably not written with monopoly markets in mind. However, the 'constraints' in AASB 17.B64 could be regarded as including the monopoly status of a market participant, which applies equally to new and existing reinsurance contracts held for cyclone risks with the ARPC. The ARPC is also expected to operate over the long term to keep reinsurance premiums as low as feasible to help ensure that the premiums charged by private sector insurers are as affordable as feasible.[6]

D.12 Therefore, literally, an insurer is deemed to have the practical ability to reassess the risks under the contract and, as a result, can set a price or level of benefits that fully reflects those risks when the current contract ends because the same terms set by ARPC would apply to any insurer acquiring ARPC reinsurance at that same time (the same price for new and existing contracts).

D.13 That is, **although an insurer must continue to reinsure with the ARPC for as long as it has issued contracts covering cyclone risks, it would always do so at the 'current' price, which the ARPC is expected to consider resetting each six months – an insurer is not locked-in to an existing price regime that differs from the regime applying to new reinsurance contracts held**.

D.14 In addition, based on the requirements imposed by section 8D of the *Terrorism and Cyclone Insurance Act 2003*, the APRC is obliged to ensure the 'current price' is benchmarked to a competitive price that would be fully reflective of the risks reinsured.

Basis for View 3 is that the private sector insurer could exit the market for cyclone risks

D.15 An ARPC reinsurance contract held contract boundary is limited by the contract boundaries of the insurer's underlying in-force insurance contracts issued because an insurer could elect to stop issuing insurance contracts that provide coverage for cyclone risks and, therefore, end its obligations to cede premiums to the ARPC [with six-month notice under Clause 1(e)].

D.16 While this may, or may not, be a commercially viable option for many insurers, it can be argued that this is not a relevant consideration. This is because the insurer's coverage of cyclone risks is within its control. The insurer could choose to exclude cyclone risks from the insurance contracts it issues, which would allow the insurer to end its ARPC reinsurance contract held contract boundary once the contract boundaries under its existing in-force insurance contracts issued expire.

Questions for AASB 17 TRG ARPC Focus Group members

Q1 Do you consider that, under AASB 17, ARPC reinsurance contracts held would have:

a) potentially perpetual contract boundaries [View 1]?

b) contract boundaries determined by reference to the insurer's foreseeable commercial expectations for issuing insurance contracts that cover cyclone risks [View 2]?

c) contract boundaries determined by reference to the contract boundaries of the insurer's underlying in-force insurance contracts issued plus those that would be expected to be issued during the six-month notice period under Clause 1(e) of the ARPC reinsurance contract [View 3]?

6 As noted in the Explanatory Memorandum to the Bill that preceded the cyclone amendments to the *Terrorism and Cyclone Insurance Act 2003*

d) contract boundaries determined using some other approach and, if so, what is that approach and why do you support it?

Q2 If you agree with View 3, what is your basis for supporting that view:

a) the ‘same constraint applies to new and existing contracts’ basis;

b) the ‘exit the market for cyclone risks’ basis; or

c) some other basis and, if so, what is that basis?

ARPC cyclone contract- AASB 17 contract boundary

AASB 17 TRG Meeting
December 2022

Australian Government
Australian Accounting Standards Board

ARCPC Reinsurance Contracts held – Contract boundary

Background on the scheme

- From 1 July 2022 the Australian Reinsurance Pool Corporation (ARPC) established a reinsurance pool for cyclones and related flood damage.
- Similar to the terrorism pool, the cyclone pool is designed to lower insurance premiums for households and small businesses with high cyclone and related flood damage by reducing the cost of reinsurance.
- Large insurers must join the pool before 31 December 2023, and insurers can progressively transfer eligible cyclone policies up to this date.
- Insurers pay eligible reinsurance premiums into the pool which will cover all eligible cyclone and related flood damage above an excess
- Consistent with the terrorism pool, an event will be declared by the government agency (BoM in this case) and will cover claims for the period of the Cyclone + 48hrs
- Unlike the terrorism pool, which insurers may join, insurers are **required to** join the cyclone reinsurance pool when they issue insurance contracts covering cyclone risks

ARCPC Reinsurance Contracts held – Contract boundary

Summary of the Act* and contract*

Reinsurer:

Right to cancel if..

- Insured has failed to comply with its material obligations and non-compliance is not rectified within 90 days
- Insured has committed fraud in connection with the reinsurance agreement
- Repeated failure of compliance with obligations over at least 6 months
- Failure to remit reinsurance premium within 30 days
- If the Corporation reasonably considers termination/ repeal/ amendment of the Act is necessary.

If any of the above applied, would need to be approved by majority of ARPC members and 6 months notice provided (2=immediate)

Insurer:

Right to cancel if..

*"The reinsured may terminate this **Agreement by giving the Corporation not less than 6 months' written notice** of its decision to terminate the Agreement. The Agreement shall terminate with effect from the next 1 January that is at least 6 months after the written notice is given if the Reinsured is a Lloyd's underwriter, otherwise the Agreement shall terminate at the date and time specified in the written notice given pursuant to this sub-clause."*

However, *Terrorism and Cyclone Insurance Act 2003*, section 8A(1) says:
*a general insurer carries on insurance business that includes undertaking liability, under pool insurance contracts, in respect of eligible cyclone losses, **the insurer must maintain contracts of reinsurance with the Corporation that**:*

*(a) **cover the insurer's liability**, under all pool insurance contracts that it enters into, in respect of **all eligible cyclone losses**; and*
*(b) **insure against 100% of the insurer's liability, under each of those pool insurance contracts**, in respect of all eligible cyclone losses.*

*Relevant for this topic of discussion

ARCPC Reinsurance Contracts held – Contract boundary

Other relevant paragraphs in the Act * (Section 8D)

When setting premiums that reinsureds are to pay under cyclone reinsurance contracts, the Corporation is to seek:

(a) to ensure that, over the longer term, premiums paid under such contracts are sufficient to cover or offset:

(i) the amounts paid in meeting the Corporation's liabilities under such contracts (including payments by the Commonwealth under section 35A in respect of such liabilities); and

(ii) all other amounts applied by the Corporation as mentioned in subsection 34(1), in so far as those amounts may reasonably be regarded as connected with the cyclone reinsurance scheme; and

*(b) in so far as those premiums are for reinsuring liability under pool insurance contracts that involve medium to high levels of exposure to eligible cyclone losses—**to keep the premiums as low as possible** while maintaining incentives to reduce and mitigate the risk of eligible cyclone losses; and*

*(c) in so far as those premiums are for reinsuring liability under pool insurance contracts that involve lower levels of exposure to eligible cyclone losses—**to keep those premiums at levels comparable to what would be charged by other reinsurers***

Considerations from AASB 17 – Contract Boundary requirements

1. Paragraph 34

a) The rights and obligations of the parties (compel to pay premiums/ substantive obligation to provide cover)

b) The reinsurer's right to reprice

2. Paragraph 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 characteristics as the existing contract issued on that date"

3. Paragraph BC309A

"Estimates of future cash flows included in the measurement of a group of reinsurance contracts held include future cash flows that relate to insurance contracts an entity expects to be covered by the reinsurance contracts held in the group. Such cash flows include cash flows related to insurance contracts the entity expects to issue in the future if the entity has a substantive right to receive reinsurance coverage for those insurance contracts."

Possible contract boundary interpretations

1. Perpetual

- *So long as the entity issues underlying insurance contracts it is obliged by law to reinsurer into the pool, they cannot cancel the contract*
- *cash flows associated with an ARPC reinsurance contract held would be all the expected cash flows from substantive rights and obligations under the contract with the ARPC based on the expectations at the reporting date.*

2. Based on an entity's expectations of issuing eligible (underlying) insurance contracts covering eligible cyclone risks

- *Similar to (1) an entity is obliged by law to reinsurer into the pool, they cannot cancel the contract so long as writing eligible underlying insurance contracts*
- *An entity may assess as part of its annual planning process whether it will continue to write eligible contracts, and therefore the contract boundary will be based on the entity's underlying expectations of how long it will continue to write the underlying contracts*

3. Determined by reference to the entity's eligible (underlying) insurance contracts + 6 month notice - (I.e.: applying Clause 1(e) of ARPC reinsurance contract)

- *This is on the basis (per IFRS 17 TRG May 2018 AP3) the ARPC can set the same price for an existing contract and a new contract with the same characteristics*
- *The ARPC has the right (under the contract) to reprice on a 6 monthly basis, where the price charged to existing policyholders is the same as new*
- *The policyholder (the insurer/entity) then can either accept the price or exit the market through exiting the underlying (i.e.: within the entity's control)*

Questions

Q1 Do you consider that, under AASB 17, ARPC reinsurance contracts held would have:

a) potentially perpetual contract boundaries [View 1]?
b) contract boundaries determined by reference to the insurer's foreseeable commercial expectations for issuing insurance contracts that cover cyclone risks [View 2]?
c) contract boundaries determined by reference to the contract boundaries of the insurer's underlying in-force insurance contracts issued plus those that would be expected to be issued during the six-month notice period under Clause 1(e) of the ARPC reinsurance contract [View 3]?
d) contract boundaries determined using some other approach and, if so, what is that approach and why do you support it?

Q2 If you agree with View 3, what is your basis for supporting that view:
a) the 'same constraint applies to new and existing contracts' basis;
b) the 'exit the market for cyclone risks' basis; or
c) some other basis and, if so, what is that basis?