Australian Government
Australian Accounting Standards Board

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.

Submission date	29/05/2023
Name	Rhian Saunsbury
Title	Manager, Group Accounting Policy and Advisory
Organisation	QBE
Address	380 George Street, Sydney, NSW, 2000
Telephone	Click here to enter text.
Email address	Rhian.Saunsbury@qbe.com
Stakeholder group	Preparer
Do you wish to present to the TRG?	Yes

Potential implementation question

Contract boundary of reinsurance contracts held with the Australian Reinsurance Pool Corporation (ARPC) for eligible cyclone risks. ('Eligible cyclone risks' are those relating to an 'eligible cyclone loss' as defined in section 8C of the Terrorism and Cyclone Insurance Act 2003.)

Please see Questions on page 7.

Previously considered at the December 2022 and March 2023 AASB 17 TRG meeting and at the February 2023 Accountants' and Actuaries' Liaison Committee.

Paragraphs of IFRS 17 *Insurance Contracts*

AASB 17.34

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 eligible cyclone risks and writing more than $10 million in annual gross premium will be required to reinsure through the ARPC).

Appendix – ARPC reinsurance contracts held contract boundary

1. This issue has previously been discussed in the following forums with no consensus reached in approach:

   - December 2022 AASB 17 TRG meeting
   - February 2023 AALC meeting
   - March 2023 AASB 17 TRG meeting

2. The background on the Australian Reinsurance Pool Corporation (ARPC) cyclone pool arrangements noted at the December 2022 AASB 17 TRG meeting and key distinguishing features of the arrangement are set out in Addendum A (below).

3. In discussing the contract boundary, members noted the May 2018 meeting summary of the Transition Resource Group for IFRS 17 *Insurance Contracts* notes [paragraph 24]:[1]

   > 24. TRG members discussed the analysis in Agenda Paper 4 and observed that:
   >
   > (a) for reinsurance contracts held, cash flows are within the contract boundary if they arise from substantive rights and obligations that exist during the reporting period in which the entity is compelled to pay amounts to the reinsurer **or** in which the entity has a substantive right to receive services from the reinsurer [emphasis added] …

4. Accordingly, both the rights and obligations that exist under the ARPC cyclone reinsurance arrangements are relevant to determining the contract boundary from the perspective of the reinsured.

Three views considered

5. Three possible Views on the contract boundary of ARPC cyclone reinsurance contracts held have been considered at previous meetings assuming the underlying contracts issued typically provide 12 months' coverage.

6. Each View is based on a particular perspective of the insurer's substantive rights to receive reinsurance cover from the ARPC and the insurer's substantive obligation to cede premiums to the ARPC.

   View 1: The contract boundary is determined by reference to the right to receive reinsurance cover, which is perpetual because the ARPC stands ready to reinsure all eligible cyclone risks under existing legislation.

   View 2: The contract boundary is determined as the longer of the 18-month right to receive reinsurance cover and the obligation of the insurer to cede premium under 12-month contract boundaries of the underlying in-force insurance contracts plus any future contracts an insurer expects to issue based on the insurer's intentions/business plans and other commercial considerations. For some insurers the contract boundary could be in excess of 18 months.

7. View 3: The contract boundary is determined as the longer of the 18-month right to receive reinsurance cover and the obligation of the insurer to cede premium under 12-month contract boundaries of the underlying in-force insurance contracts plus any future contracts an insurer might need to issue based on preventive constraints. For some insurers the contract boundary

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1 IFRS 17 TRG meeting May 2018, Agenda Paper 4 *Boundary of reinsurance contracts held with repricing mechanisms*.

could be in excess of 18 months. Analysis and conclusions on the Views is presented later in the paper

View 1: perpetual contract boundary

8. **Right to receive coverage**: The ARPC is a monopoly reinsurance provider that stands ready provide mandatory reinsurance coverage for all eligible cyclone risks based on current legislation.

9. An insurer is entitled to receive reinsurance coverage from the ARPC as long as the current legislation remains in place. Ceding insurers are price takers and have no capacity to adjust the terms (pricing or benefits) of the reinsurance contract held.

10. Accordingly, an ARPC reinsurance contract held would have a contract boundary that is perpetual under AASB 17.34.

11. The cash flows associated with an ARPC reinsurance contract held would be all the expected cash flows arising from substantive rights and obligations under the contract with the ARPC into perpetuity.

12. **Obligation to cede premium**: Not relevant under View 1 because, even if the ceding insurer ceased issuing insurance contracts that cover eligible cyclone risks, it retains a perpetual right to receive reinsurance coverage under the current legislation.

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

13. **Right to receive coverage**: In terms of the right to receive reinsurance coverage:

    (a) the ARPC can cancel the reinsurance contract held with six months' notice under Clause 1(c) based on the factors under Clause 1(f) and the ceding insurer would have no rights to receive reinsurance coverage for underlying contracts issued after six months; and/or

    (b) the ARPC can reprice its reinsurance coverage with six months' notice under Clause 7(b) and the ceding insurer would have no rights to receive reinsurance coverage for the existing price after six months.

    Accordingly, based on the right to receive reinsurance coverage, the reinsurance contract held boundary would be 18 months (six-month cancellation/repricing period plus 12 months for underlying contracts issued).

14. **Obligation to cede premium**: An insurer has an obligation to cede premium to the ARPC determined by reference to an insurer's commercial expectations about issuing insurance contracts covering eligible cyclone risks for the foreseeable future.

15. The insurer's commercial expectations of how long it intends to issue the underlying contracts may be illustrated for example by market communications it makes of its intentions or through business plans and or forecasts. However, it would also be relevant to be aware of the insurer's ability to change plans previously announced.

16. Since the contract boundary is the longer of the boundary based on the obligation to cede premium and the right to receive reinsurance[2] 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 for a period based on an insurer's commercial

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2 IFRS 17 TRG meeting May 2018, Agenda Paper 4 *Boundary of reinsurance contracts held with repricing mechanisms*.

expectations over the foreseeable future on the underlying contracts issued which cover eligible cyclone risks.

17. If, for example, the insurer had created market expectations that it would continue to issue contracts that cover eligible cyclone risks for the next two years, the reinsurance contract held boundary would be two years plus 12 months, giving a coverage period of three years. In this example, since the contract boundary is the longer of the boundary based on the obligation to cede premium and the right to receive reinsurance, the reinsurance contract held boundary is three years.

View 3: determined by reference to in-force underlying issued insurance contract boundaries plus any time period required prior to exit the market

18. **Right to receive coverage**: As per View 2.

19. **Obligation to cede premium**: An insurer is obliged to cede premium for as long as it issues insurance contracts covering eligible cyclone risks. In theory, an insurer could make a decision to exit the cyclone market and immediately stop issuing such contracts. Accordingly, the contract boundary, based on the obligation to cede premiums could be as short as one day, and the coverage period 12 months and one day, based on the coverage period of existing issued contracts plus any contracts issued on the last day.

Analysis of commercial substance of views

20. Because both the rights and obligations that exist under the ARPC cyclone reinsurance arrangements are relevant to determining the contract boundary, it is necessary to consider whether the following have commercial substance:

    (a) the ARPC's ability to reprice its reinsurance coverage under Clause 7(b); and/or the ARPC's ability to end its reinsurance coverage under Clauses 1(c)(iii) and 1(f)(v) such that the ceding insurer's rights to receive coverage could end with six months' notice from the ARPC; and

    (b) the ceding insurer's ability to cease issuing contracts that cover eligible cyclone risks.

Commercial substance of ARPC's ability to end / reprice coverage

21. Clause 1(c)(iii) (cancellation with six-months' notice) in combination with Clause 1(f)(v) (the Corporation, acting reasonably, considers that termination is necessary) is regarded as having commercial substance on the basis that the Minister retains the absolute discretion to amend or end the arrangements at any time. This Ministerial discretion is available based on section 38 of the *Terrorism and Cyclone Insurance Act 2003*[3] and applies even though the Commonwealth has signalled the existing arrangements are intended to be in place for three years before there is a Ministerial review.[4] [5]

22. Clause 7(b) provides ARPC with a right to reprice its coverage each six months. In practice, the ARPC may not exercise this right for a range of reasons, including public policy reasons. However it remains an unequivocal legal right and equates to a 'practical ability' in the context

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3 Via a notifiable instrument, which does not require a legislative process.

4 Explanatory Memorandum to *Treasury Laws Amendment (Cyclone and Flood Damage Reinsurance Pool) Bill 2022*, paragraphs 1.101 to 1.103.

5 Clause 1(c)(iii) (cancellation with six-months' notice) in combination with Clauses 1(f)(i) to (iv) (the reinsured fails to comply with material obligations or commits fraud) are not regarded as having commercial substance on the basis that these factors in Clauses 1(f)(i) to (iv) are within the control of the reinsured, not the ARPC.

of AASB 17.34. The ceding insurer's substantive rights to obtain services from the ARPC at the current price therefore ends after six months.[6]

Commercial substance of ceding insurer's ability to cancel and exit the market

23. Some TRG members who indicated support for View 2 expressed concern about whether the ceding insurer's ability to cease issuing contracts that cover eligible cyclone risks is a factor with 'commercial substance'[7] when determining the contract boundary. This is because there may be commercial obstacles to ceasing to issue contracts that cover eligible cyclone risks and the ARPC reinsurance coverage is mandatory when an insurer issues underlying insurance contracts covering eligible cyclone risks.

24. In this context it is relevant to note the May 2018 meeting summary of the Transition Resource Group for IFRS 17 *Insurance Contracts* notes in respect of Agenda paper 3[8] [paragraph 20]:

> 20. TRG members also observed that an entity should apply judgement to decide whether commercial considerations are relevant when considering the requirements in paragraph 34 of IFRS 17.

25. Accordingly, under View 2, the insurer would have regard to commercial considerations when demonstrating an ability to cease issuing underlying insurance contracts covering eligible cyclone risks. The time within which an insurer has the ability to cease issuing underlying insurance contracts covering eligible cyclone risks would depend on the facts and circumstances, such as the following.

    (a) Whether ceasing to underwrite eligible cyclone risks would make the insurer's business unviable (e.g.: if a key line of business/ monoline insurer).

    (b) The entity has additional non-cancellable specific reinsurance covers in place which cover eligible cyclone risks that may indicate the entity's intentions is to continue writing eligible cyclone risks.

    (c) Whether an insurer has a strategic direction from a controlling parent entity to issue underlying insurance contracts covering eligible cyclone risks for the foreseeable future.

    (d) Whether an insurer has material deferred tax assets that depend on future expected profits from issuing future contracts that specifically cover eligible cyclone risks that would need to be reinsured with the ARPC.

    (e) Whether there is a history of making decisions to cease issuing insurance contracts for certain types or coverage in response to events – for example, various insurers ceased issuing policies that include coverage for flood risks in flood-prone postcodes following the 2011 Queensland and 2012 NSW flooding events.[9]

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6 IASB December 2018 Agenda paper 2E notes at paragraph : "A substantive right to receive services from the reinsurer ends when the reinsurer has the practical ability to reassess the risks transferred to the reinsurer and can set a price or level of benefits for the contract to fully reflect the reassessed risk or the reinsurer has a substantive right to terminate the coverage."

7 AASB 17.2 notes [emphasis added]: "… Contractual terms include all terms in a contract, explicit or implied, but an entity shall disregard terms that have no **commercial substance** (ie no discernible effect on the economics of the contract). …"

8 IFRS 17 TRG meeting May 2018, Agenda Paper 3 *Cash flows within the contract boundary*.

9 *Flood risk, insurance and emergency management in Australia*, Rachel Anne Carter, Australian Institute for Disaster Resilience.

Please note that insurers could continue to issue property and other types of insurance contracts in cyclone areas while specifically excluding eligible cyclone risks. Accordingly the above factors would be considered in that context

26. Under View 3, the insurer's ability to cease underwriting eligible cyclone risks is regarded as having commercial substance under AASB 17.34 regardless of intent.

27. The only constraints on an insurer that would be relevant to consider would be those in the nature of constraints that prevent[10] (not simply commercially hinder) an insurer from ceasing to underwrite eligible cyclone risks. Consistent with the principle in AASB 17.34, preventive constraints could be any necessary time lag between making a decision to cease underwriting eligible cyclone risks and implementation of that decision – for example, it may take time to withdraw or revise Product Disclosure Statements.

Conclusion

28. The ARPC has substantive rights to cancel the ARPC reinsurance coverage with six-month's notice and/or can reprice reinsurance coverage with six-months' notice. Although accounting measures affected by law (such as tax effect accounting[11]) are generally based on the existing enacted or substantively enacted legislation, the ARPC cyclone reinsurance arrangements are subject to Ministerial discretion with six months' notice via a notifiable instrument, which does not require a legislative process. Therefore, **a perpetual contract boundary (View 1) has no commercial substance**.

29. Based on the principle under in AASB 17.34 (and explained in AASB 17.B64) that only preventive constraints are relevant to consider when assessing the contract boundary, this paper concludes:

    (a) **View 2 is not consistent with AASB 17**; and

    (b) **View 3 is consistent with AASB 17**.

30. The contract boundary would be a minimum of 18 months determined by reference to the right to receive reinsurance coverage in the context of the ARPC's six-month's notice period of cancellation and/or repricing, plus the 12-month coverage period of the underlying contracts.

31. The contract boundary could be longer than 18 months if there are preventive constraints that would lead to a time lag of more than six months between making a decision to cease underwriting eligible cyclone risks and implementing that decision. For example, if the insurer needed 12 months to withdraw or revise Product Disclosure Statements, the contract boundary would be two years, being the 12 months to overcome the preventive constraints plus 12 months coverage for the underlying contracts)..

32. The time lag between making a decision to cease underwriting eligible cyclone risks and overcoming any preventive constraints involved in implementing that decision would be determined based on the insurer's facts and circumstances.

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10 AASB 17.B64 says (emphasis added): "… 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. …"

11 See AASB 112 *Income Taxes*, paragraphs 46 and 47.

Questions for AASB 17 TRG

Q1: Which of the following Views, if any, do you support?

View 1: The contract boundary of an ARPC cyclone reinsurance contract held is perpetual.

View 2: The contract boundary is determined as the longer of the 18-month right to receive reinsurance cover and the obligation of the insurer to cede premium under 12-month contract boundaries of the underlying in-force insurance contracts plus any future contracts an insurer expects to issue based on the insurer's intentions/business plans and other commercial considerations.

View 3: The boundary is determined as the longer of the 18-month right to receive reinsurance cover and the obligation of the insurer to cede premium under 12-month contract boundaries of the underlying in-force insurance contracts issued by a ceding insurer plus any future contracts an insurer might need to issue based on preventive constraints.

Q2: If you support View 1, do you agree that cash flows would need to be estimated into perpetuity? Alternatively, how would this approach function?

Q3: Do you have an alternative view (from either Views 1, 2 or 3)? If so, what is that view and why?

Addendum A – background on ARPC cyclone reinsurance arrangements

33. The background on the Australian Reinsurance Pool Corporation (ARPC) cyclone pool arrangements noted at the December 2022 AASB 17 TRG meeting is outlined below.

(a) Large insurers[12] must join the Australian Reinsurance Pool Corporation (ARPC) reinsurance pool for cyclones and related flood damage before 31 December 2023, and insurers can progressively transfer eligible cyclone policies up to this date.

(b) Insurers will pay the eligible reinsurance premium[13] 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.

(c) Claim recoveries under the reinsurance contract are unlimited (above the underlying policyholder's retention limit[14]) 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.

(d) The ARPC may cancel the reinsurance contract between insurer and ARPC under **Clause 1(c)** with six months' notice based on a number of factors outlined in **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, acting reasonably, considers that termination is necessary due to the repeal or amendment, or proposed amendment or repeal of the Act.

(e) 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.

34. At the December 2022 AASB 17 TRG meeting, the following key distinguishing features of ARPC Cyclone Loss Reinsurance Arrangements were noted.

- It is mandatory to have ARPC reinsurance contract held coverage for the relevant underlying insurance contracts providing cyclone coverage.
- Pricing and benefits are set by the ARPC – there is no facility for insurers to negotiate. 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:

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

13 Set by the ARPC.

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

(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.

Addendum B – relevant extracts from AASB 17 and the IFRS 17 Basis for Conclusions

35. 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
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> (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

36. 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.

> 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.

37. 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). In contrast, if a reinsurance contract held provides an entity with neither substantive rights nor substantive obligations relating to insurance contracts it expects to issue, those insurance contracts would be outside the boundary of the reinsurance contract held. The requirements for expected future cash flows in paragraphs 33−35 of IFRS 17 form a core aspect of the Standard. The Board identified no reason for these requirements to be applied inconsistently—they should be applied both to insurance contracts issued and reinsurance contracts held.