AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY
1 Martin Place (Level 12), Sydney, NSW 2000
GPO Box 9836, Sydney, NSW 2001

T 02 9210 3000 | W www.apra.gov.au

27 September 2019

TO: ALL LIFE INSURERS, GENERAL INSURERS, LEVEL 2 INSURANCE GROUPS AND PRIVATE HEALTH INSURERS

INFORMATION REQUEST AND CONSULTATION ON DIRECTIONS FOR INTEGRATION OF *AASB 17 INSURANCE CONTRACTS* INTO THE CAPITAL AND REPORTING FRAMEWORK FOR INSURERS

APRA is releasing an information request to collect information on the readiness of industry for implementing *AASB 17 Insurance Contracts (AASB 17)*. This letter also seeks feedback from stakeholders on APRA's indicative directions for integrating AASB 17 into the capital and reporting frameworks for regulated insurers and outlines a revised timeframe for APRA's approach to integrating AASB 17.

Feedback on the indicative directions outlined in this letter is invited from stakeholders. Written submissions are requested by 22 November 2019 and can be addressed to insurance.policy@apra.gov.au.

Background

The accounting treatment for insurance contracts will be revised by the introduction of AASB 17. APRA's prudential capital framework is based on the existing accounting treatment. As AASB 17 will modify a number of accounting concepts which underpin APRA's prudential framework and introduce some new concepts, APRA is considering how to integrate these changes.

In November 2018, APRA wrote to insurers outlining its approach to integrating AASB 17 into the prudential capital framework for insurers (commonly referred to as the Life and General Insurance Capital, or LAGIC, framework). At that time, APRA indicated its preference to align capital treatment with accounting standards, with departure as needed to ensure sound prudential outcomes. This remains APRA's broad approach. Importantly, APRA's approach will depart from alignment with AASB 17 where necessary to accommodate legislative requirements (particularly relevant for the *Life Insurance Act 1995).*

For the private health insurance (PHI) industry, APRA indicated its intent is to develop the future capital framework from an AASB 17 base. This remains APRA's approach and consideration of integrating AASB 17 will be taken into account through APRA's review of the PHI capital framework.

There remains uncertainty regarding the final form of the accounting standard. APRA is monitoring the International Accounting Standards Board (IASB) process, and the outcome may impact APRA's view on integration of AASB 17 into the reporting and capital framework. APRA encourages insurers to familiarise themselves with the substance of the June 2019 IASB exposure draft. Familiarity with the IASB's proposals will assist insurers in preparing to adopt the accounting standards.

Implementation readiness to mitigate risk

APRA expects insurers to be actively planning for the implementation of AASB 17, including managing the risks arising from the transition to AASB 17 and considering how the implementation and requirements of AASB 17 may impact on their capital position. APRA's engagement with industry, and the accounting and the actuarial professions has highlighted that comprehension of AASB 17 is still developing and implementation challenges are not yet thoroughly understood.

However, insurers should not defer implementation preparation until there is full certainty regarding both the accounting and prudential regulatory treatments. Rushed implementation would heighten operational risks and may increase implementation costs. To mitigate operational risk, APRA expects insurers will deepen their understanding of the standard, as well as step-up their preparations and implementation efforts for AASB 17.

To assist in understanding the status of implementation activity by industry, APRA is requesting information from all insurers on their preparedness for AASB 17. The information request is a follow-up to APRA's survey of impacts of AASB 17 which was published in May 2018. Insurers are asked to complete the information request electronically, and provide a response to APRA by 8 November 2019.

The insights from APRA's information request will be communicated to industry in early 2020, enabling insurers to benchmark their implementation progress against peers and the wider industry. The insights will also inform APRA's supervisory engagement and assist in identifying areas of focus to be pursued with insurers.

Review approach

APRA will not settle its detailed approach to regulatory capital and reporting until there is more certainty in the international accounting framework. An option was for APRA to delay consultation on its approach to integrating AASB 17 into its prudential capital framework until the international standard is finalised. However, stakeholders have called for clarity on aspects of prudential treatment and APRA reporting requirements to assist in determining their own implementation approach. Therefore, APRA proposes to provide progressive updates regarding its indicative approach to integration of AASB 17 – commencing with this letter.

APRA will continue to carefully consider the impact of AASB 17, given the extent of complexities, to ensure integration will support sound prudential outcomes. Consistent with it's mandate to ensure sound prudential outcomes APRA will:

- consider balance sheet implications, to ensure that the capital base continues to be robust; and
- will also look to ensure that it has ongoing access to granular information to monitor the emergence of profit over time, given this can be an early indicator of emerging risks and future capital strength.

There are also complex matters where considerable work over a longer timeframe is needed to inform the policy direction, including exploring the measurement of policy liabilities for participating life insurance business and the treatment of risk adjustment for determining regulatory capital. APRA is working closely with stakeholders to consider these matters. Progressive updates are expected to provide transparency on APRA's indicative directions, while allowing for adequate consideration of complex matters that require longer timeframes, in order to facilitate insurers own implementation projects and provide opportunities for stakeholder feedback to inform APRA's proposals.

Indicative directions for feedback

This letter sets out APRA's indicative directions, and seeks feedback from stakeholders, on a number of matters relating to reporting to APRA (**Attachment A**) as well as the determination of regulatory capital (**Attachment B**). These attachments set out matters which will be relevant for all insurers, as well as industry specific matters. The below section explains APRA's directions on the level of granularity for regulatory reporting, as well as the timing for integration into APRA's prudential and reporting frameworks.

Granularity for regulatory reporting

The requirement of AASB 17 for insurers to distinguish groups of contracts expected to be profit making and those expected to be loss making (onerous) will ensure timely recognition of losses and support prudent outcomes.

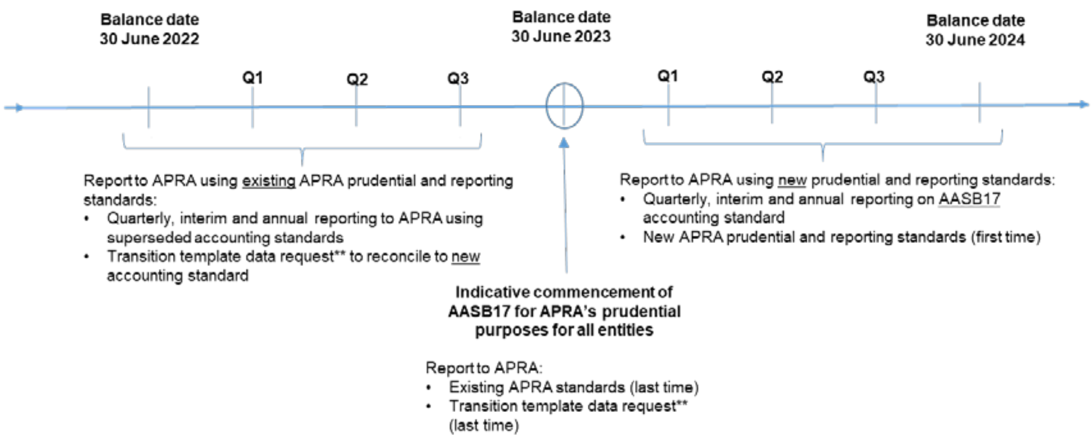
For prudential reporting, APRA's indicative direction is that groupings used to distinguish onerous contracts under AASB 17 must not extend across APRA reporting groups. Futher, APRA is considering enhancing the granularity of its reporting groups to address concerns that existing APRA reporting groups do not provide detailed insights on products.

APRA recognises this indicative direction requires more detailed reporting by insurers than would otherwise be required by AASB 17, particularly in the life insurance industry. APRA considers the additional burden of its approach is outweighed by the benefits of improved performance information for management of insurance risk and prudential oversight.

Timing for integration into APRA's prudential frameworks

At this stage, APRA's intention is for all insurers, regardless of their financial year end, to commence reporting to APRA (for quarterly and annual reports) and determining regulatory capital requirements from an AASB 17 base from 1 July 2023. The transition approach is shown in Figure 1. The indicative implementation date reflects the likelihood that, for the majority of insurers, data submitted to APRA in this timeframe is likely to be more stable and robust.

Figure 1: Transition to AASB 17 for prudential purposes



** Transition template data request likely to include capital, insurance liabilities and other items (e.g. sources of profit). The specific collection is yet to be determined.

APRA recognises the indicative 1 July 2023 commencement for prudential purposes will necessitate insurers maintaining dual accounting systems for a period after the adoption of AASB 17 for financial reporting. The indicative commencement timing reflects the need for quantitative impacts to inform final calibration of APRA's capital framework. It also reflects APRA's view that the additional implementation burden on insurers is outweighed by the benefit of robust and consistent data to inform prudential supervision.

Where an insurer adopts AASB 17 prior to APRA's indicative commencement date of 1 July 2023, insurers must continue to determine regulatory capital and submit regulatory reports under the existing prudential and reporting standards. APRA anticipates it will collect transition data from insurers to understand the impacts on commencement and enable consideration of requests for approval of transition arrangements. APRA will engage with insurers on details for these arrangements at an appropriate time.

The timeframes outlined above have been developed reflecting the IASB's proposed mandatory effective date for the new standard for annual reporting periods commencing on or after 1 January 2022. APRA will continue to monitor international developments and overall implementation timing for AASB 17 to assess whether amendments to its timeframes or indicative directions are necessary.

Stakeholder feedback on the indicative directions outlined in this letter and **Attachments A and B** will inform APRA's overall approach and the development of its positions in more detail. APRA will subsequently release a discussion paper to further consult on proposals, and seek stakeholder feedback through progressive updates, before consulting on the full package of draft prudential standards and reporting requirements. Revised indicative timeframes are set out at **Attachment C**.

APRA also welcomes feedback from insurers on their approach to other matters regarding AASB 17 implementation. Please contact Ann Dobinson (ann.dobinson@apra.gov.au or 02 9210 3468) or Peter Kohlhagen (peter.kohlhagen@apra.gov.au or 02 2910 3363) if you wish to discuss any matters raised in this letter.

Yours sincerely,

Geoff Summerhayes
Executive Board Member

Attachment A: APRA's indicative directions on reporting performance and valuation information to APRA on a AASB 17-basis[1]

Indicative directions relevant for all insurers

Implementation of AASB 17 will change the basis for reporting to APRA on insurers' financial performance and the valuation of insurance contract assets and liabilities. Reflecting APRA's overall ambition to align with the accounting standard, unless departure is justified on prudential grounds, a range of APRA reporting requirements will be revised to accommodate AASB 17 requirements. Where departures from the accounting standard are considered necessary, APRA will request reporting information on a prudential basis, and may also request that insurers report complementary information as presented in its financial reporting. To monitor reconciliation between the information reported to APRA and the insurers' financial reporting, APRA is likely to request that insurers provide a reconciliation between reporting on a prudential basis and financial reporting. This is intended to support informed discussion between APRA and the insurer.

In line with APRA's announced data transformation program, updates to reporting requirements are expected to be progressed under the new Data Collection Solution. As a result, APRA expects changes to the way that data is collected, such as shifting to structured data sets rather than tabular forms. Insurers can review APRA's published implementation plan to assist them in preparing for the commencement of the new Data Collection Solution.

a) Approaches for measuring insurance contract assets and liabilities

AASB 17 provides several accounting options to measure insurance contract assets and liabilities. These are:

- the General Measurement Model or Building Block Approach (BBA), which the standard establishes as the base accounting model for measuring insurance contracts;
- the Variable Fee Approach (VFA), which applies to insurance contracts that have direct participation features; and
- the Premium Allocation Approach (PAA), which allows a simplified measurement of insurance contracts where certain criteria are met.

To accommodate regulatory reporting by insurers regardless of the accounting option, APRA intends to revise its reporting requirements to support all accounting approaches for measuring insurance contract assets and liabilities.

b) Flow on impact of contract boundary determination

AASB 17 adopts a definition of contract boundary that in some instances could result in differences between the accounting determination of the end date and that written in an insurance contract.

APRA is aware that stakeholders have raised with the IASB concerns in relation to the timing for accounting allocation of acquisition costs and the mismatch in treatment of reinsurance contracts in relation to the underlying insurance contract. In addition, concerns have been raised with the IASB in relation to the attribution of profit to services relating to investment activities. Amendments for these matters have been proposed by the IASB in its June 2019 exposure draft and are subject to IASB's consideration following the consultation. As such,

[1] In this letter, the term 'reporting to APRA' refers to reporting of financial performance information to APRA.

APRA will await the outcome of the IASB's deliberations prior to reviewing its approach to regulatory reporting of acquisition costs and reinsurance contracts.

c) Product groupings

APRA intends to retain requirements for reporting to APRA on product grouping for life insurers (LI) and by class of business for general insurers[2] (GI). APRA is also considering enhancing the granularity of its reporting groups to obtain more detailed insights on products. APRA's consideration of reporting groups will look to address concerns that information reported to APRA at existing granularity constrains the effectiveness of monitoring sustainability and performance of certain products. APRA will consult industry on its considerations regarding revised granularity for reporting groups in due course.

For prudential reporting APRA's indicative direction is that groupings used to distinguish onerous contracts under AASB 17 must not extend across APRA reporting groups. In APRA's view, this approach will enable greater understanding of the sources of profit and sustainability of an insurer's business and is consistent with APRA's mandate to ensure sound prudential outcomes. Furthermore, monitoring onerousness within APRA's reporting groups (including any enhanced granularity of those groups required by APRA) is expected to provide an early indicator of emerging risks, which APRA considers would assist insurers in identifying business practices likely to detract from prudent outcomes, including issues in product design and insurance risk management. APRA also views more granular reporting information as desirable to support stronger prudential oversight.

APRA recognises that the indicative direction to groupings for APRA reporting purposes noted above may impose an additional burden for insurers. However, implementation of AASB 17 provides a one-off opportunity to substantially improve the foundations for future reporting and analysis while insurers are making revisions to their systems and reporting approaches. APRA considers that the additional burden of more granular reporting is outweighed by the benefits of improved performance information to support management of insurance risk by the insurer, as well as enhanced prudential oversight. APRA is therefore inclined to improve the granularity of product performance information in conjunction with its integration of AASB 17. This view also recognises that enhancing reporting granularity discretely from a change in accounting standards is likely to impose a more considerable burden on insurers.

d) Other indicative directions for reporting to APRA

Issue	Indicative approach for reporting to APRA
Discount rates	Accept insurer's determination as required by AASB 17, with information on the determination of discount rates expected to be provided in the Actuarial Valuation Report.
Illiquidity premium	Accept insurer's determination as required by AASB 17, with information on the determination of illiquidity premium expected to be provided in the Actuarial Valuation Report.

[2] Throughout this letter, references to 'reporting groups' refers to both product grouping for life insurers and class of business for general insurers.

Life insurer-specific directions

e) Product groupings

Further to APRA's general approach to product groupings, for life insurers APRA will maintain its existing requirement that product groups not extend over subcategories, where a subcategory is defined in the *Life Insurance Act 1995* (the Life Act). This also means that groupings used to distinguish onerous contracts under AASB 17 must not extend across subcategories for reporting to APRA. These requirements are being retained by APRA to adhere with requirements of the Life Act.[3]

Insurers would apply the Life Act requirements first when determining product groups followed by APRA product group requirements. As such, insurers would be required to unbundle and separately value a contract that contains both investment-linked and non-investment-linked benefit options because those benefits would be provided from different statutory funds.

f) Participating and non-participating benefits

APRA is inclined to maintain a mechanism for life companies to request a declaration from APRA that a contract is non-participating to allow the treatment under the Life Act and the treatment under AASB 17 to be aligned.

[3] The Life Act specifies that life companies must keep records for each statutory fund, each class within a fund, each category within a class and each subcategory within a category

Attachment B: APRA's indicative directions for determining regulatory capital on an AASB 17-basis

Matters relevant for all insurers

APRA considers that the LAGIC framework's coverage of risk types, capital definitions and requirements – broadly its overall structure – remains appropriate. APRA is not intending to systematically alter minimum capital requirements as it determines its approach to integrating AASB 17 into the LAGIC framework.

In considering its approach to AASB 17 and through the review of the private health insurance capital framework, APRA will look for opportunities to improve the alignment of capital approaches between industries. APRA's approach may result in some adjustments to capital requirements. APRA will consider whether transitional arrangements are necessary as it considers its approach to alignment between industries.

a) Contract boundary – potential mismatch of insurance and reinsurance boundaries

APRA recognises the accounting treatment required under AASB 17 may result in a mismatch in the timing for recognising an underlying insurance contract and related reinsurance arrangements. For the determination of regulatory capital, APRA's broad preference will be to seek to align contract boundaries to avoid the emergence of such mismatches and possible volatility in economic capital.

The IASB is currently consulting on a number of proposals which are expected to affect the extent of potential mismatches related to reinsurance contracts under the standard. Reflecting uncertainty while this is subject to active consultation, APRA proposes to await the outcome of the IASB's deliberations prior to considering its treatment of contract boundary for the determination of regulatory capital.

b) Calibration of capital charges

APRA will review whether recalibration of the risk charges in the LAGIC framework is necessary to address any unintended consequences from the integration of AASB 17.

APRA's indicative direction reflects the view that a number of adjustments related to the integration of AASB 17 may impact the determination of the capital base and the calculation of the prudential capital requirement. APRA will engage with insurers on the quantitative impacts arising from the implementation of AASB 17 to inform its view on calibration of the risk charges and the overall LAGIC framework.

c) Discount rates

APRA's indicative direction is to continue to require insurers to apply specified risk-free discount rates for determining regulatory capital. In APRA's view it remains appropriate to value liabilities based on these rates, which reflect returns that can be earned from readily realisable assets and have no credit risk, to achieve prudent capital outcomes.

For Australian denominated policy liabilities, APRA's intention is to retain the yields on Commonwealth Government Securities as the risk-free rate used for determining insurers' capital base and prescribed capital amount.

For foreign denominated policy liabilities, APRA is inclined to retain the requirement for insurers to use a risk-free rate based on the yields of highly liquid sovereign risk securities in the currency of the policy liabilities and with counterparty grade 1.

APRA further anticipates it will require insurers to make adjustments to remove any allowances for credit risk or illiquidity that are implicit in the yields applied for determining regulatory capital, and that information on the determination of discount rates be provided to APRA.

d) Acquisition costs

APRA's intention is to require insurers to make adjustments to exclude deferred acquisition costs when determining the capital base. While the IASB is currently consulting on a proposed amendment regarding the timing for the allocation of acquisition costs, APRA expects its indicative direction would not be affected by the outcomes of the IASB's current consultation. APRA's indicative approach represents a continuation of APRA's existing treatment of deferred acquisition costs in relation to life insurers and general insurers to ensure sound prudential outcomes are achieved. For private health insurers, APRA intends to consult on the capital treatment of deferred acquisition costs as part of its review of the capital framework for private health insurers.

e) Reinsurance default risk

APRA is inclined to continue to apply the current prudential default risk charge to reinsurance recoveries. This would ensure a consistent capital treatment across insurers for the risk of reinsurance default.

However, APRA notes that under AASB 17 insurers will be required to incorporate default risk of the reinsurer in the measurement of fulfilment cash flows (FCF) for the group of reinsurance contracts held. APRA recognises that this may give rise to some double counting for default risk, although generally expects the extent of this would be minimal under normal circumstances. APRA is willing to consider an adjustment to the default risk charge for reinsurance to reduce the potential for double counting. APRA's consideration of such an adjustment would depend on confirmation from insurers that the allowance for default risk used to determine the FCF can be quantified and reported to APRA.

f) Treatment of the contractual service margin (CSM)

APRA is currently engaging with the Actuaries Institute's AASB 17 Task Force to identify all issues and develop potential options for prudent treatment of the CSM in the determination of regulatory capital. Further work is needed to inform APRA's position and APRA will engage with industry as it develops its approach.

Life insurer-specific directions

g) Illiquidity premium

APRA's indicative direction is to continue to allow life insurers to apply an illiquidity premium for certain illiquid liabilities, using a rate as specified by APRA in *Prudential Standard LPS 112 Capital Adequacy: Measurement of Capital.* In APRA's view, allowing an illiquidity premium for certain liabilities where cash flows are sufficiently certain in timing and quantum remains appropriate for prudential purposes.

Reflecting that inputs for determining the existing illiquidity premium are no longer published by the Reserve Bank of Australia (RBA), APRA anticipates it will use the opportunity of integrating AASB 17 to review the specification of the illiquidity premium in the prudential standard.

h) Contract-related expenses

APRA intends to further consider the treatment of contract-related expenses (such as overheads) for determining the Adjusted Policy Liabilities. This approach will look to ensure that policy liabilities are prudently valued in determining regulatory capital.

i) Risk adjustment

APRA is currently engaging with the Actuaries Institute's AASB 17 Task Force to identify all issues and develop potential options for prudent treatment of risk adjustment in the determination of regulatory capital. These are complex matters and considerable work is needed to inform APRA's position. APRA intends to continue to engage with industry as its approach on these matters develops.

General insurer-specific directions

j) Risk adjustment and APRA risk margin

APRA is inclined to retain an approach to the risk margin that provides a capital outcome broadly consistent with that under the existing LAGIC framework. APRA is working closely with stakeholders, including the Actuaries Institute's AASB 17 Task Force, to consider potential options for how this can be achieved.

APRA also intends to consider the interaction of the risk adjustment for non-financial risk required under AASB 17 with the APRA risk margin to facilitate increased alignment of the capital treatment with accounting standards.

Private health insurer-specific directions

k) Contract boundary

APRA anticipates that the contract boundary for PHI contracts will generally be one year.

Attachment C: Revised indicative timeline for the integration of AASB 17 (Updated from the 16 November 2018 letter)