TE TAI ŌHANGA
THE TREASURY

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Dear Warren

Invitation to Comment: ED PBE IFRS 17 Insurance Contracts

The New Zealand Treasury welcomes the opportunity to provide comments to the External Reporting Board on ED PBE IFRS 17 Insurance Contracts.

We have attached our responses to the specified matters for comment.

Yours sincerely

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Application of the Development Principle

In considering the application of the development principle in the *XRB's Policy approach to the suite of PBE Standards* to accounting for insurance in the public sector it would have been helpful to have had a clearer understanding of the Board's thinking than is outlined in paragraph 8 of the ITC.

In summary, the development principle requires the IPSASB to consider whether the potential development:

- will lead to higher quality reporting by public sector PBEs
- will induce benefits outweighing the costs, considering relevance both to the public sector as a whole and not-for-profit or public sector sub-sectors, coherence of the suite of standards, and the impact on mixed groups; and
- will align with the IPSASB's likely response to the change.

A proper consideration as to whether ED PBE IFRS 17 will lead to higher quality reporting, relevance and coherence requires a consideration of insurance in the public sector. That consideration should lead to the formation of a view about whether and how that differs from insurance in the private sector, and whether such differences are relevant to the measurement, recognition and presentation of the rights and obligations arising from public sector insurance arrangements.

In the absence of a discussion on this in the ITC, the Treasury has performed its own assessment of public sector insurance below that we have used to inform our responses to the ED.

Development of Public Sector Insurance

Insurance as defined in the standard is important for living standards. It:

- contributes to risk reduction (as insurance providers incentivise the implementation of safe practices, and foster more efficient capital allocation if insurance issuers play a watchdog role in monitoring policyholders to reduce risk-increasing behaviour).
- spreads risks from individuals to larger pools or communities, (thereby promoting stability by protecting those who suffer harm and stabilising their financial situation)
- provides an important source of long-term finance, as insurance funds that are required to buffer adverse events are invested.
- enables innovation and economic activity as individuals can invest and create wealth knowing they can limit their losses; many products and services will only be produced and sold if adequate insurance is available to cover claims.

The modern insurance contract dates from the Scottish Ministers Widows' Fund[1], whereby individual premiums go into an insurance pool to be invested, the profits of which would be used to pay claims arising. The logic of such schemes derive from the great uncertainty of an individual claim-event occurring, but the remarkable precision by which the law of averages will predict the cost of such events in a large population. This logic relies on risks being random or idiosyncratic. However, some risks (e.g. earthquake risks) are not idiosyncratic but are shared. If the risk crystallises, large numbers of policyholders will make claims. A challenge for private sector insurers when ensuring such events is to ensure solvency, and there have been many insurance fund contracts that have not been able to survive major events.

One of the greatest protections against insolvency is to increase the size of the insured population. That creates more statistical or actuarial certainty about claims and more resilience to shocks. The ultimate economy of scale is to require all parties facing a risk to be covered, and so social insurance has developed where risks are covered for, and costs are funded by, the whole population, through the use of sovereign power.

Public sector insurance has therefore developed to complement private sector insurance where it is not possible or desirable for profit-oriented private sector insurance schemes to provide adequate coverage. Public sector insurance differs from private sector insurance because it can exercise sovereign powers to make the insurance compulsory, and it's advantage in not suffering from financial insolvency problems. Public sector insurance remains however exposed to liquidity risk, and the political economy challenge of keeping their financing model (social insurance premiums/levies) and operating model (risk protection) in equilibrium.

Related to the above, a challenge impacting private sector insurance schemes is the problem of adverse selection. Adverse selection is a term used that describes a situation where market participation is affected by asymmetric information. It leads for example to those taking high-risks to be more likely to purchase insurance. In these cases, it is the buyer who actually has more knowledge (e.g. about their health). To fight adverse selection, insurance companies reduce exposure to large claims by limiting coverage or raising premiums, based on information provided by their predictive risk models (e.g. refusing medical insurance for those with pre-existing conditions). However, if premiums rise too much, individuals that are low risk are more likely to opt out of the scheme. This unravelling, or death spiral, is typical of extreme adverse selection environments.

The public sector approach to the adverse selection challenge is the opposite of the private sector. Rather than reducing coverage, the public sector maintains and expands the base of policyholders by exerting its sovereign power to require policyholders to participate in the scheme.

Outside of purely commercial insurance operations best managed through profit-oriented entities therefore, there are two main reasons for public sector insurance; to increase resilience to common or related risks, and to combat adverse selection in a way not possible by markets.

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[1] Refer *The Ascent of Money,* Niall Fergusson, 2008

For these public policy reasons, public sector insurance will aim for universalist or near universalist[2] insurance to obtain wellbeing benefits not available from insurance markets. Public sector insurance must therefore be in the nature of a collective social contract. The critical public policy decisions around that social contract are likely to be over the:

- Boundaries for the risks covered and the marginal impact of proposed extensions or limitations of the scheme;
- Proportional equivalence between benefits and costs, that the policy for funding the scheme does not create inequities between the population covered by the insurance scheme and the population funding the insurance scheme;
- Collective legitimacy arrangements for making choices– e.g. public participation in changes to premium/levy setting or covered events;
- Monitoring to ensure the parameters of the social contract are not breached, where financial reporting plays a key role;
- Graduated sanctions for failure to act in accordance with the social contract both by 'insurance issuers' and 'policyholders';
- Fast and fair conflict resolution procedures;
- Appropriate relations with the tiers of rule-making authority e.g. between the governing board of the reporting entity managing the social contract, and the Ministers managing the rules of the social contract.

Much if not all public policy advice and public policy decision-making on public sector insurance will be directed at those issues.

Impact on Financial Reporting and the Insurance Accounting Standard

Resource providers (i.e. levy /premium payers) and service recipients (i.e. insurance claimants) need information about the performance, liquidity, sustainability, and adaptability[3] of public sector insurance schemes, so they can assess the public policy decisions described above.

That information need is similar to private sector schemes. Essentially financial statements will be most relevant if they report on the performance, liquidity, sustainability, and adaptability of:

- the portfolio of individual insurance contracts for the private sector
- the social contract scheme in the public sector

However, there is a crucial difference. As described above, public sector insurance is a collective social contract. But it is the concept of an individual insurance contract that is central to IFRS 17. It is portfolios of individual contracts in the private sector and the set of cash flows they generates for which IFRS provides guidance. IFRS 17 is required because the insurance contract combines features of both a financial

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[2] For example, ACC covers all accidents, EQC covers all insured properties, governments that provide deposit protection insurance covers all banks

[3] Refer paragraph 2.11 of the PBE Conceptual Framework.

instrument and a service contract, and the challenge of accounting for future cash flows when there can be substantial variability over a long period. This essential building block for IFRS 17 is missing from collective social insurance arrangements, and accounting requirements for the public sector need to allow for that to be applicable and useful.

The Treasury acknowledges that IFRS 17 is the most comprehensive and most legitimate publication on which to base insurance accounting requirements. For example the essential principles of measuring and recognising the claims liability and the movements in that lability can largely be applied. However, public sector insurance does nor comprise a set of individual contracts that can be grouped, but rather represents a single collective social contract that can be broken down into sets of funding rights and insurance service obligations. These may be integrated in a collective public sector insurance scheme, but decisions on these rights and obligations can and will be made independently of each other. Such separate decision-making is not contemplated by IFRS 17.

Therefore the Treasury is cautious every time it sees the words "insurance contract" in the Exposure Draft. Ideally, we would like to see those words replaced as appropriate with suitable notion that is relevant and applicable to public sector collective insurance arrangements.

The Treasury considers that proper due process requires a full consideration of this issue to test the relevance of each of the requirements in IFRS 17, and a willingness to make adaptations if it is to lead to high quality public sector reporting.

Do you agree with the proposed scope modification in the ED to capture schemes that are eligible to apply the insurance approach under the IPSASB's forthcoming IPSAS dealing with social benefits? If you disagree, please explain why.

The Treasury agrees with the intent, as we understand it, of the proposed scope modification. However, we believe the wording of the scope modification needs further consideration.

Currently the modified scope inclusion refers to "fully funded from contributions and levies" and evidence that the scheme manages the scheme in the same way as an issuer of insurance contracts". The application guidance states that contributions can include government contributions on behalf of those who could not afford to make contributions.

The first challenge is the meaning of fully funded. the Treasury observes that PAYGO (pay-as-you-go) and SAYGO (save-as-you-go) schemes both fully fund claims that are made. It is possible that fully PAYGO schemes may be managed in a similar way as insurance contracts, as the government did with ACC prior to 1999, but we doubt the NZASB meant to include these schemes. Even with SAYGO schemes there can be different arrangements to 'fully fund" the scheme. For example contribution and levy settings may deliberately be set to fully fund the best estimate of the obligation, with the risk adjustment guaranteed by the government. In the Treasury's view, such schemes

should be within the standard, although a narrow reading of the current proposal would exclude them.

Finally government contributions may not necessarily only be made for those that cannot afford it. Many of the tourists that benefit from the ACC scheme could surely afford an appropriately set levy. Does this mean that ACC should be accounted as insurance only if such a levy was raised on tourists?

The Treasury considers the essence of the scope issue arises from the disjunction between an individual insurance contract and a collective social contract. A scoping change is needed that applies to collective social insurance arrangements

An individual insurance contract establishes a direct relationship between issuer and policyholder. It provides the base for determining all the cash flows that arise, and is therefore the foundation stone that IFRS 17 uses to determine, profitability and financial position.

A collective social contract requires considerations of economic efficiency and fairness in the relationship between those from whom funds are sourced to enable the insurance scheme and those to whom money is applied by way of insurance claims. For such a collective social insurance arrangement, separate decisions will be made on:

- The level of funds to be sourced,
- The method of collecting funds,
- The allocation of funds sourced to the claims of policyholder groups,
- The creation of a separate fund,
- The level at which that fund is to be maintained, and
- The fund's resilience to risks that can deplete it.

Not only will the above decisions be made separately, they will be constantly modified as policy evolves. It would be most unhelpful if the accounting treatments and grouping of scheme obligations changed as government made marginal funding changes.

If it is intended that those decisions are intended to be integrated and sustainable, then it is likely that information generated by insurance accounting on the operating deficit or surplus of the scheme and its financial position is likely to be useful. If not, then such information will be of little relevance.

The Treasury therefore recommends the NZASB re-scope the standard to reflect the inclusion of collective social insurance arrangements that are intended to be integrated and sustainable.

Are there any schemes that the proposed scope modification would capture, for which the requirements of proposed PBE IFRS 17 are not appropriate? If so, please identify those schemes and explain why the requirements of PBE IFRS 17 are not appropriate.

The Treasury is not aware of any schemes that the proposed scope modification would capture, for which the requirements of proposed PBE IFRS 17 are not appropriate.

Do you agree that no PBE-specific modifications are needed to the requirements of IFRS 17 in respect of the risk adjustment? If you disagree, please explain why.

The Treasury finds the concept of the risk adjustment difficult. The definition set out in paragraph 63 of the Invitation to Comment that is meant to explain the concept, and the two definitions in paragraph 64 that are meant to explain what the concept of the risk adjustment is not, appear to the Treasury to overlap.

Secondly, as noted in our assessment of the development principle and our response to question 1, in the public sector there is not an individual insurance contract that generates cash flows, either fixed or variable. The liability is not dependent on a contract that generates premiums. The obligation is rather largely dependent on separate decisions that are made about the boundary of the scheme and the events that have occurred.

The Treasury therefore does not consider a risk adjustment **can** be applied in the manner envisaged by the proposed standard for collective social insurance schemes, referring as it does to "fixed cash flows with the same expected present value as the insurance contracts". Some modification is necessary.

Turning to the question as to whether a risk adjustment **should** be applied for public sector collective insurance arrangements, we suggest the public sector is largely indifferent to the extent of variability of the arrangement. In evidence we proffer:

- The different funding policy rates that currently apply, and the government's demonstrated willingness to make changes to those funding rates
- The ability to make future adjustments to levy/contribution rates to provide compensation for fulfilling the liability

The Treasury thinks that risk adjustments, properly understood, could provide useful information in informing and assessing decisions on the resilience of any fund, but we do not think that provides a rationale changing the reporting of the liability from the best estimate.

Are the provisions regarding the contract boundary clear enough for PBEs that are funded through levies rather than through premiums? If not, please explain how these provisions could be improved.

The Treasury understands that the Premium Allocation Approach (PAA) is intended only to apply to short term insurance contracts, and has therefore limited this approach to cases where the coverage period of each contract in the group, including coverage arising from all premiums within the contract boundary determined at one year or less.

As noted in our response to question 1 and our assessment of the development principle, the Treasury considers that the important boundary is that established by the collective insurance scheme rather than an individual insurance contract. While insurance premiums/levies are usually collected annually, coverage of benefits is not time limited but is provided on an ongoing basis that can be subject to regular review.

The Treasury recommends the NZASB consider and provide guidance on the frequency and depth of review that would be required to make the PAA methodology appropriate

Are you aware of any PBEs within the scope of the ED:

(a) that are funded by levies (or some means other than by way of premiums) but which would not be eligible to apply the premium allocation approach; and

(b) for which the requirements of the general model would not be appropriate?

If you are aware of such PBEs, please explain why the requirements of the general model would not be appropriate.

Often the terms "levies" and "premiums" can be used interchangeably. There appears to be no definition of levies in the proposed standard and the ITC.

However in the context of this question, the Treasury defines levies as having two essential characteristics:

- A levy is determined by the exercise of sovereign power; there is therefore a compulsory obligation to pay the levy if specified conditions are met
- The payment of a levy does not by itself create a set of rights for the payer. Rather the set of rights may legally exist independently of the payment as part of a social contract.

Using that definition EQC premiums would not qualify as a levy – as the payment is required for an EQC claim to be eligible, but ACC levies would qualify as a levy.

The Treasury is not aware of any reason why that difference would lead to a different view about the applicability of the PAA methodology.

Do you agree that no PBE-specific modifications are needed to the requirements of IFRS 17 in respect of:

(a) the requirements to divide portfolios of insurance contracts into more granular groups of contracts and assess onerous contracts at that granular level; and

(b) the discount rate?

If you disagree, please explain why.

More granular groups of contracts

As noted in our assessment of the development principle above, the Treasury considers a significant public policy purpose of public sector insurance schemes is to counteract the adverse selection that can occur when insurance issuers make use of granular information about the risk profiles of their portfolio, to increase their profitability.

A profit-oriented issuer of insurance contracts insurer is likely to make use of granular information to improve profitability and investors in the insurer should have information about how that reporting entity goes about doing that. It is hard to see the same relevance for a public sector insurance scheme that is expressly set up to counter-act the effects of adverse selection, and which deliberately pursues a more universalist approach.

Our discussions with ACC and EQC suggest that neither external users nor management particularly value such granular information nor do they currently systematically collect it. Put simply, their business models render the information largely irrelevant.

The Treasury considers that if the NZASB intends to require these entities to divide their portfolios into more granular groups, then it needs to supply a rationale that is relevant to the public sector. In the absence of such a rational, a PBE-specific modification is needed.

The Treasury also questions the division of contracts into onerous or non-onerous groups. As our response to question 2 hopefully made clear, the Treasury does not think that a collective insurance scheme that is designed to be onerous should qualify within the scope of the standard. Only sustainable schemes should be within scope. That requires arrangements for the future sources of funds to cover the arrangements for future applications of funds.

As we have noted before, for public sector collective insurance schemes there are no sets of individual contracts to be assessed as onerous. Rather there will be different risk expectations of sectors of the insured population. Is it the intention of the NZASB that ACC should divide its covered population into a more accident-prone sector and a less-accident prone sector, and to account for those sectors differently? The Treasury is unconvinced of the benefits of such an exercise.

The Treasury can see value in dividing or segmenting the information on a scheme's position and performance, where the scheme design is that flows from a subsets of contributors are to be allocated for a segmented purpose, as for example occurs with the motor vehicle account and other accounts of the ACC scheme.

The Treasury is not aware of any PBE specific reasons to modify the requirements of IFRS 17 in respect of the discount rate.

The discount rate (Illiquidity adjustment)

The Treasury notes that the standard requires the discount rate to be consistent with observable current market prices (if any) for financial instruments with cash flows whose characteristics are consistent with those of the insurance contracts, in terms of, for example, timing, currency and liquidity.

We understand this means that entities need to look at the liquidity nature of any liability arising in an insurance contract, as well as the timing and currency of the liability before embarking on an exercise to determine an appropriate discount rate. We do not see the relevance of the requirement to determine the illiquidity of the liability in the public sector for collective social insurance entitlements, and therefore, we doubt the relevance of an illiquidity premium adjustment to the discount rate assumption.

The Treasury notes the proposed standard refers to illiquid insurance contracts where the cash flows of insurance contracts do not vary, based on the returns of the assets in the reference portfolio. We understand in practice this issue is raised particularly in relation to life insurance contract and contracts that have notably long term fixed annuities. Those liabilities are considered not to be liquid (the fixed annuity cash flows do not vary based on returns on an asset portfolio), either for the insurer or the policyholder. Life insurance companies also sell contracts that include both protection (e.g. term life), and savings/investment services. Some universal life insurance products, can be viewed as primarily protection with a savings element.

We understand under the proposals in the ED, if the entity determines that the insurance contract liability is illiquid, the theory is a liquid government bond market rate includes, in its discount rate, an effective market rate for the liquidity of those securities. So, a true risk free rate for an illiquid liability would be expected to be slightly higher than the government bond rate observed in the market.

The Treasury requests the NZASB to consider this concept of illiquid liabilities in the public sector context we have described and provide guidance. Should we assume that because the entitlement under the public sector insurance scheme is set in legislation and does not vary in relation to the underlying assets, the liability is "illiquid" and that an illiquidity premium adjustment should be made to the discount rate assumption? If this is the case, should the concept of an illiquidity adjustment apply to all government's liabilities (based on present value calculations) where the entitlement is not link to variable asset return, not just insurance liabilities?

The Treasury is also aware that there is international debate over which insurance contracts are "illiquid". For example, the Australian regulator, APRA, for regulatory solvency purposes proposed an illiquidity premium be added to the risk-free discount rate for the purpose of calculating the liabilities for immediate life annuities, term certain annuities, fixed term/rate products and funeral bonds. For all other life insurance products and for general insurance no illiquidity premium is permitted.

The Treasury is also aware that determining an illiquidity premium is very challenging and virtually impossible to observe directly and isolate in investment markets. We understand that is why the IASB provided two ways to determine the illiquidity premium in the proposals, the top-down approach and the bottom-up approach.

For the top-down approach, a reference portfolio is necessary. For the bottom-up approach, an illiquidity premium has to be derived, which may also require a reference portfolio. Creating such a reference portfolio, to isolate the illiquidity premium will be very difficult in New Zealand, particularly where there is already limited observable reference points in bond markets to determine the discount rate before any illiquidity adjustment.

The Treasury considers there will be significant additional effort and cost associated with developing models and assumptions to derive an illiquidity adjustment and doubt the benefit of imposing this additional cost.

If you are of the view that the requirements regarding onerous contract contained in PBE IFRS 17 are not appropriate for schemes where funding is determined on a different basis to how the insurance liability is measured, please explain why, and what alternative approach the NZASB should consider for such schemes.

For the reasons described above, the Treasury considers that that the requirements regarding onerous contracts contained in PBE IFRS 17 are not appropriate for collective social contract insurance schemes where funding is determined on a separate basis to how the insurance liability is measured.

If the overall scheme itself is onerous, then the issue that seems to arise is whether insurance accounting and the going concern assumption is appropriate. The Treasury recommends that the NZASB should consider and provide guidance on this issue.

At an individual policyholder or policyholder group level however separate treatment of onerous and non-onerous portfolios is not appropriate, and the Treasury recommends such requirements are taken out of the proposed standard.

Are there any other requirements in the proposed PBE IFRS 17 that may require modification for PBEs? If, there are, please explain the requirement, the reason why the requirement needs to be modified for application by PBEs and how the requirement should be modified.

The Treasury has not completed an intensive review of the proposed standard, but rather has focussed on the issues raised in the invitation to comment. We are concerned however that the centrality of the individual insurance contract transaction to

IFRS 17 may mean that there are other matters that need to be considered for modification in the context of public sector insurance schemes where the statutory arrangements set out a collective social contract.

In our response to the last question below we suggest a possible approach to this issue.

Do you agree that there should be no RDR concessions in PBE IFRS 17 for Tier 2 PBEs? If you disagree, please explain why and identify the disclosures that should be identified as RDR concessions. It would also be helpful if you could include a description of any PBEs that are within the scope of the proposed PBE IFRS 17 and qualify for reporting in accordance with Tier 2 PBE Standards.

The Treasury agrees that there should be no RDR concessions in PBE IFRS 17 for Tier 2 PBEs

Do you agree with the proposed effective date of 1 January 2022, with early adoption permitted as long as an entity also applies PBE IPSAS 41 Financial Instruments at the same time? If you disagree, please explain why.

As will be clear from the above, the Treasury considers that there is significant work still required to prepare an insurance standard applicable to the public sector, that will

- lead to higher quality reporting by public sector PBEs
- induce benefits outweighing the costs, considering relevance both to the public sector as a whole and not-for-profit or public sector sub-sectors, coherence of the suite of standards, and the impact on mixed groups; and
- align with the IPSASB's likely response to the change.

We are doubtful that that work will be able to be completed by the NZASB in time to enable an orderly transition to the new standard with the proposed effective date of 1 January 2022

Do you have any other comments on the ED?

The Treasury observes that our comments on the standard in this submission relate particularly to the public sector. They do not apply to mutuals that are insurance issuers, and which will be regulated by the Reserve Bank of New Zealand, where there is an understandable need for comparable information with profit-oriented issuers.

The Treasury therefore suggests the proposed standard continue along the intended timeline for the not-for-profit sector, but take the opportunity to consider the public sector insurance standard separately, in particular the issues raised in our submission.