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Introduction

1. We have received a submission about the level at which the risk adjustment for non-financial risk should be determined for insurance contracts that are within industry pools managed by an association.

2. The objective of the paper is to provide background and an accounting analysis to support discussion at the Transition Resource Group for IFRS 17 *Insurance Contracts* (TRG).

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Structure of the paper

3. This paper includes the following:
   (a) background information;
   (b) implementation question; and
   (c) review of accounting requirements.

4. There are two appendices to this paper:
   (a) Appendix A—Extract: summary of the TRG meeting held on 2 May 2018 on determining the risk adjustment for non-financial risk in a group of entities; and
   (b) Appendix B—Examples of industry pools described in the submission.

Background information

5. Paragraph 2 of IFRS 17 states:

> An entity shall consider its substantive rights and obligations, whether they arise from a contract, law or regulation, when applying IFRS 17. A contract is an agreement between two or more parties that creates enforceable rights and obligations. Enforceability of the rights and obligations in a contract is a matter of law. Contracts can be written, oral or implied by an entity's customary business practices. 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). Implied terms in a contract include those imposed by law or regulation. The practices and processes for establishing contracts with customers vary across legal jurisdictions, industries and entities. In addition, they may vary within an entity (for example, they may depend on the class of customer or the nature of the promised goods or services).

6. Paragraph 37 of IFRS 17 states:

> An entity shall adjust the estimate of the present value of the future cash flows to reflect the compensation that the entity requires for bearing the uncertainty about the amount and timing of the cash flows that arises from non-financial risk.

7. Appendix A of IFRS 17 defines an insurance contract as:

> A contract under which one party (the issuer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder.

8. Appendix A of IFRS 17 defines the risk adjustment for non-financial risk as:

> The compensation an entity requires for bearing the uncertainty about the amount and timing of the cash flows that arises from non-financial risk as the entity fulfils insurance contracts.

9. Paragraph B87 of IFRS 17 states:

> […] the risk adjustment for non-financial risk conveys information to users of financial statements about the amount charged by the entity for the uncertainty arising from non-financial risk about the amount and timing of cash flows.

10. Paragraph B88 of IFRS 17 states:

> Because the risk adjustment for non-financial risk reflects the compensation the entity would require for bearing non-financial risk arising from the uncertain amount and timing of the cash flows it also reflects:
>
> (a) the degree of diversification benefit the entity includes when determining the compensation it requires for bearing that risk; […]

11. In May 2018 TRG members discussed a related topic in Agenda Paper 2 *Determining the risk adjustment for non-financial risk in a group of entities*. An

extract from the summary of the May 2018 TRG meeting is included in Appendix A to this paper.

Implementation question

12. In the submission, all entities issuing automobile insurance contracts in a specific jurisdiction are required by law to be a member of an association. The purpose of the association is to ensure that insurance coverage is provided to policyholders that cannot get that insurance in the voluntary market. The association manages two types of industry pools:

    (a) Pool 1—in which some members are appointed to issue contracts on behalf of all of the members; and

    (b) Pool 2—to which members can choose to transfer some insurance contracts they have issued.

13. The results of each industry pool are allocated to all the members of the association based on a specific sharing formula (generally based on market share). The submission notes that applying existing practice each member accounts for their share in the pool in their own financial statements as direct business. The full fact pattern described in the submission is included in Appendix B to this paper.

14. For insurance contracts that are within either of the two industry pools described, the submission asks whether the risk adjustment for non-financial risk should be determined at either:

    (a) the association level; or

    (b) the individual member entity level.

15. The submission also asks whether the risk adjustment for non-financial risk could be measured differently in the financial statements of the members when compared to the financial statements of the association.

Review of accounting requirements

Accounting by members for a share in the results of an industry pool

16. IFRS 17 applies to insurance contracts within its scope. IFRS 17 defines an insurance contract as:

    > A contract under which one party (the issuer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder.

17. In some cases, the parties to the contract are clear from the legal form of the contract. In other cases, the terms of the contract require analysis to identify the substance of the rights and obligations—including who is the issuer of the contract. For example, for insurance contracts in an industry pool the issuer could be:

    (a) the individual member entity that writes the contracts;

    (b) each member entity for its respective share of each contract in the pool; or

    (c) the collective of all member entities.

18. The staff observe that if the individual member entity that writes the contract is the issuer, that entity shall account for the contract applying IFRS 17. IFRS 17 applies to insurance contracts issued by an entity and does not have specific requirements when an insurance contract is issued by more than one entity. Entities should assess whether the arrangement under which an insurance contract is issued by more than one entity would be considered a joint arrangement in the scope of IFRS 11 *Joint Arrangements*. If the arrangement is within the scope of IFRS 11, entities are required to determine, applying the requirements of IFRS 11, whether the arrangement would meet the definition of a joint venture or a joint operation. Applying IFRS 11:

(a) if the arrangement meets the definition of a joint venture, each party that is a joint venturer is required by paragraph 24 of IFRS 11 to account for its interest using the equity method in accordance with IAS 28 *Investments in Associates and Joint Ventures.*[1]

(b) if the arrangement meets the definition of a joint operation, each party that is a joint operator is required by paragraph 20 of IFRS 11 to recognise in relation to its interest in the joint operation:

(i) its assets, including its share of any assets held jointly;

(ii) its liabilities, including its share of any liabilities incurred jointly;

(iii) its revenue from the sale of its share of the output arising from the joint operation;

(iv) its share of the revenue from the sale of the output by the joint operation; and

(v) its expenses, including its share of any expenses incurred jointly.

19. The staff observe that an arrangement under which an insurance contract is issued by more than one entity may not meet the definition of joint control as required by paragraph 7 of IFRS 11 and therefore would not be within the scope of IFRS 11.

20. Applying IAS *8 Accounting Policies, Changes in Accounting Estimates and Errors*, in the absence of an IFRS Standard that specifically applies to a transaction, other event or condition, management shall use its judgement in developing and applying an accounting policy that results in information that is relevant to the economic decision-making needs of users and reliable. An entity first refers to and considers the applicability of other IFRS Standards dealing with similar and related issues. Arrangements under which a contract is issued by more than one entity may share similar characteristics to joint arrangements as

[1] Applying paragraph 18 of IAS 28, an entity that is a venture capital organisation, or a mutual fund, unit trust and similar entities including investment-linked insurance funds may elect to measure an investment in a joint venture at fair value through profit or loss in accordance with IFRS 9 *Financial Instruments*.

described in IFRS 11 and therefore it may be appropriate to consider the requirements in IFRS 11 in applying paragraph 11 of IAS 8.

21. In the absence of an IFRS Standard that specifically applies to a transaction, other event or condition or that deals with similar and related issues, an entity should consider the principles in the *Conceptual Framework for Financial Reporting*. Applying the *Conceptual Framework*, an entity is required to reflect the substance of its contractual rights and contractual obligations. The staff observe that this may result in an approach similar to that used applying existing practice as noted in the submission.

22. In some cases, an individual member entity may write the contract and then subsequently transfer the contract to the industry pool. If that member entity is the issuer of the contract applying IFRS 17, the entity should consider whether the transfer:

    (a) is a contract that meets the definition of a reinsurance contract applying IFRS 17; or

    (b) extinguishes the individual member's obligations to the policyholder applying paragraph 74 of IFRS 17.

23. The staff observe that the analysis of whether either (a) or (b) in paragraph 22 of this paper applies and the resulting accounting may differ depending on whether the party that is receiving the contract in the transfer is:

    (a) each member entity for its respective share of each contract in the pool; or

    (b) the collective of all member entities.

At which level should the risk adjustment for non-financial risk be determined?

24. IFRS 17 is applied by an entity that is the issuer of insurance contracts as defined in Appendix A of IFRS 17. The issuer of the contract is the party that recognises

revenue from the contract, a component of which is the amounts related to the risk adjustment for non-financial risk. Therefore:

(a) if the contracts are issued by the individual member entity that writes the contracts, revenue is recognised by that member entity applying IFRS 17, and that member entity determines the risk adjustment for non-financial risk. This may be the case when an individual member entity is identified as the issuer of a contract and then subsequently transfers the contract to an industry pool (see paragraphs 22–23 of this paper).

(b) if the contracts are considered to be issued by more than one entity (ie issued by each member for its respective share or issued by the collective of all members as noted in paragraphs 17(b)–(c) of this paper) revenue is also shared. Therefore, the staff view is that the risk adjustment for non-financial risk is determined by all member entities together. This would apply to an entity's share in the results of an industry pool (see paragraphs 18–21 of this paper).

25. Applying paragraph B88 of IFRS 17, when determining the risk adjustment for non-financial risk, the entity (ie the issuer) is required to consider the degree of diversification benefit that it includes when determining the compensation it requires for bearing non-financial risk.

26. The submission asks if the risk adjustment for non-financial risk can be measured differently at different reporting levels for the same contracts. The staff view is that IFRS 17 requires that for one group of insurance contracts there is one risk adjustment for non-financial risk which reflects the degree of risk diversification that the issuer of the contract considers in determining the compensation required for bearing the non-financial risk. The staff note that some TRG members interpret the requirements in IFRS 17 differently (see Appendix A to this paper).

TRG Discussion

Question to TRG members

What are your views on the implementation question presented above?

Appendix A—Extract: summary of the TRG meeting held on 2 May 2018 on determining the risk adjustment for non-financial risk in a group of entities

Determining the risk adjustment for non-financial risk in a group of entities (Agenda Paper 2)

A1. Agenda Paper 2 addresses a submission about the level at which the risk adjustment for non-financial risk is required to be determined.

A2. The first question is whether, in the individual financial statements of the subsidiary, the risk adjustment for non-financial risk for groups of insurance contracts issued by the subsidiary should reflect the degree of risk diversification available only to the consolidated group as a whole.

A3. The second question is whether, in the consolidated financial statements of the group of entities, the risk adjustment for non-financial risk for groups of insurance contracts issued by entities in the group should reflect the degree of risk diversification that is available only to the consolidated group as a whole.

A4. TRG members discussed the analysis in Agenda Paper 2 and observed that:

(a) IFRS 17 does not specify the level at which to determine the risk adjustment for non-financial risk.

(b) in the individual financial statements of the issuing entity, the degree of risk diversification that occurs at a level higher than the issuing entity level is required to be considered in the determination of the risk adjustment for non-financial risk if, and only if, it is considered when determining the compensation the issuing entity would require for bearing non-financial risk related to insurance contracts it issues. Equally, risk diversification that occurs at a level higher than the issuing entity level must not be considered when determining the risk adjustment for non-financial risk if it is not considered when determining the compensation, the issuing entity would require for bearing non-financial risk related to insurance contracts it issues.

A5. Some TRG members agreed with the staff analysis that only the issuing entity that is party to the contract determines the compensation the entity would require for bearing non-financial risk related to insurance contracts that the entity issues. Therefore, for a group of insurance contracts issued by an entity that is party to the contracts, there is one risk adjustment for non-financial risk. This means that for a group of insurance contracts the risk adjustment for non-financial risk at the consolidated group level is the same as the risk adjustment for non-financial risk at the individual issuing entity level.

A6. The analysis in paragraph A5 of this paper precludes different measurement of the risk adjustment for non-financial risk for a group of insurance contracts at different reporting levels. Some TRG members commented that they could read the requirements in IFRS 17 differently. Those TRG members read the requirements as requiring different measurement of the risk adjustment for non-financial risk for a group of insurance contracts at different reporting levels if the issuing entity would require different compensation for bearing non-financial risk than the consolidated group would require. TRG members observed that:

(a) if the risk adjustment for non-financial risk is determined differently at different reporting levels in the group structure there could be multiple risk adjustments for non-financial risk for the same group of insurance contracts, depending on the reporting level;

(b) applying the requirements in IFRS 17 as analysed by the staff in paragraph A5 of this paper would be more practical to implement; and

(c) a group of entities must apply the requirements consistently across all groups of insurance contracts.

A7. TRG members also observed that in some cases the compensation that an entity requires for bearing non-financial risk could be evidenced by capital allocation in a group of entities.

Appendix B—Examples of industry pools described in the submission

B1. The submission describes two industry pools in a specific jurisdiction. In that specific jurisdiction, all entities issuing automobile insurance contracts are required by law to be a member of an association. The purpose of the association is to ensure that insurance coverage is provided to policyholders that cannot get that insurance in the voluntary market. The association manages two types of industry pools:

(a) Pool 1—in which some members are appointed to issue contracts on behalf of all of the members; and

(b) Pool 2—to which members can choose to transfer some insurance contracts they have issued.

B2. The operations of the association are determined by articles that are enforceable by law.

B3. The association, itself, is not an entity that issues insurance contracts.

B4. For both industry pools managed by the association:

(a) all members share in the results of the industry pool based on specific sharing formulae (generally based on market share); and

(b) if a member is unable to meet their obligations to the industry pool, the remaining members are required to fulfil those obligations.

Pool 1—in which some members are appointed to issue contracts on behalf of all of the members

B5. The association contracts with some members to write insurance contracts under their own name on behalf of the association as a whole. The association determines the rates that are charged to policyholders. In determining those rates, the association aims to achieve a specified return on equity that is set by the Board of Directors of the association. The member that writes the contract is responsible for managing the contract including any associated claims until all claims are

resolved. The member passes the premiums to the pool and claims paid by the member are reimbursed by the pool as they occur. The member also receives an administration fee for their services.

B6. Existing practice:

(a) the association establishes an insurance contract liability and provides information to the members.

(b) the member entities treat the insurance service result allocated to them as direct business (ie as if they had issued that portion of business themselves). Each member reports an insurance contract liability, premiums, claims and expenses incurred.

(c) the member that writes the contracts on behalf of the association reflects the direct expenses incurred in providing services to the association and the revenue received from the association for providing those services (administration fee).

B7. The staff observe that the facts and circumstances presented in the submission are indicative that insurance contracts in this industry pool are issued by all members together. Therefore, the risk adjustment for non-financial risk is determined from the perspective of all members together. Practically, in this case, an association may determine the risk adjustment for non-financial risk on behalf of all members.

B8. The staff observe that members should consider the analysis provided in paragraphs 18–21 of this paper to determine how to reflect their share in the results of the industry pool in their financial statements.

Pool 2—to which members can choose to transfer some insurance contracts they have issued

B9. Insurance contracts are issued by each individual member and the prices are determined by the individual member. If a contract is eligible (ie it meets specified requirements set by the association), the member can choose to transfer the contract to an industry pool. In some cases, the transferring member may be

required to retain a percentage of the insurance risk of the contract or there may be restrictions on the level of coverage that is allowed to be transferred to the industry pool for the contract.

B10. If a member chooses to transfer the contract to the industry pool, the transferring member remains responsible for managing the contract including any associated claims until all claims are resolved. The member transfers the premiums to the pool (minus an expense allowance) and claims paid by the transferring member are reimbursed by the pool as they occur.

B11. Existing practice:

(a) the transferring member treats the transferred insurance contracts as negative direct business.

(b) the member entities treat the insurance service result allocated to them as direct business. Each member reports an insurance contract liability, premiums, claims and expenses incurred.

B12. Staff observations:

(a) the facts and circumstances presented in the submission are indicative that the member that writes the contract is the issuer of the contract to the policyholder. Accordingly, that member shall account for the insurance contract it issues applying IFRS 17 and determine the risk adjustment for non-financial risk related to that contract.

(b) the facts and circumstances presented in the submission are also indicative that the transfer of the contracts to the risk sharing pool might meet the definition of a reinsurance contract between the issuing member and all other members applying IFRS 17. Accordingly, the issuing entity should account for the reinsurance contract held applying IFRS 17.

(c) the facts and circumstances presented in the submission are indicative that all members have issued together reinsurance contracts for each contract that has been transferred to the industry pool. Therefore, the

risk adjustment for non-financial risk related to these reinsurance contracts is determined from the perspective of all members together. Practically, in this case, an association may determine the risk adjustment for non-financial risk on behalf of all members.

(d) the staff observe that members should consider the analysis provided in paragraphs 22–23 of this paper to determine how to reflect their share in the results of the industry pool in their financial statements.