

STAFF PAPER

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Project	Transition Resource Group for IFRS 17 <i>Insurance Contracts</i>		
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This paper has been prepared for discussion at a public meeting of the Transition Resource Group for IFRS 17 *Insurance Contracts* and does not represent the views of any individual member of the International Accounting Standards Board or staff. Comments on the application of IFRS[®] Standards do not purport to set out acceptable or unacceptable application of IFRS Standards.

Introduction

1. We have received a submission about when a set or series of insurance contracts should be combined and treated as a whole, applying paragraph 9 of IFRS 17 *Insurance Contracts*.
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 (TRG).

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 6 February 2018 with respect to Agenda Paper 1; and
 - (b) Appendix B—Scenario and factors described in the submission.

Background information

5. Paragraph 2 of IFRS 17 states:

A contract is an agreement between two or more parties that creates enforceable rights and obligations.
6. Paragraph 9 of IFRS 17 states:

A set or series of insurance contracts with the same or a related counterparty may achieve, or be designed to achieve, an overall commercial effect. In order to report the substance of such contracts, it may be necessary to treat the set or series of contracts as a whole. For example, if the rights or obligations in one contract do nothing other than entirely negate the rights or obligations in another contract entered into at the same time with the same counterparty, the combined effect is that no rights or obligations exist.
7. Paragraph 9 of IFRS 17 is consistent with the *Conceptual Framework for Financial Reporting*, published in March 2018.

8. Paragraph 4.51 of the *Conceptual Framework* provides examples of circumstances where treating a group of rights and obligations as a single unit of account may provide more relevant information. These examples include circumstances where those rights and obligations:

- (i) cannot (or are unlikely to) be the subject of separate transactions;
- (ii) cannot (or are unlikely to) expire in different patterns;
- (iii) have similar economic characteristics and risks and hence are likely to have similar implications for the prospects for future net cash inflows to the entity or net cash outflows from the entity; or
- (iv) are used together in the business activities conducted by an entity to produce cash flows and are measured by reference to estimates of their interdependent future cash flows.

9. Paragraph 4.59 of the *Conceptual Framework* states:

The terms of a contract create rights and obligations for an entity that is a party to that contract. To represent those rights and obligations faithfully, financial statements report their substance. In some cases, the substance of the rights and obligations is clear from the legal form of the contract. In other cases, the terms of the contract or a group or series of contracts requires analysis to identify the substance of the rights and obligations.

10. Paragraph 4.62 of the *Conceptual Framework* states:

A group or series of contracts may achieve or be designed to achieve an overall commercial effect. To report the substance of such contracts, it may be necessary to treat rights and obligations arising from that group or series as a single unit of account. For example, if the rights or obligations in one contract merely nullify all the rights or obligations in another contract entered into at the same time with the same counterparty, the combined effect is that the two contracts create no rights or obligations. Conversely, if a single contract creates two or more sets of rights and obligations that could have been created through two or more separate

contracts, an entity may need to account for each set as if it arose from separate contracts in order to faithfully represent the rights and obligations (...).

11. In February 2018 the TRG discussed a related topic in Agenda Paper 1 *Separation of insurance components of a single insurance contract*. An extract from the meeting summary detailing the outcome of that discussion is included in Appendix A to this paper.

Implementation question

12. The submission asks when it may be necessary to treat a set or series of insurance contracts as a whole applying paragraph 9 of IFRS 17.
13. The submission considers that the following factors could indicate that a set or series of insurance contracts are in substance a single contract:
 - (a) the contracts are priced as a single risk;
 - (b) the lapse of one contract changes the rights and obligations of the other contract(s); and
 - (c) measuring the contracts separately would result in one/some of the contract(s) being onerous whereas when measured as a whole the contract is profitable.
14. The submission observes that different views could be reached based on whether each of these factors is considered determinative in applying the requirements of paragraph 9 of IFRS 17, and that the existence of these different views may result in diversity in practice. In a single scenario presented in the submission (see Appendix B to this paper), the submission describes one view that two contracts should be combined and another view that they should not be combined. The difference depends on which factors shown above are considered most indicative of the substance of the contracts.

Review of accounting requirements

15. When developing paragraph 9 of IFRS 17 with respect to combining separate insurance contracts into a single insurance contract, the Board intended to provide a principle on contract combination that is consistent with the principle set out in the *Conceptual Framework*.¹ The purpose of this paper is to discuss the circumstances in which multiple insurance contracts should be combined and treated as a single contract.
16. It is expected that entities would usually design contracts in a way that reflects their substance. Therefore, a contract with the legal form of a single contract would generally be considered on its own to be a single contract in substance.
17. Paragraph 9 of IFRS 17 acknowledges that there may be circumstances where a set or series of insurance contracts with the same or a related counterparty reflect a single contract in substance. This is when the contracts may achieve, or be designed to achieve, an overall commercial effect.
18. The staff view is that the fact that a set or series of insurance contracts with the same counterparty are entered into at the same time is not, in itself, sufficient to conclude that they achieve, or are designed to achieve, an overall commercial effect. Determining whether it is necessary to treat a set or series of insurance contracts as a single contract involves significant judgement and careful consideration of all relevant facts and circumstances.
19. Below are some considerations that might be relevant in the assessment of whether a set or series of insurance contracts achieve, or are designed to achieve, an overall commercial effect:
 - (a) the rights and obligations are different when looked at together compared to when look at individually (for example, the rights and

¹ When developing IFRS 17, the Board considered consistency with the principle set out in the 2015 Exposure Draft of the *Conceptual Framework for Financial Reporting* that contracts should be combined as necessary to report their substance. The *Conceptual Framework* was published in March 2018 and this principle has remained the same.

obligations of one contract negate the rights and obligations of another contract)

- (b) the entity is unable to measure one contract without considering the other. This may be the case where there is interdependency between the different risks covered in each contract and the contracts lapse together. When cash flows are interdependent, separating them can be arbitrary. This principle is reflected in the requirements of separating investment components, derivatives and other non-insurance services in paragraphs 10–13 and B31–B35 of IFRS 17 and explained in paragraph BC114 of the Basis for Conclusions on IFRS 17.

- 20. The staff observe that while no single factor is determinative in applying this assessment, when the lapse or maturity of one contract causes the lapse or maturity of another contract, there is a strong indication that the contracts were designed to achieve an overall commercial effect.
- 21. Conversely, the staff observe that the existence of a discount, in itself, does not mean that a set or series of contracts achieve an overall commercial effect. The staff observe that a discount exists when there is a price that the entity generally charges for an insurance policy and the entity offers the policyholder a price that is lower than that amount. An entity may offer the policyholder a discount if they purchase more than one insurance coverage (ie enter into more than one contract). The overall commercial effect of such contracts looked at in combination may not be any different to the commercial effect when looked at separately if the discount is allocated appropriately to each of the contracts.
- 22. IFRS 17 does not prescribe how to appropriately allocate a discount given between multiple contracts. The staff observe that it may be helpful to consider paragraph BC112 of the Basis for Conclusions on IFRS 17 relating to the allocation of discounts between separate components of a contract. It states:

Applying IFRS 15, any discounts and cross-subsidies are allocated to components proportionately or on the basis of observable evidence. In the Board's view, this approach ensures that the allocation of cross-

subsidies and discounts/supplements reflects the economics of the separated components.

23. The analysis in this paper is consistent with the observations of the TRG on the separation of insurance components of a single contract at the February 2018 meeting of the TRG.
24. The scenario and factors considered in the submission are included in Appendix B 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 for IFRS 17 meeting held on 6 February 2018 with respect to Agenda Paper 1

Separation of insurance components of a single insurance contract (Agenda Paper 1)

A.1 Sometimes entities combine different types of coverage that have different risks into one legal insurance contract. Similarly, reinsurance contracts held can provide coverage to underlying contracts that are included in different groups of insurance contracts. Agenda Paper 1 addresses two submissions received about whether:

- (a) IFRS 17 permits the separation of insurance components of a single insurance contract for measurement purposes.
- (b) when applying IFRS 17, a reinsurance contract held should be separated into components for measurement purposes to reflect the underlying contracts covered. For example, whether a reinsurance contract held that provides coverage to underlying contracts that are included in different groups of insurance contracts should be separated.

A.2 TRG members discussed the analysis in Agenda Paper 1 and observed that:

- (a) the lowest unit of account that is used in IFRS 17 is the contract that includes all insurance components.
- (b) entities would usually design contracts in a way that reflects their substance. Therefore a contract with the legal form of a single contract would generally be considered a single contract in substance. However:
 - (i) there might be circumstances where the legal form of a single contract would not reflect the substance of its contractual rights and obligations.
 - (ii) overriding the contract unit of account presumption by separating insurance components of a single insurance contract involves significant judgement and careful consideration of all relevant facts and circumstances. It is not an accounting policy choice.

- (c) combining different types of products or coverages that have different risks into one legal insurance contract is not, in itself, sufficient to conclude that the legal form of the contract does not reflect the substance of its contractual rights and obligations. Similarly, the availability of information to separate cash flows for different risks is not, in itself, sufficient to conclude that the contract does not reflect the substance of its contractual rights and obligations.
- (d) the fact that a reinsurance contract held provides cover for underlying contracts that are included in different groups is not, in itself, sufficient to conclude that accounting for the reinsurance contract held as a single contract does not reflect the substance of its contractual rights and obligations.

A.3 TRG members also observed that:

- (a) considerations that might be relevant in the assessment of whether the legal form of a single contract reflects the substance of its contractual rights and contractual obligations include:
 - (i) interdependency between the different risks covered;
 - (ii) whether components lapse together; and
 - (iii) whether components can be priced and sold separately.
- (b) an example of when it may be appropriate to override the presumption that a single legal contract is the lowest unit of account is when more than one type of insurance cover is included in one legal contract solely for the administrative convenience of the policyholder and the price is simply the aggregate of the standalone prices for the different insurance covers provided.
- (c) Appendix A to Agenda Paper 1 provides specified fact pattern of a contract containing a long term life coverage with annual renewable health riders. At each annual renewal date the entity can reassess the risks and can set a price that fully reflects these risks with respect to the

renewable health riders, but cannot reprice or cancel the life coverage of the contract. The following factors indicate its substance as a single contract:

- (i) the renewable health riders are not sold separately;
- (ii) if the life coverage is cancelled by the policyholder, the renewable riders are cancelled at the same time; and
- (iii) the renewable riders are rarely cancelled and most of them remain until the end of the coverage period of the life contract.

Therefore, in relation to the example in Appendix A to Agenda Paper 1:

- (i) the contract is included in its entirety in a single portfolio and in a single group and is not split to reflect the ways its components would be allocated to portfolios and groups as if there were issued as separate contracts.
- (ii) the cash flows within the boundary of the contract would be assessed for the contract in its entirety. The assessment of when a substantive obligation to provide the policyholder with services ends will be performed for the contract in its entirety. Therefore, in this example, cash flows related to the premiums within the contract boundaries include cash flows related to the renewable health riders beyond the annual re-pricing date.
- (iii) the contract would be evaluated against the criteria for applying the premium allocation approach in its entirety.

Appendix B—Scenario and factors described in the submission

Scenario and factors described in the submission

- B.1 Scenario: a homeowner’s policy and a motor policy are sold together with a discount. The policies are entered into at the same time and sold by the insurer to the same policyholder. The following factors were described:
- (a) in pricing the contracts the insurer takes into account the risks associated with policyholder’s location and their interaction, such as the likelihood of both the home and the vehicle being damaged (fire, flood, burglary), as well as other risks specific only to home or motor policies.
 - (b) in determining the price, the insurer also takes into account the recovery of its acquisition costs (including direct commissions) associated with signing up the same customer for two products, as opposed to issuing those products to two different customers. Additionally, the same policyholder applying for only one of the products would not get the same level of discount as it applied when purchasing two. If the contracts are considered separately, then due to the level of discount given, one of the contracts may be onerous, however, the combination of contracts overall would not be onerous if viewed together.
 - (c) in some cases, the policies may lapse independently of one another, without affecting the terms of the remaining contract. In other cases, the policies cannot be lapsed independently, so that by cancelling one policy, the other one also lapses at the same time.

B.2 Submission view: the submission expresses some views that two contracts should be combined and other views that they should not be combined depending on which factors shown above are considered most indicative of the substance of the contracts.

Factors considered by staff

B.3 Determining whether it is necessary to treat a set or series of insurance contracts as a single contract involves significant judgement and careful consideration of all relevant facts and circumstances. Below are some factors considered by the staff based on the fact pattern provided.

B.4 **Considering B.1(a)** – interdependency between the different risks covered by a set or series of contracts could be indicative that the contracts are designed to achieve an overall commercial effect. There is an interdependency between risks if different risks are dependent on each other; for example, when one offsets or reduces the other. An example of risks that are interdependent is mortality risk and longevity risk. Conversely, two separate contracts being subject to the same common risk may not reflect an interdependency between risks.

B.5 **Considering B.1(b)** – in this example, the two policies are sold separately and a discount is offered if the policyholder buys both. The staff view is that the existence of a discount, in itself, does not mean that a set or series of contracts achieves an overall commercial effect. The staff observe that IFRS 17 does not prescribe how to appropriately allocate a discount given between multiple contracts.

B.6 **Considering B.1(c)** – when the lapse or maturity of one contract causes the lapse or maturity of another contract, the staff view is that this strongly indicates that these contracts achieve an overall commercial effect and should be treated as a single contract.