IFRS

STAFF PAPER

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Project	Transition Resource Group for IFRS 17 *Insurance Contracts*		
Paper topic	Determining the risk adjustment for non-financial risk in a group of entities		

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Introduction

1. We have received a submission about the level at which the risk adjustment for non-financial risk is determined:

   (a) in the individual financial statements of entities that are part of a consolidated group (ie parent and subsidiary entities that issue insurance contracts); and

   (b) in the consolidated financial statements of the group of entities.

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).

Structure of the paper

3. This paper includes the following:
   (a) background information;
   (b) implementation question; and
   (c) review of accounting requirements.
4. Appendix A—Example provided in the submission.

Background information

5. On determining the risk adjustment for non-financial risk, 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.

6. In Appendix A of IFRS 17 the risk adjustment for non-financial risk is defined 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.

7. 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.

8. 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, the risk adjustment for non-financial risk also reflects:
>
> (a) the degree of diversification benefit the entity includes when determining the compensation it requires for bearing that risk; […]

9. Paragraph BC211(c) of the Basis for Conclusions on IFRS 17 explains that the International Accounting Standards Board (Board) decided the requirements for a separate risk adjustment for non-financial risk:

> will faithfully represent circumstances in which the entity has charged insufficient premiums for bearing the risk that the claims might ultimately exceed expected premiums.

10. Paragraph BC213(b) of the Basis for Conclusions on IFRS 17 explains:

> the objective of the risk adjustment for non-financial risk is to reflect the entity's perception of the economic burden of its non-financial risks. Specifying a level of aggregation for determining the risk adjustment for non-financial risk that was inconsistent with the entity's view of the burden of non-financial risk would contradict the objective of reflecting the entity's perception in the risk adjustment for non-financial risk.

Implementation question

11. The submission asks at which level the risk adjustment for non-financial risk is required to be determined:

    (a) in the individual financial statements of entities that are part of a consolidated group (ie parent and subsidiary entities that issue insurance contracts); and

    (b) in the consolidated financial statements of the group of entities.

12. In the fact pattern considered (see Appendix A to this paper), at the individual entity level the risk adjustment for non-financial risk reflects the compensation the

entity requires for the groups of insurance contracts it issues and it does not reflect the degree of risk diversification that is available at the group of entities level.

13. 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. The submission expresses three views:

    (a) View A—The risk adjustment for non-financial risk for contracts issued by the subsidiary can be determined considering the degree of risk diversification available at the group of entities level. This is because IFRS 17 discusses the compensation the entity **would** require and not the compensation the entity actually charges [emphasis added].

    (b) View B—The risk adjustment for non-financial risk is determined considering the issuing entity's perception, which does not reflect the degree risk diversification that is not available to the entity.

    (c) View C—Both approaches are acceptable. Judgement should be applied.

14. 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. The submission expresses three views:

    (a) View A—In the consolidated financial statements, the risk adjustment for non-financial risk can be determined considering the degree of risk diversification available only at the group of entities level. This is consistent with the view that the reporting entity is the group.

(b) View B—The risk adjustment for non-financial risk is determined considering the issuing entity's perception, which does not reflect the degree of risk diversification that is not available to the entity.

(c) View C—Both approaches are acceptable. Judgement should be applied.

Review of accounting requirements

15. The risk adjustment for non-financial risk reflects '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', as stated in the definition of the risk adjustment for non-financial risk in Appendix A of IFRS 17. The objective of the risk adjustment for non-financial risk is to reflect the entity's perception of the economic burden of its non-financial risks, as explained in paragraph BC213(b) of the Basis for Conclusions on IFRS 17. IFRS 17 does not specify the level of aggregation at which to determine the risk adjustment for non-financial risk, to do so would contradict with the objective.

16. Paragraph B88 of IFRS 17 says 'the compensation the entity **would require** for bearing the non-financial risk' [emphasis added]. The entity does not charge the policyholder an explicit separate amount for bearing non-financial risk. Rather, this is implicit within the overall actual amount charged by the entity. Therefore, the risk adjustment for non-financial risk represents the compensation that the entity would require if it was to charge the policyholder an explicit separate amount for bearing non-financial risk.

17. An entity may choose or be required, for reasons unconnected with bearing that non-financial risk, to charge a premium which does not result in a full recovery of the risk-adjusted cash flows. This could be for legal, commercial or regulatory reasons. Such pricing decisions are reflected in the loss component and consequently in profit or loss. The faithful representation of circumstances in

which the entity has charged insufficient premiums for bearing the risk that the claims might ultimately exceed expected premiums was considered by the Board when it decided that a separate risk adjustment was required, as explained in paragraph BC211(c) of the Basis for Conclusions on IFRS 17.

18. The staff view is that the term 'would require' should not be interpreted in a manner that is inconsistent with the objective of the risk adjustment for non-financial risk. Therefore, 'the compensation the entity would require' does not extend to consider the theoretical amount that would have been required if the entity had considered different compensation for bearing non-financial risk.

Individual financial statements of an entity that is part of a consolidated group

19. Applying paragraph B88 of IFRS 17, an entity shall only reflect diversification benefit in the risk adjustment for non-financial risk to the extent that the diversification benefit has been included when determining the compensation the entity would require for bearing non-financial risk. Therefore, the degree of risk diversification that occurs at a level that is higher than the 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 entity would require for bearing non-financial risk related to insurance contracts issued by the entity. Equally, risk diversification that occurs at a level that is higher than the entity level must not be considered in the determination of the risk adjustment for non-financial risk if it is not considered when determining the compensation the entity would require for bearing non-financial risk related to insurance contracts issued by the entity.

Consolidated financial statements of the group of entities

20. The submission also asks whether the risk adjustment for non-financial risk for a group of insurance contracts presented in the consolidated financial statements of

the group should reflect the degree of risk diversification available only to the consolidated group as a whole (see paragraph 14 of this paper). In other words, the submission asks whether the risk adjustment for non-financial risk can be smaller at a consolidated group level when compared to the risk adjustment for non-financial risk at the individual entity level to reflect the diversification benefit of the group of entities.

21. Determining the compensation that the entity would require for bearing non-financial risk related to insurance contracts issued by the entity is a single decision that is made by the entity that is party to the contract (ie the issuer of the insurance contract). In making that decision the entity chooses what factors to consider, including whether or not to consider the degree of risk diversification benefit available to the group of entities. Therefore, the staff view is 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 entity level. Determining a different risk adjustment for non-financial risk at a consolidated group level w ould be inconsistent with the principles of the risk adjustment for non-financial risk in IFRS 17.

TRG Discussion

Question to TRG members

What are your views on the implementation question presented above?

Appendix A—Example provided in the submission

A.1 The submission considers the following example:

(a) P is a parent holding company with two subsidiaries: subsidiary A and subsidiary L. The group prepares consolidated financial statements that include the results of P, A and L.

(b) Subsidiary A sells annuity policies and the risk adjustment for non-financial risk reflects the compensation it requires for taking on the risk of policyholders living longer than expected. Subsidiary L sells term life policies paying lump sums on death and the risk adjustment for non-financial risk reflects the compensation it requires for taking on the risk of policyholders dying earlier than expected.

(c) The overall group of entities is less sensitive to the mortality risk than subsidiaries A or L are individually, given that economically the mortality risk in A and L partly offset each other. In considering whether the group of entities is less sensitive to mortality risk, the group management considers capital requirements of individual legal entities and availability of profit of one entity to offset losses of another entity.

A.2 Staff view: according to A.1(b)–(c) above, subsidiaries A and L do not consider any diversification benefit available at a higher level than at an individual entity level when setting the price. Therefore, any diversification benefit available higher than at that level shall not be considered in the determination of the risk adjustment for non-financial risk. Furthermore, 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 entity level. The staff view for this example aligns with View B in the submission.