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| Paper topic | Cash flows within the contract boundary | | |



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## Introduction

1. We have received a number of submissions about the cash flows within the boundary of an insurance contract. Some submissions ask how to apply the requirements in paragraph 34 of IFRS 17 *Insurance Contracts* regarding:

   (a) the practical ability to set a price at a future date that fully reflects the risks of a contract or portfolio from that date; and

   (b) options to add insurance coverage.

2. Some submissions ask for further information about a few aspects discussed at the February 2018 meeting of the Transition Resource Group for IFRS 17 (TRG). Those aspects are included in the background section of this paper. Those submissions do not include any new information for the TRG to consider.

3. The objective of this paper is to provide background and an accounting analysis to support discussion at the TRG.

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## Structure of the paper

4. As background information, this paper includes:

   (a) an extract of the requirements on contract boundary in IFRS 17 that are relevant for the topics discussed in this paper; and

   (b) some observations on aspects already discussed at the February 2018 meeting of the TRG.

5. In addition, for each of the topics mentioned in paragraph 1 above, this paper includes:

   (a) an implementation question; and

   (b) review of accounting requirements.

6. There is an appendix to this paper (Appendix A) that includes a flowchart that may assist the discussion.

## Background information

### *Extract of the requirements on contract boundary in IFRS 17*

7. Paragraph 34 of IFRS 17 states:

   > Cash flows are within the boundary of an insurance contract if they arise from substantive rights and obligations that exist during the reporting period in which the entity can compel the policyholder to pay the premiums or in which the entity has a substantive obligation to provide the policyholder with services (see paragraphs B61–B71). A substantive obligation to provide services ends when:
   >
   > (a) the entity has the practical ability to reassess the risks of the particular policyholder and, as a result, can set a price or level of benefits that fully reflects those risks; or

(b) both of the following criteria are satisfied:

(i) the entity has the practical ability to reassess the risks of the portfolio of insurance contracts that contains the contract and, as a result, can set a price or level of benefits that fully reflects the risk of that portfolio; and

(ii) the pricing of the premiums for coverage up to the date when the risks are reassessed does not take into account the risks that relate to periods after the reassessment date.

8. Paragraph 35 of IFRS 17 states:

> An entity shall not recognise as a liability or as an asset any amounts relating to expected premiums or expected claims outside the boundary of the insurance contract. Such amounts relate to future insurance contracts.

9. Paragraph B61 of IFRS 17 states:

> Estimates of cash flows in a scenario shall include all cash flows within the boundary of an existing contract and no other cash flows. An entity shall apply paragraph 2 in determining the boundary of an existing contract.

10. 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).

11. Paragraph B62 of IFRS 17 states:

> Many insurance contracts have features that enable policyholders to take actions that change the amount, timing, nature or uncertainty of the amounts they will receive. Such features include renewal options, surrender options, conversion options and options to stop paying premiums while still receiving benefits under the contracts. The measurement of a group of insurance contracts shall reflect, on an expected value basis, the entity's current estimates of how the policyholders in the group will exercise the options available, and the risk adjustment for non-financial risk shall reflect the entity's current estimates of how the actual behaviour of the policyholders may differ from the expected behaviour. This requirement to determine the expected value applies regardless of the number of contracts in a group; for example it applies even if the group comprises a single contract. Thus, the measurement of a group of insurance contracts shall not assume a 100 per cent probability that policyholders will:
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> (a) surrender their contracts, if there is some probability that some of the policyholders will not; or
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> (b) continue their contracts, if there is some probability that some of the policyholders will not.

12. Paragraph B63 of IFRS 17 states:

> When an issuer of an insurance contract is required by the contract to renew or otherwise continue the contract, it shall apply paragraph 34 to assess whether premiums and related cash flows that arise from the renewed contract are within the boundary of the original contract.

13. Paragraph B64 of IFRS 17 states:

> Paragraph 34 refers to an entity's practical ability to set a price at a future date (a renewal date) that fully reflects the risks in the contract from that date. An entity has that practical ability in the absence of constraints that prevent the entity from setting the same price it would for a new contract with the same characteristics as the existing contract issued on that date, or if it can amend the benefits to be consistent with the price it will charge. Similarly, an entity has that practical ability to set a price when it can reprice an existing contract so that the price reflects overall changes in the risks in a portfolio of insurance contracts, even if the price set for each individual policyholder does not reflect the change in risk for that specific policyholder. When assessing whether the entity has the practical ability to set a price that fully reflects the risks in the contract or portfolio, it shall consider all the risks that it would consider when underwriting equivalent contracts on the renewal date for the remaining coverage. In determining the estimates of future cash flows at the end of a reporting period, an entity shall reassess the boundary of an insurance contract to include the effect of changes in circumstances on the entity's substantive rights and obligations.

## *Observations on aspects already discussed at the February 2018 meeting of the TRG*

### *Risks of the particular policyholder or of the portfolio of insurance contracts that contains the contract*

14. At the February 2018 meeting of the TRG it was observed that:

    (a) paragraph 34(a) of IFRS 17 refers to the practical ability to reassess the risks of the policyholder (ie policyholder risk);

    (b) paragraph 34(b) of IFRS 17 should be read as an extension of the risk assessment in paragraph 34(a) from the individual to portfolio level (ie policyholder risks in the portfolio), without extending policyholder

risks to all types of risks and considerations applied by an entity when pricing a contract; and

(c) policyholder risk includes the risk transferred from the policyholder to the entity, such as insurance risk and financial risk, and therefore excludes lapse risk and expense risk.

15. Paragraph B64 of IFRS 17 provides guidance on paragraph 34 of IFRS 17 and requires that, when assessing whether an entity has the practical ability to set a price at a renewal date that fully reflects the risks in the contract or portfolio, the entity shall consider all the risks that it would consider when underwriting equivalent contracts on the renewal date for the remaining coverage. Two submissions question the meaning of 'all the risks' in the light of the discussion held at the February 2018 meeting of the TRG.

16. Paragraph B64 of IFRS 17 refers to 'all the risks' that are assessed as part of the underwriting process of the contracts. Reading paragraph B64 of IFRS 17 in its context of providing guidance on paragraph 34 of IFRS 17, the risks referred to by 'all the risks' are policyholder risks—ie risks transferred from the policyholder to the entity. This observation is consistent with the observations made at the February 2018 meeting of the TRG, which are summarised in paragraph 14 of this paper.

*Contracts with multiple coverages*

17. At the February 2018 meeting of the TRG it was observed that:

(a) the lowest unit of account that is used in IFRS 17 is the contract that includes all insurance components.

(b) a contract with the legal form of a single contract would generally be considered a single contract in substance. However, there might be circumstances where the legal form of a single contract would not reflect the substance of its contractual rights and obligations.

(c) combining different types of 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.

(d) 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.

18. For a contract that includes two insurance components and that is considered a single contract, the assessment of the cash flows within the boundary is performed for the contract in its entirety. The contract is not split into two separate insurance components to assess the contract boundary of each component as if they were issued as separate contracts.

19. One submission questions the determination of the contract boundary in the following example:

(a) an entity issues a single contract with both life and health coverages, which the entity also sells separately;

(b) every year, the entity has the practical ability to reassess the risks of the life coverage and, as a result, can set a price or level of benefits for the life coverage that fully reflects those risks; and

(c) every two years, the entity has the practical ability to reassess the risks of the health coverage and, as a result, can set a price or level of benefits for the health coverage that fully reflects those risks.

20. The staff note that the entity needs to assess whether separating life and health coverages would reflect the substance of contractual rights and obligations. The fact that the life and health coverages can be sold separately is a factor to consider in performing this assessment.

21. In this example, assuming that the contract is accounted for as a single contract, in applying paragraph 34 of IFRS 17, the cash flows used to measure the contract would be those related to premiums arising up to the health coverage repricing date—ie premiums for two years. This is because the entity cannot set a price to reflect reassessed risks of the entire contract at the life coverage repricing date (refer to Appendix A to Agenda Paper 1 of the February 2018 meeting of the TRG).

## A. Practical ability to set a price at a future date that fully reflects the risks of a contract or portfolio from that date

### *A. Implementation question*

22. The submissions ask what constraints or limitations, other than those arising from the terms of an insurance contract, would be relevant in assessing the practical ability of an entity to reassess the risks of the particular policyholder (or of the portfolio of insurance contracts that contains the contract) and set a price or level of benefits that fully reflects those risks.

23. For example, the submissions note that market competitiveness and commercial considerations might affect the entity's ability to reprice an insurance contract to fully reflect the reassessed risks of the contract or portfolio. This is because, although permitted by the terms of the contract, an increase in the price (or a decrease in the level of benefits) of the contract to reflect an increase in the risks of the particular policyholder or portfolio might result in unfavourable economic consequences for the entity. Policyholders might decide to switch to a competitor

of the entity if that competitor can or is willing to write an equivalent contract at a price or level of benefits that is better for the policyholders.

24. One submission also notes that setting a price that fully reflects the reassessed risks of the contract or portfolio might expose the entity to reputational risks or to negative reactions from its distribution channels—for example, negative publicity regarding the entity's repricing practice might cause a decline in its customer base.

25. One submission notes that, in applying paragraph B64 of IFRS 17, an entity's practical ability is not constrained if the entity can set the same price it would for a new contract with the same characteristics as the existing contract issued on that date, or if it can amend the benefits to be consistent with the price it will charge. The submission provides two views:

    (a) View A—Commercial considerations might not be relevant when considering the requirements in paragraph 34 of IFRS 17. Market pressure to remain competitive is likely to apply to new contracts as well as to existing contracts. Consequently, the entity's practical ability to reprice would not be constrained by commercial considerations.

    (b) View B—Commercial considerations might be relevant when considering the requirements in paragraph 34 of IFRS 17. Market pressure might prevent the entity from fully repricing contracts with policyholders that are riskier to insure than the average individual policyholder (for example, policyholders with specific health conditions). If the equivalent new contract with the same risks is priced higher than the existing contract, the entity's practical ability to reprice would be constrained by commercial considerations.

### *A. Review of accounting requirements*

26. A constraint that equally applies to new contracts and existing contracts would not limit an entity's practical ability to reprice existing contracts to reflect their reassessed risks. This is because, as explained in paragraph B64 of IFRS 17, the entity could either:

    (a) set the same price for an existing contract and a new contract with the same characteristics (see paragraph 34(a) of IFRS 17); or

    (b) reprice an existing contract to reflect overall changes in the risks in a portfolio, even if the price set for each individual policyholder does not reflect the change in risk for that specific policyholder (see paragraph 34(b) of IFRS 17).

27. In applying paragraphs B61 and 2 of IFRS 17, when determining the boundary of an insurance contract, an entity shall consider its substantive rights and obligations, whether they arise from a contract, law or regulation. However, the entity shall disregard terms that have no commercial substance (ie no discernible effect on the economics of the contract). As noted in paragraph BC161 of the Basis for Conclusions on IFRS 17, if an entity has the practical ability to reassess the risk presented by a policyholder, but does not have the right to set a price that fully reflects the reassessed risk, the contract still binds the entity. Thus, cash flows after that point would be within the boundary of the existing contract, unless the restriction on the entity's ability to reprice the contract is so minimal that it is expected to have no commercial substance.

28. Consequently, when determining whether it has the practical ability to set a price at a future date that fully reflects the reassessed risks of a contract or a portfolio, an entity shall:

    (a) consider contractual, legal and regulatory restrictions; and

    (b) ignore restrictions that have no commercial substance.

29. Regulatory restrictions might be relevant in assessing the practical ability of an entity to set a level of benefits that fully reflect the reassessed risks of a policyholder or a portfolio. The staff believe that considerations similar to those discussed in paragraph 26 of this paper would be relevant when assessing whether regulatory constraints affect the entity's practical ability to reprice contracts.

30. One submission provides an example where some local regulations might:

    (a) require an entity to fix contractual benefits at contract inception; and

    (b) prevent an entity from reducing those benefits over the whole term of the contract (benefits enhancements might instead be allowed).

31. Although such regulatory restrictions might prevent the entity from amending the benefits of an existing contract, in applying paragraph B64 of IFRS 17, the entity shall assess whether those restrictions would also affect the pricing of existing contracts and new contracts to the same extent. If the entity can set the same price for the existing contract it would for a new contract with the same characteristics issued on that date, or can reprice the existing contract to reflect overall changes in the risks in a portfolio, the entity's practical ability to set a price that fully reflects the risks of the policyholders would not be constrained by such regulatory restrictions.

32. IFRS 17 uses the term practical ability and does not specify the sources of constraints. Therefore, it does not limit pricing constraints to contractual, legal and regulatory constraints. Market competitiveness and commercial considerations are factors that an entity typically considers when pricing new contracts and repricing existing contracts. When considering the requirements in paragraph 34 of IFRS 17, and consistent with paragraph 26 of this paper, constraints are irrelevant to the contract boundary assessment if they equally apply to new and existing policyholders in the same market.

33. A constraint that limits an entity's practical ability to price or reprice contracts differs from choices that an entity makes (pricing decisions), which may not limit

the entity's practical ability to reprice existing contracts in the way envisaged by paragraph B64 of IFRS 17.

## *A. TRG discussion*

**Question to TRG members**

What are your views on the implementation question presented above?

## B. Options to add insurance coverage

### *B. Implementation question*

34. The submissions ask how to determine the contract boundary of insurance contracts that include an option to add insurance coverage at a future date. For those contracts the entity is obligated to provide additional coverage if the policyholder exercises the option. The submissions distinguish between:

    (a) terms that are guaranteed by the entity—ie the entity sets the premiums for the additional coverage at inception and cannot reprice the premiums for the additional coverage to reflect reassessed risks of the policyholder (or of the portfolio that contains the contract); and

    (b) terms that are not guaranteed by the entity—ie the entity sets the premiums for the additional coverage only when the policyholder exercises the option.

35. The submissions provide two alternative views:

    (a) View A—The option to add insurance coverage is a feature of the insurance contract. The cash flows resulting from the option are included in the contract boundary. The measurement of the group of insurance contracts reflects the entity's estimates of how the policyholders in the group will exercise the option.

    (b) View B—The cash flows resulting from the option to add insurance coverage would be excluded from the contract boundary if the entity has the practical ability to set the premiums for the additional coverage to reflect the reassessed risks of the policyholder. In that case, when the policyholder exercises the option to add insurance coverage the entity would need either to (i) change the estimates of the fulfilment cash flows of the original contract or (ii) treat the entire contract (original and new addition) as a new contract.

### *B. Review of accounting requirements*

36. Paragraph B62 of IFRS 17 provides guidance for insurance contracts that have features that enable policyholders to take actions that change the amount, timing, nature or uncertainty of the amounts of the insurance contracts, such as renewal options. In particular, that paragraph requires that the measurement of a group of insurance contracts shall reflect, on an expected value basis, the entity's current estimates of how the policyholders in the group will exercise the options available.

37. The staff therefore think that it is clear that an option to add insurance coverage is a feature of the insurance contract. Unless the entity considers that such an option is a separate contract (see paragraph 17 of this paper), the option is an insurance component that is not measured separately from the remainder of the insurance contract. The assessment about whether the cash flows arising from that option are within the boundary of the insurance contract is performed together with the assessment of all the other cash flows arising from other features of the insurance contract. That assessment is performed applying paragraph 34 of IFRS 17.

38. In applying paragraph 34 of IFRS 17, an entity is no longer bound by an existing contract at the point at which the contract confers on the entity the practical ability to reassess the risks and, as a result, the right to set a price for the contract that fully reflects those risks. Thus, any cash flows arising beyond that point occur beyond the boundary of the existing contract and relate to a future contract, not to the existing contract.

39. For an option with terms that are guaranteed by the entity, the staff think that it is clear that the cash flows arising from the option are within the boundary of the contract because the entity cannot reprice the contract, in its entirety, to reflect the reassessed risks when it has guaranteed the price for one of the risks included in the contract. As noted in paragraph BC162(b) of the Basis for Conclusions on IFRS 17, renewal options bind the entity, but not the policyholder, by requiring the entity to continue to accept premiums and provide coverage but permitting the

policyholder to stop paying premiums. The premiums the entity is required to accept and the resulting coverage it is required to provide fall within the boundary of the contract.

40. For an option with terms that are not guaranteed by the entity, the cash flows arising from the option might be either within or outside of the contract boundary. This would depend on whether the entity has the practical ability to set a price for the contract (including the option) that fully reflects the reassessed risk.

41. If the entity has the practical ability to reprice the whole contract when the policyholder exercises the option to add coverage, the cash flows related to premiums after the option exercise date would be outside the contract boundary. In applying paragraph 35 of IFRS 17, those cash flows relate to future contracts. Consequently, when the policyholder exercises the option to add coverage, the entity treats the contract as a new contract.

42. If the entity does not have the practical ability to reprice the whole contract when the policyholder exercises the option to add coverage, the cash flows arising from the premiums after the option exercise date would be within the contract boundary and would therefore be included in the measurement of the contract on initial recognition. When the policyholder exercises the option to add coverage, the entity treats changes in cash flows as changes in estimates of fulfilment cash flows by applying paragraphs 40–52 of IFRS 17.

43. In applying paragraph 72 of IFRS 17, the exercise of a right included in the terms of a contract is not a modification. If, conversely, the entity subsequently modifies the contract to include an option to add coverage, the entity should apply the requirements about the modification of an insurance contract in paragraph 72 of IFRS 17.

## B. TRG Discussion

**Question to TRG members**

What are your views on the implementation question presented above?

## Appendix A—Flowchart

A.1 The following flowchart may assist the assessment of the cash flows within the boundary of a contract that includes an option to add coverage.