IFRS

STAFF PAPER

September 2018

Project	Transition Resource Group for IFRS 17 *Insurance Contracts*		
Paper topic	Premium waivers		
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Introduction

1. We have received a submission on whether terms in an insurance contract that waive premiums in specified circumstances create insurance risk. The identification of insurance risk is necessary to apply various aspects of IFRS 17 *Insurance Contracts*, including determining the coverage period.

2. The objective of this 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.

Background information

4. Appendix A of IFRS 17 defines insurance risk as:

   > Risk, other than financial risk, transferred from the holder of a contract to the issuer.

5. Paragraph B11 of IFRS 17 states:

   > Insurance risk is the risk the entity accepts from the policyholder. This means the entity must accept, from the policyholder, a risk to which the policyholder was already exposed. Any new risk created by the contract for the entity or the policyholder is not insurance risk.

6. Paragraph B13 of IFRS 17 states:

   > Some contracts require a payment if a specified uncertain future event occurs, but do not require an adverse effect on the policyholder as a precondition for the payment. This type of contract is not an insurance contract even if the holder uses it to mitigate an underlying risk exposure. For example, if the holder uses a derivative to hedge an underlying financial or non-financial variable correlated with the cash flows from an asset of the entity, the derivative is not an insurance contract because the payment is not conditional on whether the holder is adversely affected by a reduction in the cash flows from the asset. The definition of an insurance contract refers to an uncertain future event for which an adverse effect on the policyholder is a contractual precondition for

payment. A contractual precondition does not require the entity to investigate whether the event actually caused an adverse effect, but it does permit the entity to deny the payment if it is not satisfied that the event did cause an adverse effect.

7. Paragraphs B21(a)–(b) of IFRS 17 state:

The additional amounts described in paragraph B18 refer to the present value of amounts that exceed those that would be payable if no insured event had occurred (excluding scenarios that lack commercial substance). Those additional amounts include claims handling and assessment costs, but exclude:

(a) the loss of the ability to charge the policyholder for future service. For example, in an investment-linked life insurance contract, the death of the policyholder means that the entity can no longer perform investment management services and collect a fee for doing so. However, this economic loss for the entity does not result from insurance risk, just as a mutual fund manager does not take on insurance risk in relation to the possible death of a client. Consequently, the potential loss of future investment management fees is not relevant when assessing how much insurance risk is transferred by a contract.

(b) a waiver, on death, of charges that would be made on cancellation or surrender. Because the contract brought those charges into existence, their waiver does not compensate the policyholder for a pre-existing risk. Consequently, they are not relevant when assessing how much insurance risk is transferred by a contract.

Implementation question

8. The submission discusses a term of an insurance contract that allows a policyholder to avoid paying premiums in specified circumstances, for example, if the policyholder has been disabled for six consecutive months. The policyholder continues to receive the benefits originally promised under the insurance contract. This term is referred to in this paper as a premium waiver.

9. The insured event covered under the contract (the primary coverage) differs from the event that entitles the policyholder to a premium waiver. For example, the primary coverage might be a term life contract that covers the mortality risk of a policyholder, with premiums waived if the policyholder becomes unable to work because of a disability.

10. The submission asks whether the risk related to the premium waiver is a pre-existing risk of the policyholder transferred to the entity by the contract and is therefore an insurance risk, or a new risk created by the contract applying paragraphs B11 and B21 of IFRS 17.

Review of accounting requirements

11. As a preliminary note, the staff observe that the definition of insurance risk in IFRS 17 has not changed from IFRS 4 *Insurance Contracts* and it is therefore not expected that the practice of determining whether a risk is an insurance risk would change.

12. The possible waiver of premiums is caused by an uncertain future event (for example, the policyholder being disabled for a period of six consecutive months). That uncertain future event results in an adverse effect on the policyholder such as the loss of income. To the extent of the premiums payable, that risk is transferred to the entity which has to provide benefits under the contract for the primary coverage without being paid premiums.

13. The examples given in the submission of events that would trigger a waiver of premiums are disability, critical illness and severe injury. The staff observe that the risk of these events occurring exists before the contract is issued. They are not created by the contract, and the contract does not increase their potential adverse effects. Further, the occurrence of the events that trigger a waiver of premiums are contractual preconditions without which the entity can deny the premium waiver.

14. The staff also observe that a waiver of premiums differs from the situations discussed in paragraphs B21(a)–(b) of IFRS 17:

    (a) in paragraph B21(a) of IFRS 17, the death of the policyholder means the entity does not receive future premiums. However, it also means the entity does not have to pay additional amounts or provide service in the future. The policyholder has not transferred risk to the entity.

    (b) in paragraph B21(b) of IFRS 17, the death of the policyholder means the policyholder does not pay charges that would be made on cancellation or surrender. Those charges relate to ending the contract, not continuing the provision of benefits under the contract. Before entering the contract, the policyholder had pre-existing risk of death however had no risk corresponding to the charges (before the contract the policyholder does not have to pay charges to terminate the contract, after entering into the contract, the policyholder would have to pay such charges if they were not waived on death). In contrast, with the premium waiver, the policyholder had the pre-existing risk of the event that triggers the waiver of the premiums and no additional adverse consequence relating to that risk is created by the contract itself (before the contract the policyholder has to pay premiums to obtain insurance coverage, after entering into the contract, the policyholder would have to pay premiums to obtain coverage if they were not waived on death). Another way of explaining this difference is that the death of the policyholder is not a contractual precondition for the waiver of the termination charges—they could also be waived if the policyholder does not terminate the contract early. Because the charges can be avoided if the policyholder does not die, they are an additional adverse effect created by the contract if they die.

15. In summary, the staff observe that a waiver of premiums if a specified event occurs creates insurance risk. The staff also observe that the consequences of this are:

(a) the inclusion of such a waiver in an investment contract makes the investment contract an insurance contract; and

(b) the inclusion of such a waiver in a contract that would be an insurance contract without the waiver may affect the quantity of benefits provided by the contract and the coverage period, both of which could affect the recognition of the contractual service margin in profit or loss. The recognition of the contractual service margin was discussed in Agenda Paper 5 of the February 2018 TRG meeting and Agenda Paper 5 of the May 2018 TRG meeting.

TRG discussion

Question to TRG members

What are your views on the implementation question presented above?