STAFF PAPER

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Insurance working group

Project	Insurance contracts
Paper topic	Reporting back on the definition of an insurance contract and the scope of the insurance contracts standard

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Introduction

1. This paper provides:

   (a) A feedback statement on the IASB's tentative decisions to date on the definition of an insurance contract and the scope of the insurance contracts standard, including an outline of significant matters raised with us and how we responded.

   (b) A working draft of how we propose to implement the boards' tentative decisions on those matters. This draft has been prepared by IASB staff and has not been reviewed by the IASB. Official pronouncements of the IASB are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

Next steps

2. The IASB has tentatively decided that the scope of the insurance contracts Standard should include investment contracts with discretionary participation features, but only if those contracts are issued by insurers. The IASB plans to consider how to implement that decision.

Question for working group members
Do you have any comments on the IASB's tentative decisions or the proposed drafting?

Introduction

The IASB's exposure draft *Insurance Contracts* (the ED) defined an insurance contract and proposed that a new Standard would apply to all insurance contracts, with specified exceptions. That definition was based on the definition in IFRS 4 *Insurance Contracts* (including the related guidance in Appendix B of IFRS 4, with the two additions discussed on page 3 of this paper).

Most did not comment on the definition of an insurance contract or the scope exclusions proposed in the ED. Those commenting generally supported the IASB's proposals. Accordingly, the IASB confirmed that the following contracts would not be within the scope of the insurance contracts Standard:

- product warranties issued by a manufacturer, dealer or retailer;
- employers' assets and liabilities under employee benefit plans and retirement benefit obligations reported by defined benefit retirement plans;
- contractual rights or contractual obligations that are contingent on the future use of, or right to use, a non-financial item;
- residual value guarantees provided by a manufacturer, dealer or retailer, as well as a lessee's residual value guarantee embedded in a finance lease;
- contingent consideration payable or receivable in a business combination; and
- direct insurance contracts that the entity holds (ie direct insurance contracts in which the entity is the policyholder).

In the pages that follow, we outline the areas that the boards considered in more detail and the modifications that they made as a result.

Definition of an insurance contract

Proposal in the ED

IFRS 4 proposed to define an insurance contract as "A contract under which one party (the insurer) 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."

The ED used the existing definition in IFRS 4, but proposed two additions in the application guidance supporting that definition to reflect the boards' understanding of current practice and existing US GAAP. Those additions:

- require that an insurer consider the time value of money in assessing whether the additional benefits payable in any scenario are significant; and
- state that a contract does not transfer significant insurance risk if there is no scenario that has commercial substance in which an insurer can suffer a loss. Loss is defined here as an excess of the present value of net cash outflows over the present value of the premiums.

Respondents' comments

Most respondents to the IASB's ED did not comment on the definition of an insurance contract. However, of the few that did, most disagreed with the decision to modify the guidance in IFRS 4 on the grounds that making minor changes to the definition for those IFRSs would have little merit, particularly since the application of IFRS 4 has been consistent with the proposed changes.

Some respondents asked for clarification on how to interpret the proposal in the ED that a contract does not transfer significant insurance risk unless there is a scenario with commercial substance in which the insurer can suffer a loss.

In particular, some were concerned that the present value of cash outflows arising from a reinsurance contract might not exceed the present value of the premiums because the underlying portfolio of insurance contracts is highly likely to be profitable, even though the reinsurer has assumed all the economic risks and benefits of those underlying contracts.

Our response

We noted that the application of IFRS 4 had been consistent with the proposed changes and that no significant objections were made to the proposals in the ED.

We therefore confirmed the definition of an insurance contract and the supporting application guidance, with the clarification that a reinsurance contract is deemed to transfer significant insurance risk if substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contract is assumed by the reinsurer, even if the reinsurer is not exposed to a loss from the contract.

Fixed-fee service contracts

Proposal in the ED

The ED proposed that the insurance contracts Standard should exclude fixed-fee service contracts that have, as their primary purpose, the provision of services, but that expose the service provider to risk because the level of service depends on an uncertain event.

Examples include:

- A maintenance contract in which the service provider agrees to repair specified equipment after a malfunction.
- Roadside assistance contracts, in which a provider agrees to provide roadside assistance, sometimes including the costs of any related parts and labour, in exchange for a fixed fee.
- Capitation agreements in which a provider agrees to provide, in exchange for a fixed fee, a variable amount of defined medical services for a specified group of patients. For example, a provider might agree to provide all ambulance transfer services for a specified period.

Respondents' comments

Some respondents found difficulty in drawing the line between fixed-fee service contracts and insurance contracts, and between different types of fixed-fee service contracts. Some also argued that applying different accounting models to such similar types of contracts could result in a lack of comparability.

Nonetheless, most support excluding fixed-fee service contracts from the scope of the insurance contracts Standard, because they believe that:

- accounting for these contracts as revenue contracts provides relevant information for users of financial statements of the entities that issue such contracts; and
- changing the existing basis for accounting for these contracts will impose costs and disruption for no significant benefits.

Some asked the IASB to clarify how to determine the primary purpose of a contract.

Our response

We confirmed that fixed-fee service contracts that have, as their primary purpose, the provision of service would be excluded from the scope of the insurance contracts Standard. We clarified that such contracts would exhibit all the following characteristics:

- they are not priced on the basis of an assessment of the risk associated with an individual customer;
- they compensate customers by providing a service, rather than by paying cash; and
- the primary risk they transfer relates to the overutilisation of services.

Financial guarantee contracts

Proposal in the ED

The ED proposed that the insurance contracts Standard should apply to financial guarantee contracts.

A financial guarantee contract is defined in IFRSs as "a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument".

Such contracts meet the definition of insurance contracts.

Respondents' comments

There were two mutually incompatible views on the appropriate accounting method for financial guarantee contracts:

- Financial guarantee contracts meet the definition of an insurance contract because the issuer of the contract agrees to compensate the policyholder in the event of an uncertain future event (ie default) that would adversely affect the policyholder. Therefore an insurer should account for financial guarantee contracts in the same way as for other insurance contracts.
- Financial guarantee contracts are economically similar to other credit-related contracts within the scope of IAS 32, IAS 39 and IFRS 9. Similar accounting should apply to similar contracts. As a result, an issuer should account for financial guarantee contracts in the same way as for other financial instruments.

Some drew attention to the existing option in IFRS 4 that permits an issuer of a financial guarantee contract to account for the contract as an insurance contract if it had previously asserted that it regards the contract as an insurance contract. Although this option may appear imprecise, there is a clear answer in the vast majority of cases and no implementation problems appear to have been identified in practice.

Our response

We are currently debating the accounting treatment for financial guarantee contracts within the scope of the financial instruments Standards as part of the IASB's project on amortised cost and impairment of financial assets.

We decided to wait for the outcome of that project before deciding the applicable method for financial guarantee contracts. In the meantime, we decided to carry forward the existing option in IFRS 4 that:

- permits an issuer of a financial guarantee contract to account for the contract as an insurance contract if it had previously asserted that it regards the contract as an insurance contract; and
- requires an issuer to account for a financial guarantee contract in accordance with the financial instruments Standards in all other cases. Such contracts would be measured initially at fair value, with subsequent amortisation of that amount, coupled with a test for credit losses.[1]

[1] The FASB have yet to consider which financial guarantee arrangements, if any, should be within the scope of the insurance contracts Standard.

Financial instruments with discretionary participation features ('participating investment contracts')

Proposal in the ED

The ED proposed that an entity should apply the insurance contracts Standard to the financial instruments it issues containing a discretionary participation feature.

The definition of a discretionary participation proposed in the exposure draft is identical to the existing definition in IFRS 4, except that it included a criterion that would limit the scope of the insurance contracts standard to financial instruments that share in the performance of the same pool of assets as insurance contracts.

Respondents' comments

Most respondents commenting on this matter—particularly those in Europe and in some other jurisdictions that apply IFRS 4 at present—supported the ED's proposal to apply the insurance contracts Standard to financial instruments containing a discretionary participation feature, for the following reasons:

- Comparability between participating insurance contracts and other financial instruments with discretionary participation features is more important than comparability between financial instruments with such features and those without.
- The vast majority of investment contracts with discretionary participation features are issued by insurers and managed alongside participating insurance contracts. It would simplify processes, reduce costs and provide more readily understandable information to users to include them within the scope of the insurance contracts Standard.
- It is unclear how to apply IFRS financial instruments Standards in accounting for some aspects of such instruments. It is simpler to apply the insurance contracts model to such instruments than to modify those financial instruments Standards to make their requirements more suitable for those instruments
- The model developed for insurance contracts gives more meaningful information to users of financial statements because it includes all cash flows that are expected to be paid to policyholders (and hence will not be available to other investors).

Most respondents commenting on the exposure draft definition opposed the proposal to restrict it to contracts that participate in the performance of the same pool of assets as insurance contracts. In particular they challenged the IASB's assumption that the financial instruments with discretionary participation features issued by insurers always share in the performance of the same pool of assets as insurance contracts.

Our response

We confirmed that insurers (and only insurers) should apply the insurance contracts Standard to financial instruments containing a discretionary participation feature. However, we would not limit the scope of the insurance contracts standard to financial instruments that share in the performance of the same pool of assets as insurance contracts.

We will consider how to implement these decisions at a future meeting.

In addition, we propose to clarify the definition of the financial instruments containing a discretionary participation feature that are within the scope of the proposed Standard.

Working draft

A working draft of the wording for the Standard is as follows (changes from the ED are marked). New text is underlined and deleted text is struck through. This draft has been prepared by IASB staff and has not been reviewed by the IASB. Official pronouncements of the IASB are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

Standard

Scope

2 An ~~entity~~ *insurer* shall apply this [draft] IFRS to:

(a) insurance contracts (including reinsurance contracts) that it issues ~~and reinsurance contracts that it holds~~.

(b) ~~financial instruments~~ *participating investment contracts* that it issues ~~containing a discretionary participation feature~~ (see paragraphs 62–66).

(c) reinsurance contracts that it holds.

[Staff note: the IASB tentatively decided that insurers (and only insurers) should apply the insurance contracts Standard to participating investment contracts. We will consider how to implement this decision in a future meeting.]

3 This [draft] IFRS does not address other aspects of accounting by insurers, such as accounting for their financial assets and financial liabilities, other than those mentioned in paragraph 2(b) (see IFRS 9 *Financial* Instruments, IFRS 7 *Financial Instruments: Disclosures,* IAS 32 *Financial Instruments: Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement*), except in the transition requirements in paragraph 102.

4 An entity shall not apply this [draft] IFRS to:

(a) product warranties issued by a manufacturer, dealer or retailer (see IAS 18 *Revenue* and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*).

(b) employers' assets and liabilities under employee benefit plans (see IAS 19 *Employee Benefits* and IFRS 2 *Share-based Payment*) and retirement benefit obligations reported by defined benefit retirement plans (see IAS 26 *Accounting and Reporting by Retirement Benefit Plans*).

(c) contractual rights or contractual obligations that are contingent on the future use of, or right to use, a non-financial item (eg some licence fees, royalties, contingent lease payments and similar items, see IAS 17 *Leases*, IAS 18 and IAS 38 *Intangible Assets*).

(d) residual value guarantees provided by a manufacturer, dealer or retailer, as well as a lessee's residual value guarantee embedded in a finance lease (see IAS 17 and IAS 18).

(e) fixed-fee service contracts that meet all of the following conditions:

(i) ~~have as their~~ the primary purpose of the contract is the provision of services. ~~but expose the service provider to risk because the level of service depends on an uncertain event,~~

(ii) the price of the contract is not based on an assessment of the risk associated with an individual customer.

(iii) the contract compensates customers by providing a service, rather than cash payment.

(iii) the insurance risk transferred by the contract arises primarily from uncertainty about the extent or frequency of the counterparty's use of services (see IAS 18).

~~, for example maintenance contracts in which the service provider agrees to repair specified equipment after a malfunction (see IAS 18). However, an insurer shall apply this [draft] IFRS to insurance contracts in which the insurer provides goods or services to the policyholder to compensate the policyholder for insured events.~~

(f) financial guarantee contracts, unless the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, in which case the issuer may elect to apply either IFRS 9, IAS 39, IAS 32 and IFRS 7 or this IFRS to such financial guarantee contracts. The issuer may make that election contract by contract, but the election for each contract is irrevocable.

(~~f~~g) contingent consideration payable or receivable in a business combination (see IFRS 3 *Business Combinations*).

(~~g~~h) direct insurance contracts that the entity holds (ie direct insurance contracts in which the entity is the policyholder). However, a cedant shall apply this [draft] IFRS to reinsurance contracts that it holds.

~~5 For ease of reference, this [draft] IFRS describes any entity that issues an insurance contract as an *insurer*, whether or not the issuer is regarded as an insurer for legal or supervisory purposes.~~

6 A reinsurance contract is a type of insurance contract. Accordingly, all references in this IFRS to insurance contracts also apply to reinsurance contracts.

7 Appendix B provides guidance on the definition of an insurance contract (see paragraphs B2–B33).

Appendix A
Defined terms

~~**guaranteed benefits**~~	~~Payments or other benefits to which a particular **policyholder** or investor has an unconditional right that is not subject to the contractual discretion of the issuer.~~

participating investment contracts ~~**discretionary participation feature**~~
: A financial instrument that provides a particular investor with the contractual right to receive, as a supplement to guaranteed benefits that are of an amount not subject to discretion of the issuer, additional non-guaranteed benefits:

(a) that are likely to be a significant portion of the total contractual benefits;

(b) whose amount or timing is contractually at the discretion of the issuer; and

(c) that are contractually based on:

(i) the performance of a specified pool of insurance contracts or a specified type of insurance contract;

(ii) realised and/or unrealised investment returns on a specified pool of assets held by the issuer; or

(iii) the profit or loss of the company, fund or other entity that issues the contract.~~,~~

~~provided that there also exist insurance contracts that provide similar contractual rights to participate in the performance of the same insurance contracts, the same pool of assets or the profit or loss of the same company, fund or other entity.~~

[Staff note: We plan to consider application guidance on the definition of a participating investment contract.]

insurance contract
: A contract under which one party (the insurer) 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. (See Appendix B for guidance on this definition.)

insurer
: The party that has an obligation under an **insurance contract** to compensate a **policyholder** if an **insured event** occurs.

Application guidance

Definition of an insurance contract (paragraph 7 and Appendix A)

B2 This section provides guidance on the definition of an insurance contract as specified in Appendix A. It addresses the following:

(a) the term 'uncertain future event' (paragraphs B3–B5).

(b) payments in kind (paragraphs B6 and B7).

(c) insurance risk and other risks (paragraphs B8–B17).

(d) examples of insurance contracts (paragraphs B18–B22).

(e) significant insurance risk (paragraphs B23–B31).

(f) changes in the level of insurance risk (paragraphs B32 and B33).

Uncertain future event

B3 Uncertainty (or risk) is the essence of an insurance contract. Accordingly, at least one of the following is uncertain at the inception of an insurance contract:

(a) whether an insured event will occur;

(b) when it will occur; or

(c) how much the insurer will need to pay if it occurs.

B4 In some insurance contracts, the insured event is the discovery of a loss during the term of the contract, even if the loss arises from an event that occurred before the inception of the contract. In other insurance contracts, the insured event is an event that occurs during the term of the contract, even if the resulting loss is discovered after the end of the contract term.

B5 Some insurance contracts cover events that have already occurred, but whose financial effect is still uncertain. An example is a reinsurance contract that covers the direct insurer against adverse development of claims already reported by policyholders. In such contracts, the insured event is the discovery of the ultimate cost of those claims.

Payments in kind

B6~~B7~~ For some fixed-fee service contracts, the level of service depends on an uncertain event. Although such contracts meet the definition of an insurance contract if the uncertain event would cause significant additional payments by the insurer, they are outside the scope of this [draft] IFRS if the primary purpose of the contract is the provision of services and the contracts meet all the criteria in paragraph 2(e). Examples of such contracts are:

(a) a maintenance contract in which the service provider agrees to repair specified equipment after a malfunction.

(b) a contract for car breakdown services in which the provider agrees, for a fixed annual fee, to provide roadside assistance or tow the car to a nearby garage.

B7~~B6~~ Although fixed-fee service contracts typically compensate customers by providing a service, rather than cash payment, some ~~Some~~ insurance contracts also require or permit payments to be made in kind. ~~, in which case~~ In such cases, the insured provides goods or services to the policyholder to settle its obligation to compensate the policyholder for insured events. An example is when the insurer replaces a stolen article directly, instead of reimbursing the policyholder for the amount of its loss. Another example is when an insurer uses its own hospitals and medical staff to provide medical services covered by the insurance contract. However, such contracts are not fixed-fee service contracts because the price of the contract is based on an assessment of the risk associated with the individual policyholder (or class of policyholders), and the insurance risk transferred arises from the severity and timing risks, as well as from utilisation (or frequency) of services. Therefore, an entity applies this [draft] IFRS to insurance contracts in which it provides goods or services to the policyholder to compensate the policyholder for insured events.

Distinction between insurance risk and other risks

B8 The definition of an insurance contract refers to insurance risk, which this [draft] IFRS defines as risk, other than financial risk, transferred from the holder of a contract to the issuer. A contract that exposes the issuer to financial risk without significant insurance risk is not an insurance contract.

B9 The definition of financial risk in Appendix A includes a list of financial and non-financial variables. That list includes non-financial variables that are not specific to a party to the contract, such as an index of earthquake losses in a particular region or an index of temperatures in a particular city. It excludes non-financial variables that are specific to a party to the contract, such as the occurrence or non-occurrence of a fire that damages or destroys an asset of that party. Furthermore, the risk of changes in the fair value of a non-financial asset is not a financial risk if the fair value reflects not only changes in market prices for such assets (ie a financial variable), but also the condition of a specific non-financial asset held by a party to a contract (ie a non-financial variable). For example, if a guarantee of the residual value of a specific car exposes the guarantor to the risk of changes in the car's physical condition, that risk is insurance risk, not financial risk.

B10 Some contracts expose the issuer to financial risk, in addition to significant insurance risk. For example, many life insurance contracts both guarantee a minimum rate of return to policyholders (creating financial risk) and promise death benefits that at some times significantly exceed the policyholder's account balance (creating insurance risk in the form of mortality risk). Such contracts are insurance contracts.

B11 Under some contracts, an insured event triggers the payment of an amount linked to a price index. Such contracts are insurance contracts, provided that the payment that is contingent on the insured event could be significant. For example, a life-contingent annuity linked to a cost-of-living index transfers insurance risk because payment is triggered by an uncertain event—the survival of the annuitant. The link to the price index is an embedded derivative, but it also transfers insurance risk. If the resulting transfer of insurance risk is significant, the embedded derivative meets the definition of an insurance contract, in which case it shall not be separated from the host contract (see paragraph 12).

B12 The definition of insurance risk refers to risk that the insurer accepts from the policyholder. In other words, insurance risk is a pre-existing risk transferred from the policyholder to the insurer. Thus, a new risk created by the contract is not insurance risk.

B13 The definition of an insurance contract refers to an adverse effect on the policyholder. The definition does not limit the payment by the insurer to an amount equal to the financial effect of the adverse event. For example, the definition does not exclude 'new-for-old' coverage that pays the policyholder sufficient to permit replacement of a used and damaged asset with a new asset. Similarly, the definition does not limit payment under a term life insurance contract to the financial loss suffered by the deceased's dependants, nor does it preclude the payment of predetermined amounts to quantify the loss caused by death or an accident.

B14 Some contracts require a payment if a specified uncertain event occurs, but do not require there to be an adverse effect on the policyholder as a precondition for payment. Such a contract is not an insurance contract even if the holder uses that contract to mitigate an underlying risk exposure. For example, if the holder uses a derivative to hedge an underlying nonfinancial variable that is correlated with the cash flows from an asset of the entity, the derivative is not an insurance contract because payment is not conditional on whether the holder is adversely affected by a reduction in the cash flows from the asset. Conversely, the definition of an insurance contract refers to an uncertain event for which an adverse effect on the policyholder is a contractual precondition for payment. That contractual precondition does not require the insurer to investigate whether the event actually caused an adverse effect, but it does permit the insurer to deny payment if it is not satisfied that the event caused an adverse effect.

B15 Lapse or persistency risk (ie the risk that the counterparty will cancel the contract earlier or later than the issuer had expected when pricing the contract) is not insurance risk because the payment to the counterparty is not contingent on an uncertain future event that adversely affects the counterparty. Similarly, expense risk (ie the risk of unexpected increases in the administrative costs associated with the servicing of a contract, rather than in costs associated with insured events) is not insurance risk because an unexpected increase in expenses does not adversely affect the counterparty.

B16 ~~Therefore~~ <u>Consequently</u>, a contract that exposes the issuer to lapse risk, persistency risk or expense risk is not an insurance contract unless that contract also exposes the issuer to significant insurance risk. However, if the issuer of that contract mitigates that risk by using a second contract to transfer part of that risk to another party, the second contract exposes that other party to insurance risk.

B17 An insurer can accept significant insurance risk from the policyholder only if the insurer is an entity separate from the policyholder. In the case of a mutual insurer, the mutual entity accepts risk from each policyholder and pools that risk. Although policyholders bear that pooled risk collectively in their capacity as owners, the mutual entity has accepted the risk that is the essence of insurance contracts.

Examples of insurance contracts

B18 The following are examples of contracts that are insurance contracts, if the transfer of insurance risk is significant:

(a) insurance against theft or damage to property.

(b) insurance against product liability, professional liability, civil liability or legal expenses.

(c) life insurance and prepaid funeral plans (although death is certain, it is uncertain when death will occur or, for some types of life insurance, whether death will occur within the period covered by the insurance).

(d) life-contingent annuities and pensions (ie contracts that provide compensation for the uncertain future event—the survival of the annuitant or pensioner—to assist the annuitant or pensioner in maintaining a given standard of living, which would otherwise be adversely affected by his or her survival).

(e) insurance against disability and medical cost.

(f) surety bonds, fidelity bonds, performance bonds and bid bonds (ie contracts that compensate the holder if another party fails to perform a contractual obligation, for example an obligation to construct a building).

~~(g) credit insurance that provides for specified payments to be made to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due under the original or modified terms of a debt instrument.~~

(<u>g</u>~~h~~) product warranties. Product warranties issued by another party for goods sold by a manufacturer, dealer or retailer are within the scope of this [draft] IFRS. However, product warranties issued directly by a manufacturer, dealer or retailer are within the scope of IAS 18 and IAS 37 because they either:

(i) do not meet the definition of an insurance contract (warranties intended to provide a customer with <u>assurance that the related product complies with agreed-upon specifications</u> ~~coverage for latent defects in the product~~); or

(ii) meet the definition of an insurance contract but are outside the scope of this [draft] IFRS (warranties intended to provide a customer with <u>a service, with or without providing assurance that the product complies with agreed-upon specifications</u> ~~coverage for faults that arise after the product is transferred to the customer~~).

(<u>i</u>~~h~~) title insurance (ie insurance against the discovery of defects in title to land that were not apparent when the insurance contract was issued). In this case, the insured event is the discovery of a defect in the title, not the defect itself.

(j~~i~~) travel insurance (ie compensation in cash or in kind to policyholders for losses suffered during travel).

(k~~j~~) catastrophe bonds that provide for reduced payments of principal, interest or both if a specified event adversely affects the issuer of the bond (unless the specified event does not create significant insurance risk, for example if the event is a change in an interest rate or foreign exchange rate).

(l~~k~~) insurance swaps and other contracts that require a payment based on changes in climatic, geological or other physical variables that are specific to a party to the contract.

(m~~l~~) reinsurance contracts.

B19 The following are examples of items that are not insurance contracts:

(a) investment contracts that have the legal form of an insurance contract but do not expose the insurer to significant insurance risk. For example, life insurance contracts in which the insurer bears no significant mortality risk are not insurance contracts (such contracts are non-insurance financial instruments or service contracts—see paragraphs B20 and B21). However, participating investment contracts are within the scope of this Standard, although those contracts do not meet the definition of an insurance contract.

(b) contracts that have the legal form of insurance, but pass all significant insurance risk back to the policyholder through non-cancellable and enforceable mechanisms that adjust future payments by the policyholder to the issuer as a direct result of insured losses. For example, some financial reinsurance contracts or some group contracts pass all significant insurance risk back to the policyholder (such contracts are normally noninsurance financial instruments or service contracts—see paragraphs B20 and B21).

(c) Self-insurance (ie retaining a risk that could have been covered by insurance). In such situations, there is no insurance contract because there is no agreement with another party.

(d) contracts (such as gambling contracts) that require a payment if a specified uncertain future event occurs, but do not require, as a contractual precondition for payment, that the event adversely affects the policyholder. However, this does not preclude the specification of a predetermined payout to quantify the loss caused by a specified event such as death or an accident (see paragraph B13).

(e) derivatives that expose one party to financial risk but not insurance risk, because they require that party to make payment solely on the basis of changes in one or more of a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a nonfinancial variable that the variable is not specific to a party to the contract (such contracts are accounted for in accordance with IFRS 9 or IAS 39).

(f) Credit-related guarantees (or letters of credit, credit derivative default contracts or credit insurance contracts) that require payments even if the holder has not incurred a loss on the failure of the debtor to make payments when due (such contracts are accounted for in accordance with IFRS 9 or IAS 39). (Some credit insurance contracts provide for specified payments to be made to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due under the original or modified terms of a debt instrument. Such a contract meets the definition of an insurance contract but is excluded from the scope of this Standard unless the issuer had previously asserted that it regards the contract as an insurance contract.)

(g) contracts that require a payment based on a climatic, geological or other physical variable that is not specific to a party to the contract (commonly described as weather derivatives).

(h) catastrophe bonds that provide for reduced payments of principal, interest or both, based on a climatic, geological or other physical variable that is not specific to a party to the contract.

B20 If the contracts described in paragraph B19 create financial assets or financial liabilities, they are within the scope of IFRS 9 or IAS 39. Among other things, this means that the parties to the contract use what is sometimes called deposit accounting, which involves the following:

(a) one party recognises the consideration received as a financial liability, rather than as revenue; and

(b) the other party recognises the consideration paid as a financial asset, rather than as an expense.

B21 If the contracts described in paragraph B19 do not create financial assets or financial liabilities, IAS 18 applies. In accordance with IAS 18, revenue associated with a transaction involving the rendering of services is recognised as an entity satisfies its performance obligation by providing the services to the customer.

B22 The ~~credit insurance discussed in paragraph B18(g) and the~~ credit-related guarantees and credit insurance discussed in paragraph B19(f) can have various legal forms, such as that of a guarantee, some types of letter of credit, a credit default contract or an insurance contract. If those contracts require the issuer to make specified payments to reimburse the holder for a loss the holder incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument, they are insurance contracts but are excluded from ~~and are within~~ the scope of this [draft] IFRS unless the issuer had previously asserted that it regards the contract as an insurance contract.

~~However,~~ IFRS 9 or IAS 39 apply to credit-related guarantees and credit insurance contracts that are not within the scope of this IFRS. ~~described in paragraph B19(f),~~ Such ~~such as~~ contracts include those that require payment:

(a) regardless of whether the counterparty holds the underlying debt instrument; or

(b) on a change in credit rating or change in credit index, rather than on the failure of a specified debtor to make payments when due.

Significant insurance risk

B23 A contract is an insurance contract only if it transfers significant insurance risk. Paragraphs B8–B22 discuss insurance risk. The following paragraphs discuss the assessment of whether insurance risk is significant.

B24 Insurance risk is significant if, and only if, an insured event could cause an insurer to pay significant additional benefits in any scenario, excluding scenarios that lack commercial substance (ie have no discernible effect on the economics of the transaction). If significant additional benefits would be payable in scenarios that have commercial substance, the condition in the previous sentence can be met even if the insured event is extremely unlikely or even if the expected (ie probability-weighted) present value of contingent cash flows is a small proportion of the expected present value of all the remaining cash flows from the insurance contract.

B25 In addition, a contract does not transfer insurance risk if there is no scenario that has commercial substance in which the present value of the net cash outflows paid by the insurer can exceed the present value of the premiums. However, a reinsurance contract that does not expose the reinsurer to a loss is deemed to transfer significant insurance risk if it transfers to the reinsurer substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts.

B26 In determining whether it will pay significant additional benefits in a particular scenario, the insurer takes into account the effect of the time value of money. As a result, contractual terms that delay timely reimbursement to the policyholder can eliminate significant insurance risk. Consider the following reinsurance example. A cedant enters into a contract covering a book of one-year contracts. The contract provides that the reinsurer's payment will be ten years after the start of the contract. At the beginning of the contract, the reinsurer expects that claims will range from CU1,000 to CU1,200.[2] In assessing whether the reinsurance contract transfers significant insurance risk, the reinsurer considers the present value of the future payments in each scenario, ie not their nominal amounts. Assuming a discount rate of 5 per cent, the relevant benefit payments range from CU614 to CU737 (ie the nominal payments discounted at a rate of 5 per cent over 10 years).

[2] In this [draft] IFRS, monetary amounts are denominated in 'currency units (CU)'.

B27 The additional benefits described in paragraph B24 refer to the present value of amounts that exceed the present value of amounts that would be payable if no insured event occurred (excluding scenarios that lack commercial substance). Those additional amounts include claims handling and claims assessment costs, but exclude:

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

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

(c) a payment conditional on an event that does not cause a significant loss to the holder of the contract. For example, consider a contract that requires the issuer to pay CU1 million if an asset suffers physical damage causing an insignificant economic loss of CU1 to the holder. In this contract, the holder transfers to the insurer the insignificant risk of losing CU1. At the same time, the contract creates non-insurance risk that the issuer will need to pay CU999,999 if the specified event occurs. Because the issuer does not accept significant insurance risk from the holder, this contract is not an insurance contract.

(d) possible reinsurance recoveries. The insurer accounts for these separately.

B28 An insurer shall assess the significance of insurance risk contract by contract, rather than by reference to materiality to the financial statements. For ~~(for~~ that purpose, contracts form a single contract if:

(a) the two contracts relate to the same risk and are entered into simultaneously with a single counterparty or related counterparties, or

(b) the two contracts ~~that~~ are otherwise interdependent~~, form a single contract)~~.

B28A Thus, insurance risk can be significant even if there is a minimal probability of material losses for a whole book of contracts. This contract-by-contract assessment makes it easier to classify a contract as an insurance contract. However, if a relatively homogeneous book of small contracts is known to consist of contracts that all transfer insurance risk, an insurer need not examine each contract within that book to identify a few non-derivative contracts that transfer insignificant insurance risk.

B29 It follows from paragraphs B24–B28A that if a contract pays a death benefit exceeding the amount payable on survival, the contract is an insurance contract unless the additional death benefit is insignificant (judged by reference to the contract rather than to an entire book of contracts). As noted in paragraph B27(b), the waiver on death of cancellation or surrender charges is not included in this assessment if that waiver does not compensate the policyholder for a pre-existing risk. Similarly, an annuity contract that pays out regular sums for the rest of a policyholder's life is an insurance contract, unless the aggregate life-contingent payments are insignificant.

B30 Paragraph B24 refers to additional benefits. Those additional benefits could include a requirement to pay benefits earlier if the insured event occurs earlier and the payment is not adjusted for the time value of money. An example is whole life insurance for a fixed amount (ie insurance that provides a fixed death benefit whenever the policyholder dies, with no expiry date for the cover). It is certain that the policyholder will die, but the date of death is uncertain. The insurer will suffer a loss on those individual contracts for which policyholders die early, even if there is no overall loss on the whole book of contracts.

B31 If an insurance contract is unbundled in accordance with paragraph 8 into an insurance component and one or more other components (eg an investment component), the significance of insurance risk transfer is assessed by reference to the insurance component. The significance of insurance risk transferred by an embedded derivative is assessed by reference to the embedded derivative.

Changes in the level of insurance risk

B32 Some contracts do not transfer any insurance risk to the issuer at inception, although they do transfer insurance risk at a later time. For example, consider a contract that provides a specified investment return and includes an option for the policyholder to use the proceeds of the investment on maturity to buy a life-contingent annuity at the annuity rates charged by the insurer to other new annuitants at the time the policyholder exercises the option. Such a contract transfers no insurance risk to the issuer until the option is exercised because the insurer remains free to price the annuity on a basis that reflects the insurance risk transferred to the insurer at that time. However, if the contract specifies the annuity rates (or a basis for setting the annuity rates), the contract transfers insurance risk to the issuer at inception.

B33 A contract that qualifies as an insurance contract remains an insurance contract until all rights and obligations are extinguished (ie discharged, or cancelled or expires).