IFRS® Foundation

Takaful contracts
IFRS 17 *Insurance contracts*

Islamic Finance Consultative Group Meeting

Agenda Paper **2**

November 2021

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- Overview of IFRS 17
- Applying IFRS to Takaful Contracts
- Questions and Answers

Overview of IFRS 17

General Model

Cash flows

Discount rate

Risk adjustment

Present value future cash flows

Fulfilment cash flows

+

Contractual service margin

=

IFRS 17 asset or liability

All insurance contracts are measured as the sum of:

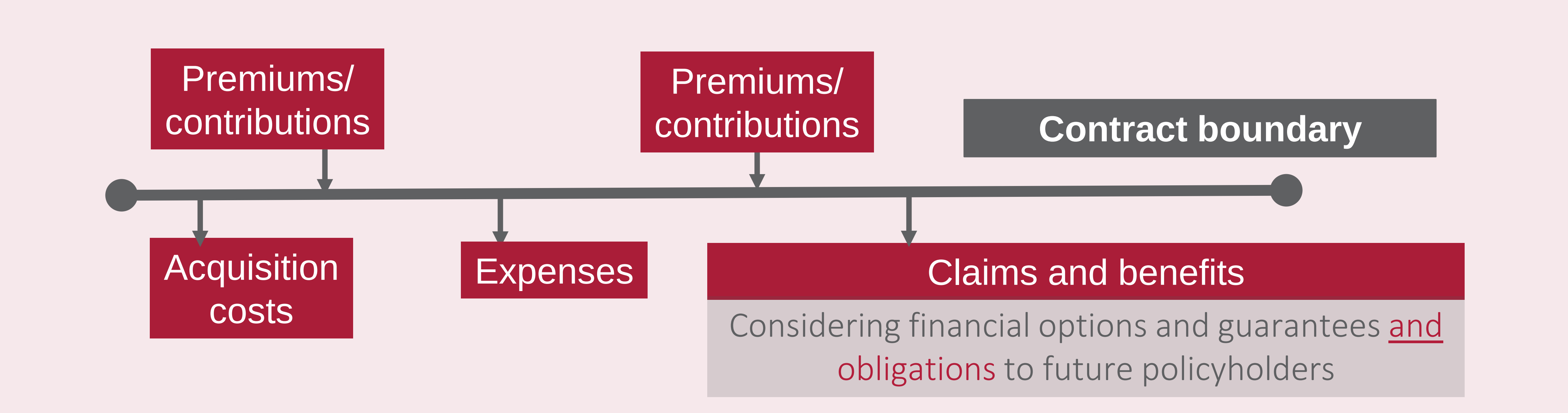
- **fulfilment cash flows**; and
- **contractual service margin**

Current value that incorporates all available information, consistent with observable market info. **Updated each** period using updated assumptions about cash flows, discount rate and risk.

Unearned profit of a group of contracts. It is adjusted by changes in estimates and is recognised in profit or loss as insurance coverage is provided.

Cash Flows

- Current estimates of future cash flows within the contract boundary



- Probability weighted and unbiased
- Stochastic modelling for financial options and guarantees, where relevant

Risk Adjustment

- Explicit, current adjustment for the compensation a company requires for bearing non-financial risk (eg insurance risk)
- Compensation that makes a company indifferent between:
  - – fulfilling a liability that has a range of possible outcomes; and
  - – fulfilling a liability that generates fixed cash flows

Group A		Group B	
Probability	Pay-off	Probability	Pay-off
0.5	1 000 000	1	500 000
0.5	0		

	Group A	Group B
Probability weighted average	(0.5 x 1,000,000)+(0.5 x 0) = CU500,000	1 x 1,000,000 = CU500,000

Contractual service margin

The unearned profit of the group of contracts that relates to future service to be provided

The amount determined so that no gains are recognised in profit or loss on initial recognition

- **Example**—Consider a group of contracts with PV of future cash flows of CU4,250 and risk adjustment of CU750

If premiums CU5,500

- Contracts profitable at inception
- CSM = CU500 [CU5,500 – CU750 – CU4,250]

If premiums CU3,500

- Contracts onerous at inception
- Day-one loss CU1,500 recognised in profit or loss

Subsequent measurement

	Initial Measurement	Subsequent Measurement
PV of future cash flows	Current assumptions	Current assumptions
Risk adjustment	Current assumptions	Current assumptions
Unearned profit – contractual service margin	The amount that results in no gain recognised in profit or loss	Update by reflecting: • Time value of money • Adjustments related to future service • Allocation for services provided

Measurement models

Core requirements

Modifications for contract Types

- Insurance contracts with direct participation features
- Reinsurance contracts held
- Investment contracts with discretionary participation features

Simplifications: premium allocation approach

Application to Takaful contracts

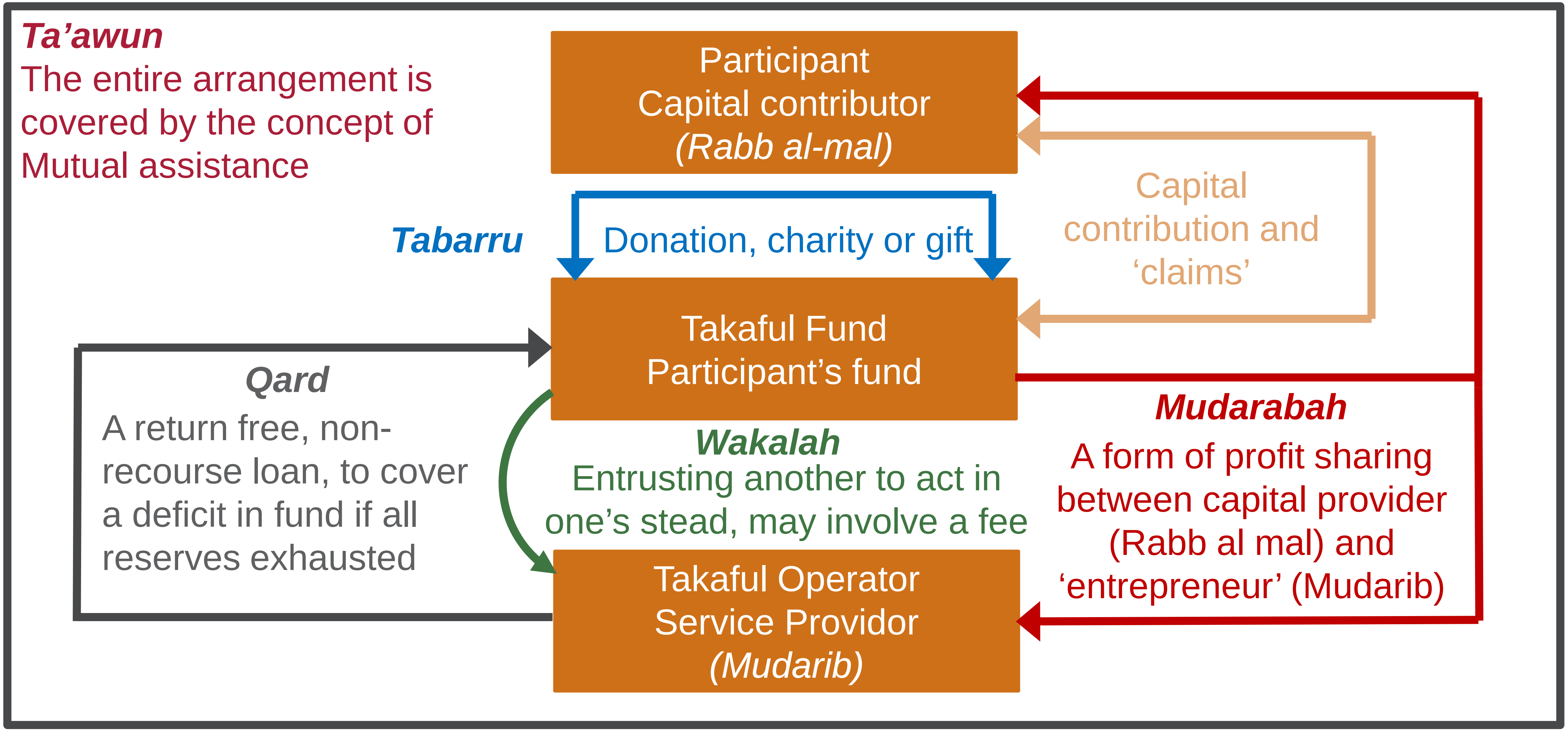
Typical structure

- Two primary ‘models’:

Wakalah	Mudarabah
Nature: agency contract Role: TO as ‘agent’. participant as ‘principal’	Nature: profit-sharing contract; losses, borne by capital provider Role: TO as ‘entrepreneur’. Participant

Takaful contracts can either fit within the first or the second approach, or a combination of both

Typical Structure



Reporting entity

What is a **reporting entity**?
Can a Takaful fund be considered a reporting entity?

Reporting Entity
Characteristic

Reporting entity = **Takaful operator**

Underlying Takaful funds

- Underlying Takaful funds are set up to be distinct entities
- Takaful fund may or may not be separate legal entity, however legal framework creates distinct rights and obligations
- Assets and liabilities, surplus and deficits of fund are first and foremost those of policyholders

Takaful operator

- Operator receives a fee which may or may not be linked to performance of the Takaful fund (eg wakalah fee (fixed) and mudarabah (profit sharing))
- The operator has an obligation to make good any deficits through return free, non-recourse loan or other form of financial support

Reporting Entity
Characteristic

Takaful Funds

- Underlying Takaful funds are set up to be distinct
- Takaful fund may or may not be separate legal entity, however legal framework creates distinct rights and obligations
- Assets and liabilities, and surplus and deficits of the fund are first and foremost those of the policyholders

Reporting Entity
IFRS requirements

- CF 3.8 notes that:

  Financial statements provide information about transactions and other events viewed from the perspective of the reporting entity as a whole

- CF 3.10 explains that a reporting entity is an entity that is:

  ….required, or chooses, to prepare financial statements. [It] can be a single entity or a portion of an entity or can comprise more than one entity. [It] is not necessarily a legal entity.

- CF 3.12 describes entities that are not legal entities:

  … the boundary … is driven by the information needs of the primary users of the reporting entity's financial statements. Those users need relevant information that faithfully represents what it purports to represent. Faithful representation requires that:

  (a) the boundary ….does not contain an arbitrary or incomplete set of economic activities;

  (b) including that set of economic activities within the boundary …. results in neutral information; and

  (c) a description is provided of how the boundary of the reporting entity was determined and of what constitutes the reporting entity.

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Reporting Entity
Application

- Consider:

Reporting entity	• Can a Takaful fund choose to prepare Financial Statements? • Is it a single entity or a portion of an entity? • Is there a need for information from the primary users of financials statements
Boundary of a Takaful fund	• Can that need for information be satisfied by reporting the assets, liabilities and activities of the Fund? • Can the boundary be established in a way that it does **not** contain an arbitrary or incomplete set of economic activities? • Can that set of economic activities result in neutral information?

Definition of Insurance

Does a Takaful fund provide insurance services as defined in IFRS 17?

Definition of Insurance
Characteristic

- Takaful is built on the concept of pooling of risk for the mutual benefit of participants
- The Takaful fund is a separate entity from the participants
- It pools funds from participants and distributes first to those that submit valid claims arising from a pre-agreed circumstance
- Remaining undistributed amounts, if any, are either distributed to participants at a predefined future date, or held as a liability against future claims of benefits

Definition of Insurance
IFRS requirements

Insurance contract	A contract under which one party (the issuer) 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
Insurance risk	Risk, other than **financial risk** transferred from the holder of a contract to the issuer
Financial risk	The risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, currency exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is **not specific** to a party to the contract
Insured event	An uncertain future event covered by an insurance contract that creates insurance risk
Policyholder	A party that has a right to compensation under an insurance contract if an insured event occurs

Definition of Insurance
IFRS requirements

- Paragraph B16 of IFRS 17 in discussing mutual entities states that:

> "In the case of a mutual entity, the **mutual entity accepts risk** from each policyholder and pools that risk. Although policyholders **bear that pooled risk collectively** because they hold the residual interest in the entity, the **mutual entity is a separate entity** that has accepted the risk."

- Paragraph B27(b) of IFRS 17 provides examples of items that are not insurance contracts:

> "The following are examples of **items that are not** insurance contracts:
> … contracts that have the legal form of insurance, but return all significant insurance risk 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…"

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Definition of insurance
Application

- Consider:

Insurance contract	• Does the relationship between the Takaful fund and the participant result in the sharing of risks of participants • Does the Takaful Fund agree to compensate the participant for an uncertain adverse event, thus allocating pooled funds unevenly
Separate entity	• Is the Takaful fund a separate entity from the participants • Does the Takaful fund pool the risks of the participants and distributes to participants in the event of adverse events
Non cancellable and enforceable mechanisms	• Does the takaful fund have a non-cancellable and enforceable mechanism to recover any losses from the policyholder? • Note emphasis on policyholder (as opposed to say operator)

Qard

How is qard accounted for under IFRS?

Qard
Characteristics

- A TO (typically) must:
  - Stand ready to provide Qard in the event of a deficiency in a TF; and
  - Contribute cash to the TF when a deficiency arises
- Qard is profit-free in nominal terms – no more or less than the nominal amount would be repaid to a TO
- A TF must repay Qard according to agreed terms, it is not a benevolent loan or donation
- Qard is an unsecured liability of a TF – participants rank first in a wind up

Qard
IFRS requirements

- Accounting considerations may be affected by IFRS 17:
- IFRS 17 deficits will typically be determined at a more granular level than is currently the case under IFRS 4
- Consequently, deficits may be recognized more frequently under IFRS 17 due to the change in measurement approach
- All else being equal, that may in turn trigger more frequent requirements for qard
- Liquidity considerations are not dependent on accounting methods, and therefore will be unaffected by change from IFRS 4 to IFRS 17

Qard
IFRS requirements

Qard

TO's stand-ready obligation to provide Qard:
Unrecognised loan commitment but subject to explanatory disclosures

TO provides Qard to rectify deficit in TF

TF's perspective

IFRS 17

- Qard is a direct consequence of a takaful entity issuing a group of takaful contracts
- Qard forms part of fulfilment cash flows

TO's perspective

IFRS 9

- Qard represents a TO's right to receive cash from TF
- Qard classified as a financial asset

Qard
IFRS requirements

TF: Qard within scope of IFRS 17

- Qard is a fulfilment cash flow
- Fulfilment cash flows would include expected cash inflows from qard and expected repayments of qard
- Fulfilment cash flows should also consider expected timing of inflows and outflows

Takaful Entity as a whole: Qard on consolidation

- Qard is fully eliminated on consolidation of the TO and the TF
- Any difference in the carrying value of amounts affected by qard in the accounts of the TF and TO are eliminated against current or retained profits

Presentation and disclosure

Can a Takaful operator present or disclose Takaful fund's results in its (the operator's) financial statements?

Presentation and disclosure
Characteristic

- An operator typically concludes
  - Takaful fund issues contracts as defined by IFRS 17
- Takaful fund has separately identifiable assets and liabilities
- Operator's rights and obligations over the assets and liabilities of the fund(s) are constrained by law and/or convention
- Operator typically has an obligation to contribute to the fund(s) in the event of a deficit (Qard)
- Operator will typically have its own assets and liabilities (and equity) which are separated from the rights and obligations of the fund other than to the extent Qard applies

Presentation and disclosure
IFRS Requirements

- IAS 1.15 requires financial statements to fairly present:

  ……Fair presentation requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the Framework. The application of IFRSs, *with additional disclosure when necessary*, is presumed to result in financial statements that achieve a fair presentation.

- IAS 1.31 expands on additional disclosure requirements, stating:

  An entity shall also consider whether to provide additional disclosures when compliance with the specific requirements in IFRS is insufficient to enable users of financial statements to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance.

Presentation and disclosure
IFRS Requirements

- IAS 1.55 requires an entity to present:

  additional line items ….., headings and subtotals in the statement of financial position when such presentation is relevant to an understanding of the entity's financial performance.

- IAS1.55A requires that those subtotals shall:

  (a) be comprised of line items made up of amounts recognised and *measured in accordance with IFRS*;

  (b) be presented and labelled in a manner that makes the line items that constitute the subtotal *clear and understandable*;

  (c) be *consistent from period to period*, in accordance with paragraph 45; and

  (d) *not be displayed with more prominence* than the subtotals and totals required in IFRS for the statement of financial position.

Presentation and disclosure

IFRS Requirements

IFRIC update May 2014

…The submitter expressed a concern that the absence of definitions in IAS 1 and the lack of implementation guidance give significant flexibility ….. The submitter provided examples in the following areas: ……(c) *presentation of additional statements or columns* in the primary statements; …. The Interpretations Committee observed that a complete set of financial statements is comprised of items *recognised and measured in accordance with IFRS*. …. It also noted that while IAS 1 does permit flexibility in presentation, it also includes various principles for the presentation and content ….. The Interpretations Committee observed that securities regulators, as well as some members of the Interpretations Committee, *were concerned about the presentation of information* in the financial statements that is *not determined in accordance with IFRS*. They were particularly concerned when such information is presented on the face of the primary statements. The Interpretations Committee noted that it *would be beneficial if the IASB's Disclosure Initiative considered what guidance should be given* for the presentation of information beyond what is required in accordance with IFRS. …..

Presentation and disclosure
IFRS Requirements

PFS Project

- The PFS exposure draft proposes to prohibit columns in the statements of Financial Performance for Management performance measures
  - Decision relates only to Management Performance Measures
  - MPM is specifically considered to be an item not measured in accordance with IFRS
- PFS project **does not** otherwise limit disclosure of this information
- However, the need for proposing a prohibition is in itself indicative of the current position

Presentation and disclosure
IFRS Requirements

Summary

- IFRS Standards don't specify requirements for using columns
- As long as any additional subtotals presented are calculated in accordance with IFRS Standards and provide faithful representation there is nothing specific to prohibit such presentation on face.
- Such presentation may be relevant to understanding entity's financial position or performance and thus required
- IFRS Interpretations committee considered the topic and noted column were permitted
- PFS ED is proposing to prohibit columns in narrow circumstance

Presentation and disclosure
Application

- Consider:

Relevant information	• Do the assets and liabilities held within the funds represent distinct rights and obligations • Are those asset and liabilities clearly distinguishable from the other rights and obligations of the reporting entity • Is the information useful to primary users
Requirements of IAS 1	• Are the assets and liabilities of the fund measured in accordance with IFRS Standards (refer discussion elsewhere) • Can they be presented/disclosed without displaying more prominence then amounts required to be presented/disclosed by IFRS Standards

Separation of Insurance Contracts

The February 2018 IASB TRG discussion concluded an entity is not permitted to separate insurance components in a single contract for measurement purposes.

Does that conclusion impact on the ability of an insurer to present columns of the face of its accounts

Separation of insurance contracts
Characteristic

Two Reporting entities with different characteristics

Underlying Takaful fund(s)

- The legal framework of a Takeful Fund creates distinct rights and obligations
- Those rights and obligations exist at the level of the fund, thus:
  - Is has rights and obligations in respect of participants, and
  - It has rights and obligations in respect of the Operator

Takaful operator

- Consolidated accounts present the outcome for the entire insurance contract in accordance with IFRS 17

Separation of Insurance contracts
IFRS requirements (TRG Conclusion)

- IFRS 17 is
  - silent on separating insurance components of an insurance contract
  - lowest unit of account is a contract, except if non-insurance components
- Availability of information is not, in itself, sufficient to conclude that contract does not reflect the substance of its rights and obligations
- Contracts usually designed to reflect substance. Therefore, legal form would generally prevail. However:
  - there may be circumstances where legal form would not reflect substance
  - overriding legal form involves significant judgement (not a policy choice)

Separation of Insurance contracts
IFRS requirements (TRG Conclusion)

- If insurer believes legal form does not reflect substance of contractual rights and obligations, it should apply judgement to determine whether it is appropriate to separate a contract
- Relevant facts and circumstances to consider may include:
  – interdependency between the different risks covered;
  – whether components lapse together; and
  – whether components can be priced and sold separately.
- How an entity identifies its contract will impact various aspects of the accounting under IFRS 17, including the measurement of the contract and its insurance service results.

Separation of Insurance contracts
IFRS requirements (TRG Conclusion)

- The TRG **did not** consider contracts which bind multiple parties
- Such contracts occur frequently in practice, eg certain
  - – Sub leases
  - – Underwriting agreements
  - – Construction contracts
- In such contracts, each party typically accounts for its own rights and obligations only
  - – Not considered a splitting of a contract

Separation of Insurance contracts
IFRS requirements (TRG Conclusion)

Summary

- IFRS 17 is silent and therefore does not prohibit separation
- TRG conclusion requires
  - an assumption that form of contract reflects substance
  - judgement be applied if indications are substance differs from form
  - lists non exhaustive facts and circumstances to consider
- TRG did not consider circumstance in which contract is triparty (ie gives rise to rights and obligations for three (or more) parties)
- In multi party contracts, each party should consider its own rights and obligations (ie not a separation)

Determination of ‘Reserves’

A Takaful fund, like some participating funds, have some excess assets not required to satisfy the claims of current participants. Contractual law or regulations prevent these excess funds from been distributed to the operator and instead require that they held as reserves, or in the event that is not required, then for the benefit of future participants through either lower premiums or higher distributions. The question is whether these amounts are equity or liabilities?

Determination of ‘Reserves’
Characteristic

- Takaful built on the concept of mutual assistance between participants
- The fund is a separate entity from the participants
- It pools funds from participants and distributes only to those that submit valid claims arising from a pre-agreed circumstance
- Any residual funds in the entity at the end of a reporting period are not for the account of the operator, although the operator may be entitled to a portion based on an agreed sharing ratio
- Instead they are for the account of the fund, held for the benefit of future participants through either reductions in premiums or increase in distributions (unallocated surplus)

Determination of ‘Reserves’
IFRS requirements

IFRS 17 B67

Some insurance contracts affect the cash flows to policyholders of other contracts by requiring:

(a) the policyholder to share with policyholders of other contracts the returns on the same specified pool of underlying items; and

(b) either:

- (i) the policyholder to bear a reduction …. because of payments to policyholders of other contracts that share in that pool, ….; or
- (ii) policyholders of other contracts ... bear a reduction ... because of payments to the policyholder ..

IFRS 17 B71

After all coverage has been provided to the contracts in a group, the fulfilment cash flows may still include payments expected to be made to current policyholders in other groups or future policyholders. An entity is not required to allocate such fulfilment cash flows to specific groups but can instead recognise and measure a liability for such fulfilment cash flows arising from all groups.

Determination of ‘Reserves’
Application

- Consider:

Mutualisation	• Whether current and future participants share in the returns of same pool of assets (the assets of the takaful fund), and • Whether returns in the fund that are not immediately disbursed to current participants are held for the benefit of future participants
Future participants	• Whether the fulfilment cash flows should include amounts expected to be paid to future policyholders

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