IFRS

STAFF PAPER

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Project	**Transition Resource Group for IFRS 17 *Insurance Contracts***
Paper topic	Separation of insurance components of a single insurance contract

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Introduction

1. We have received a submission (the submission) about whether IFRS 17 *Insurance Contracts* permits the separation of insurance components of a single insurance contract for measurement purposes.

2. We have also received a submission (the additional submission) about whether a reinsurance contract held should be separated into components to reflect the underlying contracts covered for measurement purposes when applying IFRS 17.

3. The objective of the 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

1. This paper includes the following:
   (a) background information;
   (b) implementation questions; and
   (c) review of accounting requirements.
2. There is one appendix to this paper:
   (a) Appendix A—Example of a contract that includes a number of insurance risks

Background information

3. Paragraph 2 of IFRS 17 states that a contract is an agreement between two or more parties that creates enforceable rights and obligations.
4. Paragraphs 10-13 of IFRS 17 set out the requirements on separating derivatives, investment components and distinct goods and non-insurance services (non-insurance components) from an insurance contract. After separating non-insurance components IFRS 17 is applied to all remaining components of the host insurance contract.
5. There is no paragraph in IFRS 17 that requires or permits separating insurance components of an insurance contract. That is, the lowest level of the unit of account used in IFRS 17 is a contract, or a host insurance contract after separating non-insurance components (when relevant).
6. Paragraph 9 of IFRS 17 sets out the requirements on combining a set or a series of insurance contracts with the same or related counterparty that may achieve or be designed to achieve an overall commercial effect. Combination of contracts may be necessary in order to report the substance of such contracts. Applying

paragraph 9 therefore may result in a combination of two or more contracts to form a contract for the purpose of applying IFRS 17.

7. A portfolio of insurance contracts is defined as insurance contracts subject to similar risks and managed together. Paragraph 14 of IFRS 17 requires entities to identify portfolios of insurance contracts. Paragraphs 16-24 of IFRS 17 are then applied to divide portfolios into groups of insurance contracts.

8. Paragraph 33 of IFRS 17 states that an entity shall include in the measurement of a group of insurance contracts all the future cash flows within the boundary of each contract in the group. Paragraph 34 of IFRS 17 sets out the requirements on the cash flows within the boundary of an insurance contract.

9. Paragraph 53 of IFRS 17 states the criteria to be met for an entity to be eligible to apply the premium allocation approach to a group of insurance contracts. One of the criteria is that the coverage period of each contract in the group (including coverage arising from all premiums within the contract boundary determined at that date applying paragraph 34) is one year or less.

Implementation questions

10. The submission states that insurers combine different types of products or coverages that have different risks into one legal insurance contract. Some of the examples provided in the submission are as follows:

    (a) A term life insurance coverage and a medical expenses coverage that are included in a single contract.

    (b) A commercial contract that includes both coverage for workers compensation and general liability coverage.

    (c) A 10 year life insurance with a rider for one year health coverage.

    (d) A contract that includes one year coverage for medical expenses and two years of motor coverage. The entity often sells each coverage separately and the cash flows related to each coverage are not interdependent. The same contract can also be sold with a shared deductible and a shared limit for claims.

11. The submission notes several concerns related to prohibiting the separation of insurance components within a single insurance contract:
    (a) Components that cover different risks that would otherwise be in different portfolios would be forced into the same portfolio.
    (b) Components that cover different risks that would otherwise be in different measurement models, i.e. the general model and the premium allocation approach, would be forced into one model.
    (c) Profit that is related to the component with a shorter coverage period would be spread over the longer coverage period of a different component.

12. The additional submission provides an example of a reinsurance contract held that provides coverage to underlying contracts that are included in different groups of insurance contracts. This submission notes that applying the measurement requirements of IFRS 17 to the reinsurance contract as a whole could result in significant complexity and cost.

13. The submission questions whether IFRS 17 permits the separation of insurance components of a single contract for measurement purposes.

14. The submission provides five alternative views:
    (a) View A – separation is not permitted under IFRS 17.
    (b) View B – separation is permitted where the components are determined to be distinct. Distinct is assessed by applying the requirements in IFRS 17 for non-insurance components (B31-B35) or paragraphs 26-30 of IFRS 15 *Revenue from Contracts with Customers* by analogy.
    (c) View C – separation is permitted using a principle-based approach. The submission notes that separation applying a principle-based approach would result in reflecting the economic substance of the contracts rather than their legal form.

(d) View D – applying paragraphs 10-11 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, both view B and C should be acceptable[1].

(e) View E – IFRS 17 requires separation of insurance components that would fall into different portfolios had they been sold separately and considered distinct. The submission acknowledges the absence of such requirements in IFRS 17 and considers view E difficult to support.

15. Both submissions observe that applying different views might result in diversity in practice.

Review of accounting requirements

16. IFRS 17 identifies a contract as an agreement that creates enforceable rights and obligations. IFRS 17 does not provide specific requirements on separating enforceable rights and obligations of a contract except with respect to non-insurance components. Therefore, the staff observe that the lowest unit of account that is used under IFRS 17 is the contract that includes all insurance components.

17. When developing paragraph 9 of IFRS 17 with respect to combining separate insurance contracts into a single insurance contract, the Board intended to provide a principle-level paragraph on contract combination that is consistent with the principles in the Exposure Draft *Conceptual Framework For Financial Reporting* (the Conceptual Framework ED) published in May 2015[2] with respect to reporting the substance of contractual rights and contractual obligations (paragraphs 4.53-4.56).

[1] Paragraphs 10-11 of IAS 8 require the use of judgment in developing and applying an accounting policy in the absence of an IFRS that specifically applies to a transaction, other event, or condition.

[2] The Conceptual Framework is expected to be published by March 2018. The Board tentatively decided that the Board and the IFRS Interpretations Committee will start using the revised Conceptual Framework as soon as it is issued. It is therefore appropriate that the revised Conceptual Framework would be used as soon as it is issued for the analysis included in this paper. The relevant wording in the revised Conceptual Framework is not expected to change significantly from the Draft Conceptual Framework.

18. Paragraph 4.56 of the Conceptual Framework ED also states that if a single contract creates two or more sets of rights and obligations that would have been identical if each set had been created through separate contracts, the entity may need to account for each set as if it arose from separate contracts in order to faithfully represent the rights and obligations. It also refers to paragraphs 4.57–4.63 of the Conceptual Framework ED that discuss the unit of account.

19. Paragraph 4.62 of the Conceptual Framework ED provides examples of circumstances where treating a group of rights and obligations as a single unit of account may provide more relevant information. These examples include circumstances where those rights and obligations:

    (i) cannot (or are unlikely to) be the subject of separate transactions.
    (ii) cannot (or are unlikely to) expire in different patterns.
    (iii) are used together in the context of the business activities conducted by the entity to produce cash flows and are measured by reference to the estimates of their interdependent future cash flows.
    (iv) have similar economic characteristics and risks. Rights and obligations with different characteristics and risks are likely to have different implications for the prospects for future net cash inflows to an entity and so may need to be separated.

20. It is expected that entities would usually design contracts in a way that reflects their substance. Therefore a contract with the legal form of a single contract, unless artificially constructed this way, would generally be considered a single contract in substance. The staff observe that this is consistent with the contract being the lowest unit of account used under IFRS 17.

21. The staff acknowledge that there might be circumstances where the legal form of a single contract would not reflect the substance of its contractual rights and contractual obligations and therefore there might be justification in overriding the presumption of the contract being the lowest unit of account under IFRS 17.

22. The staff view is that overriding the contract unit of account presumption by separating insurance components of a single insurance contract involves

significant judgment and careful consideration of all relevant facts and circumstances.

23. The staff view is that combining different types of products or coverages that have different risks into one legal insurance contract is not, in itself, sufficient to conclude that the contract does not reflect the substance of its contractual rights and contractual obligations.

24. Similarly, the staff view is that a reinsurance contract held covering underlying contracts that are included in different groups is not in itself, sufficient to conclude that the reinsurance contract held does not reflect the substance of its contractual rights and contractual obligations.

25. Appendix A includes an example of a contract that includes a number of insurance risks.

TRG Discussion

Question to TRG members

What are your views on the implementation question presented above?

Appendix A—Example of a contract that includes a number of insurance risks

A1. The staff have been made aware of an example of a contract containing a long term life coverage with annual renewable health riders. The terms of the contract include the following:

(a) The entity does not sell the renewable health riders separately from the life coverage but the life coverage can be sold on its own. There is no similar product to the renewable health riders available in the jurisdiction the entity operates in.

(b) The policyholder can choose not to renew any of the renewable health riders and maintain the life coverage, however, if the life coverage is cancelled by the policyholder, the renewable riders are cancelled at the same time.

(c) The renewable riders are rarely cancelled and most of them remain until the end of the coverage period of the life contract.

(d) At each annual renewal the entity cannot reprice or cancel the life coverage of the contract.

(e) At each annual renewal date the entity can reassess the risks and can set a price that fully reflects these risks with respect to the renewable health riders.

A2. The staff observe that in the example above, the contract including the renewable heath riders is the lowest unit of account used under IFRS 17, and in the staff's view, the facts and circumstances described above do not provide sufficient evidence to suggest otherwise. In concluding this the staff has considered the following:

(a) the renewable health riders are not sold separately;

(b) if the life coverage is cancelled by the policyholder, the renewable riders are cancelled at the same time; and

(c) the renewable riders are rarely cancelled and most of them remain until the end of the coverage period of the life contract.

A3. The staff note that any single factor would not be considered determinative applying this judgment and an assessment of all the relevant facts and circumstances should be performed.

A4. The staff note that applying some of the requirements of IFRS 17 for this contract is expected to result in the following outcomes:

(a) Applying paragraphs 14-24 of IFRS 17, a contract is included in its entirety in a single portfolio and in a single group and it is not split to reflect the way its components would be allocated to portfolios and groups as if they were issued as separate contracts. The staff note that applying paragraph 33 of IFRS 17, an entity may estimate the future cash flows at a level of aggregation that is higher than a group and then allocate the resulting fulfilment cash flows to individual groups of contracts, and therefore an entity is not required to develop its estimates on a contract basis.

(b) Applying paragraphs 33-34 of IFRS 17, the cash flows within the boundary of each contract in the group would be assessed for each contract in its entirety. Therefore, the assessment of when a substantive obligation to provide the policyholder with services ends will be performed for the contract in its entirety. In the example, the entity does not have the practical ability to set a price or level of benefits that fully reflects the reassessed risks of the entire contract at each annual renewal. Therefore the contract boundary is longer than a year. The contract is not split to its components in order to assess the contract boundary of each component as if they were issued as separate contracts.

(c) Applying paragraph 53(b) of IFRS 17, the contract would be evaluated against the criteria for applying the premium allocation approach in its entirety. In the example, and following the above noted, the contract is not expected to meet the requirement in paragraph 53(b) even if one of its component would, if assessed on its own.