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STAFF PAPER

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Project	Transition Resource Group for IFRS 17 *Insurance Contracts*		
Paper topic	Insurance risk consequent to an incurred claim		
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Introduction

1. We have received a number of submissions on insurance contracts under which an incurred claim results in insurance risk for the issuer that would not exist if no claim were made.

2. An example described in the submissions is an insurance contract that provides coverage for a policyholder becoming disabled during a specified period. If a valid claim is made, the entity is required to make regular payments to the policyholder until the policyholder recovers, reaches a specified age or dies.

3. The objective of this paper is to provide background and an accounting analysis to support discussion at the Transition Resource Group for IFRS 17 *Insurance Contracts* (TRG).

Structure of the paper

4. This paper includes the following information:

   (a) background information;

   (b) implementation question; and

   (c) review of accounting requirements.

Background information

5. Appendix A of IFRS 17 defines the coverage period as:

   > The period during which the entity provides coverage for insured events. This period includes the coverage that relates to all premiums within the boundary of the insurance contract.

6. Appendix A of IFRS 17 defines an insured event as:

   > An uncertain future event covered by an insurance contract that creates insurance risk.

7. Appendix A of IFRS 17 defines a liability for remaining coverage as:

   > An entity's obligation to investigate and pay valid claims under existing insurance contracts for insured events that have not yet occurred (ie the obligation that relates to the unexpired portion of the coverage period).

8. Appendix A of IFRS 17 defines a liability for incurred claims as:

   > An entity's obligation to investigate and pay valid claims for insured events that have already occurred, including events that have occurred but for which claims have not yet been reported, and other incurred insurance expenses.

9. Paragraph B5 of IFRS 17 states:

   > Some insurance contracts cover events that have already occurred but the financial effect of which is still uncertain. An example is an insurance

contract that provides coverage against an adverse development of an event that has already occurred. In such contracts, the insured event is the determination of the ultimate cost of those claims.

Implementation question

10. The submissions discuss a situation in which an incurred claim under an insurance contract creates insurance risk for the entity that would not exist if no claim were made. In this paper, such insurance risk is referred to as consequential insurance risk.

11. The submissions ask whether the entity's obligation to pay amounts subsequent to an incurred claim that are subject to insurance risk should be treated as:

    (a) a liability for incurred claims; or

    (b) a liability for remaining coverage.

12. The classification of the obligation as a liability for incurred claims or a liability for remaining coverage does not affect the determination of the fulfilment cash flows. However, it does affect the determination of the coverage period. Consequently, it affects whether some changes in the fulfilment cash flows adjust the contractual service margin and the allocation of the contractual service margin.

Review of accounting requirements

13. This paper uses two examples to illustrate alternative applications of the relevant definitions in IFRS 17:

    (a) insurance coverage for disability that provides an annuity for the period in which the policyholder is disabled; and

(b) insurance coverage for fire that provides compensation for the cost of rebuilding a house after a fire.

14. Different interpretations of the definitions in IFRS 17 lead to different views on whether the obligation to pay an annuity after a disability event and the obligation to pay the costs of rebuilding a house after a fire event are part of a liability for remaining coverage or a liability for incurred claims.

15. Applying the definitions in support of the consequential insurance coverage being part of the liability for incurred claims:

(a) disability insurance:

(i) the insured event is the uncertain event that a policyholder becomes disabled because of the occurrence of an accident/illness.

(ii) the coverage period is the period in which a policyholder can make a valid claim for becoming disabled due to an accident/illness.

(iii) the liability for remaining coverage is the entity's obligation to pay valid claims relating to accidents/illnesses that have not yet occurred causing disability.

(iv) the liability for incurred claims is the entity's obligation to pay for a policyholder's claim on becoming disabled. The amount of the claim (the total payments under the annuity) is uncertain and subject to insurance risk.[1] However, such features are clearly envisaged as potentially being part of the liability for incurred claims applying IFRS 17 by the

[1] The amount of the claim is subject to insurance risk because the risk of the policyholder being disabled for an uncertain period is transferred to the entity.

inclusion of a risk adjustment for non-financial risk in that liability.[2]

(b) fire insurance:

(i) the insured event is the uncertain occurrence of a fire.

(ii) the coverage period is the period in which a fire can occur for which a policyholder can make a valid claim.

(iii) the liability for remaining coverage is the entity's obligation to pay claims relating to fire events that have not yet occurred.

(iv) the liability for incurred claims is the entity's obligation to pay for a policyholder's claim for a fire. The amount of the claim (the cost of rebuilding the house) is uncertain and subject to insurance risk (because house building costs may increase), but such features are clearly envisaged under IFRS 17 by the inclusion of a risk adjustment for non-financial risk in the liability for incurred claims.

16. Applying the definitions in support of the consequential insurance coverage being part of the liability for remaining coverage:

(a) disability insurance:

(i) the insured events are the uncertain event of the policyholder becoming disabled following an accident/illness in the period specified in the contract and the uncertain event of the policyholder remaining disabled and eligible to claim.

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[2] Paragraph 40(b) of IFRS 17 requires the fulfilment cash flows for the liability for incurred claims to be measured applying paragraphs 33–37 of IFRS 17. Paragraph 37 of IFRS 17 requires an entity to make an adjustment for non-financial risk.

(ii) the coverage period is the period in which a policyholder may be eligible to make a claim for being disabled.

(iii) the liability for remaining coverage is the entity's obligation to pay claims for future periods of disability both for policyholders that are already disabled and for policyholders yet to become disabled. This treatment would be consistent with the treatment of such insurance contracts when they are acquired after the policyholder becomes disabled, applying paragraphs B5 and B93 of IFRS 17 (see paragraph 24 of this paper).

(iv) the liability for incurred claims is the entity's obligation to settle a claim already made by a policyholder for a period of disability. The amount of the claim is relatively certain, not subject to insurance risk and is expected to be small assuming annuities are paid monthly.

(b) fire insurance:

(i) the insured events are claims for the cost of rebuilding a house damaged by a fire that occurred in the period specified in the contract.

(ii) the coverage period is the period in which a fire can occur or in which the policyholder can make a claim for the cost of rebuilding a house damaged by a qualifying fire event.

(iii) the liability for remaining coverage is the entity's obligation to pay claims relating to fire events that have not yet occurred and to pay claims for the cost of building the house for buildings already damaged by qualifying fire events. This treatment would be consistent with the treatment of such insurance contracts when they are acquired in the period after a fire event, applying paragraphs B5 and B93 of IFRS 17 (see paragraph 24 of this paper).

(iv) the liability for incurred claims is the entity's obligation to pay for a policyholder's claims for the cost of rebuilding the house. The amount to settle the claims as they are made is relatively certain and not subject to insurance risk.

17. The staff think that the analyses in both paragraphs 15 and 16 of this paper are valid interpretations of IFRS 17 for both examples. The staff think it is a matter of judgement for the entity as to which interpretation provides the most useful information about the insurance service provided by the entity to the policyholder under the contract. The staff think that judgement will be influenced by:

(a) the relative complexity of the two approaches. Treating payments caused by an initial claim as a liability for remaining coverage is more complex than treating them as a liability for incurred claim because:

(i) the period in which adjustments are made to the contractual service margin is extended; and

(ii) the determination of coverage units includes two types of insurance coverage.

(b) comparability with other products available in the market. If the insurance coverage provided as a consequence of an initial claim is also commonly available as a standalone product, more useful information may be given by treating the consequential payments as a liability for remaining coverage, consistent with the treatment of the standalone products.

18. The staff observe that in some cases, the difference between the two approaches may not be significant. The number of contracts in a group that continue into the consequential insurance coverage period is likely to be a small proportion of the total number of contracts. In addition, if the expected coverage period of the

consequential insurance coverage is short compared to the initial coverage period, the amount of the contractual service margin recognised in the consequential coverage period may be small.

19. The staff also observe that the approach applied by an entity is an accounting policy as defined in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.[3] Applying IAS 8, an entity is required to:

    (a) select and apply accounting policies consistently for similar transactions, other events and conditions.

    (b) change an accounting policy only if the change:

        (i) is required by an IFRS Standard; or

        (ii) results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows.

    (c) disclose the nature of a change in accounting policies and the reasons why applying the new accounting policy provides reliable and more relevant information.

20. Hence, an entity should apply an approach consistently for similar transactions and over time. For example, the same approach should be applied to all groups of contracts for the same product type or all groups of contracts with similar insurance service provided by the entity to the policyholder.

21. Given the factors discussed in paragraphs 17–20 of this paper, the staff think it is likely that for many products, different entities will adopt the same approaches. However, as practice develops, if evidence emerges of diversity that is widespread

[3] IAS 8 defines accounting policies as 'the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements.'

and has a material effect, the International Accounting Standards Board can consider whether to take any action.

22. The staff note that whichever approach an entity applies, IFRS 17 requires disclosure of significant judgements made in applying the Standard and substantial disclosures relating to the contractual service margin (for example, the reconciliation of the opening and closing balances and an explanation of when the entity expects to recognise the remaining balance in profit or loss), which will enable users to understand the effects of the approach applied.

Additional points

23. The submissions raise two additional questions:

    (a) whether the treatment of the payments consequent to an incurred claim depends on whether the contracts are reinsurance contracts relating to underlying contracts for which the insured event has already occurred (for example, reinsurance for adverse development of claims) or are insurance contracts that were transferred during the claims settlement period; and

    (b) what effect law or regulation might have.

24. The staff observe that reinsurance contracts relating to underlying contracts for which the insured event has already occurred create a liability for remaining coverage, applying paragraph B5 of IFRS 17. IFRS 17 also specifies that insurance contracts acquired after the insured event has occurred create a liability for remaining coverage, applying paragraphs B5 and B93 of IFRS 17.[4] The analysis in this paper does not affect those classifications.

[4] Paragraph B93 of IFRS 17 states 'When an entity acquires insurance contracts issued or reinsurance contracts held in a transfer of insurance contracts that do not form a business or in a business combination, the entity shall apply paragraphs 14–24 to identify the groups of contracts acquired, as if it had entered into the contracts on the date of the transaction.'

25. One submission asks about an example of coverage for personal or third party injury caused by a motor vehicle accident. The contract does not specify how claims will be settled. However, law or regulation might, in rare circumstances, impose a requirement for the entity to settle a claim by life-contingent annuity payments.

26. Paragraph 2 of IFRS 17 states:

> An entity shall consider its substantive rights and obligations, whether they arise from a contract, law or regulation, when applying IFRS 17. A contract is an agreement between two or more parties that creates enforceable rights and obligations. Enforceability of the rights and obligations in a contract is a matter of law. Contracts can be written, oral or implied by an entity's customary business practices. Contractual terms include all terms in a contract, explicit or implied, but an entity shall disregard terms that have no commercial substance (ie no discernible effect on the economics of the contract). Implied terms in a contract include those imposed by law or regulation. The practices and processes for establishing contracts with customers vary across legal jurisdictions, industries and entities. In addition, they may vary within an entity (for example, they may depend on the class of customer or the nature of the promised goods or services).

27. Hence an entity would need to consider the possibility of law or regulation imposing settlement by life-contingent annuity payments in its assessment of insurance risk created by the contract. The same analysis in paragraphs 15–20 of this paper then applies.

TRG discussion

Question to TRG members

What are your views on the implementation question presented above?