AASB 17 *Insurance Contracts*

Application of IFRS 17 paragraph 9 to insurance and reinsurance arrangements between related entities within a consolidated group

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Potential implementation question

The implementation question addressed in this paper is the extent to which the requirements of IFRS 17.9 should be applied to a set or series of insurance contracts with the same or a related counterparty to reflect the commercial substance of a transaction over its legal form.

Paragraph of IFRS 17 *Insurance Contracts*

IFRS 17 Paragraphs 2, 9, B18, b19, B34, B35. Sections of the conceptual framework and IFRS 15 are also included for ease of reference.

Analysis of the question

Refer Appendix A.

Is the question pervasive?

There are a number of reinsurance arrangements in Australia and globally that are variations on the example set out below and therefore the question is considered pervasive, particularly in the general insurance market.

Appendix A - Application of IFRS 17 paragraph 9 to insurance and reinsurance arrangements between related entities within a consolidated group

BACKGROUND

The issue of combining a set or series of insurance contracts was discussed at IFRS 17 Transition Resource Group (TRG), May 2018. Agenda paper 1 *Combination of insurance contracts.* At the TRG, IASB staff noted that **the Board intended to provide a principle on contract combination that is consistent with the principle set out in the Conceptual Framework**[1].

1 When developing IFRS 17, the Board considered consistency with the principle set out in the 2015 Exposure Draft of the Conceptual Framework for Financial Reporting that **contracts should be combined as necessary to report their substance**. The Conceptual Framework was published in March 2018 and this principle has remained the same.

IFRS 17 highlights the need to consider the substance of insurance arrangements. In particular IFRS 17.9 specifically addresses cases in which combined accounting might apply: "A set or series of insurance contracts with the same or a related counterparty may achieve, or be designed to achieve, **an overall commercial effect**. In order to report the substance of such contracts, it may be necessary to treat the set or series of contracts as a whole. …" [Emphasis added]

In discussing situations where it may be necessary to treat a set or series of contracts as one contract the IASB TRG noted that this 'involves significant judgement and careful consideration of all relevant facts and circumstances'. It is not considered an accounting policy choice.

Below are some considerations that IASB staff indicated might be relevant in the assessment of whether the legal form of a single contract reflects the substance of its contractual rights and contractual obligations include:

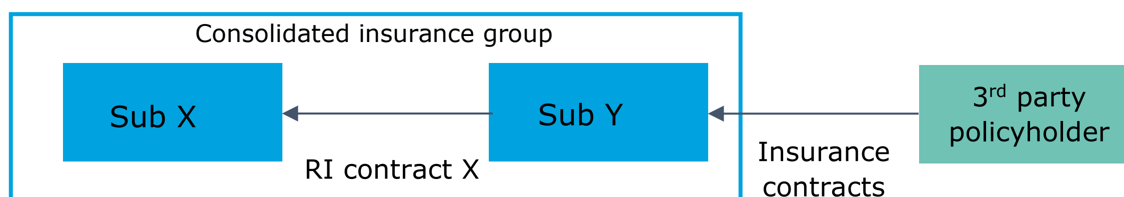
(i) interdependency between the different risks covered;

(ii) whether components lapse together; and

(iii) whether components can be priced and sold separately.

Fact Pattern

This situation may arise in global groups where one entity may specialise in a particular Product but can use the services (including, for example, distribution platforms, marketing, licences) of a related entity in its own or other jurisdictions to grow the Product business whilst exposing the related entity to minimal or no insurance risk. These arrangements are commonly referred to as fronting arrangements but may take many forms. In this scenario:



Sub X underwrites warranty business and Sub Y underwrites a broad range of property and liability business but does not underwrite warranty business in the normal course of its business.

A third-party policyholder wishes to place property, liability and warranty business with the consolidated insurance group. As Sub Y does not have the requisite skills to underwrite warranty business or to assess

warranty claims, it enters into a reinsurance arrangement with a related party Sub X under which **all the insurance and related risks of underwriting the warranty contract** will be transferred from Sub Y to Sub X.

Pricing and underwriting activity is performed by Sub X and the only activity performed by Sub Y is:

- to issue a contract to the policyholder using terms and conditions provided by Sub X and based on underwriting and pricing performed by Sub X;
- collect premium from the 3rd party policyholder and remit premium to Sub X; and,
- to pay claims as and when instructed by Sub X.

Sub Y is legally required to honour the obligations to the policyholder in the event that Sub X fails to indemnify Sub Y, however, given the related party nature of both Sub X and Sub Y this credit risk is considered remote.

For performing their administrative role Sub Y deducts a fee from the premium received from third parties before remitting cash to Sub X. The fee is based on a % of the premium received.

If the policyholder cancels the warranty contract with Sub Y, then premium is refunded and an equivalent cancellation of a component of the reinsurance contract occurs and reinsurance premium is refunded from Sub X to Sub Y.

QUESTION 1

In accounting for the warranty insurance contract issued to the third party policyholder and the reinsurance contract entered into with a related party should Sub Y consider these to be separate contracts accounted for as a gross insurance contract issued (to a third party) and a reinsurance contract held (with Sub X) – **View A**, or together as one combined contract **– View B**.

View A – the arrangement is accounted for as two separate transactions.

The insurance contract issued to the third party is accounted for as an insurance contract issued and the reinsurance held with the related party is accounted for as reinsurance held and eliminated in the financial statements for the consolidated group.

Proponents of this view note that Sub Y has a legal obligation to fulfil the requirements of the insurance contract issued irrespective of whether Sub X pays or not. This is because an entity that holds a reinsurance contract does not have a right to reduce the amounts it owes to the underlying policyholder by amounts it expects to receive from the reinsurer.

They consider that there is always some residual credit risk held by Sub Y even though the transaction is with a related party.

Proponents of this view note that there are enforceable rights and obligations in the contract issued by Sub Y to the third party and these cannot be ignored in accordance with IFRS 17.2.

Proponents of this view also note that IFRS 17.9 gives an example of combining contracts “entered into at the same time with the same counterparty”; however, in the fact pattern, the insurance contract issued is with a third party and therefore cannot be combined with the reinsurance arrangement.

View B – the arrangement is accounted for as a combined contract in Sub Y, with only the admin fee being included in the statement of financial performance of Sub Y.

Proponents of view B note the commercial substance of the transaction is that Sub X had performed the service of underwriting and providing insurance coverage and that Sub Y is simply providing a cash collection and payment service to Sub X. The nature of Sub Y's role is closer to that of an agent, noting that IFRS 15 does not consider credit risk as a factor in identifying agent vs. principle relationship. Sub Y would not enter into the underlying insurance contract without the Reinsurance contract in place and that is why both must be considered together to reflect the commercial substance.

Proponents of this view also acknowledge that whilst there are legally enforceable rights and obligations in the contract issued by Sub Y to the third party the **commercial substance** of the arrangement with Sub X is to negate these rights and obligations and IFRS 17.9 recognises the commercial substance.

Proponents of this view also note that whilst IFRS 17.9 gives an example of combining contracts as "entered into at the same time with the same counterparty" this is an example only and not limit the application of commercial substance.

The following is also noted:

(i) Cash flows are interdependent as a cash flow between the third party and Sub Y triggers a cash flow between Sub Y and Sub X;

(ii) If the insurance contract issued to a third party is cancelled an equivalent cancellation occurs for a component of the reinsurance contract – therefore components lapse together. Similarly, if the reinsurance contract was cancelled, no further insurance contracts would be issued by Sub Y.

(iii) The components could be priced and sold separately – however in this fact pattern, the pricing of the contract with the third party determines the pricing of the contract between Sub X and Sub Y as it is a 100% quota share.

RELATED QUESTIONS

Question 2 - If your answer is **view A**, would your view change if Sub X posted collateral against any obligations Sub Y has to policyholders – i.e. if the credit risk was entirely removed?

Question 3 – If your answer is **view B**, does your answer depend on which entity performs the underwriting, pricing and claims activity?

Question 4 - If your answer is **view B** would you change your view if Sub Y entered into a reinsurance held 100% quota share arrangement with Sub X for all warranty contracts into which Sub Y enters in perpetuity and the reinsurance contract held would be accounted for under GMM and the underlying insurance contracts with third parties were all annual contracts accounted for under the PAA i.e. does the accounting methodology influence the commercial substance of the transaction?

Question 5 – If your answer is **view B** would you change your view if Sub Y in the normal course of business underwrites and manages claims for warranty business with third parties and then cedes this business to a related party through a 100% quota share reinsurance contract held in order to manage capital constraints across jurisdictions?

Question 6 – If your answer is **view B** and the transaction is accounted for in Sub Y as a combination of the insurance contract issued and reinsurance contract held, is the residual fee income in Sub Y accounted for and presented under IFRS 17 or under IFRS 15 as a fee for a service?

Question 7 – If your answer is **view B** would you change your view if the arrangement only ceded a portion of the insurance risk (i.e. 60% quota share)?

Appendix – Relevant technical extracts

B.1 **IFRS 17** requirements relating to combining contracts include the following:

2 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).

9 A set or series of insurance contracts with the same or a related counterparty may achieve, or be designed to achieve, an overall commercial effect. In order to report the substance of such contracts, it may be necessary to treat the set or series of contracts as a whole. For example, if the rights or obligations in one contract do nothing other than entirely negate the rights or obligations in another contract entered into at the same time with the same counterparty, the combined effect is that no rights or obligations exist.

B18 Insurance risk is significant if, and only if, an insured event could cause the issuer to pay additional amounts that are significant in any single scenario, excluding scenarios that have no commercial substance (ie no discernible effect on the economics of the transaction). If an insured event could mean significant additional amounts would be payable in any scenario that has 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 the contingent cash flows is a small proportion of the expected present value of the remaining cash flows from the insurance contract.

B19 In addition, a contract transfers significant insurance risk only if there is a scenario that has commercial substance in which the issuer has a possibility of a loss on a present value basis. However, even if a reinsurance contract does not expose the issuer to the possibility of a significant loss, that contract is deemed to transfer significant insurance risk if it transfers to the reinsurer substantially all the insurance risk relating to the reinsured portions of the underlying insurance contracts.

B34 A good or non-insurance service promised to a policyholder is distinct if the policyholder can benefit from the good or service either on its own or together with other resources readily available to the policyholder. Readily available resources are goods or services that are sold separately (by the entity or by another entity), or resources that the policyholder has already got (from the entity or from other transactions or events).

B35 A good or non-insurance service that is promised to the policyholder is not distinct if:

(a) the cash flows and risks associated with the good or service are highly interrelated with the cash flows and risks associated with the insurance components in the contract; and

(b) the entity provides a significant service in integrating the good or non-insurance service with the insurance components.

B.2. **Conceptual Framework**

Paragraph 4.51 of the Conceptual Framework 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) have similar economic characteristics and risks and hence are likely to have similar implications for the prospects for future net cash inflows to the entity or net cash outflows from the entity; or
(iv) are used together in the business activities conducted by an entity to produce cash flows and are measured by reference to estimates of their interdependent future cash flows.

Paragraph 4.59 of the Conceptual Framework states: The terms of a contract create rights and obligations for an entity that is a party to that contract. To represent those rights and obligations faithfully, financial statements report their substance. In some cases, the substance of the rights and obligations is clear from the legal form of the contract. In other cases, the terms of the contract or a group or series of contracts requires analysis to identify the substance of the rights and obligations.

Paragraph 4.62 of the Conceptual Framework states: A group or series of contracts may achieve or be designed to achieve an overall commercial effect. To report the substance of such contracts, it may be necessary to treat rights and obligations arising from that group or series as a single unit of account. For example, if the rights or obligations in one contract merely nullify all the rights or obligations in another contract entered into at the same time with the same counterparty, the combined effect is that the two contracts create no rights or obligations. Conversely, if a single contract creates two or more sets of rights and obligations that could have been created through two or more separate contracts, an entity may need to account for each set as if it arose from separate contracts in order to faithfully represent the rights and obligations (…).

B.3 **IFRS 15** includes the following guidance on identifying when an entity is acting as an agent versus being a principal.

B34 When another party is involved in providing goods or services to a customer, the entity shall determine whether the nature of its promise is a performance obligation to provide the specified goods or services itself (ie the entity is a principal) or to arrange for those goods or services to be provided by the other party (ie the entity is an agent). …

B34A To determine the nature of its promise (as described in paragraph B34), the entity shall:

(a) identify the specified goods or services to be provided to the customer …; and

(b) assess whether it controls … each specified good or service before that good or service is transferred to the customer.

B35 An entity is a principal if it controls the specified good or service before that good or service is transferred to a customer. However, an entity does not necessarily control a specified good if the entity obtains legal title to that good only momentarily before legal title is transferred to a customer. …

B35B When (or as) an entity that is a principal satisfies a performance obligation, the entity recognises revenue in the gross amount of consideration to which it expects to be entitled in exchange for the specified good or service transferred.

B36 An entity is an agent if the entity's performance obligation is to arrange for the provision of the specified good or service by another party. An entity that is an agent does not control the specified good or service provided by another party before that good or service is transferred to the customer. When (or as) an entity that is an agent satisfies a performance obligation, the entity recognises revenue in the amount of any fee or commission to which it expects to be entitled in exchange for arranging for the specified goods or services to be provided by the other party. An entity's fee or commission might be the net amount of consideration that the entity retains after paying the other party the consideration received in exchange for the goods or services to be provided by that party.

B37 Indicators that an entity controls the specified good or service before it is transferred to the customer (and is therefore a principal (see paragraph B35)) include, but are not limited to, the following:

(a) the entity is primarily responsible for fulfilling the promise to provide the specified good or service. …

(b) the entity has inventory risk before the specified good or service has been transferred to a customer or after transfer of control to the customer (for example, if the customer has a right of return). …

(c) the entity has discretion in establishing the price for the specified good or service. …