Paper for AASB TRG discussion - proposed submission to IASB

The AASB TRG is asked to consider whether they support sending this submission to the IASB and also discuss whether AASB support is also desirable and/or feasible.

Contracts acquired in their claims settlement period

This paper considers the accounting for contracts acquired in their claims settlement period in the following respect:

(1) the application of IFRS 17.B5, B95 and IFRS 17 more generally;

(2) operational (practical) challenges including those related to Groups of companies; and

(3) suggested solutions for the IASB staff to consider adopting to mitigate the complexity and cost of the current requirements.

Contracts acquired in their claims settlement period that are acquired **either** in a transfer of insurance contracts that do not form a business; **or** in a business combination within the scope of IFRS 3 *Business Combinations* are considered in this paper. Transactions under which contractual responsibility remains with the issuer of the underlying contracts and risk is ceded via a separate contract **are not included** for consideration in this paper, they are reinsurance.

1. Interpreting IFRS 17

1.1 IFRS 17.B5 and B95 say:

> B5 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.
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> B95 Unless the premium allocation approach for the liability for remaining coverage in paragraphs 55–59 applies, on initial recognition the contractual service margin is calculated applying paragraph 38 for acquired insurance contracts issued and paragraph 65 for acquired reinsurance contracts held using the consideration received or paid for the contracts as a proxy for the premiums received or paid at the date of initial recognition. If acquired insurance contracts issued are onerous, applying paragraph 47, the entity shall recognise the excess of the fulfilment cash flows over the consideration paid or received as part of goodwill or gain on a bargain purchase for contracts acquired in a business combination or as a loss in profit or loss for contracts acquired in a transfer. The entity shall establish a loss component of the liability for remaining coverage for that excess, and apply paragraphs 49–52 to allocate subsequent changes in fulfilment cash flows to that loss component

Highlighting the wide scope of contracts caught by IFRS 17.B5 and B95

1.2 There are three clear and distinct transactions that would be accounted for under IFRS 17.B5 but which have very different natures:

(1) An **adverse development coverage contract** (ADC contract) is issued for the purpose of providing coverage for variability in claims. The parties to an ADC contract would be:

- the policyholder – an insurer that has contracts with other policyholders under which the coverage has expired and against which it wishes to insure for possible adverse development; and
- the insurer – the issuer of the ADC contract.

ADC contracts are regarded as a form of reinsurance contract. Determining a liability for remaining coverage (LfRC) and recognising revenue from such transactions is logical and not disputed.

(2) Contracts acquired in their settlement period, generally with unexpired contracts, pursuant to a **business model of growth through generating revenue from renewal of contracts**. Determining a LfRC and recognising revenue from the unexpired portion of **unexpired contracts** is logical and not disputed. However, determining a LfRC from contracts in their claims settlement period creates operational complexity and inappropriately recognises revenue. Further details are set out below in section 2.

(3) Contracts acquired in their settlement period may reflect a second **business model whereby the insurer accepts the residual claims settlement risk in the contracts to deliver profitability through investment returns and effective claims management**. Determining a LfRC and recognising revenue from such transactions is logical and not disputed because the transaction reflects the entity revenue generation model.

1.3 Although the IFRS 17 TRG contemplated that insurance coverage might arise as a consequence of a claim; the TRG meeting concluded that:

> "… it is a matter of judgement for an entity to develop an accounting policy that reflects the insurance service provided by the entity to the policyholder under the contract in accordance with IFRS 17."[1]

1.4 Whilst not disputing that there is generally consequential insurance coverage in contracts acquired in the claims settlement period. For consistency, an insurer acquiring contracts in their claims settlement period should be able to make the same judgement based on the relevant **facts and circumstances** for those acquired contracts in order to reflect the insurance service provided, as reflected by the acquiring insurer's business model.

1.5 Revenue should only be recognised for contracts which reflect the insurers business model. This aligns to the approach under IFRS 9 whereby the **nature of an asset and the business model for which the asset is held** are both relevant when determining the appropriate accounting treatment.

2. Operational (practical) challenges

2.1 In the IFRS 17 TRG May 2018 meeting discussion of Agenda paper 6 *Implementation challenges outreach report*, the TRG considered the practical issues around the subsequent treatment of insurance contracts acquired in their settlement period. The content of that Agenda paper was informed by TRG member Submissions on IASB Staff questions, including the AASB TRG. This followed the TRG discussion of Agenda paper 7 *Subsequent treatment of contracts acquired in their settlement period* at the TRG's February 2018 meeting.

2.2 The **IASB's current position regarding the ongoing accounting for contracts acquired in their settlement period** involves:

(a) identifying any sub-groups of contracts (onerous versus non-onerous contracts) among the contracts at the time of acquisition [IFRS 17.B93];

(b) identifying the coverage duration as the period over which there is expected to be uncertainty about the level of claims;

(c) on acquisition, identifying the relevant coverage units and recognising a LfRC, including a CSM for any gain and including the yield curve for the purpose of subsequent interest accretion to the CSM;

(d) subsequently allocating the CSM to profit or loss over the expected claims settlement period based on coverage units, including reassessing coverage units for the allocation of CSM to profit or loss, when relevant;

(e) subsequently recognising insurance revenue in each period over which there is a reduction in the LfRC, measured based on the amount of expected claims settlement, as reassessed at each reporting date;

(f) subsequently recognising insurance service expense, measured based on the actual claims settlement amounts in each reporting period; and

(g) subsequently identifying changes to fulfilment cash flows that could unlock the CSM in each period of coverage.

2.3 In the unlikely event that the consideration received is less than the acquiring insurer's fulfilment cash flows, the difference would need to be immediately recognised as a loss. Based on IFRS 17.B95, the loss component would need to be tracked.

Significant change and cost of implementation

2.4 The above is a significant change from current accounting practices whereby contracts acquired in their claims settlement period are measured on the basis of the loss event for which the insurance contracts were originally written. The Liability for Incurred Claims (LIC) is recognised at the acquisition date and no revenue is recognised from the transaction. Contracts acquired with an 'unearned premium' component may have two components – a LfRC for the unexpired portion and LIC for the unexpired portion.

2.5 Accordingly, the IASB's current position would result in **significant increased costs and complexity to the industry.**

Complexity for preparers

2.6 Many types of acquired LIC are expected to have claims settlement periods longer than a year, even though many of the original underlying contracts have coverage periods of a year or less. For a general insurer that has mainly annual

1 Summary of the Transition Resource Group for IFRS 17 *Insurance Contracts* meeting held on 26–27 September 2018 – *Insurance risk consequent to an incurred claim* (Agenda paper 1).

contracts that apply the premium allocation approach (PAA), there may be **significant operational issues** associated with assessing PAA eligibility of contracts acquired in their settlement period and, in the event of ineligibility, having to apply the general model. For example, if an insurer were to acquire a portfolio of contracts in their claims settlement period with a long claims tail, it may need to establish a system to apply the general model solely to address these acquired contracts, at great cost.

Complexity for users and loss of claims development information

2.7 Under IFRS 17.B93-B95, accounting and reporting by insurers will be more complex for users of the financial statements. These complexities would arise for all contracts acquired in their claims settlement period, and would be particularly concerning when the acquiring insurer's business model is not to generate revenue from those contracts.

2.8 'Premium revenue' would need to be recognised for contracts acquired in their claims settlement period. This is expected to give rise to a number of issues:

(a) An insurer with a business model of acquiring portfolios of contracts that include contracts in their claims settlement period, together with unexpired contracts for the purpose of business growth through generating revenue from renewal of contracts, would need to provide supplementary (non-IFRS) revenue information reversing out the revenue impacts of the contracts acquired in their claims settlement period to 'normalise' revenue. This supplementary information would show users a consistent revenue measure for all of the contracts being managing for the purpose of business growth through generating revenue from renewal.

(b) Some regulators may be concerned about the significant grossing up of premium revenue we would see across the insurance industry. Regulators may seek information based on existing practice because regulators do not want to see premium revenue being recognised twice (albeit not as identical amounts) for the same group of contracts – first by the insurer that issued the contracts and subsequently, by the acquirer of the group of contracts as the claims are settled.

(c) Under IFRS 17.B93-B95, for contracts acquired in their claims settlement period there would never be a claims development period. The claims development information provides users with insight into the adequacy of the claims reserving of the insurer. Information about claims development would be absent from the claims development disclosures required under IFRS 17.130 as there is no LIC for those contracts acquired in their claims settlement period. The way in which claims develop is key information for users. In order to provide relevant information for users, an insurer would need to have supplementary (non-IFRS) claims development information that incorporates the contracts that are absent when IFRS 17.B93-B95 apply.

Complexity related to intra-group transfers in consolidated Groups

2.9 When a subsidiary within a Group acquires contracts in their claims settlement period from a sister subsidiary in a transaction that is not a business combination, based on IFRS 17.B95, the contracts could have a different form of accounting in the acquiring subsidiary when compared to the Group.

(a) For the Group as a whole, the transaction would be eliminated.

(b) For the individual acquiring entity within the Group, different revenue and other accounting would apply in the separate financial statements versus the information provided for consolidation purposes.

Any user examining the subsidiary financial statements and the Group financial statements could become confused about the true financial impact of transfers of contracts that are not business combinations.

2.10 In the event that the IASB is not prepared to change its accounting approach to contracts acquired in their claims settlement period, to reduce the cost burden on an insurer acquiring contracts from another entity within a Group, it would be best to provide relief from IFRS 17.B93-B95 to acquisitions of insurance contacts between entities in a Group under common control but in which the acquired contracts are not part of a business combination.

3. Mitigating problems with IFRS 17.B93-B95

3.1 Below are some suggested ways in which the main problems posed by IFRS 17.B93-B95 might be mitigated.

Liability for incurred claims business model applied to certain acquired contracts

3.2 The most comprehensive solution to the problems created by applying IFRS 17.B93-B95 is to permit an acquiring insurer to treat contracts acquired in their claims settlement period as giving rise to LIC. This would be consistent with the existing latitude provided in respect of consequential risks on originated contracts (discussed at the September 2018 IFRS 17 TRG meeting).

3.3 Insurers could be required to apply the accounting that, based on facts and circumstances, reflects their business model.

(a) Insurers that acquire contracts in their claims settlement period and manage them as ADC contracts should apply the existing IFRS 17.B93-B95 requirements. These insurers would be largely seeking to earn revenue from acquiring contracts in their claims settlement period.

(b) Insurers with a business model of acquiring portfolios of contracts that include contracts in their claims settlement period, together with unexpired contracts, for the purpose of business growth through generating revenue from renewal of contracts, would account for the expired contracts as liabilities for incurred claims.

3.4 The revised wording in IFRS 17 could be along the following lines.

> B5 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.
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> *B5A When insurance contracts are acquired in their claims settlement period, an insurer accounts for those contracts on the basis of its the entity's business model for managing the contracts.*
>
> *(a) Insurers that have a business model of managing contracts acquired in their claims settlement period to provide coverage against adverse development of events apply paragraphs B93-B95.*
>
> *(b) Insurers with a business model of acquiring portfolios of contracts that include contracts in their claims settlement period, together with unexpired contracts for the purpose of business growth through generating revenue from renewal of contracts, would account for the expired contracts as liabilities for incurred claims*
>
> *An insurer's **business model is based on relevant facts and circumstances**.*

Alternative solution to offset revenue recognition against insurance service expenses

3.5 Assuming that IFRS 17.B93-B95 continues to apply, to help mitigate users' potential confusion over the consideration being recognised as revenue, IFRS 17 could permit the revenue to be presented as an offset to insurance service expenses when an insurer's business model is to acquire portfolios of that include contracts in their claims settlement period, together with unexpired contracts for the purpose of business growth through renewals.

3.6 The revised wording in IFRS 17 could be along the following lines.

> B120 The total insurance revenue for a group of insurance contracts is the consideration for the contracts, ie the amount of premiums paid to the entity:
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> (a) adjusted for a financing effect; and
>
> (b) excluding any investment components.
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> B120A *When a portfolio of insurance contracts is acquired comprising both contracts in their claims settlement period and contracts with remaining coverage for the purpose of business growth through renewals, and entity is permitted to present premium revenue from the acquired contracts in their claims settlement period within the relevant insurance service expenses.*

PAA practical expedient to avoid potential operational complexity

3.7 As a practical expedient, PAA eligibility could be extended to all contracts acquired in their claims settlement period, regardless of whether they meet the criteria in IFRS 17.53, when the insurer has equivalent originated contracts in their claims settlement period that apply the PAA. IFRS 17.B94 says the consideration received is used as a proxy for the premiums received. The consideration received would be the basis for measuring the LfRC under IFRS 17.55.

3.8 In many cases, contracts acquired in their claims settlement period might still be judged to be eligible to be accounted for using the PAA, even though the originating insurer may not have qualified. This is because, although the claims tail could be long, the incidence of claims would often be largely a known quantity and the entity could reasonable expect the PAA would produce a measurement of the liability for remaining coverage similar to the general model in the context of IFRS 17.53(a) (with low variability in the context of IFRS 17.54).

3.9 The revised wording in IFRS 17 could be along the following lines.

> B94 An entity shall use the consideration received or paid for the contracts as a proxy for the premiums received. The consideration received or paid for the contracts excludes the consideration received or paid for any other assets and liabilities acquired in the same transaction. In a business combination, the consideration received or paid is the fair value of

the contracts at that date. In determining that fair value, an entity shall not apply paragraph 47 of IFRS 13 (relating to demand features).

B94A *When an entity has originated insurance contracts in their claims settlement period that qualified for the premium allocation approach which relate to similar risks and are managed together with contracts acquired in their claims settlement period, the entity is permitted to apply the premium allocation approach to the acquired contracts, regardless of whether they meet the criteria in IFRS 17.53.*

3.10 Appendix A also includes a possible practical expedient for accounting for a CSM that is expected to have the same profile as the incidence of release from risk should this be an area of concern for the IASB.

Potential solution to inconsistency in transactions between commonly-controlled entities

3.11 When contracts are transferred within a Group (but not as part of a business combination) the acquiring entity should be relieved from applying IFRS 17.B93-B95 in its separate financial statements.

3.12 The revised wording in IFRS 17 could be along the following lines.

B94B *When the entity acquiring contracts in their claims settlement period from the originating insurer are commonly controlled, the acquiring entity is permitted to account for those contracts in its separate financial statements on the same basis as the originating insurer, regardless of whether the acquisition is a business combination.*

Appendix A – For reference during AASB TRG discussions

***Difference between* consideration received by an acquiring insurer and its estimate of fulfilment cash flows**

A.1 In a commercial setting:

(a) an acquiring insurer would typically transact when its estimate of the fulfilment cash flows acquired is less than the consideration it will receive from the selling insurer; and

(b) the selling insurer would typically enter into the transaction because:

(i) its estimate of fulfilment cash flows is greater than the consideration it pays; and/or

(ii) it is exiting a particular line of business due to a strategic decision; financial distress or regulatory action.[2]

A.2 It appears that a key concern for the IASB is addressing the largely practical problem of accounting for any difference between the consideration received by an acquiring insurer and its estimate of fulfilment cash flows.[3] Applying the CSM (or possibly loss component) requirements of IFRS 17 provides a solution, albeit a complex one that creates further practical problems.

Treatment of Risk adjustment and CSM

A.3 Assuming that IFRS 17.B93-B95 continue to apply, a possible approach would be to treat the difference between consideration received and fulfilment cash flows as an addition to the risk adjustment. In most of cases, this would be expected to provide a recognition pattern highly similar to creating a CSM, but at a fraction of the effort.

A.4 This approach would be particularly relevant if the economics of the transaction are being driven by different levels of risk diversification between the acquiring insurer and originating insurer. That is, the incidence of release from risk would have the same profile as a CSM.

A.5 The below example shows contracts acquired in the claims settlement period with estimated fulfilment cash flows of $200 and consideration received of $230.

	Debit	Credit
Cash	$230	
Insurance liability (fulfilment cash flows)		$200
Insurance liability (additional risk adjustment)		$30

A.6 The revised wording in IFRS 17 could be along the following lines.

B95 <u>Subject to paragraph B95A, </u>~~U~~unless the premium allocation approach for the liability for remaining coverage in paragraphs 55–59 applies, on initial recognition the contractual service margin is calculated applying paragraph 38 for acquired insurance contracts issued and paragraph 65 for acquired reinsurance contracts held using the consideration received or paid for the contracts as a proxy for the premiums received or paid at the date of initial recognition. If acquired insurance contracts issued are onerous, applying paragraph 47, the entity shall recognise the excess of the fulfilment cash flows over the consideration paid or received as part of goodwill or gain on a bargain purchase for contracts acquired in a business combination or as a loss in profit or loss for contracts acquired in a transfer. The entity shall establish a loss component of the liability for remaining coverage for that excess, and apply paragraphs 49–52 to allocate subsequent changes in fulfilment cash flows to that loss component.

<u>B95A *In cases when the CSM is expected to have the same profile as the incidence of release from risk, an insurer is permitted to incorporate the CSM within the risk adjustment and account for that CSM as if it were part that risk adjustment*.</u>

2 There may be cases when an acquiring insurer's estimate of the fulfilment cash flows acquired is more than the consideration it will receive from the selling insurer, for example, when it is trying to gain a foothold in a particular line of business.

3 For example, Agenda paper 2C *Business combinations – contracts acquired in their claims settlement period*, IASB January 2020 meeting – especially paragraph 18.

Intangible asset

A.7 An alternative practical accounting treatment for the difference between the consideration received by an acquiring insurer and its estimate of fulfilment cash flows would be to carry forward the approach in IFRS 4 *Insurance Contracts*. IFRS 4.31 says:

> 31 To comply with AASB 3, an insurer shall, at the acquisition date, measure at fair value the insurance liabilities assumed and *insurance assets* acquired in a business combination. However, an insurer is permitted, but not required, to use an expanded presentation that splits the fair value of acquired insurance contracts into two components:
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> (a) a liability measured in accordance with the insurer's accounting policies for insurance contracts that it issues; and
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> (b) an intangible asset, representing the difference between (i) the fair value of the contractual insurance rights acquired and insurance obligations assumed and (ii) the amount described in (a). The subsequent measurement of this asset shall be consistent with the measurement of the related insurance liability.

A.8 IFRS 4.31 applies to both insurance contracts acquired in a business combination or in a portfolio transfer. The IFRS 4.31 accounting could be retained for portfolio transfers, while IFRS 17.B95 addresses contracts acquired in a business combination. Applying intangible asset accounting to portfolio transfers may provide a more cost-beneficial solution than applying the CSM requirements in IFRS 17.