PAPER 3

Potential implementation question

Determining the fair value of insurance contracts is a key judgement in applying the fair value approach ('FVA') on transition to IFRS 17. One of the key questions is regarding the contract boundary for IFRS 13 fair value measurement ('FVM') – whether it should be the same as the contract boundary for IFRS 17 fulfilment cash flows ('FCF').

There appear to be different interpretions of the standard's requirements on the contract boundary for FVM on transition under the FVA. Some believe the contract boundaries for FVM should be the same as those for IFRS 17 FCF otherwise an inappropriate accounting result might arise, eg double counting the contractual service margin ('CSM'). Others think pursuant to the general principles of IFRS 13 a market participant would not be limited by the contract boundary guidance in IFRS 17 when setting a price for a group of insurance contracts, hence the fair value should include the current market expectation of future cash flows from renewals.

The above question on contract boundary is also relevant to the fair value measurement in a business combination as the fair value will be deemed as the consideration for insurance contracts acquired per IFRS 17.B94.

To address the above implementaiton issues, the following two questions are raised:

Question 1: Is the contract boundary guidance in IFRS 17 relevant in measuring the fair value, in accordance with IFRS 13, of groups of contracts on transition to IFRS 17 using the FVA?

Question 2: should the fair value methodology used for the purposes of transition (based on the conclusion to question 1) also be applied to the measurement of the fair value of insurance contracts acquired in a business combination?

Paragraph of HKFRS/IFRS 17 *Insurance Contracts*

IFRS 17 para 33
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 (see paragraph 34). Applying paragraph 24, an entity may estimate the future cash flows at a higher level of aggregation and then allocate the resulting fulfilment cash flows to individual groups of contracts. The estimates of future cash flows shall:
(a) incorporate, in an unbiased way, all reasonable and supportable information available without undue cost or effort about the amount, timing and uncertainty of those future cash flows (see paragraphs B37–B41). To do this, an entity shall estimate the expected value (ie the probability-weighted mean) of the full range of possible outcomes.
(b) reflect the perspective of the entity, provided that the estimates of any relevant market variables are consistent with observable market prices for those variables (see paragraphs B42–B53).

(c) be current—the estimates shall reflect conditions existing at the measurement date, including assumptions at that date about the future (see paragraphs B54–B60).
(d) be explicit—the entity shall estimate the adjustment for non-financial risk separately from the other estimates (see paragraph B90). The entity also shall estimate the cash flows separately from the adjustment for the time value of money and financial risk, unless the most appropriate measurement technique combines these estimates (see paragraph B46).

IFRS 17 Appendix A Defined terms – group of insurance contracts
A set of insurance contracts resulting from the division of a portfolio of insurance contracts into, at a minimum, contracts written within a period of no longer than one year and that, at initial recognition:
(a) are onerous, if any;
(b) have no significant possibility of becoming onerous subsequently, if any; or
(c) do not fall into either (a) or (b), if any.

IFRS 17 para B93
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.

IFRS 17 para 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).

IFRS 17 para 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.

IFRS 17 para C20
To apply the fair value approach, an entity shall determine the contractual service margin or loss component of the liability for remaining coverage at the transition date as the difference between the

fair value of a group of insurance contracts at that date and the fulfilment cash flows measured at that date. In determining that fair value, an entity shall not apply paragraph 47 of IFRS 13 Fair Value Measurement (relating to demand features).

IFRS 13 Appendix Defined terms – fair value
The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

IFRS 13 para 14
Whether the asset or liability is a stand-alone asset or liability, a group of assets, a group of liabilities or a group of assets and liabilities for recognition or disclosure purposes depends on its unit of account. The unit of account for the asset or liability shall be determined in accordance with the IFRS that requires or permits the fair value measurement, except as provided in this IFRS.

Analysis of the question

Question 1: Is the contract boundary guidance in IFRS 17 relevant in measuring the fair value, in accordance with IFRS 13, of groups of contracts on transition to IFRS 17 using the FVA?

View 1 – Yes

IFRS 17.C20 refers to 'the fair value of a group of insurance contracts'. Inherent in the reference to 'group' is the IFRS 17 contract boundary, given IFRS 17.33 states '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'. The permission in para C20 to measure these cash flows using fair value does not alter which cash flows have to be measured - i.e. para C20 is read as being about measurement rather than unit of account.

If renewals that are outside of the IFRS 17 contract boundary are included in the fair value at transition, a CSM on those renewals would be recognised at the transition date. When in a later period the renewals are recognised as new contracts in accordance with IFRS 17, it would lead to recognition of that element of the CSM again - that would seem to result in double counting. Equally, for the cases where the group of insurance contracts is in an asset position (ie the FCF represent an asset on transition), as illustrated using a simple example in the Appendix, a loss component might be recognised due to different boundaries for IFRS 13 FVM and IFRS 17 FCF.

Some entities may well use the fair value approach for some groups and modified retrospective approach for others on transition. Whilst these will not be comparable in a number of respects, to have different contract boundaries depending on which approach is used seems to lead to an even greater lack of comparability.

View 2 - No

All cash flows under the contracts, including those relating to future premiums and expenses beyond the repricing point, should be included in measuring fair value under the general principles of IFRS 13, as this is how a market participant would price the group of insurance contracts. The market participant is not limited by the contract boundary guidance in IFRS 17 and should include the current market expectations of future cash flows from renewals.

Fair values on transition may be determined using either a ‘top down’ or a ‘bottom up’ approach. When market prices are observed in actual market transactions where contracts are bought/sold, a market approach under IFRS 13 generally would be used to determine the fair value (‘top down’). If the requirements of IFRS 13 are amended to ignore what a market participant would pay for the contract, and instead try to model what they would pay for a hypothetical contract without a renewal feature, then it is hard to see how a top down approach is valid (without adjustment at least, which seems to negate using a market price as a starting point as much of the market information is likely to then be stripped out in relation to renewal behaviour).

IFRS 17.C20 states that IFRS 13 is applied in determining the fair value, but that IFRS 13.47 (demand deposit guidance) is ignored. This indicates that IFRS 17 requires a ‘real’ fair value to be used in measurement, ie not one that limits the fair value to the amount repayable on demand and/or ignores 'renewal' behaviour. It is therefore clear that customer/renewal behaviour must be included in the measurement of fair value.

The IASB clearly could have modified the requirements of IFRS 13 in areas other than IFRS 13.47 to align with the contract boundary requirements of IFRS 17, but did not do so, while IFRS 13 itself does not incorporate any consideration of arbitrary boundaries on cash flows used to determine fair value such as those in IFRS 17. The reference to a ‘group’ of insurance contracts in IFRS 17.C20 merely refers to the unit of account used for the purposes of determining CSM/loss components. This is clear from the definition in Appendix A, which defines a group as:
“a set of insurance contracts resulting from the division of a portfolio of insurance contracts into, at a minimum, contracts written within a period of no longer than one year and that, at initial recognition:
(a) are onerous, if any;
(b) have no significant possibility of becoming onerous subsequently, if any; or
(c) do not fall into either (a) or (b), if any”.
IFRS 17.33, which is used by proponents of View 1, is not relevant as this paragraph refers only to the measurement or initial recognition of groups of insurance contracts, which is not applicable for groups of insurance contracts to which the fair value model has been applied on transition.

View 3 – No, but the standard should be amended

As noted in View 2, IFRS 17 defines a group of insurance contracts as
“a set of insurance contracts resulting from the division of a portfolio of insurance contracts into, at a minimum, contracts written within a period of no longer than one year and that, at initial recognition:

(a) are onerous, if any;
(b) have no significant possibility of becoming onerous subsequently, if any; or
(c) do not fall into either (a) or (b), if any",
while IFRS 13 requires that set of insurance contracts to be measured based on the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Accordingly, there is no technical basis on which to conclude the fair value should be arbitrarily restricted to reflect the contract boundary in IFRS 17.

Nevertheless, as noted in View 1, the use of different contract boundaries on initial recognition using the fair value approach and subsequently could result in double counting the CSM, or recognising a loss component where the group is in an asset position. While having the same boundary of cash flows included in the fair value determined under IFRS 13 and the FCF calculated under IFRS 17 has intuitive appeal, it is hard to see how this aligns with the words in the standard.

Therefore an amendment should be suggested to the IASB staff to eliminate the unintuitive result arising from applying IFRS 17 as currently drafted.

Question 2: should the fair value methodology used for the purposes of transition (based on the conclusion to question 1) also be applied to the measurement of the fair value of insurance contracts acquired in a business combination?

View 1 - Yes – the accounting should be consistent with the conclusion reached in Question 1

The initial CSM or loss component of insurance contracts acquired in business combinations is determined as the difference between the fair value (deemed as the consideration for the contracts acquired) and the fulfilment cash flows at the acquisition date, which follows the same logic as that for calculating initial CSM or loss component on transition under the fair value approach. Therefore the same approach should be taken to ensure consistent accounting policy applied to similar transactions.

View 2 - No – because the guidance in IFRS 17.B94 does not refer to group of contracts

Proponents of View 1 in Question 1 believe that the term 'group of insurance contracts' refers both to the unit of account as well as the measurement of fair value. Accordingly, since IFRS 17.B94 requires measurement of "the fair value of the contracts at that date" there is no scope to measure anything other than the fair value of the contracts. The contracts incorporate all features of the contractual arrangements, including renewal terms, which should therefore be taken into account to the extent they would affect the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Note:
If amendments to IFRS 17.C20 were to be made as proposed in View 3 to Question 1, the same should be made for business combinations, ie IFRS 17.B94 should be amended to include an additional exception on contract boundary to the general principles of IFRS 13.

This additional exception could allow for part of the real fair value of the group of insurance contracts to be included as an acquired intangible (associated with the customer relationship and the option to renew), as the acquirer clearly would calculate consideration they were willing to pay in the business combination based on the real fair value of those contracts, not an artificially constrained value that ignored the economic characteristics of the contracts.

Appendix – a simple illustration of the issue on contract boundary

In $	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Expected premium	100	100	100	100	100	500
Expected claims and expenses	-60	-60	-60	-60	-60	-300
Risk adjustment/compensation	-10	-10	-10	-10	-10	-50
Net – IFRS 17 FCF/ IFRS 13 FV	30	30	30	30	30	150

Assumptions:

- *YRT contract*
- *Estimates of cash flows and risk adjustment/compensation are the same for both IFRS 13 fair value measurement and IFRS 17 fulfilment cash flows*
- *Contract boundary under IFRS 17: one year (e.g. insurer has ability to fully reprice each year)*
- *Ignore discounting*

In this example, if the IFRS 17 contract boundary of one year is used to restrict the cash flows used to determine the fair value of the group of contracts under IFRS 13, the contractual service margin on transition (under the simplifying assumptions) would be nil.

However, if the IFRS 17 contract boundary is not considered when measuring fair value (as a market participant would expect the contract to be renewed for another 4 years), a loss component of $120 has to be established on transition. This loss component represents the difference between the fair value of $150 (asset) and the fulfilment cash flows (net inflow) of $30.