The Actuarial Society of Hong Kong

CONTRACT BOUNDARIES & UNBUNDLING

2017 Insurance IFRS Seminar

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Session 3

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Why separate non-insurance components?

- An entity shall apply **IFRS 17** to contracts that meet the **definition of an insurance contract**
- However, many insurance products contain one or more components that would be **in the scope of another standard**.
- Separating and accounting such **non-insurance components** using other applicable standards can:
  - improve **transparency**,
  - make them **more comparable** to similar contracts that are issued as separate contracts, and
  - **allow users of financial statement to better compare** the risks undertaken by entities in different businesses or industries.

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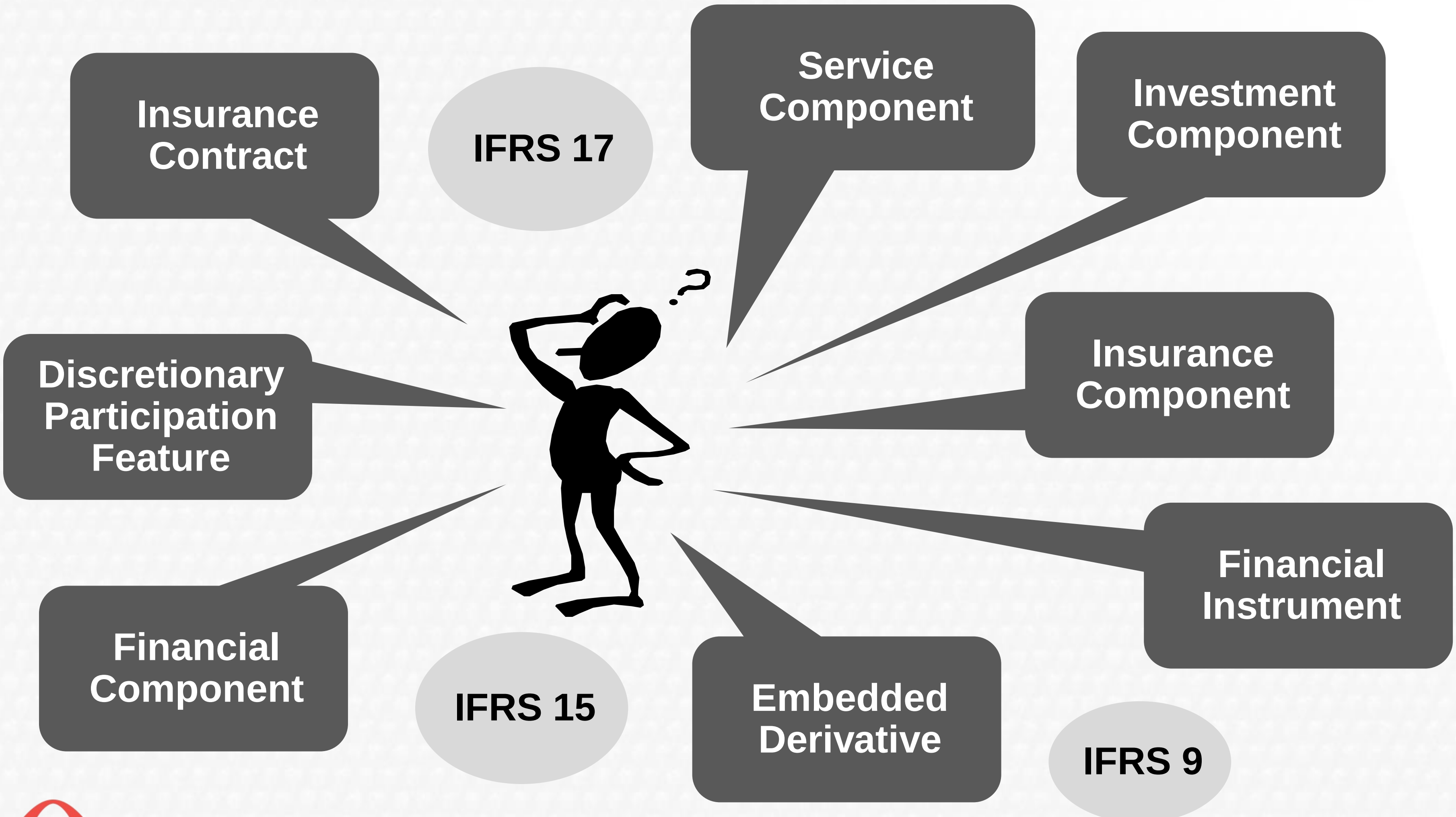
What to separate?



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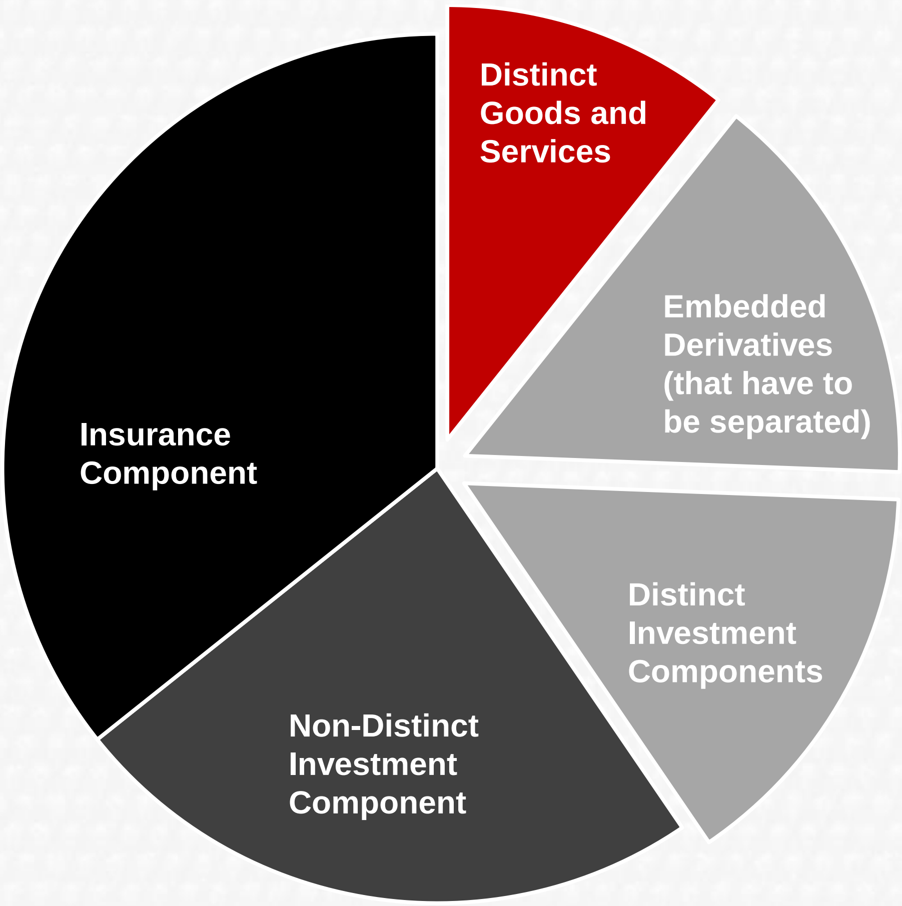
Separating Non-Insurance Components



Measured under:

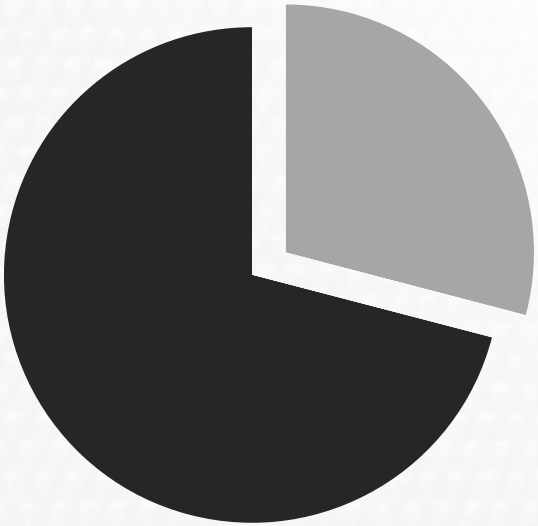
- IFRS 17
- IFRS 17, but excluded from insurance revenue and service expenses
- IFRS 9
- IFRS 15

Separation is **required** for certain components.

Embedded derivatives

- An entity shall apply **IFRS 9** to determine **whether there is an embedded derivative to be separated** and, if there is, **how to account** for that derivative. (Para. 11)

- An embedded derivative is separated under IFRS 9 if and only if:
  - The embedded derivative is **not closely related** to the host contract, and
  - the embedded derivative on a stand-alone basis would meet the definition of a derivative and would be in scope of IFRS 9.

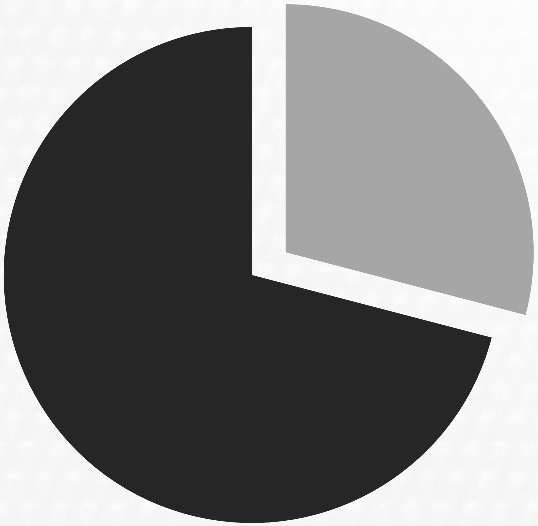


Distinct investment components

- An investment component represents the amounts that an insurance contract requires the entity to repay to a policyholder **even if an insured event does not occur**.

- Entities will now be required to **separate investment components** if it is distinct.

- An investment component is distinct if it is **not highly inter-related** and **a contract with equivalent terms is or could be sold separately**.



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Example: investment components

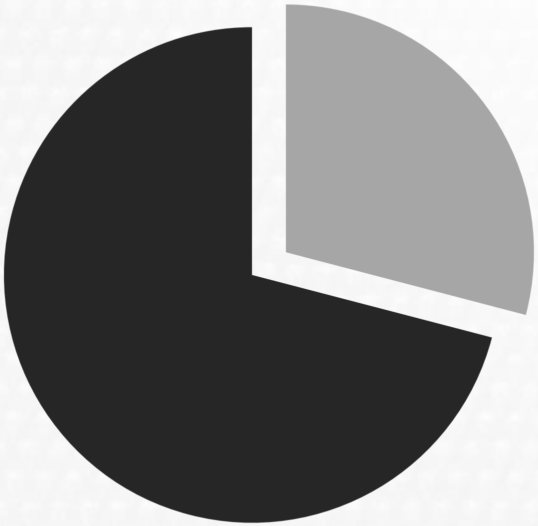
- Product is a single premium unit-linked life insurance product with either:
  a) A fixed death benefit of HKD 1mm
  b) A guaranteed minimum death benefit equal to the initial premium paid x 105%
  c) A guaranteed minimum death benefit equal to current account value x 105%

- In any of the above, should the investment component be separated?

Distinct goods or non-insurance services

- Goods or non-insurance service components are distinct if the policyholder can **benefit from them on their own or with other resources** that are readily available.

- If they are **highly inter-related** and the entity provides a **significant service integrating it** with the insurance component, they are not distinct.



Example: goods or non-insurance services

- With single premium payment of a whole life policy, the insurer provided the insured with a box seat at the Happy Valley race course for the first policy year.

- Should this benefit be unbundled?

Application and calculation

- No options are provided to **voluntarily separate** non-insurance components. Non-insurance components **can only be separated when required**.
  - Distinct goods or non-insurance services follow the **revenue recognition standard (IFRS 15)**.
  - Embedded derivatives and distinct Investment components follow the **financial instrument standard (IFRS 9)**.
- Allocating components:
  - Attribute cash flows to a separated embedded derivative or to a distinct investment component on a stand-alone basis.
  - Separate discounts/supplements and cash flows (including expenses and acquisition costs) between insurance and goods & service on a "rational and consistent" basis

Non-distinct investment components

- Non-distinct (non-separable) investment components **must not be included** in **insurance revenue and insurance service expenses** reported.
- An entity shall:
  - **identify the investment components** at the time revenue and incurred claims are recognised, and
  - **exclude the amounts** so identified from insurance revenue and insurance service expenses, and
  - **disclose** these amounts **separately**.

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Example: non-distinct investment components

1. "105" single premium product where the death benefit is 105% of the account value
   - If the paid premium is $1000 with no front end loads, what is recognized as revenue in the Profit and Loss statement?
   - Policyholder dies when the AV = $1100. What is the benefit shown in the Profit and Loss statement?

2. Whole life product with DB of $40,000 If the paid premium is $1000 per annum, how much is recognized as revenue in the Profit and Loss statement if:
   - PV of total expected premiums = $20,000
   - PV of total expected DB = $5,000
   - PV of total expected surrender values = $10,000

   Policyholder dies when the cash value = $5,000. What is the claim listed in the Profit and Loss statement?

Example: separating an account balance

Separating component from a life insurance contract with an account balance

Fact Pattern

A life insurance contract has the following terms:

- the policyholder pays a premium of 1,000 at contract inception;
- the account balance is increased by voluntary amounts paid by the policyholder, adjusted by investment returns from specified assets and reduced by asset management fees and an insurance charge;
- the contract matures on the earlier of the policyholder's death or contract cancellation.

The pay-out comprises:

- a death benefit of 5,000 if the policyholder has died; plus
- an amount equal to the account balance, whether the policyholder has died or cancelled the contract.
- A competitor sells an investment product equivalent to the account balance, but without the insurance coverage.

Analysis

Is the account balance separable?

- The fact that a comparable investment product is sold by another financial institution indicates that the components may be distinct.
- However, if the right to death benefits provided by the insurance coverage either lapses or matures at the same time as the account balance, the insurance and investment components are highly interrelated and are therefore not distinct.

Consequently, the account balance would not be separated from the insurance contract and would be accounted for applying IFRS 17.

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Example: separating non-insurance service

Separating components from a stop-loss contract with claims processing services

Fact Pattern

An entity issues a stop-loss contract to an employer. The contract provides health coverage for the policyholder's employees and has the following features:

- insurance coverage of 100% for the aggregate claims from employees exceeding 25 million (the 'stop-loss threshold'). The employer will self-insure claims from employees up to 25 million.
- claims processing services for employees' claims during the next year, regardless of the stop-loss threshold of 25 million. The entity is responsible for processing the health insurance claims of the employees on behalf of the employer.
- The entity considers whether to separate the claims processing services. The entity notes that similar services to process claims on behalf of customers are sold on the market.

Analysis

Is the claim processing services separable?

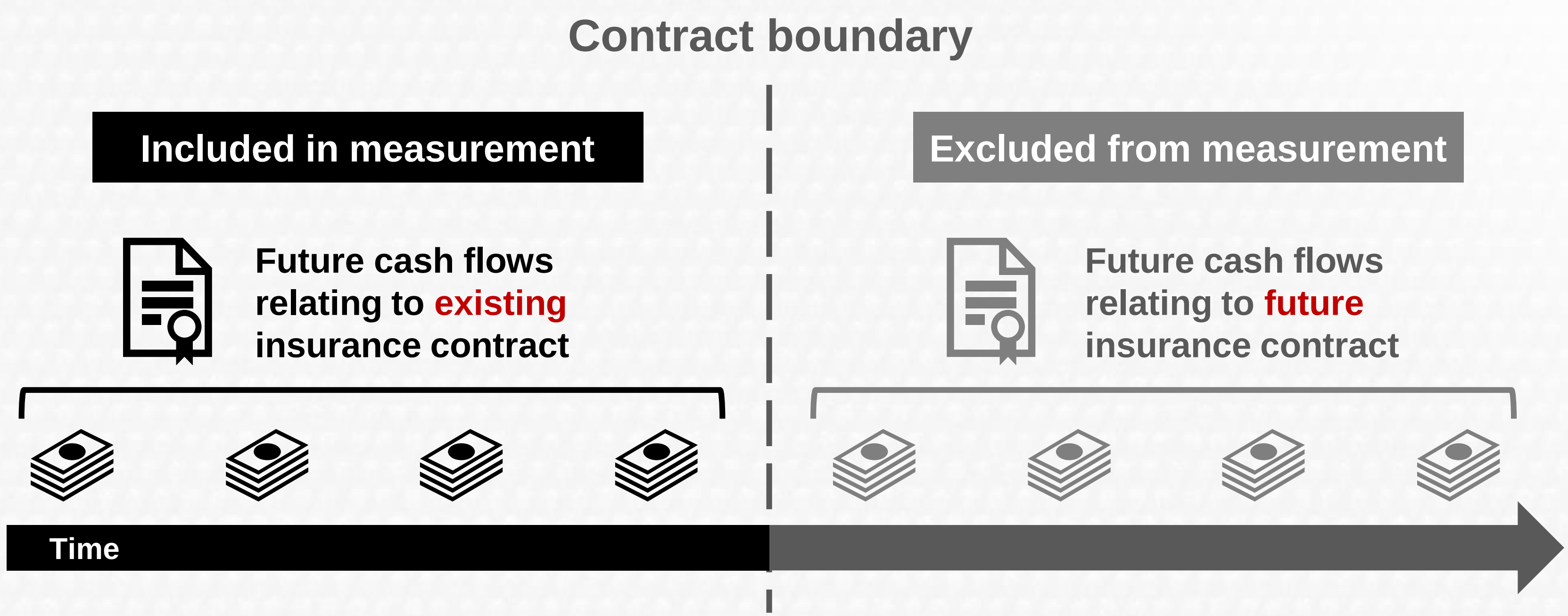
The criteria for distinct non-insurance are met in this example:

- similar claims processing services are sold as a standalone service; and
- the services benefit the policyholder independently of the insurance coverage.
- the cash flows associated with the claims processing services are not highly interrelated with the insurance coverage.
- entity does not provide a significant service of integrating the claims processing services with the insurance components.

The entity shall separate the claims processing services from the insurance contract and accounts for them applying **IFRS 15**.

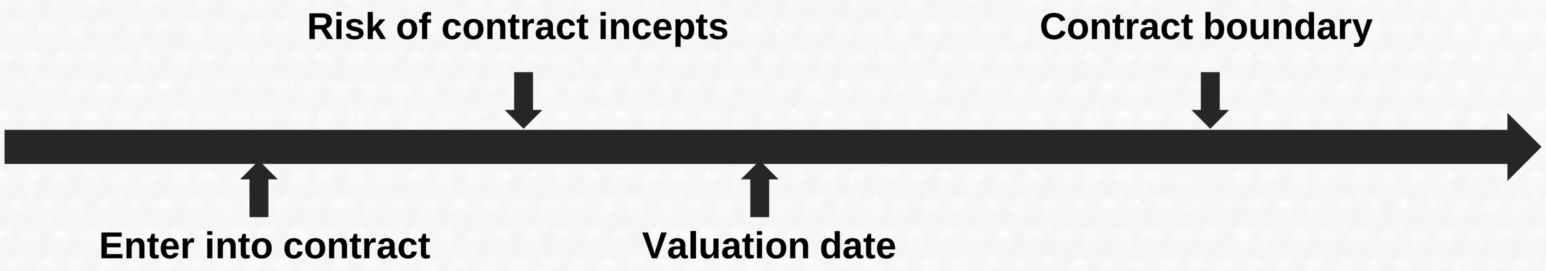
Contract boundary concept

The measurement of a group of contracts shall include **all cash flows within the boundary** and **no other cash flows**.



Initial recognition

- An entity shall recognise a group of insurance contracts it issues from the **earliest of the following**:
  - the **beginning of the coverage period** of the group of contracts;
  - the date when the **first payment from a policyholder** in the group becomes due; and
  - for a group of onerous contracts, **when the group becomes onerous**.



Contract boundary concept

- Cash flows are within the boundary of an insurance contract if they arise from **substantive rights and obligations** that exist during the reporting period in which the entity:
  - **can compel the policyholder to pay the premiums,** or
  - has a **substantive obligation** to provide the policyholder with services.

Examples of cash flows in the boundary of an insurance contract

Payments to, or on behalf of, a policyholder	Premiums and any other costs specifically chargeable to the policyholder	Policy administration and maintenance costs
Allocation of fixed and variable overheads directly attributed to fulfilling contracts	Insurance acquisition cash flows directly attributable to the portfolio of contracts and allocated to the contract	Claims handling costs – investigating, processing and resolving claims
Costs of providing benefits in kind		Cash flows from options and guarantees that were not separated from the contracts

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Substantive obligation ends when…

- A substantive obligation to provide services ends when:
  - the entity has the **practical ability** to reassess the **risks of the particular policyholder** and, as a result, can **set a price or level of benefits** that fully reflects those risks; or
  - both of the following criteria are satisfied:
    - the entity has the **practical ability** to reassess the **risks of the portfolio of insurance contracts that contains the contract** and, as a result, can **set a price or level of benefits** that fully reflects the risk of that portfolio; and
    - the pricing of the premiums for coverage up to the date when the risks are reassessed **does not take into account the risks that relate to periods after the reassessment date.**

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Entity's practical ability

- An entity has **practical ability** to set a price, if
  - there is no constraints that prevent the entity from **setting the same price it would for a new contract** with the same characteristics as the existing contract issued on that date, or
  - if it can **amend the benefits to be consistent with the price**.
- When assessing its practical ability, an entity shall consider **all the risks that it would consider when underwriting equivalent contracts** on the renewal date for the remaining coverage.
- In determining the estimates of future cash flows at the end of a reporting period, an entity shall **reassess the boundary of an insurance contract** to include the effect of changes in circumstances on the entity's substantive rights and obligations.

Questions: contract boundary

1. For 25 year term assurances, with benefits paid on death of policyholder, premiums reviewable after 5 years at discretion of insurer (renewed on experience of portfolio), where is the contract boundary?

2. For a group life contract, renewable yearly, where is the contract boundary?

3. For employers liability contract (with no asbestos exclusion) with coverage period of one year, where is the contract boundary?

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Questions: contract boundary

1. For 25 year term assurances, with benefits paid on death of policyholder, premiums reviewable after 5 years at discretion of insurer (renewed on experience of portfolio), where is the contract boundary?

   25 years

2. For a group life contract, renewable yearly, where is the contract boundary?

   1 year

3. For employers liability contract (with no asbestos exclusion) with coverage period of one year, where is the contract boundary?

   >50 years

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Thank You