Interpretation of "an exercise of a right existing in a contract" in the context of contract modification (Deloitte)

IFRS 17:72 provides that the exercise of a right included in the terms of a contract is not a modification. This right refers to either the rights of the insurer or the rights of the policyholder in an insurance contract.

Examples of an insurer right include:

- The right to increase/decrease charges/prices for any of the benefits under the contract;
- The right to increase/decrease the amounts of benefits under the contract for the same charge/price;
- The right to extend or reduce the service period of the contract for one or all of the benefits under the contract.
- The right to cancel the contract after providing notice;
- The right to extend or reduce notice periods for rights under the contract (both for the insurer and the policyholder);
- The right to set a price for an optional benefit that was made available at the issue date of the contract for subsequent election at a price to be determined when such election is made by the policyholder; and
- The right to refuse additional contributions to an investment account within an insurance contract

Examples of a policyholder right include:

- The right to surrender the contract for cash;
- The right to cancel the contract;
- The right to elect the addition of benefits that were optionally available when the contract was entered;
- The right to elect the removal of a previously selected benefit among those available from a given multi-benefit contract;
- The right to obtain the temporary suspension of premium payment (premium holiday);
- The right to obtain a cash advance (a "policy loan") from the insurance contract cash value;
- The right to pay additional amount into an investment account within an insurance contract;
- The right to convert from one product type to another, e.g. from term insurance to a participating contract without the need of further underwriting; and
- The right to switch between different pools of underlying items in a contract with direct participation features and more than one specified pool of underlying items the policyholder can choose from.

IFRS 17:2 mandates that an insurer *"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."*

IFRS 17:72 does not specify whether the right in the context of "the exercise of a right included in the terms of a contract" should be a substantive right at initial recognition. However, with reference to IFRS 17:2, it is clear that the right must be enforceable under the contract to be considered. A distinction is made with IFRS 17:34 which specifically refers to the notion of substantive rights and obligations for the setting of the contract boundary. As a reference, we include some relevant guidance on the assessment of substantive right or substantive obligation given that IFRS 17 does not include a definition of a substantive right or a substantive obligation. Reference can be made to IFRS 10:B22, which states that for a right to be substantive, the holder must have the practical ability to exercise that right. In addition, as provided by IFRS 10:B23(c), a factor that can also be considered when determining whether a right is substantive is whether the party that holds the rights would benefit from the exercise of those rights.

We set out below example scenarios to illustrate that in applying the guidance "the exercise of a right included in the terms of a contract" does not necessarily require such right to be substantive at initial recognition for this right to be scoped out of a contract modification treatment.

Where "the exercise of a right existing in a contract" by the policyholder obliges the insurer to fulfil while granting to the insurer the practical ability to reprice the whole contract at the right's exercise date

For example, an insurer issues an insurance contract to a policyholder with an option to add coverage at a future date and the insurer does not consider the option as a separate contract. The insurer is under an enforceable obligation to provide the additional coverage when requested but it also has the practical ability to reprice the whole of the contract at the option exercise date. Applying IFRS 17:34, the cash flows relating to premiums arising after the option exercise date are outside the boundary of the original contract and the insurer will recognise a new contract arising from the exercise of the option. In this scenario there is no contract modification applying IFRS 17:72 because the respective rights and obligations between the parties are both substantive and enforceable at the outset and they determine the contract boundary beyond which IFRS 17 recognises a new contract without modifying the previous one.

Where "the exercise of a right existing in a contract" by the policyholder obliges the insurer to fulfil while granting to the insurer the practical ability to set the price for the obligation requested at the right's exercise date

On the other hand, the scenario below illustrates the accounting treatment for the exercise of a right that already exists in the contract but is assessed as not substantive at the initial recognition of the contract.

An insurer issues an insurance contract with an option to add additional coverage and the insurer does not consider the option as a separate contract. This enforceable obligation to provide coverage is such that when the right is exercised, the insurer can set the premiums for the additional coverage based on prevailing market prices. The price for all of the other pre-existing rights and obligations within the same contract cannot be changed. This enforceable obligation to add coverage at a price to be set at the time when the coverage is added is not considered substantive at the time of the initial recognition of the contract. This is because the price of the additional coverage is not yet determined thus it would not have an impact on the contract boundary. However, the insurer will need to take into account IFRS 17:B62 requirement when determining the fulfilment cash flows of the contract. All of the cash inflows and outflows associated with this option are within the boundary of the original contract.

In this scenario, the right provided to the policyholder to purchase an additional insurance coverage, although not assessed as a substantive right at initial recognition, is an enforceable right existing in the original contract and the exercise of such right would not be considered as a contract modification applying IFRS 17:72.

In addition to the contract boundary assessment noted above, an insurer assessing the eligibility of this contract for applying the variable fee approach should take into account, on an expected value basis (IFRS 17:B62), its current estimates of how the policyholder will exercise the option and how it would price the additional coverage. This is necessary because, while the obligation is not substantive due to the unconstrained pricing of the optional additional coverage, its estimate may affect the proportion of any change in the amounts to be paid to the policyholders that does not vary with the change in fair value of the underlying items (IFRS 17:B101(c)) thus impacting the classification of the contract as one that should be accounted for using the variable fee approach or not.

Where the original terms of the contract are changed such that the policyholder is given a fresh substantive right to purchase additional coverage that did not exist at the issue date of the contract

This scenario illustrates a modification of the contract to be accounted for applying IFRS 17:72 because the additional right provided, either to the policyholder or to the insurer, is a right that does not exist at the issue date of the original contract but it is added only subsequently.

Consider an insurance contract that does not have an option to add coverage when the contract is issued. Subsequently the insurer offers to the policyholder a substantive option to add coverage to the contract. In this case the insurer needs to judge if the fresh option is a separate contract. If it concludes that it is not a separate contract from the one previously issued (e.g. through the assessment required under IFRS 17:9 which stipulates that "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."), then the insurer should apply the requirements for modifications of an insurance contract as set out in IFRS 17:72.