Paper 6

Consideration of foreign currency risk when identifying a portfolio of insurance contracts (Deloitte)

Background

IFRS 17 requires insurers to identify a portfolio of insurance contracts and defines a portfolio of contracts as contracts that are subject to similar risks and are managed together. As an example, IFRS 17 provides that contracts within the same product line would be expected to have similar risks and hence would be expected to be in the same portfolio if they are also being managed together. No further guidance has been provided as to what constitutes “similar risks”.

While there is not further guidance on "similar risks" for the establishment of portfolios, IFRS 17 Appendix A defines risks, in line with other IFRS pronouncements, as follows (emphasis added):

Financial risk – The risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, currency exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract.

Insurance risk – Risk, other than financial risk, transferred from the holder of a contract to the issuer.

When it comes to foreign currency risk, there are several fact patterns in the insurance market where insurance contracts have cash flows in different currencies, thereby exposing the insurer to foreign currency risk. We consider three scenarios below.

Scenario 1: Insurer 1 operates in Taiwan and its functional currency is TWD. Insurer 1 issues an insurance contract in which premiums and claims are denominated in USD but expenses are denominated in TWD. The insurer and the policyholder are domiciled within Taiwan, with the insurance coverage being provided within Taiwan. At the same time, Insurer 1 also issues identical insurance contracts except that premiums and claims are denominated in TWD.

Scenario 2: Insurer 2 operates in the UK and in France with a branch office in Paris. Insurer 2 has GBP functional currency for its UK operations and EUR functional currency for the French branch. The UK operations issue insurance contracts to UK policyholders and are denominated in GBP while insurance contracts that Insurer 2 issues through its branch in Paris are denominated in EUR. Expenses for the two operations are denominated in GBP and EUR respectively.

Scenario 3: Insurer 3 issues two types of car insurance contracts for policyholders who plans to drive their cars overseas. The two contracts are identical except for the fact that one type includes in the contractual terms that the payment of claims will be in the currency of the country in which the insured event occurs and the policy limits have been guaranteed in the relevant foreign currency denomination in a table attached to the contract that has been calculated annually by Insurer 3 for all of the major foreign currencies. The other type of insurance contract only pays claims in the same currency as premiums in all cases irrespective of where the insured event occurs. For claims in foreign currency the policyholders receive their indemnity in the currency of the contract based on the spot foreign exchange rate of the day the insurer has accepted to pay them. Premiums and expenses for both contracts are denominated in the currency of the country in which both the insurer and the policyholder are domiciled which happens to be the functional currency of Insurer 3.

This paper focuses only on foreign currency risk and its implication on the identification of a portfolio of contracts. Other aspects of the definition of portfolio ("similar risks" – excluding the impact of foreign currency risk and "managed together" are not covered).

Question

Should foreign currency risk be taken into consideration when assessing "similar risks" for the purpose of determining portfolios of insurance contracts?

Views

View 1 – No, foreign currency risk is not considered a risk that is relevant when assessing whether contracts have similar risks in the identification of portfolios. Contracts with cash flows in different currencies can be included within one portfolio, and consequently, also within a group of contracts (subject to the criteria set out in IFRS 17:22).

Supporters of this view argue that currency risk is not an insurance risk that is transferred from the policyholder to the insurer. They note that, like expense risk and lapse risk, foreign currency risk is a risk that is created by the contract itself and it does not pre-exist the contract. The exposure to foreign currency risk results from an entity's business to issue insurance contracts with exposure to foreign currency fluctuations.

Applying View 1 to Scenario 1, the insurance contracts issued by Insurer 1 within the same product line can be included in the same portfolio, regardless of whether the premiums and claims are denominated in USD or TWD. A similar conclusion applies to Scenarios 2 and 3, where insurance contracts issued that are within the same product line but include cash flows in different currencies can be included in the same portfolio.

The practical implication of View 1 is that it requires a greater amount of judgement in determining the currency of the CSM of the groups of insurance contracts belonging to portfolios of contracts with cash flows in multiple currencies and the application of IFRS 17:30 to the CSM of those groups.

View 2 – Yes, currency risk is a relevant risk to consider when assessing whether contracts have similar risks. Depending on the facts and circumstances, the exposure to different currencies could require that insurance contracts within the same product line but with cash flows in different currencies be aggregated in different portfolios.

Supporters of this view argue that although the foreign currency risk would not give rise to an insured event and is not in itself relevant when assessing the significance of insurance risk in a contract, it is a valid and relevant risk when assessing "similar risks" for identifying portfolios of contracts.

In Agenda Paper 2 of the February 2018 TRG meeting, the IASB staff noted that the policyholder risk referred to in IFRS 17:34 includes both the insurance risk and financial risk transferred from the policyholder to the insurer and excludes lapse risk and expense risk. The definition of financial risk, as set out in Appendix A of IFRS 17, includes the risk *"of a possible future change in […] currency exchange rate"*.

In applying this view, professional judgement needs to be applied. Supporters of this view argue that where the currency risk is directly linked to the features of a contract and is assessed as a policyholder risk (i.e. a transferred risk), foreign currency risk can create a "dissimilar risk" from other otherwise similar contracts within the same product line where there is no transfer of foreign currency risk to the insurer.

Applying View 2 to Scenario 1, the insurance contracts with premium and claims denominated in USD are identified as a separate portfolio from the portfolio of insurance contracts issued by Insurer 1 that have all cash flows in TWD (the insurer's functional currency). This is because in the first portfolio, the exposure to foreign currency risk (i.e. the risk that the claim incurred is in USD) is transferred from the policyholder to the insurer.

Applying View 2 to Scenario 3, the car insurance contracts with claims paid in foreign currency are identified as a separate portfolio from the portfolio of car insurance contracts issued by Insurer 3 that have claims payable in the same currency as that of the premiums and expenses. This is because in the first portfolio, the exposure to currency risk (i.e. the risk that the insured event occurs abroad and the claim incurred is settled in a foreign currency) is transferred from the policyholder to the insurer.

However, applying View 2 to Scenario 2, the insurance contracts issued by Insurer 2 in its main office and its branch in Paris can be grouped into one portfolio if, and only if, they are managed together because the currency risk is not considered a policyholder risk being transferred in an insurance contract. Supporters of View 2 have observed that it is unlikely that the "managed together" condition would be met in Scenario 2 because Insurer 2 would typically manage the assets backing the insurance contracts denominated in GBP via a portfolio of GBP-denominated assets while it would usually create a portfolio of EUR-denominated assets for the insurance contracts issued by the Paris branch. This would usually be the case irrespective of the status of the Paris branch as a "foreign operation" under IAS 21.

View 2 requires less judgment than view 1 in determining the currency of the CSM balance associated with the groups of insurance contracts belonging to the portfolios so defined.

In relation to this last point and the application of IFRS 17:30, supporters of this view add to their conclusion above the fact that in IFRS 17:BC124(a) the IASB noted that the level of aggregation is a concept bound by the notion of cash flows that "<u>respond similarly in amount and timing to changes in key assumptions—meaning that losses on insurance contracts for one type of insurance risk would not be offset by gains on insurance contracts for a different type of risk</u>". They would argue that the foreign currency risk can be a key assumption in the measurement of an insurance contract and if the contract has different exposure to foreign currency risk than another contract, then it would not respond in a similar way to changes in that variable thus corroborating the consideration of foreign currency risk as one of the risks that has to be "similar".

Finally, they also observe that the IASB in IFRS 17:BC277 noted that they intended for IFRS 17 to treat "all components of the measurement of an insurance contract denominated in a single currency as either monetary or non-monetary". They argue that the reference to a contract denominated in a single currency is an additional corroborating element in support of groups and portfolios to be set in a way that they have only contracts denominated in a single currency because the application of IFRS 17:30 was intended not to be particularly judgmental.

Technical References (emphasis added)

IFRS 17:14 — An entity shall identify portfolios of insurance contracts. A portfolio comprises contracts subject to similar risks and managed together. Contracts within a product line would be expected to have similar risks and hence would be expected to be in the same portfolio if they are managed together. Contracts in different product lines (for example single premium fixed annuities compared with regular term life assurance) would not be expected to have similar risks and hence would be expected to be in different portfolios.

IFRS 17:30 — When applying IAS 21 The Effects of Changes in Foreign Exchange Rates to a group of insurance contracts that generate cash flows in a foreign currency, an entity shall treat the group of contracts, including the contractual service margin, as a monetary item.

IFRS 17 Appendix A

Financial risk — The risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, currency exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract.

Insurance risk — Risk, other than financial risk, transferred from the holder of a contract to the issuer.

Basis for Conclusion

IFRS 17:BC124 — The Board concluded that the balance described above could be achieved in principle by:

(a) requiring contracts in a group to have future cash flows the entity expects will respond similarly in amount and timing to changes in key assumptions—meaning that losses on insurance contracts for one type of insurance risk would not be offset by gains on insurance contracts for a different type of risk, and would provide useful information about the performance of contracts insuring different types of risk.

IFRS 17:BC277 — When applying IAS 21 *"The Effects of Changes in Foreign Exchange Rates"*, the fulfilment cash flows are clearly monetary items. However, the contractual service margin component might be classified as non-monetary because it is similar to prepayments for goods and services. The Board decided that it would be simpler to treat all components of the measurement of an insurance contract denominated in a single currency as either monetary or non-monetary. Because the measurement in IFRS 17 is largely based on estimates of future cash flows, the Board concluded that it is more appropriate to view an insurance contract as a whole as a monetary item.

IFRS 17:BC278 Accordingly, IFRS 17 requires an insurance contract to be treated as a monetary item for foreign currency translation in applying IAS 21. This applies for both the fulfilment cash flows and the contractual service margin. The Board's conclusion that the insurance contract is a monetary item does not change if an entity measures a group of insurance contracts using the simplified approach for the measurement of the liability for remaining coverage.

February 2018 TRG – Post meeting IASB Staff notes on Agenda Paper 2 (emphasis added)

11. TRG members discussed the analysis in Agenda Paper 2 and noted that:
   (a) paragraph 34(a) of IFRS 17 refers to the practical ability to reassess the risks of the policyholder (i.e. policyholder risk). Paragraph 34(b) of IFRS 17 should be read as an extension of the risk assessment in paragraph 34(a) from the individual to portfolio level, without extending policyholder risks to all types of risks and considerations applied by an entity when pricing a contract. The staff noted that policyholder risk includes both the insurance risk and the financial risk transferred from the policyholder to the entity and therefore excludes lapse risk and expense risk.