Other payments to policyholders in insurance contracts with short-term contract boundary

Background

Insurance contracts often contain non-claims payments that are not a non-distinct investment component or a premium refund (referred to as 'other payments to policyholders' in this paper). They might exist in a number of contracts including direct insurance contracts (eg experience refund, no claims bonus, no claims discount on future premiums) and reinsurance contracts (eg profit commission).

A legal contract with cancellation or renewal terms might have a short contract boundary applying IFRS 17 para 34, eg a reinsurance contract where both parties have the unilateral right to cancel subject to a 90-day notice period, or a yearly renewable contract where the insurer has the practical ability to fully reprice the risks. These short-boundary contracts might also contain 'other payments to policyholders'.

For the purposes of discussion in this paper, the 'other payments to policyholders' contained in short-boundary contracts are divided into the following two types:

Type 1 – payment of the amount won't be affected by the cancellation/renewal while the measurement of the amount would be affected by the exercise of cancellation/renewal

Type 2 – payment of the amount would be affected by cancellation/renewal, ie if the contract were cancelled or not renewed, there would be no payment obligation for the insurer

An example of Type 1 (Example 1) is the profit commission of a reinsurance contract where the amount of profit commission is calculated on a whole treaty basis over the whole period of the reinsurance contract and the payment of the profit commission shall still be made when either party exercises its termination right.

An example of Type 2 (Example 2) is the no claims bonus contemplated in a yearly renewable contract whose amount is calculated annually on a portfolio basis (could be nil if the loss rate of the portfolio exceeds a threshold) but payment is contingent on the future renewal by the policyholder.[1]

[1] The short contract boundary conclusion on the yearly renewable contract might be challenged given the existence of such a no claims bonus. The contract boundary could be one year in certain circumstances, eg the no claims bonus is a way for the insurer to reassess the risks of the particular policyholder and set a price that fully reflects the risks. However, this paper does not cover the detailed assessment on contract boundary; assume that the short boundary is appropriate in the fact pattern.

Question/issue

How should the two types of ‘other payments to policyholders’ be considered in determination of the fulfilment cash flows of each accounting contract?

Discussion and alternative views

View 1 – both types shall be treated as fulfilment cash flows of each accounting contract

Both types of other payments to policyholders shall be treated as fulfilment cash flows of each accounting contract if the amounts of the payment would be affected by the exercise of cancellation/renewal contemplated in the contract. Whether the payment obligation is contingent on renewal (or no cancellation) of the contract is not determinative in the identification of fulfilment cash flows of each accounting contract. Similar to the mutualised cash flows specified in IFRS 17 para B67-71, the fulfilment cash flows of one accounting contract could include cash flows paid to the same policyholder of another accounting contract.

View 2 – Type 1 shall be treated as fulfilment cash flows of each accounting contract, while Type 2 can only be fulfilment cash flows of the new accounting contract

Consistent with View 1, Type 1 payments to policyholders shall be treated as fulfilment cash flows of each accounting contract since the payment obligation is not contingent on the existence of future accounting contracts.

However, Type 2 payments to policyholders cannot be fulfilment cash flows of the existing accounting contract since the insurer does not have a payment obligation if there is no future accounting contract with the policyholder. Type 2 payments are therefore beyond the boundary of the existing accounting contract.

Para 35 of IFRS 17 states that an entity shall not recognise as a liability or as an asset any amounts relating to expected premiums or expected claims outside the boundary of the insurance contract. The paragraph continues: “Such amounts relate to future insurance contracts.” Therefore, expected cash flows representing ‘other payments to policyholders’ outside the boundary of the existing contract at its initial recognition would not be recognised at that time but would be treated as relating to a future contract if and when the new accounting contract is recognised.

Under this view, the no claims bonus in Example 2 shall not form part of the fulfilment cash flows of the existing accounting contract but would be treated as a reduction of premiums for the new accounting contract provided the contract were renewed by the policyholder (or not cancelled by either party). This treatment would ensure consistency with the treatment for no claims discount applied to the renewal premium given no claims bonus contingent on renewal has a similar economic substance to a no claims discount on the renewal premium.

Appendix: Technical references/guidance

IFRS 17 para 34

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 in which the entity has a substantive obligation to provide the policyholder with insurance contract services (see paragraphs B61–B71). A substantive obligation to provide insurance contract services ends when (…).

IFRS 17 para 35

An entity shall not recognise as a liability or as an asset any amounts relating to expected premiums or expected claims outside the boundary of the insurance contract. Such amounts relate to future insurance contracts.

IFRS 17 para B67

Some insurance contracts affect the cash flows to policyholders of other contracts by requiring:

(a) the policyholder to share with policyholders of other contracts the returns on the same specified pool of underlying items; and

(b) either:

  (i) the policyholder to bear a reduction in their share of the returns on the underlying items because of payments to policyholders of other contracts that share in that pool, including payments arising under guarantees made to policyholders of those other contracts; or

  (ii) policyholders of other contracts to bear a reduction in their share of returns on the underlying items because of payments to the policyholder, including payments arising from guarantees made to the policyholder.

IFRS 17 para B68

Sometimes, such contracts will affect the cash flows to policyholders of contracts in other groups. The fulfilment cash flows of each group reflect the extent to which the contracts in the group cause the entity to be affected by expected cash flows, whether to policyholders in that group or to policyholders in another group. Hence the fulfilment cash flows for a group:

(a) include payments arising from the terms of existing contracts to policyholders of contracts in other groups, regardless of whether those payments are expected to be made to current or future policyholders; and

(b) exclude payments to policyholders in the group that, applying (a), have been included in the fulfilment cash flows of another group.

IFRS 17 para B71

After all insurance contract services have been provided to the contracts in a group, the fulfilment cash flows may still include payments expected to be made to current policyholders in other groups or future policyholders. An entity is not required to continue to allocate such fulfilment cash flows to specific groups but can instead recognise and measure a liability for such fulfilment cash flows arising from all groups.