HKICPA POCKET SUMMARY

Implementing HKFRS 17 *Insurance Contracts*

Contract Boundary

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Hong Kong Institute of
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CONTENTS

1. Introduction
2. Level of aggregation
3. What is a contract boundary and why is it important
4. Overview of contract boundary requirements
   - 4.1 Substantive rights and obligations
     - 4.1.1 Substantive right
     - 4.1.2 Substantive obligation
     - 4.1.3 Assessment of practical ability
     - 4.1.4 Assessment of the risks
     - 4.1.5 Commercial substance
     - 4.1.6 Features of an insurance contract
   - 4.2 Decision tree
   - 4.3 Illustrative example
5. Reinsurance contracts
   - 5.1 Reinsurance Contract boundary considerations
   - 5.2 Illustrative example

Users of this publication should consider taking their own accounting and/or legal advice if in doubt as to their obligations under HKFRS 17 *Insurance Contracts* and other related requirements.

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1. INTRODUCTION

This publication is the second in a series covering Hong Kong Financial Reporting Standard (HKFRS 17) *Insurance Contracts*. The first pocket summary provides insurers with a simple framework and general references for planning the implementation of HKFRS 17 *Insurance Contracts*.

This pocket summary provides insurers with general references for applying the requirements on the cash flows within the boundary of an insurance contract in HKFRS 17. It also includes a simple decision tree and illustrative examples. For easy reference, the left hand side of this publication contains the references to the related HKFRS paragraphs.

This publication also incorporates the observations relating to contract boundary considerations arising from the International Accounting Standards Board's Transition Resource Group for IFRS 17 (IASB TRG) meetings in February, May and September 2018. The IASB TRG comprises financial-statement preparers and auditors with both practical and direct knowledge of implementing IFRS 17 *Insurance Contracts* from different countries.

Readers should note that this publication is not a comprehensive summary of the requirements for determining a contract boundary under HKFRS 17 and that this publication may be updated in the future with new information regarding HKFRS 17.

HKICPA thanks staff of Deloitte Touche Tohmatsu China, and staff of the International Accounting Standards Board, for their input into this publication.

2. LEVEL OF AGGREGATION

17.14

An entity is required to identify portfolios of insurance contracts that are subject to similar risks and are managed together.

17.16, 17.22

The entity then must split the portfolio, as follows, into groups of contracts that at initial recognition:

- are onerous;
- have no significant possibility of becoming onerous; and
- the remaining contracts in the portfolio.

These groups are then further disaggregated so that all contracts within a single group are issued within one year.

17.25

These groups of insurance contracts are then recognised on the balance sheet.

3. WHAT IS A CONTRACT BOUNDARY AND WHY IT IS IMPORTANT

17.33, 17.BC159

Groups of insurance contracts are measured based on expected future cash flows, which should reflect estimates of policyholder behaviour.

It is important to draw a contract boundary because it distinguishes whether the future cash flows (for example, premiums and the resulting benefits and claims) arise from existing insurance contracts issued, or future insurance contracts.

17.34

Thus, the *contract boundary* marks the **accounting points in time** when the entity's substantive rights and obligations under an insurance contract begin and end. The contract boundary correlates to the:

17.Appendix A, 17.B119, 17.BC283

Coverage period

Which is

The **accounting period** over which the entity provides coverage for uncertain future events which create insurance risks. This period includes all of the insurance cover the entity is obligated to provide because of the premiums that are in the contract boundary.

The coverage period also impacts the pattern of profit recognition, which is based on the quantity of the benefits provided under each contract and its expected coverage period.

However, a contract boundary differs from:

Contract duration / Policy period

Which is:

The **legal period** over which insurance coverage / protection is granted to the policyholder as per contractually agreed terms. This includes all periods over which the entity is standing ready to meet valid claims from the policyholder.

17.BC283

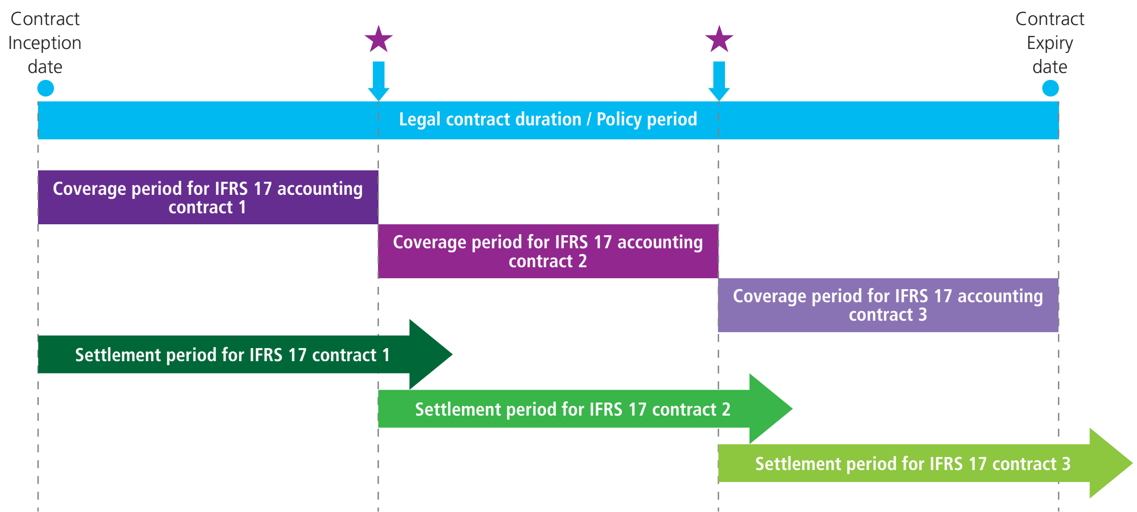
Settlement period

Which is:

The period over which the insurance liability expects to be settled (i.e. paid out to the policyholder).

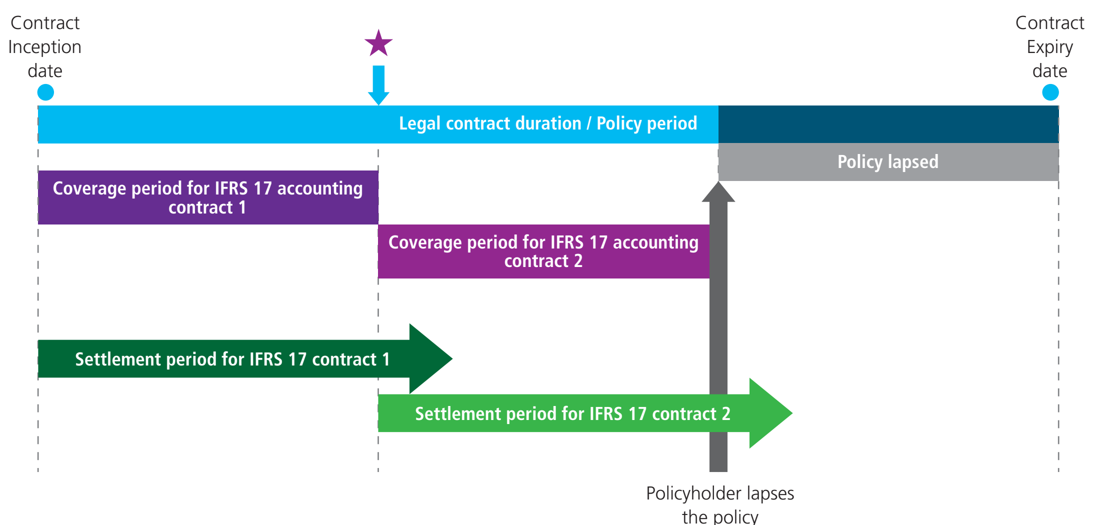
The following diagrams illustrate the differences described:

Scenario 1: No lapse in policy



★ Entity's substantive rights and obligations under an insurance contract begin and end, because it has the ability to reassess risks and reprice the contract. Refer to section 4 for the accounting requirements for determining the contract boundary. Cash flows within the contract boundary include those arising from both the coverage period and settlement period for claims incurred.

Scenario 2: Lapse in policy



★ Entity's substantive rights and obligations under an insurance contract begin and end, because it has the ability to reassess risks and reprice the contract. Refer to section 4 for the accounting requirements for determining the contract boundary. Cash flows within the contract boundary include those arising from both the coverage period and settlement period for claims incurred.

4. OVERVIEW OF CONTRACT BOUNDARY REQUIREMENTS

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Cash flows are within the contract boundary if they arise from substantive rights and obligations that exist during the period in which the entity:
(i) can compel the policyholder to pay the premiums; or
(ii) has a substantive obligation to provide the policyholder with services.

17.B64, 17.BC164, 17.35

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. Any expected premiums or claims outside the boundary of the insurance contract are related to future insurance contracts, and therefore no related insurance asset or liability is recognised.

17.B65

Cash flows within the contract boundary are those that relate directly to the fulfilment of the contract (including those at the discretion of the entity). The cash flows within the boundary include:

- premium receipts and payments to the policyholder;
- policy administration and maintenance costs and transaction-based taxes;
- an allocation of insurance acquisition cash flows; and
- an allocation of fixed and variable overheads.

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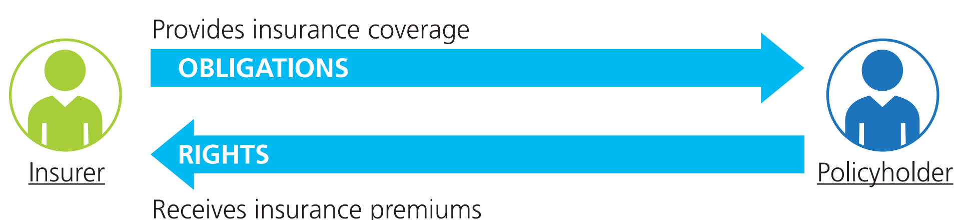
4.1. Substantive rights and obligations

An entity's substantive right is to receive premiums from the policyholder, while the substantive obligation is to provide services to the policyholder.

From the perspective of the entity:



4.1.1 Substantive right

If an entity can compel the policyholder to pay premiums during a reporting period, then all the cash flows are within the boundary of an insurance contract during such a reporting period.

Staff observations from the Hong Kong Institute of CPAs

- An entity can compel the policyholder to pay premiums during a reporting period when it is contractually enforceable. That is, the entity can enforce this through legal action, for example by taking the policyholder to court.
- The assessment of contractual enforceability should include a consideration of both the contract terms and any legal precedent under common law in Hong Kong that could override the contract terms.
- An entity is still considered to be able to compel a policyholder to pay premiums even if it decides not to enforce this right when the policyholder does not pay its premiums.

17.34

4.1.2 Substantive obligation

A substantive obligation ends when either of the following is met:

Contract level		Portfolio level
The entity has the practical ability to reassess risks (section 4.1.3); and		The entity has the practical ability to reassess risks (section 4.1.3);
the entity can set a price or level of benefits that fully reflects those risks (section 4.1.4).	**OR**	the entity can set a price or level of benefits that fully reflects those risks (section 4.1.4); and
		pricing of the premiums for coverage up to the date when the risks are reassessed did not take into account the risk after the reassessment date.

4.1.3 Assessment of "practical ability"

17.B64

An entity considers whether it has the practical ability to reassess the risks of the particular contract or portfolio and, as a result, set a price or level of benefits that fully reflects those risks.

An entity does not have such a practical ability when there are constraints that prevent it from:

- setting the same price for a new contract as an existing contract;
- amending the benefits in the contract to be consistent with the price it will charge; or
- repricing an existing contract so that the price reflects overall changes in the risks in a portfolio of insurance contracts. (Note that in this instance, the price set for each individual policyholder does not have to reflect the change in risk for that specific policyholder.)

TRG Insights (summarized from the IASB TRG May 2018 meeting observations)

What constraints should be considered in the assessment of practical ability?

- Contractual, legal and regulatory constraints (e.g. when an insurer cannot change the premium over a given period).
- Market competitiveness and commercial considerations (e.g. factors that limit an entity when pricing new contracts and repricing existing contracts).
- A constraint that limits an entity's practical ability to price or reprice contracts differs from choices that an entity makes (pricing decisions).

However, constraints are irrelevant to the contract boundary assessment if they:

- apply equally to new and existing policyholders in the same market; or
- relate to terms that have no commercial substance.

Staff observation from the Hong Kong Institute of CPAs

- In analysing pricing constraints, the entity also needs to consider whether it is also prevented from changing the level of benefits, either for a contract or a portfolio as a whole.

4.1.4 Assessment of the risks

17.B64

When assessing whether it has the practical ability to reassess the risks of the particular contract or portfolio, an entity considers all the risks that it would consider when underwriting equivalent contracts on the renewal date for the remaining coverage.

> ***TRG Insights (summarized from the IASB TRG February 2018 meeting observations)***
>
> *What does 'risks' constitute when assessing whether an entity has the practical ability to reassess the risks of the portfolio?*
>
> - an entity should consider exclusively policyholder risks rather than any risks factored into the pricing.
> - policyholder risks includes only the insurance and financial risks that the policyholder can transfer to the insurer but exclude policyholder-behaviour related risks i.e. lapse or expenses risk, which are created by the contract.

4.1.5 Commercial substance

17.2, 17.BC161, 17.BC164

When contract terms have no discernible effect on the substance of the contract, they are considered to have no commercial substance. As such, these contract terms should not be considered as factors impacting the entity's substantive right and obligations.

For example, in one reporting period an entity may decide that a renewal premium for a portfolio of contracts is outside the contract boundary because the restriction on the entity's practical ability to reprice the contract has no commercial substance.

However, circumstances can change, and the same restriction on the entity's practical ability to reprice the portfolio might take on commercial substance. That is, the restriction on the entity's ability to reprice the contract changes from having no discernible effect, to one that will impact the economics of the transaction. In this scenario, the entity may subsequently conclude that future renewal premiums for that portfolio of contracts are within the boundary of the contract.

> ***TRG Insights (summarized from the IASB TRG September 2018 meeting observations)***
>
> *How to account for cash flows that, at initial recognition, are outside the boundary of the contract when facts or circumstances change over time?*
>
> - When reassessing when the entity has the ability to reprice a contract applying HKFRS 17.B64, the fulfilment cash flows are updated to reflect changes in cash flows that are within the (revised) contract boundary. When such changes relate to future service they are recognised by adjusting the carrying amount of the contractual service margin of the group of contracts to which the contract belongs.
>
> *Staff observation from the Hong Kong Institute of CPAs*
>
> - Changes surrounding the practical ability to reprice may include circumstances where the commercial substance of terms or restrictions change.

4.1.6 Features of an insurance contract

17.B62

Many insurance contracts have features that enable policyholders to take actions that change the amount, timing, nature or uncertainty of the amounts they will receive, for example:

- renewal options;
- surrender options;
- conversion options; and
- options to stop paying premiums while still receiving benefits under the contracts.

If the options are determined to be within the contract boundary, the measurement of a group of insurance contracts shall reflect, on an expected value basis:

- the entity's current estimates of how the policyholders in the group will exercise the options available; and
- a risk adjustment which reflects the entity's current estimates of how the actual behaviour of the policyholders may differ from the expected behaviour.

TRG Insights (summarized from the IASB TRG May 2018 meeting observations)

How to determine the contract boundary of insurance contracts that include an option to add insurance coverage at a future date (assuming the entity has no right to compel the policyholder to pay premiums)?

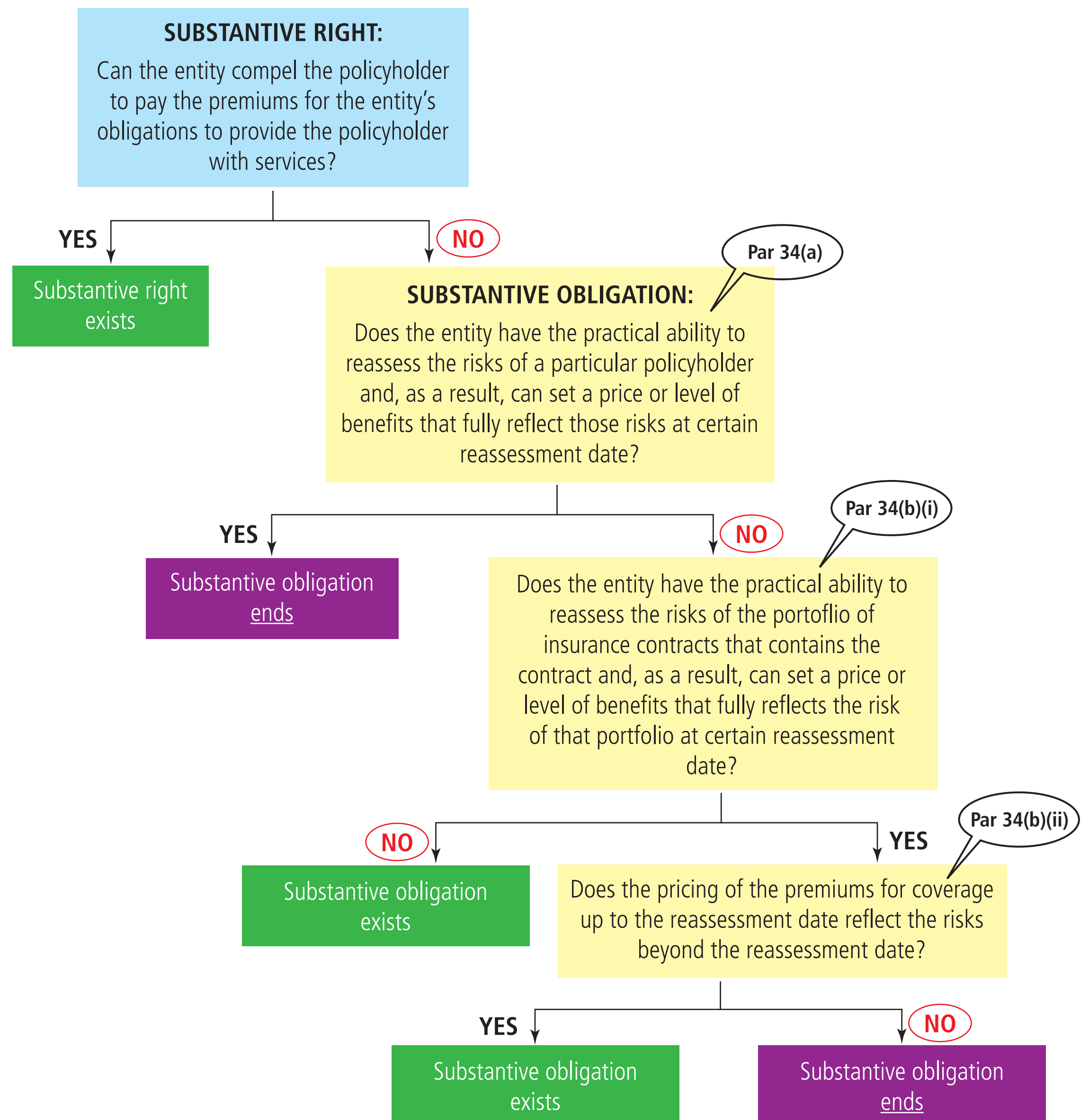
- an option to add insurance coverage at a future date is a feature of the insurance contract.
- an entity should focus on substantive rights and obligations arising from that option to determine whether the cash flows related to the option are within or outside the contract boundary.

For example, if an option to add insurance coverage is not a separate contract and the terms are:

Terms of option are	Cash flows are	Rationale
Guaranteed	Inside contract boundary	Since the entity has guaranteed the price for one of the risks included in the contract, it cannot reprice the contract to reflect the reassessed risks
Not guaranteed	Inside or outside contract boundary	The entity needs to assess whether it has the practical ability to set a price that fully reflects the reassessed risks

4.2 Decision tree

The decision tree below can summarize the contract boundary requirements:



The contract boundary begins and ends at the same time when an entity's substantive rights and obligations begins and ends.

However, when an entity's substantive rights and obligations exist, the contract boundary continues.

4.3 Illustrative example – Contract boundary of insurance contracts

The example below demonstrates two scenarios for a yearly renewable term insurance contract that would lead to different contract boundaries.

Insurance contract 1

- Premiums are determined using a step-rated premium table applicable to a portfolio of contracts
- Guaranteed to be renewable annually
- Repricing of the premiums takes into account future risks that are expected to arise beyond the next 12 months

Insurance contract 2

- Same as scenario 1 above except the repricing of the premiums only takes into account future risks that are expected to arise within the next 12 months and doesn't take into account future risks

Insurance contract 3

- Same as scenario 2 above except the entity can compel the policyholder to pay premiums

Analysis of the example

	Decision point	IFRS 17 reference	Insurance Contract			Reason
			1	2	3	
1	Can the entity compel the policyholder to pay the premiums for the entity's obligations to provide the policyholder with services?	IFRS 17:34	✗	✗	✔	For the purpose of this illustration, the entity cannot compel the policyholder to pay premiums in Contracts 1 and 2. For Contract 3, the entity can compel the policyholder to pay premiums.
2	Does the entity have the practical ability to reassess the risks of a particular policyholder and, as a result, can set a price or level of benefits that fully reflects those risks at certain reassessment date?	IFRS 17:34 (a)	✗	✗	▲	For the purpose of this illustration, pricing and subsequent reassessment of risk are done at a portfolio level rather than an individual policy level.

▲ Note: This decision point is not applicable for Contract 3 because the HKFRS 17.34 criteria on 'compel' is already met.

	Decision point	IFRS 17 reference	Insurance Contract			Reason
			1	2	3	
3	Does the entity have 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 reflect the risks of that portfolio at certain reassessment date?	IFRS 17:34 (b)(i)	✔	✔	▲	For the purpose of this illustration, pricing and subsequent reassessment of risk are done at a portfolio level rather than an individual policy level. Hence an entity only has a practical ability to reassess risk at a portfolio level.
4	Does the pricing of the premiums for coverage up to the reassessment date reflect the risks beyond the reassessment date?	IFRS 17:34 (b)(ii)	✔	✖	▲	Contracts are renewable on an annual basis. However, the pricing in Contract 1 takes into account future risks and reflects the risks beyond the reassessment date i.e. beyond 12 months coverage period. This is different from Contract 2 where only the risks related to the next 12 months coverage are taken into account in pricing.
	Conclusion	–	Cash flows inside contract boundary. Both HKFRS 17.34(b)(i) and (b)(ii) met.	Cash flows outside contract boundary. None of criteria in HKFRS 17.34 are met.	Cash flows inside contract boundary. HKFRS 17.34 criteria on 'compel' met.	–

▲ Note: This decision point is not applicable for Contract 3 because the HKFRS 17.34 criteria on 'compel' is already met.

5. Reinsurance contracts

17.61, 17.63
17.65

An entity typically purchases reinsurance contracts to mitigate risk exposures arising from its insurance contracts issued.

IFRS 17 requires an entity to separately account for its reinsurance contract held from its corresponding insurance contracts.

This is because an entity that holds a reinsurance contract does not normally have a right to reduce the amount it owes to the policyholder by the amount it expects to receive from the reinsurer.

From an entity's perspective, the accounting for reinsurance contracts held is the same as insurance contracts, with a few modifications, such as:

- Reinsurance contracts held cannot be onerous or have unearned profit. Instead there is a net cost or net gain on purchasing the reinsurance which is amortised over its coverage period.
- In identifying portfolios and groups, references to onerous contracts are replaced with a reference to contracts on which there is a net gain on initial recognition.
- Estimates of the present value of the future cash flows for the group of reinsurance contracts held:
  - include the effect of any risk of non-performance by the issuer of the reinsurance contract (e.g. effects of collateral and losses from disputes)
  - use consistent assumptions between reinsurance contracts held and its corresponding insurance contracts

5.1 Reinsurance contact boundary considerations

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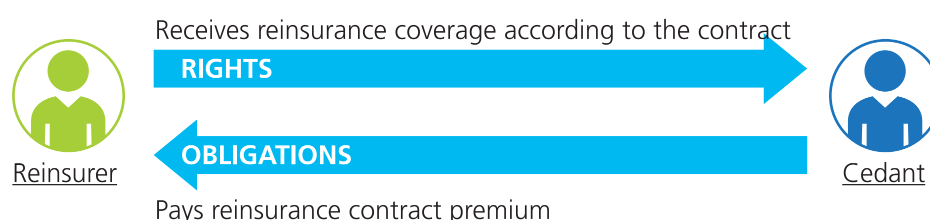
The entity's substantive right (as holder of the reinsurance policy) is to receive service from the reinsurer, whilst the substantive obligation is to pay premiums to the reinsurer.



TRG Insights (summarized from the IASB TRG February and September 2018 meeting observations)

How is the boundary of a reinsurance contract held determined from the cedant's perspective, and is there an expectation of symmetry between the contract boundaries of the reinsurer and the cedant?

- Applying HKFRS 17.34, a cedant's substantive right to receive services ends when the reinsurer has:
  - ✔ the practical ability to reassess the risks transferred to the reinsurer and can set a price or level of benefits for the contract to fully reflect the reassessed risk;

  or
  - ✔ has a substantive right to terminate the coverage.
- Thus, the boundary of a reinsurance contract held could be different from the insurance contract boundary, because it could include cash flows that relate to insurance contracts that are expected to be issued in the future (e.g. when the reinsurer does not have the practical ability or right to terminate coverage).
- However, the contract boundary for the reinsurance contract is the same from the perspectives of both the cedant and reinsurer because:
  - ✔ when the cedant has a right to receive services, the reinsurer has an obligation to provide services; and
  - ✔ when the cedant has an obligation to pay premiums, the reinsurer has a right to compel the payment of premiums.

TRG Insights (summarized from the IASB TRG May 2018 meeting observations)

- Both rights and obligations need to be considered when applying HKFRS 17.34 for assessing the contract boundary:
  - ✔ For reinsurance contracts held, cash flows are within the contract boundary if they arise from substantive rights and obligations that exist during the reporting period in which the entity is compelled to pay amounts to the reinsurer or in which the entity has a substantive right to receive services from the reinsurer.
  - ✔ A right to terminate coverage that is triggered by the reinsurer's decision to reprice the reinsurance contract is not relevant when considering whether a substantive obligation to pay premiums exists. Such a right is not within the entity's control and therefore the entity would continue to be compelled to pay premiums for the entire contractual term.
  - ✔ The entity's expectations about the amount and timing of future cash flows should incorporate the probability of the reinsurer repricing the contract.

5.2 Illustrative example – Contract boundary of reinsurance contracts held

The example below demonstrates considerations when determining the boundary of a reinsurance contract:

- The reinsurer has the right to adjust the premium rates it will charge for remaining coverage related to underlying insurance contracts that have already been issued and that are covered by the reinsurance contract.
- Premium adjustments apply prospectively and would not allow the reinsurer to recover losses already incurred for coverage already provided under the contract.
- There are no substantive restrictions on the reinsurer's ability to reassess the risks of the reinsurance contract and to adjust premium rates to reflect those risks.
- The reinsurer can adjust premium rates at any time, subject to a minimum notice period of three months.
- If the reinsurer does not increase premium rates, the cedant has no right to recapture / take back the business and must continue to pay premiums to the reinsurer.
- If the reinsurer provides notice that it intends to increase premium rates, the cedant has the right to recapture the business.
- If the cedant recaptures the business, the cedant would cease paying premiums and the reinsurer would cease providing coverage as of the recapture date. There is no financial settlement associated with the recapture (besides the refund of paid but unearned premium).

Key question

How should the boundary of a reinsurance contract held be determined by the cedant, when the reinsurer has the right to reprice the remaining coverage prospectively?

Key outcome

- A cedant needs to consider when its substantive rights and substantive obligations end.
- The reinsurer's right to terminate coverage, being outside the cedant's control, is ignored because the cedant has an unavoidable obligation to pay premiums continuing for the entire term of the contract held.
- The cedant reflects its expectations about the amount and timing of future cash flows, including the probability of the reinsurer repricing the contract, in the measurement of the reinsurance contracts held.

Conclusion

The entity has a substantive obligation to pay premiums to the reinsurer for the full duration of the underlying contracts. Therefore, the contract boundary would reflect the full duration of underlying contracts.

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