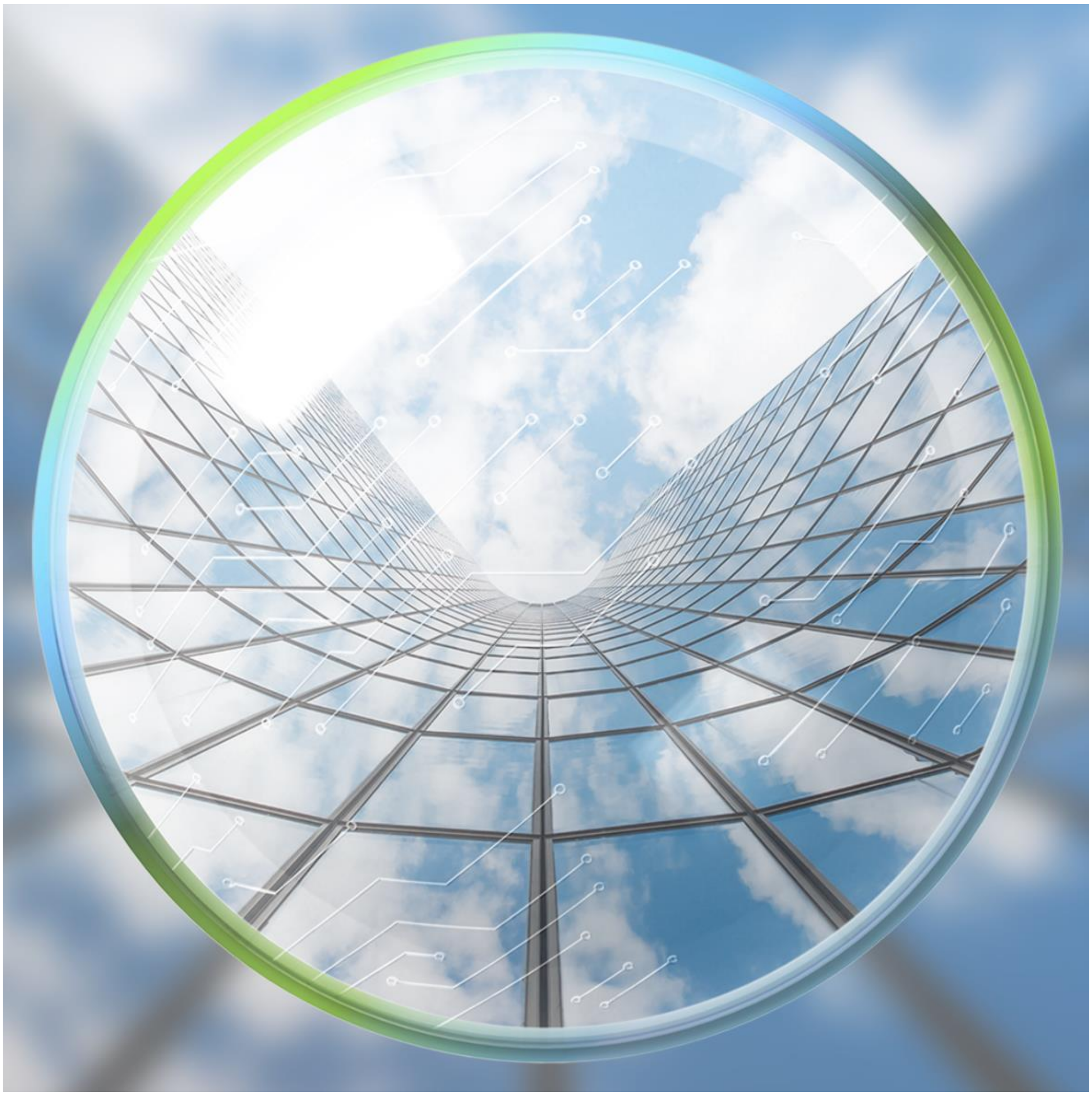

IFRS 17 for non-insurers

IFRS and Corporate Reporting Centre of Excellence, Switzerland

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1. Introduction

IFRS 17 *Insurance Contracts* applies to insurance contracts regardless of the issuer, i.e., IFRS 17 does not apply only to insurance or reinsurance entities but also to entities in other industries.

The assessment as to whether a contract is an insurance contract can be very complex. Entities will need to pay attention to the scope of IFRS 17 that includes various exceptions and exemptions that require or allow some insurance contracts to be accounted for applying another IFRS Accounting Standard.

In this publication we explain how to assess whether a contract is an insurance contract and we use examples to explain the IFRS Accounting Standards applicable to insurance contracts.

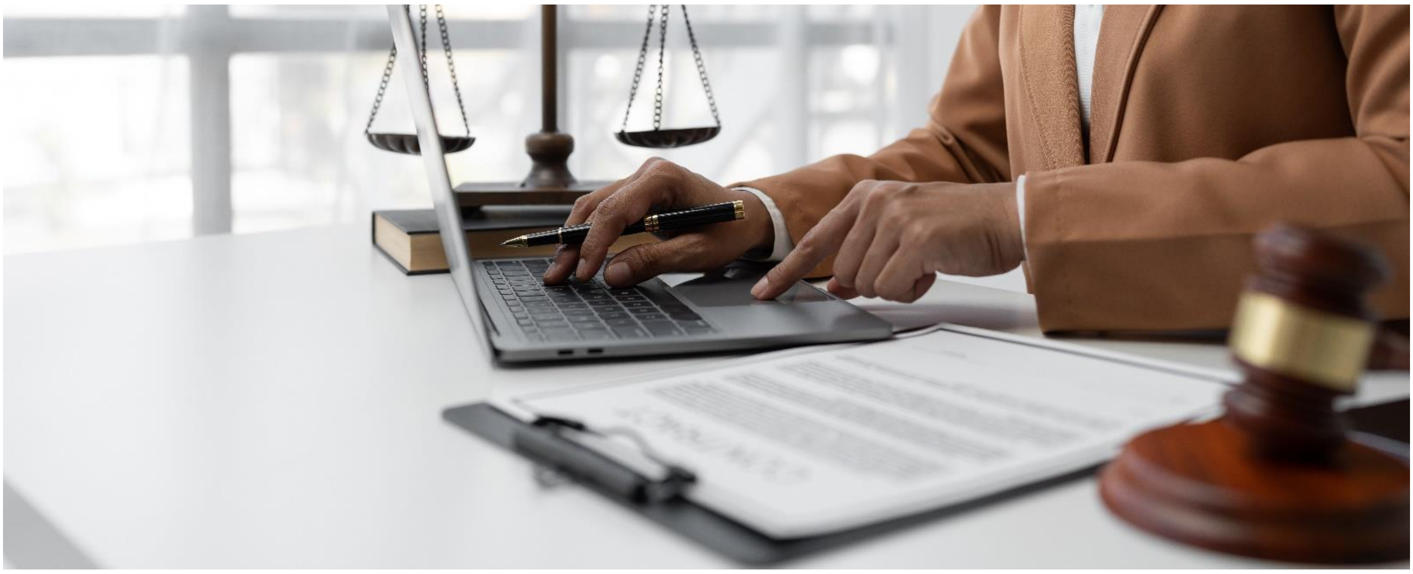
2. The definition of insurance contract captures a wide range of contracts

In assessing whether a contract is an insurance contract, IFRS 17 focuses on the economic substance of the contract, rather than its legal form. Some contracts are legally described and regulated as insurance contracts but do not transfer significant insurance risk and are therefore outside the scope of the Standard. On the other hand, contracts that do not have the legal form of insurance contracts but transfer significant insurance risk may meet the definition of an insurance contract and be subject to the requirements of IFRS 17.

An insurance contract is defined as a contract under which one party (the issuer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder. We will explain in this publication the key concepts involved in this definition and how to apply these concepts in practice.

The definition of insurance contract captures a wide range of contracts that may not have traditionally been considered as insurance contracts, for example:

- Fixed fee service contracts, maintenance contracts that transfer significant insurance risk
- Credit cards and certain loans with insurance cover including death waivers and student loans
- Travel insurance
- Surety bonds, fidelity bonds, performance bonds and bid bonds, i.e., contracts that compensate the holder if another party fails to perform a contractual obligation
- Insurance against disability and medical costs
- Prepaid funeral plans
- Insurance against product liability, professional liability, civil liability or legal expenses
- Product/service warranties issued by another party who is **not** a manufacturer, dealer or retailer



3. Definition of insurance risk

For a contract to be in the scope of IFRS 17, there needs to be a transfer of significant insurance risk from the policyholder to the issuer on a present value basis. This is because IFRS 17 defines an insurance contract as a contract under which one party (the issuer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder.

Consequently, key to the assessment is understanding what is meant by insurance risk, and more specifically, *significant* insurance risk. A contract is not an insurance contract unless the insurer accepts significant insurance risk.

IFRS 17 defines insurance risk as any risk other than financial risk transferred from the holder (policyholder) of the contract to the issuer. A good starting point is therefore to understand what risks are being transferred by a contract and then whether those risks are 'financial risks' or not using the definitions and examples in IFRS 17.

IFRS 17 positively defines financial risk as the risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, foreign 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. We can see that this definition of financial risk includes both financial and non-financial variables, but the latter are included in financial risk only if they are not specific to a party to the contract. Examples of financial risk due to non-financial variables not specific to the party to the contract include exposures to an index of earthquake losses in a particular region or an index of temperatures in a particular city. In contrast, the risk of an earthquake or high temperature affecting a particular property owned by an entity would be the risk of a possible future change in a non-financial variable specific to a party to the contract and would be an insurance risk.

The definition of financial risk therefore excludes non-financial variables that are specific to a party to the contract, such as the occurrence of a fire that damages or destroys an asset of that party. In addition, the risk of changes in the fair value of a non-financial asset is not a financial risk if the fair value reflects not only changes in market prices for such assets (a financial variable) but also the condition of a specific non-financial asset held by a party to a contract (a non-financial variable).

Based on the definition of an insurance contract if a contract transfers financial risks only (i.e., the contract results in no, or only insignificant, transfer of insurance risk) it is not an insurance contract.

Identifying whether a contract contains significant insurance risk is a key step in the assessment. We will address this later in the publication (Section 6. Assessment of the transfer of significant insurance risk).

4. The characteristics of an insurance contract in IFRS 17

As explained above, an insurance contract is defined as a contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder.

There are key aspects of this definition, namely:

- The requirement for a specified uncertain future event
- The meaning of insurance risk (discussed above)
- Whether insurance risk is significant
- Whether the insured event adversely affects the policyholder

To be an insurance contract there must be a **contract** which identifies an **uncertain future insured event** which can **adversely affect the policyholder** and has the **possibility of causing a loss** to the issuer if it occurs. The contract should have, as a condition, that payment will only be made if the customer has suffered a loss due to the occurrence of the insured event.

4.1. Existence of a contract

For there to be an insurance contract there must be a contractual arrangement. The existence of a contractual arrangement applying IFRS 17 relies on the same concepts as those in other standards, for example IFRS 15 and include:

- A contract is an agreement between two parties that creates substantive rights and obligations enforceable as a matter of law
- Contracts can be written, oral, or implied by the entity's customary business practice
- Implied terms in a contract include those imposed by law or regulation

- All terms in a contract should be considered, whether explicit or implied, except for those terms that have no commercial substance (i.e., terms that have no discernible effect on the economics of the contract), which should be disregarded

An insurance contract necessarily involves at least two parties. This is important when considering exposure to self-insurance. An entity may self-insure certain risks, such as workers' compensation. Self-insurance occurs when the entity retains a risk that could have been covered by insurance by setting aside resources to be used to pay for the adverse effects of a future uncertain event specific to that entity. Under IFRS 17, self-insurance does not give rise to an insurance contract because there is no agreement with another party.

5. Insurance risk and the insured event

In an insurance contract, the issuer of the contract agrees to compensate another party, the policyholder, if a specified uncertain event adversely affects the policyholder. This specified uncertain event is referred to as the insured event.

An adverse effect on a policyholder means that the policyholder suffers a loss as a result of the occurrence of the insured event. This is an important requirement because contracts which pay the counterparty when an event occurs regardless of whether the counterparty is adversely affected or not are not insurance contracts. For example, a gambling contract that requires a payment if a specified uncertain future event occurs is not an insurance contract because the payment to the holder is not conditional on whether the holder has been adversely affected by the event.

The definition of an insurance contract also requires the uncertain event to be specific to the policyholder. If the uncertain event is not specific to the policyholder, then the contract is not an insurance contract. For example, a weather derivative contract that will entitle the holder to a payment if a climatic event occurs regardless of whether the contract holder is adversely affected by the event is not an insurance contract because the uncertain event is not specific to the holder.

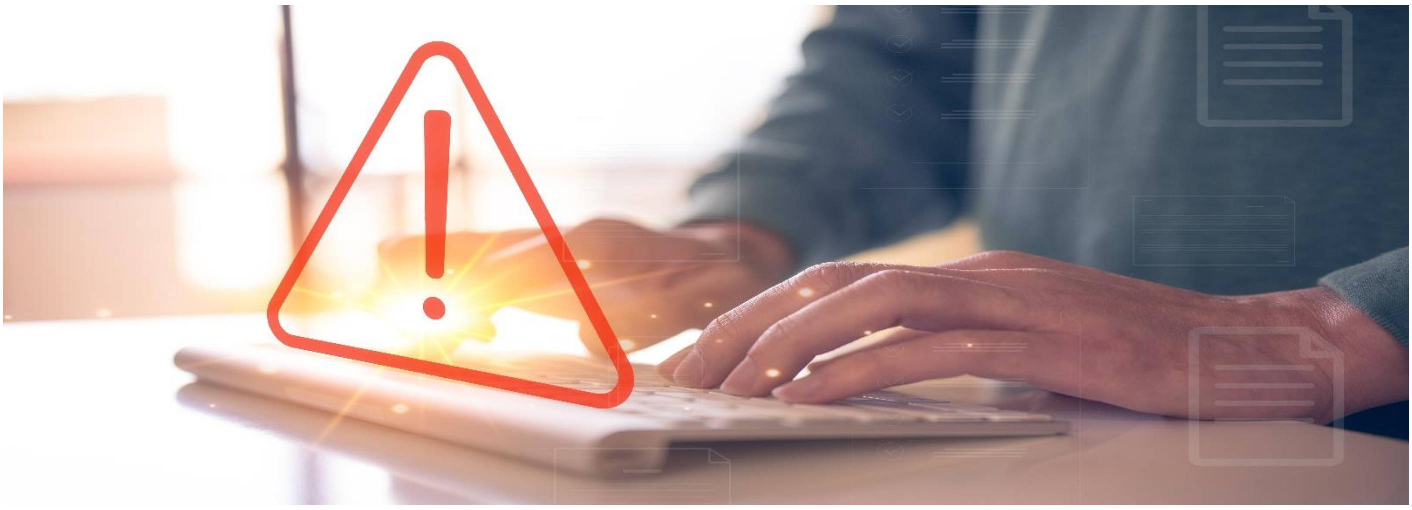
The compensation to the policyholder can be in cash or in kind. A payment in kind is a payment by the insurer in the form of goods or services rather than cash, for example, when the entity replaces a stolen good instead of reimbursing the policyholder in cash for its loss.

5.1. Uncertainty and insurance risk

Uncertainty and insurance risk

Uncertainty is the essence of an insurance contract. At least one of the following should be uncertain at the inception:

- Whether the insured event will occur
- When the insured event will occur
- How much the insurer will need to pay if the insured event occurs



6. Assessment of the transfer of significant insurance risk

We have discussed above what is meant by insurance risk. But to be an insurance contract, IFRS 17 requires that there is a transfer of insurance risk that is significant. The assessment of whether a contract transfers significant insurance risk is critical because some contracts may appear to meet the definition of an insurance contract but they are not considered to be insurance contracts for the purposes of IFRS 17 because the insurance risk transferred is not significant. There is no quantitative guidance in IFRS 17 as to what constitutes significant insurance risk, therefore this is an area that may require significant judgement by entities.

Insurance risk is significant if, and only if, there is at least one scenario where the insured event could cause the issuer to pay additional amounts that are significant compared to payments under any other scenario.

IFRS 17 mandates that an entity can only consider scenarios that have commercial substance. IFRS 17 explains that scenarios with no commercial substance are those that have no discernible effect on the economics of the transaction. If an insured event could mean that significant additional benefits would be payable in any scenario that has commercial substance, the contract is considered to transfer significant insurance risk even if the insured event is extremely unlikely or if the expected (i.e., probability-weighted) present value of contingent cash flows is a small proportion of the expected present value of all the remaining contractual cash flows.

In addition, a contract transfers significant insurance risk only if there is a scenario that has commercial substance in which the issuer has a possibility of a loss on a present value basis (i.e., the present value of outflows is larger than the present value of the inflows).

An entity should assess the significance of insurance risk contract by contract. Consequently, the insurance risk can be significant even if there is minimal probability of significant losses for a portfolio or group of contracts.

7. Insurance contract assessment under IFRS 17

The assessment of whether a contract meets the definition of an insurance contract under IFRS 17, and the consequential accounting treatment can be very complex depending on the terms and conditions of the contract. The flowchart below summarises steps in the assessment.

Insurance contract flow chart

ORIGINATION BY CONTRACT

Does the insurance risk transfer originate from a contract or a statute (i.e., the risk transfer is imposed by law)?

(Contracts can be written, oral or implied by custom, and contractual rights and obligations may arise from contract, law or regulation) (IFRS 17:2)

No

Yes

COMPENSATION FOR FUTURE UNCERTAIN EVENT

Does the contract provide for compensation of another party for:

- An uncertain future event which is specific to the counterparty? (IFRS 17:B3)
- Pre-exiting risk of the counterparty (IFRS 17:B21)

(Compensation can be in cash or in kind – e.g., goods or services)

No

- Self-insurance is **not** an insurance contract within consolidated financial statements as there is no contractual arrangement with an external party. However, in the separate financial statements of a parent or subsidiary, it is insurance (IFRS 17:B27(c))
- Event should be specific to the counterparty
- A risk created by a contract is not insurable risk

Yes

ADVERSE EFFECT ON POLICYHOLDER

Is it a contractual precondition that the compensation is payable only when the event adversely affects the policyholder? (IFRS 17:B13)

No

Some contracts pay a counterparty even if the event does not adversely affect the holder (i.e., the holder has not suffered a loss)—e.g., gambling (IFRS 17:B27(d))

Yes

TRANSFER OF NON-FINANCIAL RISK

Does the transaction transfer non-financial risk or both non-financial risk and financial risk?

No

Transactions that expose the issuer to financial risk only are not insurance contracts – for example, financial derivatives

Yes

SIGNIFICANT INSURANCE RISK

Does the contract transfer significant insurance risk? (A quantitative assessment on a present value basis is required) (IFRS 17:B17)

No

Contracts that do not transfer significant insurance risk are not insurance contracts

Yes

Transaction is an insurance contract

Consider the scoping exclusions/accounting policy choices

Transaction is <u>not</u> an insurance contract (out of scope of IFRS 17)

Out of Scope

Some insurance contracts are out of the scope of IFRS 17

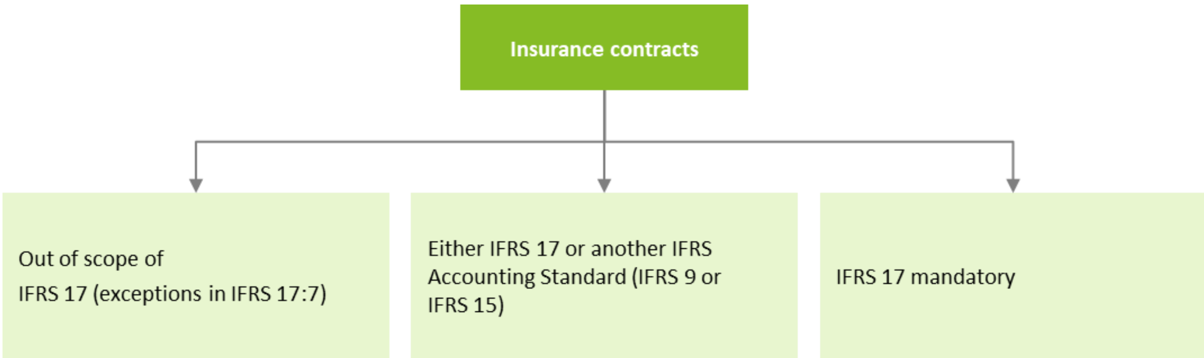
Accounting Policy Choice

Some insurance contracts have an accounting policy choice between IFRS 17, IFRS 9 or IFRS 15

IFRS 17 must be applied to insurance contracts that do not qualify for scope exemption or accounting policy choice

8. Scope of IFRS 17

Once an entity has determined that it issues insurance contracts it then needs to consider whether it is required to account for these contracts under IFRS 17. Contracts that meet the definition of an insurance contract are not automatically accounted for under IFRS 17. IFRS 17 includes various scope exclusions or allows an entity to choose to account for the contract applying another IFRS Accounting Standard.



8.1. Fixed fee service contracts

A type of insurance contract that may be issued by non-insurers are fixed fee service contracts. The primary purpose of a fixed fee service contract is the provision of services for a fixed fee rather than payment of cash to the customer when the insured event happens.

Subject to strict criteria, an entity can elect to account for such contracts applying either IFRS 17 or IFRS 15. A careful analysis of the contractual terms and conditions and the pricing of fixed fee service contracts is important to determine if **all** the criteria are met (such that the accounting policy choice is available). If any criterion below is not met, the entity must account for the contract applying IFRS 17.

1. Risk assessment
The entity does not reflect an assessment of the risk associated with an individual customers in setting the price of the contract with that customer (no underwriting)

2. Service compensation
The contract compensates the customer by providing services, rather than by making cash payments to the customer

3. Risk from use of services (overutilisation risk)
The insurance risk transferred by the contract arises primarily from the customer's use of services rather than from uncertainty over the cost of those services

8.2. Examples of fixed fee service contracts which meet the definition of an insurance contract

As fixed fee service contracts issued by non-insurers may be significant to a non-insurer, we have included some examples (not exhaustive) of typical types of arrangements that will need to be assessed.

Type of contract	Comments
Maintenance contracts—equipment A service provider agrees, under an annual maintenance contract, to repair specified equipment after a malfunction. The fixed service fee is based on the expected number of malfunctions across the population of equipment that the service provider will maintain, but it is uncertain whether a particular machine will break down. The malfunction of the equipment adversely affects the owner (e.g., through production disruption) and the contract compensates the owner by repairing the equipment (provision of services rather than cash).	The fixed-fee annual contract meets the definition of an insurance contract because the customer has a pre-existing risk of the equipment breaking down and is compensated through maintenance services only when the equipment breaks down. The pricing of the fixed fee does not take into account the condition of the asset as it is based on expected malfunctions across the population of pieces of equipment that the service provider will maintain. The customer's entitlement is only to a service and the uncertainty is over the number of breakdowns rather than their cost (overutilisation risk). Therefore, the contract may be accounted for applying either IFRS 15 or IFRS 17. However, if, for example, the pricing of the contract takes into account the condition of the asset (underwriting), the contract is required to be accounted for applying IFRS 17.
Car breakdown services Under a contract for car breakdown services, the provider agrees, for a fixed annual fee, to provide roadside assistance or to tow the car to a nearby garage. The fixed annual fee is based on the expected number of breakdowns across the population of cars that the provider will assist, but it is uncertain whether a particular car will break down. The breakdown of a car adversely affects the owner, and the contract compensates the owner by taking the car to a nearby garage if the roadside assistance is not successful in putting the car back into circulation (provision of services rather than cash).	The fixed fee contract meets the definition of an insurance contract because the customer has a pre-existing risk that their car will break down and is compensated through roadside assistance services only when they experience a car breakdown. The pricing of the fixed fee does not take into account the condition of the car as it is based on expected breakdowns across the population of cars that the service provider will assist after a breakdown. The customer's entitlement is only to a roadside assistance service and the uncertainty is over the number of breakdowns rather than their cost (overutilisation risk). Therefore, the contract may be accounted for applying either IFRS 15 or IFRS 17. However, if, for example, the pricing takes into account the customer's age, gender or driving history such that different categories of customers are charged different fees for similar service, the contracts are required to be accounted for applying IFRS 17.

8.3 Other examples of insurance contracts that may be issued by non-insurance entities that are subject to the requirements of IFRS 17

In addition to fixed fee service contracts, there are some contracts that are issued by non-insurers that may transfer significant insurance risk. These contracts may be subject to any IFRS 17 scoping exceptions or to an accounting policy choice between IFRS 17 and another IFRS Accounting Standard. Included below are some examples of contracts that may meet the definition of insurance contracts.

Type of contract	Examples and notes
Surety bonds, fidelity bonds, performance bonds and bid bonds, i.e., contracts that compensate the holder if another party fails to perform a contractual obligation	Depending on the facts and circumstances, performance bonds may or may not be in the scope of IFRS 17
Travel insurance	Travel insurance contracts that offer compensation in cash or in kind to customers for losses suffered in advance of, or during travel
Insurance against theft or damage	A contract where an entity may compensate another party for loss or damage of goods

8.4 Insurance contracts for which IFRS 17 allows an accounting policy choice

IFRS 17 allows entities to apply either IFRS 17 or another IFRS Accounting Standard to certain contracts (that meet the definition of an insurance contract). Some examples are below:

Type of contract	Accounting policy options	Examples
Fixed service fee contracts that meet all the conditions required by IFRS 17:8	IFRS 17 or IFRS 15 (irrevocable choice on a contract-by-contract basis)	• Roadside assistance • Maintenance and repair contracts
Loan contracts that meet the definition of an insurance contract but limit the compensation for insured events to the amount otherwise required to settle the policyholder's obligation created by the contract	IFRS 17 or IFRS 9 (irrevocable choice on a portfolio-by-portfolio basis)	• Mortgage loans with death waivers • Equity-release mortgages/No negative equity guarantees/Lifetime mortgage contracts • Student loan contracts with repayments contingent on income

8.5 Contracts specifically excluded from IFRS 17

IFRS 17:7 specifies a list of contracts that cannot be accounted for applying IFRS 17 (even though the contract may otherwise meet the definition of an insurance contract). Some examples are below:

Type of contract	Applicable accounting standard	Notes
Warranties provided by a manufacturer, dealer or retailer in connection with the sale of its goods or services to a customer	IFRS 15	However, if the warranty is not issued in connection with the sale of goods or services, it **is** within the scope of IFRS 17
Employers' assets and liabilities from employee benefit plans	IAS 19 *Employee Benefits* or IFRS 2 *Share-based Payment*	Employee benefits are all forms of consideration given by an entity in exchange for service rendered by employees or for the termination of employment
Contractual rights or contractual obligations contingent on the future use of, or the right to use, a non-financial item.	IFRS 15, IAS 38 *Intangible Assets* or IFRS 16 *Leases*	Examples include some licence fees, royalties, variable and other contingent lease payments and similar items

9. Conclusion

IFRS 17 is a highly complex accounting standard that captures contracts issued that transfer significant insurance risk. Such contracts can be issued by any entity including non-insurers who have not applied insurance accounting prior to IFRS 17. IFRS 17 includes various scope exclusions or allows an entity to choose to account for the contract applying another IFRS Accounting Standard. For example, an entity can elect to account for fixed fee service contracts applying either IFRS 17 or IFRS 15, provided the criteria are met. Accordingly, entities need to complete a careful analysis of the contractual terms and conditions to identify whether the contract is in scope of IFRS 17 and if an accounting choice is available.

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