Modification and Derecognition

Version	Date	Comments
0.1	25 Oct 2019	Draft
1.0	25 Sep 2020	First circulation

This IFRS17 Working Paper aims to facilitate discussion among actuaries and other stakeholders to capture the range of opinions on the application of IFRS17 in the Singapore context and is not meant to serve as mandatory practice notes.

Any interpretation of IFRS17 set out in this Paper represents a plausible treatment given the text of IFRS17. However, it shall neither be construed as the only possible treatment nor the agreed interpretation for Singapore insurers. Users of this Working Paper shall be mindful that differences in the exact fact pattern and operating context facing each insurer may drive different interpretations. Users shall also be mindful that for the same fact pattern and operating context, there is scope for the substance of same transaction to be articulated differently depending on how the transaction is analysed. (For example, in substance, cash flows from a call option with strike price $X on an asset is equivalent to the combined cash flow from the underlying asset and a put option with strike price $X on the asset, less cash of $X.) Differences in articulation can give rise to a range of plausible treatments. An insurer remains responsible for justifying its choice of treatment after discussion with its auditor. Opinions expressed in the working papers are not representative of that of the Singapore Actuarial Society.

Table of contents

1. IFRS17 Standards 2
2. Interpretation of Standards 6
3. Derecognition of extinguished contract 6
4. Derecognition of modified contract and recognition of the new contract 7
5. Implementation Challenges 7

1. IFRS17 Standards

The key passages in the IFRS17 standards that relate to modification and derecognition of insurance contracts and their treatment are outlined below:

Modification and derecognition

Modification of an insurance contract

Paragraph 72

If the terms of an insurance contract are modified, for example by agreement between the parties to the contract or by a change in regulation, an entity shall derecognise the original contract and recognise the modified contract as a new contract, applying IFRS 17 or other applicable Standards if, and only if, any of the conditions in (a)–(c) are satisfied. The exercise of a right included in the terms of a contract is not a modification. The conditions are that:

(a) if the modified terms had been included at contract inception:

I. the modified contract would have been excluded from the scope of IFRS 17, applying paragraphs 3–8;

II. an entity would have separated different components from the host insurance contract applying paragraphs 10–13, resulting in a different insurance contract to which IFRS 17 would have applied;

III. the modified contract would have had a substantially different contract boundary applying paragraph 34; or

IV. the modified contract would have been included in a different group of contracts applying paragraphs 14–24.

(b) the original contract met the definition of an insurance contract with direct participation features, but the modified contract no longer meets that definition, or vice versa; or

(c) the entity applied the premium allocation approach in paragraphs 53–59 or paragraphs 69–70 to the original contract, but the modifications mean that the contract no longer meets the eligibility criteria for that approach in paragraph 53 or paragraph 69.

Paragraph 73

If a contract modification meets none of the conditions in paragraph 72, the entity shall treat changes in cash flows caused by the modification as changes in estimates of fulfilment cash flows by applying paragraphs 40–52.

Derecognition

Paragraph 74

An entity shall derecognise an insurance contract when, and only when:

(a) it is extinguished, ie when the obligation specified in the insurance contract expires or is discharged or cancelled; or

(b) any of the conditions in paragraph 72 are met.

Paragraph 75

When an insurance contract is extinguished, the entity is no longer at risk and is therefore no longer required to transfer any economic resources to satisfy the insurance contract. For example, when an entity buys reinsurance, it shall derecognise the underlying insurance contract(s) when, and only when, the underlying insurance contract(s) is or are extinguished.

Paragraph 76

An entity derecognises an insurance contract from within a group of contracts by applying the following requirements in IFRS 17:

(a) the fulfilment cash flows allocated to the group are adjusted to eliminate the present value of the future cash flows and risk adjustment for non-financial risk relating to the rights and obligations that have been derecognised from the group, applying paragraphs 40(a)(i) and 40(b);

(b) the contractual service margin of the group is adjusted for the change in fulfilment cash flows described in (a), to the extent required by paragraphs 44(c) and 45(c), unless paragraph 77 applies; and

(c) the number of coverage units for expected remaining coverage is adjusted to reflect the coverage units derecognised from the group, and the amount of the contractual service margin recognised in profit or loss in the period is based on that adjusted number, applying paragraph B119.

Paragraph 77

When an entity derecognises an insurance contract because it transfers the contract to a third party or derecognises an insurance contract and recognises a new contract applying paragraph 72, the entity shall instead of applying paragraph 76(b):

(a) adjust the contractual service margin of the group from which the contract has been derecognised, to the extent required by paragraphs 44(c) and 45(c), for the difference between (i) and either (ii) for contracts transferred to a third party or (iii) for contracts derecognised applying paragraph 72:

  I. the change in the carrying amount of the group of insurance contracts resulting from the derecognition of the contract, applying paragraph 76(a).

  II. the premium charged by the third party.

  III. the premium the entity would have charged had it entered into a contract with equivalent terms as the new contract at the date of the contract modification, less any additional premium charged for the modification.

(b) measure the new contract recognised applying paragraph 72 assuming that the entity received the premium described in (a)(iii) at the date of the modification.

Paragraph 91

If an entity transfers a group of insurance contracts or derecognises an insurance contract applying paragraph 77:

(a) it shall reclassify to profit or loss as a reclassification adjustment (see IAS 1 Presentation of Financial Statements) any remaining amounts for the group (or contract) that were previously recognised in other comprehensive income because the entity chose the accounting policy set out in paragraph 88(b).

(b) it shall not reclassify to profit or loss as a reclassification adjustment (see IAS 1) any remaining amounts for the group (or contract) that were previously recognised in other comprehensive income because the entity chose the accounting policy set out in paragraph 89(b).

Modification and derecognition

(Paragraphs 72–77 of IFRS 17)

BC316
Paragraph B25 of IFRS 17 states that a contract that qualifies as an insurance contract remains an insurance contract until all rights and obligations are extinguished. An obligation is extinguished when it has expired or has been discharged or cancelled. However, in some cases, an entity may modify the terms of an existing contract in a way that would have significantly changed the accounting of the contract if the new terms had always existed. IFRS 17 specifies different requirements for these and other modifications. In some cases, insurance contract modifications will result in derecognising the insurance contract.

Modifications that would have resulted in significantly different accounting for the contract

(Paragraphs 72, 76 and 77 of IFRS 17)

BC317
A modification of an insurance contract amends the original terms and conditions of the contract (for example, extending or shortening the coverage period or increasing the benefits in return for higher premiums). It differs from a change arising from either party to the contract exercising a right that is part of the original terms and conditions of the contract. If an insurance contract modification meets specific criteria (see paragraph 72 of IFRS 17), the contract is modified in a way that would have significantly changed the accounting of the contract had the new terms always existed. IFRS 17 therefore requires the original contract to be derecognised and a new contract based on the modified terms to be recognised. The consideration for the new contract (ie the implicit premium) is deemed to be the price the entity would have charged the policyholder had it entered into a contract with equivalent terms at the date of the modification. That deemed consideration determines:

(a) the adjustment to the contractual service margin of the group to which the existing contract belonged on derecognition of the existing contract; and
(b) the contractual service margin for the new contract.

BC318
The Board concluded that modifications to contracts that trigger derecognition should be measured using the premium the entity would have charged had it entered into a contract with equivalent terms as the modified contract at the date of the contract modification. Such an approach measures the modified contract consistently with the measurement of other insurance contract liabilities.

BC319
The Board considered whether the contractual service margin of the group to which the existing contract belonged should be adjusted for the gain or loss arising on the derecognition of the existing contract and recognition of the modified contract (paragraph BC317(a)). The alternative (not adjusting the contractual service margin) would result in a gain or loss in profit or loss. However, the Board concluded that:

(a) not adjusting the contractual service margin of the group from which the existing contract is derecognised; and
(b) establishing the contractual service margin for the group that includes the new modified contract based on the premiums that would have been charged for that new contract would result in the contractual service margin of the two groups double-counting the future profit to be earned from the contract. Hence, the Board decided that the contractual service margin of the group from which the existing contract has been derecognised should be adjusted.

Modifications that would not have resulted in significantly different accounting for the contract

(Paragraph 73 of IFRS 17)

BC320
The Board decided that all modifications that would not have resulted in significantly different accounting for the contract should be accounted for in the same way as changes in estimates of fulfilment cash flows. Doing so results in symmetrical accounting for contract modifications that eliminate rights and obligations and for contract modifications that add rights and obligations. This reduces the potential for accounting arbitrage through contract modification.

Derecognition

(Paragraph 74–75 of IFRS 17)

BC321
IFRS 17 requires an entity to derecognise an insurance contract liability from its statement of financial position only when it is extinguished or modified in the way discussed in paragraph BC317. An insurance contract is extinguished when the obligation specified in the insurance contract expires or is discharged or cancelled. This requirement is consistent with requirements in other IFRS Standards, including the derecognition requirements for financial liabilities in IFRS 9. The requirement also provides symmetrical treatment for the recognition and derecognition of insurance contracts.

BC322
The Board considered concerns that an entity might not know whether a liability has been extinguished because claims are sometimes reported years after the end of the coverage period. It also considered concerns that an entity might be unable to derecognise those liabilities. Some argued that, in some cases, the delayed derecognition would result in unreasonable and unduly burdensome accounting. In the Board’s view, ignoring contractual obligations that remain in existence and that can generate valid claims would not give a faithful representation of an entity’s financial position. However, the Board expects that when the entity has no information to suggest there are unasserted claims on a contract with an expired coverage period, the entity would measure the insurance contract liability at a very low amount. Accordingly, there may be little practical difference between recognising an insurance liability measured at a very low amount and derecognising the liability.

2. Interpretation of Standards

The term "modification" under IFRS 17 refers to specific alteration on the original terms and conditions of the contract *(such as a "substantially" different contract boundary or grouping)*. It differs from a change arising from either party to the contract exercising a right that is part of the original terms and conditions of the contract *(as per Basis for Conclusions Paragraph 317)*.

The standard defines "modification" as contract alteration that meets specific criteria *(as per Paragraph 72)*:

Scenario	IFRS 17 Guidance
Modified terms had been included at contract inception	The modified contract would have: I. been excluded from the scope of IFRS 17 II. separated different components from the host insurance contract resulting in a contract to which IFRS 17 would have applied III. a **substantially**[1] different contract boundary IV. been included in a different group of contracts
Original contract does not meet / does meet the definition of an insurance contract with direct participation features	The modified contract meets / no longer meets the definition of an insurance contract with direct participation features
Original contract applied the premium allocation approach	The modified contract no longer meets the eligibility criteria for the premium allocation approach

[1] IFRS 17 did not elaborate on the definition of substantial

Besides modifications that meet Paragraph 72, all the other contract alterations are captured as changes in estimates of fulfilment cash flows of the original contract *(as per Basis for Conclusions Paragraph 320)*.

As for modifications that meet Paragraph 72, IFRS 17 requires derecognition of the original contract similar to a contract cancellation *(as per Paragraph 76)* and recognition of the modified contract *(as per Paragraph 77)*.

3. Derecognition of extinguished contract

The standards require derecognition when the obligation specified in the insurance contract expires or is discharged or cancelled *(as per Paragraph 74)*. Meaning an entity shall derecognise a contract when it is no longer at risk and no longer required to transfer any economic resources to satisfy the contract.

As per Paragraph 76, an entity derecognises an insurance contract from within a group of contracts by:

Items	Adjustments
Fulfilment Cash Flows	Eliminating present value of the future cash flows, risk adjustment for non-financial risk and any adjustments for financial risks relating to the derecognised rights and obligations
Contractual Service Margin	Adjusting for the change in fulfilment cash flows
Coverage Units	Adjusting to reflect the coverage units derecognised from the group

4. Derecognition of modified contract and recognition of the new contract

Derecognition is similar between extinguished contract and modified contract. As per Paragraph 76, an entity derecognises an insurance contract from within a group of contracts by:

Items	Adjustments
Fulfilment Cash Flows	Eliminating present value of the future cash flows, risk adjustment for non-financial risk and any adjustments for financial risks relating to the derecognised rights and obligations
Coverage Units	Adjusting to reflect the coverage units derecognised from the group

The only difference is the treatment of Contractual Service Margin. Instead of adjusting for the change in fulfilment cash flows, the adjustment is calculated using a specific formula *(as per Paragraph 77)*:

CSM Adjustment = Fulfilment Cash Flows of the derecognized policy + (theoretical premium of the new modified policy - additional premium for modification)

The theoretical premium of the new modified policy is the premium the entity would have charged had it entered into a contract with equivalent terms as the modified contract at the date of modification *(as per Basis for Conclusions Paragraph 318)*.

After adjusting the CSM of the original group, the modified contract will be recognised using the same theoretical premium assuming the entity received the premium at the date of the modification.

5. Implementation Challenges

I. Definition

Not all contract alterations are modifications under IFRS 17. In fact, majority of prevalent alterations in Singapore *(including Extended Term Assurance and Reduced Paid-up)* are unlikely to meet such definition. Industry participants are to assess its existing alterations and determine the correct treatment under IFRS 17.

II. Adjusting CSM of the original group

Adjusting the CSM of the original group is necessary to avoid double-counting of future profits to be earned from the modified contract. Industry participants are required to distinguish contract alterations that are modifications under IFRS 17 and apply separate treatment.