# IFRS 17 Accounting Policy Paper: Initial recognition and contract boundary

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| **Date:** | November 10, 2021 |
| **Approvers / Reviewers:** | Approved by:<br>FA Accounting Committee |
| **Subject:** | Initial recognition and contract boundary |

***Disclaimer:***

This accounting policy paper, which is the responsibility of the Facility Association's (FA) management, is prepared solely for the FA as administrator of certain insurance pools, namely the Facility Association Residual Market (FARM) and each of the Risk Sharing Pools (RSPs). It is intended solely for the use of the FA to document management's accounting policy determinations under IFRS 17 as part of management's internal financial reporting and governance processes as applicable to the FARM and each of the RSPs.

This accounting policy paper is being made available through the FA website to member insurance companies for general information purposes only and does not constitute advice from the Facility Association. Member insurance companies are responsible for their own assessment of IFRS 17 as applicable to their financial reporting. We disclaim any responsibility to any member insurance company who may rely on this document.

**Contents**

**Purpose**

The purpose of this paper is to summarize Facility Association's assessment of the requirements of IFRS 17 relating to the accounting treatment associated with the contract boundary and initial recognition. This paper provides guidance on how Facility Association plans to fulfil the IFRS 17 requirements for insurance contracts associated with the Facility Association Residual Market ("FARM") and with each of the six Risk Sharing Pools ("RSPs").

***Entities:***

Facility Association (FA) administers three types of mechanisms on behalf of its membership. This paper covers only the two mechanisms in the scope of IFRS 17, namely:

- Facility Association Residual Market ("FARM")
- Risk Sharing Pools ("RSPs")*

* Outside the scope of this paper are requirements relating to the direct business issued by the individual members prior to transferring the business to the RSPs. Only business assumed via the RSPs will be addressed in this memo.

***Topics Covered:***

The topics covered in this paper are as follows:

1. Initial Recognition: When to begin recognizing insurance contracts associated with FARM and the RSPs.
2. Contract boundary: Which cash flows are included within the contract boundary of insurance contracts associated with FARM and the RSPs.

***Dependencies and Relationships:***

The technical positions developed in this paper affect (i.e., have downstream dependency on) the conclusions of the following papers:

1. Scope
2. Level of aggregation
3. Initial recognition and subsequent measurement (which includes qualification for the premium allocation approach (PAA) and onerous contract analysis)
4. Insurance acquisition cash flows
5. Risk adjustment
6. Discount rate
7. Transition
8. Modification and extinguishment of insurance contract

**Executive summary**

FA reached the following conclusions regarding the requirements of IFRS 17 relating to the contract boundary assessments and the initial recognition requirements for insurance contracts associated with the FARM and the RSPs.

1- Initial Recognition: When to begin recognizing insurance contracts?

   a. FARM: Contracts will be recognized at the earliest of:

      i. The beginning of the coverage period of the group of contracts;
      ii. The date when the first payment from a policyholder in the group becomes due; and
      iii. For a group of onerous contracts, when the group becomes onerous.
      For the FARM, onerous contracts "become onerous" on the "entry date", with "Entry date" being defined as the date when the issuer (being the servicing carrier on behalf of the FARM members) of the contract assumes insurance risk and therefore, becomes obligated to provide coverage to the underlying policyholder at this date.

   b. RSPs: Similar to FARM, contracts will be recognized at the earliest of:

      i. The beginning of the coverage period of the group of contracts;
      ii. The date when the first payment from a policyholder in the group becomes due; and
      iii. For a group of onerous contracts, when the group becomes onerous.
      RSP is expected to be onerous for most accident years (AY) – and therefore, the date the contract "becomes onerous" is the date that an individual member company transfers a policy into the pool which will exist in the subsequent AY – being January 2 of the preceding year.

2- Contract boundary: Which cash flows are included within the contract boundary of insurance contracts?

   a. FARM: The contract boundary for each insurance contract issued by the servicing carrier on behalf of the FARM members is up to 12 months and includes:

      i. total expected premiums;
      ii. total expected claims; and
      iii. total expected expenses, including insurance acquisition cash flows.

   b. RSPs: The contract boundary for each accident year (AY) insurance contract is up to 12 months and, at initial recognition, includes within the contract boundary:

      i. Ceded premiums (net of premium payment service charges) allocated to the AY;
      ii. Expected incurred claims for the AY; and
      iii. Expected directly attributable expenses (e.g. expense allowance) for the AY.

   Cash flows relating to in-force and forecasted future business are within the contract boundary at inception. This is because the RSP cannot reject qualifying business (that is in accordance with the transfer rules set out in the Plan of Operations) which a member chooses to cede to the RSP, similar to other reinsurance treaties with extended cancellation features.

**Question 1: When should insurance contracts be initially recognized in accordance with IFRS 17?**

***Technical References and Guidance***

**IFRS 17 Standard**

25. An entity shall recognise a group of insurance contracts it issues from the earliest of the following:
    (a) the beginning of the coverage period of the group of contracts;
    (b) the date when the first payment from a policyholder in the group becomes due; and
    (c) for a group of onerous contracts, when the group becomes onerous.

26. If there is no contractual due date, the first payment from the policyholder is deemed to be due when it is received. An entity is required to determine whether any contracts form a group of onerous contracts applying paragraph 16 before the earlier of the dates set out in paragraphs 25(a) and 25(b) if facts and circumstances indicate there is such a group.

28. In recognising a group of insurance contracts in a reporting period, an entity shall include only contracts that individually meet one of the criteria set out in paragraph 25 and shall make estimates for the discount rates at the date of initial recognition (see paragraph B73) and the coverage units provided in the reporting period (see paragraph B119). An entity may include more contracts in the group after the end of a reporting period, subject to paragraphs 14–22. An entity shall add a contract to the group in the reporting period in which that contract meets one of the criteria set out in paragraph 25. This may result in a change to the determination of the discount rates at the date of initial recognition applying paragraph B73. An entity shall apply the revised rates from the start of the reporting period in which the new contracts are added to the group.

47. An insurance contract is onerous at the date of initial recognition if the fulfilment cash flows allocated to the contract, any previously recognised insurance acquisition cash flows and any cash flows arising from the contract at the date of initial recognition in total are a net outflow.

48. A group of insurance contracts becomes onerous (or more onerous) on subsequent measurement if the following amounts exceed the carrying amount of the contractual service margin:

    (a) unfavourable changes relating to future service in the fulfilment cash flows allocated to the group arising from changes in estimates of future cash flows and the risk adjustment for non-financial risk; and
    (b) for a group of insurance contracts with direct participation features, the decrease in the amount of the entity's share of the fair value of the underlying items.

    Applying paragraphs 44(c)(i), 45(b)(ii) and 45(c)(ii), an entity shall recognise a loss in profit or loss to the extent of that excess.

***Technical Analysis***

Following the guidance set out above, IFRS 17.25 notes an insurance contract should be recognized from the earlier of:

a) The beginning of the coverage period;

b) The date when the first payment becomes due; and

c) When the group becomes onerous.

In the instance there is no premium due date specified in the contract, the date when the first payment is received from the policyholder is deemed to be the date when the first payment becomes due.

A group of contracts initially recognized in a reporting period will only include contracts that individually meet one of the criteria set out in paragraph 25. Contracts may be added to the group within the reporting period in instances that each contract meets one of the criteria set out in paragraph 25.

IFRS 17.47 and 17.48 detail that a contract is considered onerous when there is a net outflow of cash flows in the contract at initial recognition or upon subsequent measurement. IFRS 17.26 requires the entity to determine whether any contracts form a group of onerous contracts before the earlier of the dates set out in paragraphs 25(a) and 25(b) (i.e. beginning of the coverage period or when the first payment is due) if facts and circumstances indicate there is such a group. A contract will be recognized on the date the contract is determined onerous. If the contract was to be determined onerous, all the cash flows within the contract boundary are included in the liability, including the loss component.

**FARM**

Contracts under the residual market mechanism are issued by approved servicing carriers on behalf of FA's members. (See Scope memo for the full description of the mechanism). Such contracts are recognized initially when the servicing carriers issue the insurance contract to the underlying policyholder, which is also when the servicing carriers report an 'entry date' or 'issue date' to Facility Association (i.e., the date when an insurance contract is entered in insurer's accounting records).

The contract issuer is viewed as the collective of the FA membership that is exposed to the obligations arising from the contracts, based on their share as determined by the FA Plan of Operation. Based on this and the applicable contract law specific to automobile insurance contracts, the entry date is defined as the date that the insurance contract issuer accepts the obligations associated with a transfer of insurance risk from the other party in the contract (the policyholder).

Therefore, entry date would be the date when the issuer of the contract assumes insurance risk and therefore becomes obligated to provide coverage to the underlying policyholder at this date. The entry date of a contract is when the issuer is bound by the terms of the contract and, as such, has a contractual obligation to accept risk (also known as the issue date of a contract). The entry date is typically before the beginning of coverage and due date for the initial premium. For FARM, the entry date could vary depending on the composition of the group and therefore an assessment will be done at the inception of each group.

**Contracts will be recognized at the earliest of the three dates outlined in IFRS 17.25 being:**

a) **The beginning of the coverage period;**

b) **The date when the first payment becomes due; and**

c) **When the group becomes onerous.**

**Onerous contracts issued by the FARM "become onerous" on the "entry date".**

**RSP**

The RSPs function as a facultative-obligatory reinsurance treaty and as such, for FA's members (The Collective) assuming their share of the financial results of each RSP, this is assumed business (not reinsurance contracts held). As a result, the initial recognition criteria are the same as for direct written business.

The RSP by nature is expected to be onerous, but a question arises as to when the group "becomes" onerous.

The RSP has no ability to decline qualifying business – one might argue that the RSP has a substantial obligation to provide service in perpetuity.

Taking the view that the RSP is the counterparty to the arrangement with the cedant, regardless of which FA member is ultimately responsible for benefiting from the rights and settling the obligations, there would be no substantive rights or obligations that exist until the "Dispatch Date". This date is defined in Article XI of the Plan of Operation as "the date on which a transfer notification can be established to have left a member's Canadian head office, or the office designated by the member for that jurisdiction for delivery to the risk sharing pool."

Therefore, the date of initial recognition of the 20XX AY is the later of:

- The coverage period start date for a cession; or
- The Dispatch date for a cession.

As contracts ceded to the RSP must be up to 12 months, this date is expected to be January 2 of the preceding AY.

**Contracts will be recognized at the earliest of the three dates outlined in IFRS 17.25 being:**

a) **The beginning of the coverage period;**

b) **The date when the first payment becomes due; and**

c) **When the group becomes onerous.**

**For RSPs, since they are expected to be onerous for most accident years, the date of initial recognition of each AY contract is likely going to be January 2 of the preceding year.**

***Technical Position***

| Contract | Technical Position |
|---|---|
| FARM | Contracts will be recognized at the earliest of the three dates outlined in IFRS 17.25.<br><br>Onerous contracts issued by approved servicing carriers on behalf of FA's members "become onerous" on the "entry date". |
| RSP | Contracts will be recognized at the earliest of the three dates outlined in IFRS 17.25.<br><br>For RSP, since it is expected to be onerous for most accident years, the date of initial recognition of each AY contract is likely going to be January 2 of the preceding year. |

**Question 2: Which cash flows are within the contract boundary of the insurance contract?**

***Technical References and Guidance***

**IFRS 17 Standard**

33. An entity shall include in the measurement of a group of insurance contracts all the future cash flows within the boundary of each contract in the group.

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:
   (a) the entity has the practical ability to reassess the risks of the particular policyholder and, as a result, can set a price or level of benefits that fully reflects those risks; or
   (b) both of the following criteria are satisfied:
      (i) the entity has 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 reflects the risk of that portfolio; and
      (ii) the pricing of the premiums up to the date when the risks are reassessed does not take into account the risks that relate to periods after the reassessment date.

B61. Estimates of cash flows in a scenario shall include all cash flows within the boundary of an existing contract and no other cash flows. An entity shall apply paragraph 2 in determining the boundary of an existing contract.

B63. When an issuer of an insurance contract is required by the contract to renew or otherwise continue the contract, it shall apply paragraph 34 to assess whether premiums and related cash flows that arise from the renewed contract are within the boundary of the original contract.

B64. Paragraph 34 refers to an entity's practical ability to set a price at a future date (a renewal date) that fully reflects the risks in the contract from that date. An entity has that practical ability in the absence of constraints that prevent the entity from setting the same price it would for a new contract with the same characteristics as the existing contract issued on that date, or if it can amend the benefits to be consistent with the price it will charge. Similarly, an entity has that practical ability to set a price when it can reprice an existing contract so that the price reflects overall changes in the risks in a portfolio of insurance contracts, even if the price set for each individual policyholder does not reflect the change in risk for that specific policyholder. When assessing whether the entity has the practical ability to set a price that fully reflects the risks in the contract or portfolio, it shall consider all the risks that it would consider when underwriting equivalent contracts on the renewal date for the remaining service. 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.

**Summary of the Transition Resource Group for IFRS 17 Insurance Contracts meeting held on 6 February 2018**

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.
(b) the specified fact patterns of the two contracts described in the submission have been understood in different ways.
(c) for the specified fact patterns of the two contracts described in the submission, the conclusion in the paper is that an entity can reset the premiums of the portfolios to which both of the example contracts belong annually to reflect the reassessed risk of those portfolios. The entity has the practical ability to reassess the risks of the specific portfolio of insurance contracts that contains the contract and, as a result, can set a price that fully reflects the risk of that portfolio and therefore meets the requirements of paragraph 34(b)(i) of IFRS 17. In the fact pattern presented, premiums increase in line with age each year based on the step-rated table—i.e. the contract does not charge level premiums, consequently the staff analysis assumes that the requirements in paragraph 34(b)(ii) of IFRS 17 are also met. Accordingly, for those two contracts, the cash flows resulting from the renewal terms should not be included within the boundary of the existing insurance contract.
(d) if, conversely, the fact patterns of the two contracts described in the submission was varied such that the entity instead has a practical ability to reassess risks only at a general level (for example, for a general community) and, as a result, can set a price for the portfolio of insurance contracts that contains the contract (for example, using a generic step-rate table) then this would provide the individual policyholders within the portfolios with a substantive right and consequently, the cash flows resulting from these renewal terms should be included within the boundary of the existing contract.

***Technical Analysis***

The contract boundary distinguishes the expected cash flows that relate to existing insurance contracts from those that relate to future insurance contracts. Included within the measurement of a group of contracts will be all the future cash flows within the boundary of each contract in the group.

As per IFRS 17.34, the contract boundary includes all cash flows that arise from substantive rights and obligations that exist during a period of time that:

1. The entity can compel the policyholder to pay premiums; or
2. The entity has a substantive obligation to provide the policyholder with services.

The analysis below assesses when policies associated with FARM and the RSP have substantive rights to premiums and substantive obligations to provide the policyholder with services.

**FARM**

Under the FARM, agents and brokers who are unable to find automobile insurance coverage for one of their clients can contact a servicing carrier who will issue a policy for the particular client on behalf of FA's members (as The Collective).

The financial results of the insurance coverage provided to the policyholders through the FARM are pooled among all insurance companies licensed to write automobile insurance in the province based on the participation ratios. FA's Plan of Operation lists five classes of business that determine a member's participation in the Facility Association, two of which relate to FARM:

1) Private passenger non-fleet non-pool automobile business;

2) All automobile business other than that included in (1) or transferred to a risk sharing pool;

The FARM contract boundary is assessed to be up to 12 months based on the nature and the type of insurance contract. (See Appendix 1 for illustrative example of a FARM policy)

Once a policy has been issued, FA's members (The Collective) assuming their share of the financial results have:

1. No substantive right to premiums, a policyholder can cancel their policy or cease paying premiums without notice; and
2. A substantive obligation to provide services for the coverage during the contractual term (i.e. up to 12 months from the start of the coverage period), as long as the policyholders continue to pay their premiums.

**The contract boundary is up to 12 months and includes:**

— **total expected premiums;**

— **total expected claims; and**

— **total expected expenses, including insurance acquisition cash flows.**

**RSP**

Each of the RSPs allow automobile insurance companies to cede qualifying personal automobile insurance exposures to the applicable provincial risk sharing pool. While these exposures do not qualify for the FARM, insurance companies believe that they represent a higher risk of loss.

Similar to the FARM, the financial results of each of the RSPs are pooled among all insurance companies licensed to write automobile insurance in the province, who are required by law to be a member of the Facility Association. The financial results are calculated on an accident year basis.

As previously mentioned, the RSP functions as a facultative-obligatory reinsurance treaty. Unlike traditional reinsurance arrangements, no legal contract exists between the individual originating insurer and the collective of members who participate in the financial results of each of the RSPs.

From the perspective of the RSPs:

1. The RSPs have a right to receive the transfer premium from the cedant for each risk transferred into the pool. As the RSP is facultative-obligatory, the RSP has no right to receive premiums beyond what has been transferred into the RSP; and
2. Due to the members (via the RSP) having no practical ability to reassess the risks of each cedant and reprice the "contract" based on those reassessed risks, the RSP has an obligation to provide service to each cedant for:
    a. Risks transferred into the RSP; and
    b. Anticipated risks to be transferred into the RSP (i.e. forecasted new business which has not yet been written).

**At initial recognition, each AY contract includes within the contract boundary:**

— **Transfer premiums (net of premium payment service charges) allocated to the AY**

— **Expected incurred claims for the AY; and**

— **Expected directly attributable expenses (e.g. expense allowance) for the AY**

**Cash flows relating to in-force and forecasted future business are within the contract boundary at inception. This is because the RSP has no ability to reject qualifying business which a member chooses to cede to the RSP, similar to other reinsurance treaties with extended cancellation features.**

***Technical Position***

| Contract | Technical Position |
|---|---|
| FARM | The contract boundary is up to 12 months and includes:<br>— total expected premiums;<br>— total expected claims; and<br>— total expected expenses, including insurance acquisition cash flows. |
| RSP | The contract boundary for each accident year (AY) insurance contract is up to 12 months and, at initial recognition, each AY contract includes within the contract boundary:<br>— Transfer premiums (net of premium payment service charges) allocated to the AY<br>— Expected incurred claims for the AY; and<br>— Expected directly attributable expenses (e.g. expense allowance) for the AY<br><br>Cash flows relating to in-force and forecasted future business are within the contract boundary at inception. This is because the RSP has no ability to reject qualifying business which a member chooses to cede to the RSP, similar to other reinsurance treaties with extended cancellation features. |

Appendix 1 - Illustrative example of a FARM policy

Insured's name/address removed
ST. JOHN'S NL
CANADA

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|---|---|
| Inquiries: (Call your Broker) | 877 787 0469 |
| Claims: (Call your Insurer) | 1 800 319 9993 |
| Policy Number | RPV policy number removed |

## Your Insurance Summary

Dear Policyholder:

Print Date 1 December 2020

Please find the enclosed following document(s):

| Policy Number | Effective Date | Description | Product |
|---|---|---|---|
| RPV | 22 October 2020 | Amendment | Auto |

*We recommend you review your document(s) carefully to ensure that the details are correct and that the coverage provided meets your needs.*

*Should you want to make any changes to your insurance policy, please contact your broker at 877 787 0469*

### Your Automobile Insurance

Coverage may be invalid if you have not provided correct information, or if you have failed to inform us of a change regarding an automobile's use or its drivers. Please contact your broker if you have any questions or need to make changes to your policy.

### Amendment Effective 22 October 2020

Policy Period
Policy Effective Date 2 July 2020
Policy Expiry Date 2 July 2021 at 12:01 a.m.

**Reason(s) for Amendment**
Driver type/assignment changed
Automobile substituted
Additional named insured deleted

Additional Premium $758.00

**Name and Address of Insured or Lessee**
removed