IFRS 17 Accounting Policy Paper: Modification and Extinguishment

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Subject:	Modification and Extinguishment

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.

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Purpose

The purpose of this paper is to summarize Facility Association's assessment of the requirements of IFRS 17 relating to the accounting treatment for the modification and extinguishment of contracts. This paper provides guidance on how the Facility Association plans to fulfil the IFRS 17 requirements for insurance contracts issued by servicing carriers through the Facility Association Residual Market ("FARM") and to insurance contracts ceded by individual member companies through the Risk Sharing Pools ("RSPs") to the collective members.

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. When should contracts be derecognized?
2. Do FARM and RSPs have any modifications to contracts that meet the conditions for derecognition?
3. What is the accounting treatment for modification to contracts that do not result in derecognition?
4. What is the accounting treatment for derecognition?

Dependencies and Relationships

The technical positions developed in this paper are subject to the conclusions of the following papers:

1. Scope
2. Level of Aggregation
3. Initial recognition and contract boundary
4. Initial and subsequent measurement
5. Insurance acquisition cashflows

Executive summary

The purpose of this paper is to assess the appropriate accounting treatment for contract modification and extinguishment under IFRS 17. FA reached the following conclusions:

1- When should contracts be derecognized?

   a. FARM:

      i. Contracts are derecognized upon extinguishment or modification (meeting certain criteria).
      ii. Derecognition of insurance contracts would only occur when FARM has no further obligations associated with the contract, which can be expected to be many years after the coverage period has ended.

   b. RSPs:

      i. Contracts are derecognized upon extinguishment or modification (meeting certain criteria).
      ii. Derecognition of insurance contracts assumed through the RSPs would only occur when RSPs have no further obligations associated with the contract, which can be expected to be many years after the coverage period has ended.

2- Do FARM and RSPs have any modifications to contracts that meet the conditions for derecognition?

   a. FARM

      i. No modifications meet the criteria for derecognition.

   b. RSPs

      i. No modifications meet the criteria for derecognition.

3- What is the accounting treatment for modification to contracts that do not result in derecognition?

   a. FARM

      i. Modifications to contracts which include changes in drivers, changes in vehicles, convictions, and so forth would meet the definition of a modification which would not require a derecognition. Any adjustments to premium receipts or insurance acquisition cash flows arising from a modification adjust the liability for remaining coverage (LRC). Insurance revenue is allocated to the period for services provided.

   b. RSPs

      i. Modifications to underlying policies having an impact on the risks assumed through the RSPs, which include changes in drivers, changes in vehicles, convictions, and so forth would meet the definition of a modification which would not require a derecognition. Any adjustments to premium receipts or insurance acquisition cash flows arising from a modification adjust the LRC. Insurance revenue is allocated to the period for services provided.

4- What is the accounting treatment for derecognition?

a. FARM:

i. In considering extinguishment as detailed in question 1, the liability for remaining coverage (LRC) should be exhausted or derecognized. Any fulfilment cash flows for the liability for incurred claims (LIC) will also be eliminated with a corresponding adjustment to profit or loss.

ii. FARM contracts have not historically had modifications that would meet the criteria for derecognition under IFRS 17.

b. RSPs

i. In considering extinguishment as detailed in question 1, the LRC should be exhausted or derecognized. Any fulfilment cash flows for the LIC will also be eliminated with a corresponding adjustment to profit or loss.

ii. RSPs have not historically had modifications that would meet the criteria for derecognition under IFRS 17.

Question 1: When should contracts be derecognized?

Technical References and Guidance

IFRS 17 Standard

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 3–8A8;

(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.

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

(a) it is extinguished, i.e. 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.

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.

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.

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.

Technical Analysis:

Insurance contracts should be derecognised when they are extinguished or if any of the conditions for modifications which result in derecognition are met.

When an insurance contract is extinguished, the entity is no longer at risk and therefore, not required to transfer economic resources to satisfy the contract. For derecognition to occur, all obligations must be discharged or cancelled.

FARM

As defined in FA's ***Scope*** accounting policy paper each individual policy issued to a policyholder is an insurance contract within the scope of IFRS 17. Therefore, FA would derecognize a policy issued via FARM when it has no further obligations to pay any claims relating to the policies. This might be unknown or hard to predict for FARM because the claims are sometimes reported years after the end of the coverage period. Notwithstanding this difficulty, it continues to be expected that the liability would remain in order to give a faithful representation of FARM's financial position and the contractual obligations that remain in existence and that can generate valid claims

Contracts would be de-recognised only when FARM has no further obligations associated with the contract.

RSP

The arrangement for RSPs is similar to a facultative-obligatory reinsurance treaty written on a losses-occurring-during basis. As a result, insurance contract services in relation to the policies associated with the RSPs are provided to the policyholders during a one-year term (i.e. the accident year). It is important to note that per FA's ***Scope*** accounting policy paper, a contract exists for each province in which the RSP operates and two contracts exist for Alberta (grid vs non-grid).

Similar to FARM, the RSPs continue to be liable for claims incurred during the coverage period even after the coverage period has ended (the coverage period being defined as the accident year). As such, the obligations defined in the contract do not expire at the end of the coverage period. These obligations will continue to exist and will not be derecognized until the RSPs have no further obligations to pay any claims relating to the specific accident year contracts.

Contracts would be de-recognised only when the RSPs have no longer any obligations associated with the contract.

<u>Technical position:</u>

Mechanism	Technical Position
FARM	Contracts are derecognized upon extinguishment or modification (meeting certain criteria). Modification is discussed in further detail in the following sections. Extinguishment of insurance contracts would only occur when FARM has no longer any obligations to pay any claims, which can be expected to be significantly after the coverage period has ended.
RSP	Contracts are derecognized upon extinguishment or modification (meeting certain criteria). Modification is discussed in further detail in the following sections. Extinguishment of insurance contract would occur either only when RSPs have no longer any obligations to pay any claims, which can be expected to be significantly after the coverage period has ended.

Question 2: Do FARM and RSPs have any modifications to contracts that meet the conditions for derecognition?

Technical References and Guidance

IFRS 17 Standard

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 3–8A8;
  - (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.

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 (i.e. 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.

Technical Analysis:

Contract modifications that require a change in the accounting model or change to the application of the standard for measuring the components of the insurance contract generally result in derecognition. It should be noted that the exercise of a right included in the original terms of a contract is not considered to be a modification.

If a modification meets the criteria for derecognition, the initial contract would be derecognized and a new contract would be established with the new terms and conditions to reflect that modification.

FARM

Historically, insurance contracts issued through the FARM do not include options.

Standard modifications can include: changes in vehicles or adding an additional driver. Changes in policyholder behaviour (e.g. change in commute distance, driver receiving a conviction) may result in contract modifications if they result in changes in risk ratings and therefore premiums or eligibility, however, based on the analysis below, this would not meet the requirements of a modification resulting in de-recognition as per IFRS 17. .

Criteria	Conclusion
If the modified terms had been included at contract inception:	
— the modified contract would have been excluded from the scope of IFRS 17, applying paragraphs 3–8A8	N/A, the modifications would not result in an exclusion from IFRS 17
— 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	N/A, the modifications would not result in a separation of a component
— the modified contract would have had a substantially different contract boundary applying paragraph 34; or	N/A, no changes to contract boundaries
— the modified contract would have been included in a different group of contracts applying paragraphs 14–24	N/A, no changes to grouping as there is only a single group for each FARM jurisdiction
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;	N/A, FARM do not contain direct participation features and the modification would not change that
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	N/A, the PPA would remain applicable

The modifications would not result in de-recognition of the FARM contracts

RSPs

Occasionally, subsequent to the transfer of a risk to the RSP, the member may receive information that could affect the initial classification and/or rating of the risk. Examples of new information may include a change in commute, change in vehicles, driver receiving a conviction, etc. If this new information affects the risk's eligibility for transfer, the member will be required to cancel the transfer no later than twenty one days after the information came to its knowledge unless sixty days have passed since the commencement date of the period of insurance. In the latter case, the member may permit the transfer to the RSP until the expiry of the period of insurance. If the new information does not affect the risk's eligibility for transfer, the risk may remain transferred to the RSP if the member amends the premium associated to the contract appropriately.

As discussed above, if new information becomes available and eligibility for transfer of the risk into the RSPs remains, the contract could meet the criteria for modification. The original terms and conditions of the RSP contract would be modified to accommodate the change in risk, however, based on the analysis below, this would not meet the requirements of a modification resulting in de-recognition as per IFRS 17.

Criteria	**Conclusion**
if the modified terms had been included at contract inception	
— the modified contract would have been excluded from the scope of IFRS 17, applying paragraphs 3–8A8	N/A, the modifications would not result in an exclusion from IFRS 17
— 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	N/A, the modifications would not result in a separation of a component
— the modified contract would have had a substantially different contract boundary applying paragraph 34; or	N/A, no changes to contract boundaries
— the modified contract would have been included in a different group of contracts applying paragraphs 14–24	N/A, no changes to grouping
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;	N/A, there are no participation features in those contracts and the modifications would not change that
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	N/A, the PAA would remain applicable

paragraph 53 or paragraph 69	

The modifications would not result in de-recognition of the RSP contracts

<u>Technical position:</u>

Mechanism	**Technical Position**
FARM	No contracts meet the modification criteria under IFRS 17.
RSPs	No contracts meet the modification criteria under IFRS 17.

Question 3: What is the accounting treatment for modifications to contracts that do not result in derecognition?

Technical References and Guidance

IFRS 17 Standard

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.

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.

Technical Analysis:

Modifications that do not result in derecognition are treated as changes in estimate of fulfilment cash flows. For contracts applying the premium allocation approach (PAA), any adjustments to premium receipts or insurance acquisition cash flows arising from a modification adjust the LRC. Insurance revenue is allocated to the period for services provided.

FARM

Modifications not requiring de-recognition could occur for FARM as listed in question 2 (change in commute (average distance), change in vehicles, driver receiving a conviction, adding a new driver, and so forth). These changes in the policies would result in a reassessment of the fulfillment cashflows.

The modifications of FARM policy would result in reassessment of fulfilment cashflows

RSP

The same changes could apply to RSPs and would impact the risks ceded to the pool. As such, similar impact would need to be assessed and changes in fulfillment cashflows accounted for accordingly.

The modifications of RSP would result in reassessment of fulfilment cashflows

Technical position:

Mechanism	Technical Position
FARM	Any adjustments to premium receipts or insurance acquisition cash flows arising from a modification adjust the LRC. Insurance revenue is allocated to the period for services provided.
RSP	

Question 4: What is the accounting treatment for derecognition?

Technical References and Guidance

IFRS 17 Standard

28C An entity shall derecognise an asset for insurance acquisition cash flows when the insurance acquisition cash flows are included in the measurement of the related group of insurance contracts applying paragraph 38(c)(i) or paragraph 55(a)(iii).

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 insurance contract services 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.

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.

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).

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.

Technical Analysis:

When an insurance contract is extinguished, it is derecognized from within a group of contracts by adjusting the fulfilment cash flows to eliminate the present value of future cash flows and risk adjustment for nonfinancial risk relating to rights and obligations that have been derecognized from the group (including any premium refunds or claims settlement payments) and differences are recognized in profit or loss.

FARM

As defined in question 2, it is expected that no modifications to FARM insurance contracts would result in derecognition of the contracts. As such, the contracts would be derecognized when they are extinguished as explained in question 1.

In considering extinguishment, as defined in question 1, the LRC should be exhausted or derecognized. Any fulfilment cash flows for the LIC will also be eliminated with a corresponding adjustment to profit or loss.

FARM contracts will be derecognized when extinguished with any remaining impact recorded in the P&L

RSPs

As defined in question 2, it is expected that no modifications to RSPs insurance contracts would result in derecognition of the contracts. As such, the contracts would be derecognized when they are extinguished as explained in question 1.

In considering extinguishment, as defined in question 1, the LRC should be exhausted or derecognized. Any fulfilment cash flows for the LIC will also be eliminated with a corresponding adjustment to profit or loss.

RSP contracts will be derecognized when extinguished with any remaining impact recorded in the P&L

Technical position:

Mechanism	Technical Position
FARM	In considering extinguishment, the LRC should be exhausted or derecognized. Any fulfilment cash flows for the LIC will also be eliminated with a corresponding adjustment to profit or loss. FARM contracts have not historically had modifications that would meet the criteria for derecognition under IFRS 17 and as such, the accounting treatment for modifications is not applicable.
RSP	In considering extinguishment, the LRC should be exhausted or derecognized. Any fulfilment cash flows for the LIC will also be eliminated with a corresponding adjustment to profit or loss. RSP contracts have not historically had modifications that would meet the criteria for derecognition under IFRS 17 and as such, the accounting treatment for modifications is not applicable.