Suggested agenda item: Foreign currency considerations on accounting for insurance contracts

Background

This submission considers the following scenarios observed in the insurance market where insurance contracts have cash flows in multiple currencies. These are not all-inclusive and other fact patterns may be observed in the market. Scenario 1 is described using actual jurisdictions and currencies. This is for illustrative purposes only and is not intended to imply that the issue is specific to a given jurisdiction.

Scenario 1: Insurer 1 operates in Taiwan and its functional currency is Taiwanese dollar (TWD). Insurer 1 issues an insurance contract in which premiums and claims are denominated in US dollars (USD) but the insurance contract-related expenses are denominated in TWD. The insurer and the policyholder are domiciled in Taiwan, with the insurance coverage being provided within Taiwan. Insurer 1 also issues identical insurance contracts in Taiwan except that premiums and claims are denominated in TWD.

Scenario 2: Insurer 2 issues two types of car insurance contracts for policyholders who plan to drive their cars overseas. These two types of contracts have identical terms and conditions except for the fact that one type includes contractual terms under which the payment of claims will be in the currency of the country in which the insured event occurs and the policy limits have been guaranteed in the relevant foreign currency denomination in a table attached to the contract that has been calculated annually by Insurer 2 for all of the major foreign currencies. The other type of insurance contract pays claims in the same currency as premiums in all cases irrespective of where the insured event occurs. For contracts in which the claims are payable in foreign currency, the policyholders receive the foreign currency-denominated claims payments based on the spot foreign exchange rate of the day the insurer has accepted to pay them. Premiums and expenses for both contracts are denominated in the currency of the country in which both the insurer and the policyholder are domiciled which happens to be the functional currency of Insurer 2.

For insurance contracts with cash flows in different currencies, such as those illustrated in Scenarios 1 and 2, an accounting issue arises with regards to the currency in which the contractual service margin (CSM) of such group of contracts should be denominated in. IFRS 17:30 indicates that the CSM is a monetary item, and any effect of changes in exchange rates of the currency of the CSM are accounted for in accordance with IAS 21 *The Effects of Changes in Foreign Exchange Rates*. IAS 21:8 defines monetary items as "units of currency held or assets and liabilities to be received or paid in a fixed or determinable number of units of currency." However, CSM is neither an asset nor a liability to be received or paid in a fixed or determinable number of units. The Board recognised that fact in IFRS 17:BC277 (emphasis added):

> When applying IAS 21, *The Effects of Changes in Foreign Exchange Rates*, the fulfilment cash flows are clearly monetary items. ***However, the contractual service margin component might be classified as non-monetary because it is similar to prepayments for goods and services.*** The Board decided that it would be simpler to treat all components of the measurement of an insurance contract denominated in a single currency as either monetary or non-monetary. Because the measurement in IFRS 17 is largely based on estimates of future cash flows, the Board concluded that it is more appropriate to view an insurance contract as a whole as a monetary item.

When all of the cash flows for the contracts within a group are denominated in a single currency, it seems clear that IFRS 17 requires the currency for the CSM to be the same as the currency of the underlying cash inflows and outflows. However, when the cash inflows and outflows of a group of insurance contracts are denominated in different currencies, IFRS 17 does not provide guidance on the currency in which the CSM should be considered denominated.

We believe that it would be useful to address three related issues:

1. The determination of the currency in which an individual insurance contract is considered denominated when the contract includes cash flows in multiple currencies, and at which date this determination is made;
2. Whether foreign currency risk is a risk to be taken into consideration when assessing "similar risks" for the purpose of determining portfolios of insurance contracts;
3. The determination of the currency in which the CSM of a group of insurance contracts is established within a given portfolio.

We explain these three issues in turn below.

Currency denomination of an insurance contract with cash flows denominated in multiple currencies

Question 1

In which currency is an individual insurance contract considered denominated when the contract includes cash flows in multiple currencies and at which date is that currency denomination determined?

View 1 – The insurance contract is denominated in the currency of the premiums, as determined at the initial recognition of the contract and not subsequently reassessed.

An insurance contract is denominated in the currency of its premiums because these are the dominant cash flows in profitable contracts. This is the currency that has the greatest influence on the determination of the overall currency of the contract given cash inflows are expected to be greater than cash outflows at initial recognition for contracts that are not onerous. The currency denomination for the insurance contract is determined at the initial recognition of the insurance contract and is not reassessed subsequently.

Supporters of this view argue that this approach provides a direct link between the determination of the currency of the contract's cash flows (and their changes) and the determination of the group CSM balance. The interaction between IFRS 17:30 (which stipulates that a group of insurance contracts is a monetary item), IFRS 17:44(d) and 45(d) (which address how to account for the adjustment of the CSM for the effect of currency exchange differences) and IFRS 17:92 (which stipulates that foreign exchange gains and losses are recognised in profit or loss or in other comprehensive income) requires a close alignment of the CSM to the currency of the cash flows used to establish its initial measurement and the determination of the associated number of currency units denominated in the resulting currency.

Supporters of View 1 argue that considering the "predominant" cash flow denomination as expressed in View 2 could create groups of contracts that are denominated in different currencies within the same portfolio. For example, this would be the case when the predominant cash flows are the outflows in an onerous group of contracts while the predominant cash flows are the cash inflows in a profitable group of contracts in the same portfolio and possibly the same period. This is further complicated by the fact that when an onerous contract becomes profitable in subsequent periods the CSM would be denominated in the currency of the outflows as it was set at initial recognition. This complication appears to be contrary to the approach that could be derived by IFRS 17:30. Accordingly, supporters of View 1 believe that assessing the currency denomination of an insurance contract based on the currency of its premiums/inflows is more in line with IFRS 17 than View 2.

View 2 – The insurance contract is denominated in the currency of the "predominant" cash flows, as determined at the initial recognition of the contract and not subsequently reassessed.

Under this view, the insurance contract is denominated in the currency of the predominant cash flows. Similar to View 1, the currency denomination for the insurance contract is determined at initial recognition of the insurance contracts and is not reassessed subsequently. This means that the currency in which the insurance contract is denominated, once determined at initial recognition, does not change even when the predominant currency of the fulfilment cash flows changes over the lifetime of the contract (e.g. following collection or disbursement of cash flows in a particular currency that were previously expected and dominant).

Supporters of View 2 acknowledge that 'predominant' is not a defined term in IFRS Standards, thus the application of View 2 requires judgement, considering all the cash flows arising from the contract.

Supporters of this view argue that it aligns with the view set out in IFRS 17:BC277-BC278 whereby the Board viewed the whole of the insurance contract as a monetary item because the measurement in IFRS 17 is largely based on estimates of future cash flows, resulting in the whole contract also being accounted for as a single monetary item (i.e. inclusive of its contribution to the CSM of the group of contracts in which the particular contract belongs).

Supporters of View 2 argue that View 1 is an application of View 2 when the predominant cash flows are the premiums. However, View 1 does not address cases in which the premium cash flows are not the predominant cash flows, such as for onerous contracts. At initial recognition, IFRS 17:16 requires all onerous contracts to be in a group of contracts of their own.

View 3 – The insurance contract is not denominated in any particular currency with all foreign currency cash flows translated to the entity's functional currency.

Supporters of View 3 consider that where a single contractual arrangement has multiple currencies then for each foreign currency element it is accounted for under IAS 21. Under View 3, an insurer is required to isolate the foreign currency cash flows of insurance contracts with cash flows in multiple currencies and translate them into the functional as if they were separate streams of cash flows.

Applying View 3, the resulting net inflow or net outflow at initial recognition of a contract with multi-currency cash flows contributes to the CSM balance of the group of contracts it belongs to, as determined by translating the foreign currency net inflow or net outflow into the functional currency of the insurer and then applying IFRS 17:38 guidance on the CSM measurement for the group.

The CSM of the group of insurance contracts with multiple currencies cash flows will always be denominated in the functional currency of the entity. Supporters of View 3 argue that this is consistent with the nature of CSM as unearned profit. This accounting treatment is aligned with IAS 21:21 and offers an analogy to the treatment of a prepayment of future services under IFRS 15 *Revenue from Contracts with Customers*, as interpreted in IFRIC 22 *Foreign Currency Transactions and Advance Consideration*. Although the IFRIC 22 addresses the accounting treatment of non-monetary items, supporters of View 3 argue that the non-monetary nature of CSM is admitted in IFRS 17:BC277 as a characteristic of the CSM, which is a deferral of profit to be recognised as services are provided, thus making the analogy to IFRIC 22 on the accounting for a prepayment of future services relevant to interpret the interaction between IFRS 17 and IAS 21.

Consideration of foreign currency risk when identifying a portfolio of insurance contracts

Once the currency of an insurance contract has been determined, the next step is to determine the portfolio to which the contract belongs. For insurance contracts denominated in different currencies, the accounting issue of whether foreign currency risk is a risk that should be taken into account when identifying a portfolio of insurance contracts is important because, depending on the view taken, it could result in otherwise identical contracts being considered as having dissimilar risks due to exposure to foreign currency risk. Hence, depending on the view taken, a portfolio may be comprised of contracts with the same currency or contracts with cash flows in multiple currencies.

IFRS 17:14 requires insurers to identify a portfolio of insurance contracts. A portfolio of contracts is defined as comprising contracts that are subject to similar risks and are managed together. As an example, IFRS 17:14 provides that contracts within the same product line would be expected to have similar risks and hence would be expected to be in the same portfolio if they are being managed together. No further guidance is provided as to what constitute "similar risks."

Whilst there is no further guidance on "similar risks" for the establishment of portfolios, Appendix A of IFRS 17 defines risks as follows (emphasis added):

> *Financial risk – The risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price,* ***currency 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.*
>
> *Insurance risk – Risk, other than financial risk, transferred from the holder of a contract to the issuer.*

Question 2 focuses only on foreign currency risk and its implication on the identification of a portfolio of contracts. Other aspects of the definition of portfolio, i.e. "similar risks" (excluding the impact of foreign currency risk) and "managed together", are not considered in this question.

Question 2

Should foreign currency risk be taken into consideration when assessing "similar risks" for the purpose of determining portfolios of insurance contracts?

View 1 – No, foreign currency risk is not considered a risk that is relevant when assessing whether contracts have similar risks for the purposes of identifying portfolios. Contracts with cash flows in different currencies can be included within the same portfolio and, consequently, within a group of contracts (subject to the criteria in IFRS 17:22).

Supporters of this view argue that foreign currency risk is not an insurance risk that is transferred from the policyholder to the insurer. They note that, like expense risk and lapse risk, foreign currency risk is a risk that is created by the contract itself and does not pre-exist the contract. The exposure to foreign currency risk results from an entity's business to issue insurance contracts with exposure to foreign currency fluctuations.

Applying View 1 to Scenario 1 above, the insurance contracts issued by Insurer 1 within the same product line can be included in the same portfolio, regardless of whether the premiums and claims are denominated in USD or TWD. A similar conclusion applies to Scenario 2, where insurance contracts issued that are within the same product line but include cash flows in multiple currencies can be included in the same portfolio.

The practical implication of View 1 is that it requires a greater amount of judgement in determining the currency of the CSM of the groups of insurance contracts belonging to portfolios of contracts with cash flows in different currencies. This is because, in applying this View 1, contracts that have similar risks (excluding foreign currency risk) and are managed together could result in a group of contracts where the individual contracts are denominated in multiple currencies (only applicable for Views 1 and 2 for Question 1) .   Supporters of this view, however, acknowledge that the insurer, in applying View 1, can also choose to group contracts within the portfolio based on the currency denomination applying IFRS 17:21 guidance by analogy. This would make it operationally easier to determine the currency of the CSM currency of the group of contracts since all contracts within the group would have the same currency denomination.

View 2 – Yes, foreign currency risk is a relevant risk to consider when assessing whether contracts have similar risks. Depending on the facts and circumstances, the exposure to multiple currencies could require that insurance contracts within the same product line be aggregated in different portfolios.

Supporters of this view argue that although the foreign currency risk would not give rise to an insured event and is not in itself relevant when assessing the significance of insurance risk in a contract, it is a valid and relevant risk when assessing "similar risks" for identifying portfolios of contracts.

In Agenda Paper 2 of the February 2018 TRG meeting, the IASB staff noted that the policyholder risk referred to in IFRS 17:34 includes both the insurance risk and financial risk transferred from the policyholder to the insurer and excludes lapse risk and expense risk. The definition of financial risk, as set out in Appendix A of IFRS 17, includes the risk *"of a possible future change in […] currency exchange rate"*.

In applying this view, professional judgement needs to be applied. Supporters of this view argue that when the foreign currency risk is directly linked to the features of a contract and is assessed as a policyholder risk (i.e. a transferred risk), foreign currency risk can create a "dissimilar risk" from other otherwise similar contracts within the same product line that do not transfer of foreign currency risk to the insurer.

Applying View 2 to Scenario 1, the insurance contracts with premiums and claims denominated in USD are identified as a separate portfolio from the portfolio of insurance contracts that have all cash flows in TWD. This is because in the first portfolio, the exposure to foreign currency risk (i.e. the risk that the claim incurred is in USD) is transferred from the policyholder to the insurer. If the cash flows of other contracts are in currencies other than the functional currency of the entity, a different foreign currency risk is transferred from the policyholder to the insurer necessitating different portfolios for different contracts.

Applying View 2 to Scenario 2, the car insurance contracts with claims paid in foreign currency are identified as a separate portfolio from the portfolio of car insurance contracts that have claims payable in the same currency as that of the premiums and expenses. This is because in the first portfolio, the exposure to foreign currency risk (i.e. the risk that the insured event occurs abroad, and the claim incurred is settled in a foreign currency) is transferred from the policyholder to the insurer.

In relation to this last point and the application of IFRS 17:30, supporters of this view also note that that in IFRS 17:BC124(a) the Board noted that the level of aggregation is a concept bound by the notion of cash flows that "*respond similarly in amount and timing to changes in key assumptions—meaning that losses on insurance contracts for one type of insurance risk would not be offset by gains on insurance contracts for a different type of risk*". These supporters argue that the foreign currency risk can be a key assumption in the measurement of an insurance contract. A contract that has different exposure to foreign currency risk than another contract would not respond in a similar way to changes in that variable thus corroborating that foreign currency risk is one of the risks that has to be "similar".

Finally, supporters of this view also observe that the Board noted in IFRS 17:BC277 that the intention in drafting IFRS 17 was to treat "*all components of the measurement of an insurance contract* ***denominated in a single currency*** *as either monetary or non-monetary*". They argue that the reference to a contract denominated in a single currency is an additional corroborating element supporting that groups and portfolios should be aggregated in such a way that they contain only contracts denominated in a single currency, either because all cash flows of the contracts have the same currency or if the contracts have multiple currency cash flows, the contracts are deemed to be denominated in the single currency.

Currency denomination of the CSM of a group of contracts with cash flows denominated in different currencies

Once the currency denomination of the contract and the portfolio in which it would belong has been established, it is necessary to determine the currency of the CSM of the group of insurance contracts.

Question 3

In which currency should the CSM of a group of insurance contracts be denominated?

View 1 – CSM currency of the group should be the currency of the insurance contracts in the group

Supporters of this view argue that the CSM is the amount of deferred profit in a contract and it represents the premium paid in excess of the expected claims and benefits.

The supporters of View 1 that also support the portfolio definition set out in View 1 of Question 2 believe that there is a logical flow between the insurance contract and the contract CSM's currency denomination (regardless if it is determined based on a contract premiums or its predominant cash flows) and the currency denomination of the CSM balance for the group.

Supporters of View 1 that support the portfolio definition set out in View 2 of Question 2 conclude that the insurer would apply the concept of predominance of the contract currency denomination to determine the currency of the CSM balance for the group.

Supporters of this view believe that the interaction between IFRS 17:30 (which stipulates that a group of insurance contracts is a monetary item), IFRS 17:44(d) and 45(d) (which address how to account for the adjustment of the CSM for the effect of currency exchange differences) and IFRS 17:92 (which stipulates that foreign exchange gains and losses are recognised in profit or loss or in other comprehensive income) requires a close alignment of the CSM to the currency of the cash flows used to establish its initial measurement and the determination of the associated number of currency units denominated in the resulting currency.

View 2 – CSM currency should be the functional currency of the entity

Supporters of View 2 consider that the CSM contributed by individual contracts to the group is denominated in the functional currency of the entity. These supporters would logically support View 3 in Question 1. They argue that this approach aligns with the treatment of a prepayment of future services under IFRS 15 and IFRIC 22. Although the analogy is with the accounting treatment of a non-monetary item, the non-monetary nature of the CSM is recognised in IFRS 17:BC277 and the accounting of the CSM as having the currency of the functional currency of the entity is not incompatible with the treatment of the whole insurance contract as a monetary item.

It is also to be noted that IFRS 17:44(d) and 45(d) are intended to capture the effects of any currency differences on the CSM when translating foreign currency items into the functional currency of the entity and therefore, in applying this view, the amount would be nil given that the CSM, including any changes therein, is already denominated in the functional currency.

The interaction between the views expressed in this submission can be summarised in the following table:

<table>
<tr><th></th><th colspan="2">Insurance portfolio – consideration of the foreign currency risk</th></tr>
<tr><td>Insurance contract – currency denomination</td><td>View 1 – Foreign currency risk is not one of the “similar risks” such that groups can contain contracts with different currency exposures. A group may contain multi-currency cash flows.</td><td>View 2 – Foreign currency risk is one of the “similar risks” such that groups contain contracts with similar currency exposures.</td></tr>
<tr><td>View 1 – the currency of the premiums</td><td>Contracts are grouped without regard to foreign currency risk. A group may contain multi-currency cash flows.

View 1 for Question 3 is the logical view to support for this combination of views - the currency of the CSM of the group is the currency of the predominant premiums in the group at initial recognition.</td><td rowspan="2">Contracts are grouped if their net cash flows (individual contract’s contribution to the CSM balance) are determined to be denominated in the same currency (based on the premium or predominant cash flow).

View 1 for Question 3 is the logical view to support for this combination of views, the currency of the CSM of the group is the same as the currency of the CSM of the individual contracts in the group at initial recognition.</td></tr>
<tr><td>View 2 – the predominant currency</td><td>Contracts are grouped without regard to foreign currency risk. A group may contain multi-currency cash flows.

View 1 for Question 3 is the logical view to support for this combination of views - the currency of the CSM of the group is the currency of the predominant premiums in the group at initial recognition.</td></tr>
<tr><td>View 3 – no denomination, each cash flow is denominated in its own currency</td><td>Contracts are grouped without regard to foreign currency risk. A group will contain multi-currency cash flows.

View 1 for Question 3 is the logical view to support for this combination of views, the currency of the CSM of the group is the currency of the predominant premiums in the group at initial recognition.</td><td>Contracts are grouped if they have a similar mix of foreign currency cash flows, thus belonging to the same portfolio because they have “similar risks”, including foreign currency risk.

View 2 for Question 3 is the logical view to support for this combination of views, the currency of the group CSM is the functional currency of the entity.</td></tr>
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Reasons for the Committee to address the issue

We believe that this accounting issue is prevalent in the global insurance market where major insurers have presence in multiple jurisdictions worldwide. We have observed differing views being applied as part of the ongoing implementation of IFRS 17. This issue is not related to a Board project that is expected to be completed in the near future.

For these reasons, we believe that this issue is urgent and meets the criteria for acceptance into the Committee’s agenda.