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Discussion Paper

Cash-Back Products

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Disclaimer
This discussion paper captures a summary of views expressed during the IFSR 17 Working Group meetings. The paper is intended to assist in considerations when implementing the IFRS 17 Insurance Contract Standard, each insurer would still need to consider facts and circumstances specific to their contracts in applying the Standard. Please note that every effort has been made to ensure that the views given in this discussion paper is correct. Nevertheless, that advice is given purely as guidance to members of SAICA to assist them with particular problems relating to the subject matter of the educational material, and SAICA will have no responsibility to any person for any claim of any nature whatsoever that may arise out of, or relate to, the contents of this educational material.

Cash-back products

Cash-back products are unique to South Africa. The big question for the short-term industry is whether these products could qualify as short duration contracts i.e. one year or less in IFRS 17. This is an important consideration as it will impact the decision on the measurement model. If the contracts are short duration contracts, insurers may apply the simplified premium allocation approach which is more closely aligned to their current accounting model.

A typical example is as follows:

An insurer issued a motor policy in terms of which cash will be paid to the policyholder if he/she does not claim for three consecutive years. The policyholder will receive 10% of all premiums paid within this period (3 years).

The insurer reprices the insurance policy annually, on the policy's anniversary. At that point the insurer will set the price for the renewed contract as it would for a new contract issued on that date with the same characteristics as the existing contract. A policyholder may cancel the policy at any time and with immediate effect. The insurer may cancel the policy by giving the policyholder 30 days' notice.

The policyholder will not receive the cash-back if the policy is cancelled before the cash-back has been paid and therefore the cash-back does not meet the definition of an investment component in IFRS 17.

Contract boundary

The first important question was to determine whether the cash-back had an impact on the contract boundary of the insurance contracts. IFRS 17 states the following on contract boundary:

"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. 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" (IFRS 17.34).

Most of the interest group members believed that the cash-back feature did not impact the contract boundary when the principles in IFRS 17.34 are applied to the example above. Some members viewed the contract boundary as 30 days as the right to cancel seemed to have commercial substance and reflected a substantive right (IFRS 17.2).

Other members argued that the contract boundary is 12 months (i.e. up to the repricing point). If the insurer cancels, it may be seen as not treating customers fairly. On that basis the members argued that the right to cancel was not substantive. However, there was general consensus that the boundary was short (30 days or 12 months).

Effectively for IFRS 17, if the boundary is 30 days, there will be 36 insurance contracts issued and if the boundary is 12 months, there will be 3 contracts issued (in a three-year period).

Accounting for the cash-back feature

The interest group considered whether the cash-back feature should be included as part of the liability for remaining coverage or the liability for incurred claims on the basis that the insurer is applying the premium allocation approach.

The liability for remaining coverage is “an entity’s obligation to investigate and pay valid claims under existing insurance contracts for insured events that have not yet occurred (i.e. the obligation that relates to the unexpired portion of the insurance coverage)” (IFRS 17 Appendix A).

Some believed that the cash-back feature should be accounted for as part of the liability for remaining coverage. As the cash-back is conditional only on claims, the policyholder will get the cash either in the form of a bonus or as a claim and therefore it should be treated as a reduction in premiums.

The general consensus was that the cash-back should be accrued for in the liability for incurred claims[1]. IFRS 17 defines the liability for incurred claims as an entity’s obligation to “investigate and pay valid claims for insured events that have already occurred, including events that have occurred but for which claims have not been reported, and other incurred insurance expenses and pay amounts that relate to insurance contract services that have already been provided or any investment components …” (IFRS 17 Appendix A).

It is argued that the cash-back should be accrued for as one necessary pre-condition for payment has been met, specifically passage of a discreet element of time. The policyholder met the eligibility criteria and is building up to the total anticipated cash-back payment at the end of the reward cycle (3 years in the example).

It should be noted that the estimate of the cash-back portion accrued for in each contract period (based on the contract boundary) should be the expected value (probability weighted) of the cash-back feature (IFRS 17.33). Therefore if the contract boundary of the contract is 30 days, the expected value of the cash back earned in 30 days is included in the liability for incurred claims.

[1] The liability for incurred claims comprises the fulfilment cash flows related to past service (IFRS 17.40(b)). The fulfilment cash flows comprise the estimates of cash flows, an adjustment for the time value of money and the financial risks related to the future cash flows (to the extent that the financial risks are not included in the estimates of the future cash flows) and a risk adjustment.