4th Capacity Building seminar on IFRS 17
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Reinsurance under IFRS 17

Institute of Actuaries of India

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Agenda

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- ❑ **IFRS 17 Requirements**
  - **Initial Recognition**
  - **Level of Aggregration**
  - **Contract Boundary**
  - **Measurement**
  - **Initial Measurement Example**
  - **Subsequent Measurement & Example**
- ❑ **Accounting and Presentation**
- ❑ **Challenges and Considerations**

Background

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Scope

*IFRS 17 is applicable for reinsurance contracts – Both **issued** and reinsurance contracts **held.***

	Reinsurance Issued	**Reinsurance Held**
Application to	Reinsurers	Direct Insurers
Approach	Treatment similar to insurance contracts	Significant differences as compared to insurance contracts

Existing vs IFRS 17 Practice

- Common existing practice is to account for reinsurance contracts held using a ‘**mirroring approach**’, essentially matching reinsurance contract revenue, costs, assets and liabilities to the underlying insurance contracts. Reinsurance is not valued separately as a standalone contract currently.
  Reinsurance is to be valued separately under IFRS 17

- The ‘mirroring approach’ implies that there are no accounting mismatch between reinsurance and underlying insurance contract.
- Mismatch between the insurance contracts and corresponding reinsurance expected due to differences in contract boundary, measurement and aggregation under IFRS 17.

- There are no separate disclosures for reinsurance currently vs the need under IFRS 17

Why the Difference in Approach

Clear and Independent picture

- separate accounting is necessary to truly reflect the economics of an entity's rights and obligations under insurance contracts it issues and reinsurance contracts it holds.
- insurer is obligated to pay claims to the policyholder, irrespective of whether the reinsurer meets its obligations.

CSM Definition

- CSM for reinsurance defined in line with underlying CSM insurance contracts will be not be the true.
- CSM for a group of reinsurance contracts is different in substance to the CSM for a group of insurance contracts issued as the former is an expense not revenue for the company
- CSM release pattern may not align for reinsurance held and underlying insurance contract

Loss deferment

- Amount paid to buy reinsurance would typically exceed the expected present value of cashflows generated by the contract implying a net cost.
- Unlike insurance contracts, any such cost is to be recognized over the coverage period.

IFRS 17 Requirements for Reinsurance Held

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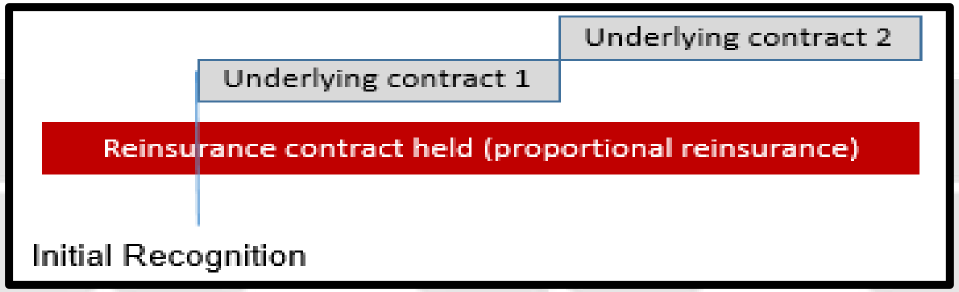
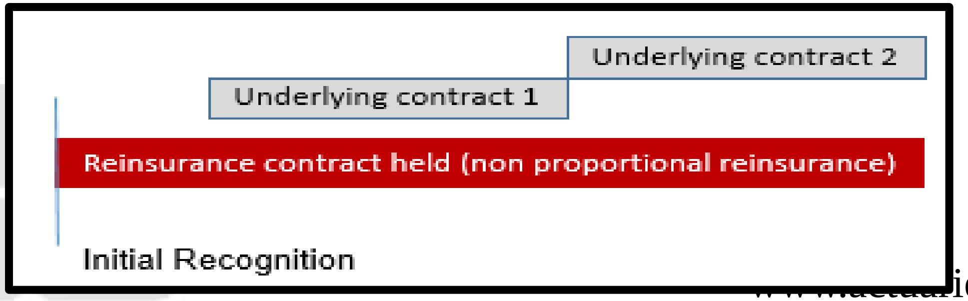
How they stack up against the IFRS 17 Requirements for Insurance

Initial Recognition

Do the reinsurance contracts held provide:

- **Proportionate Coverage**
  - Latest of:
    - Initial recognition of any underlying contract
    - Beginning of the coverage period of the group
- **Non Proportionate Coverage**
  - Beginning of the coverage period of the group.





Contract Boundary – (1/2)

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Factors for Consideration

CONSIDERATION 1 – Substantive Right to Receive Service from Reinsurer

RISK ATTACHING	**Claims -** towards policies written during the coverage period of the treaty **Contract Boundary -** based on contract boundary of underlying contracts
LOSS OCCURING	**Claims -** claims occurring during the contract period, irrespective of underlying contract inception **Contract boundary -** based on reinsurance contract itself

CONSIDERATION 2 – Substantive Obligation to pay premiums

EARLY COMMUNICATION	Multiyear duration treaties with an early communication clause (that allows one or both parties to **terminate a contract**) should be considered as **annual treaties**.
TACTIC RENEWAL	Annual duration treaties with **auto renewal** option should be considered as **multiyear** treaties in term of contract boundaries
BOTH	All treaties with **both** early communication clause and tacit renewal options should be considered as **annual treaties** in term of contract boundaries

Contract Boundary – (2/2)

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CONSIDERATION 2 – Substantive Obligation to pay premiums

REINSURER'S RIGHT TO REVIEW PREMIUM RATE

Contract boundary is not impacted by this 'right'

- since the entity has a substantive obligation to pay premiums for the full duration of underlying contracts
- assumptions related to future premium should be reflected in future cash flows

ISSUE

Possibility of mismatch in contract boundary between reinsurance and underlying insurance contract.

EXAMPLE

Example 1: Reinsurance contracts having clause that enables either party to terminate after 90 days

Example 2: A Insurance contract with a coverage period of 1 years is reinsured.
A **reinsurance treaty** (risk attaching) with a **coverage period of 3** is taken against this insurance contract and hence the coverage periods are not aligned.

Measurement (1/3)

Approach

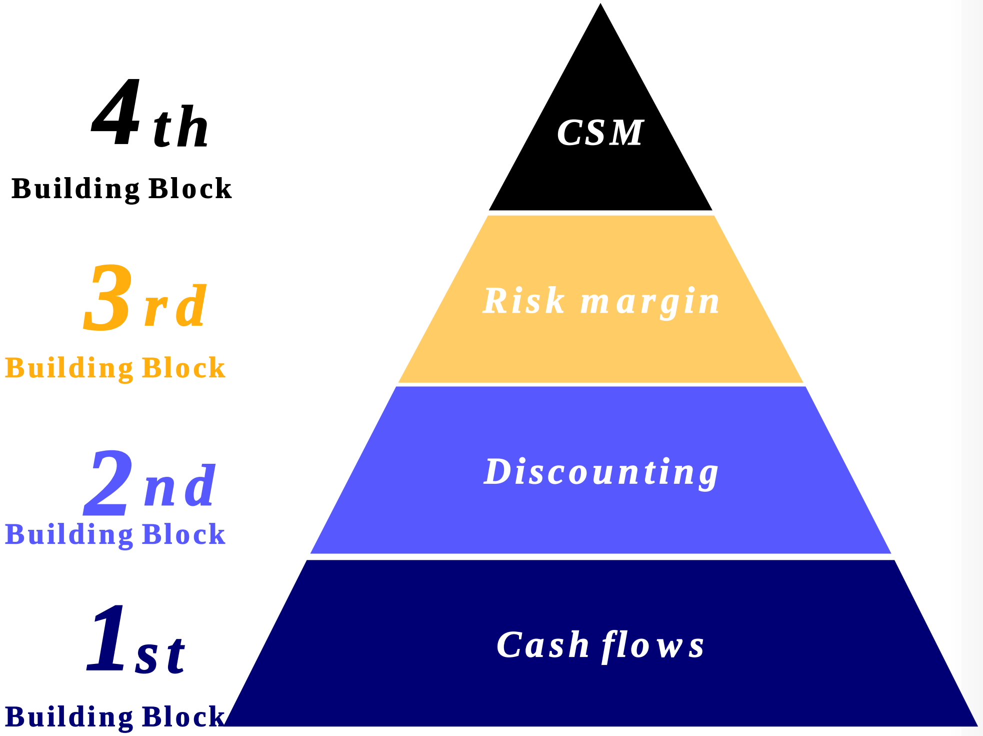
- Building Block Approach is the default approach

- Simplification of Premium Allocation Approach is available after performing PAA eligibility test.
  - ✓ Coverage Period < 1 year or
  - ✓ Measurement is not materially different

- Criteria for Variable Fee Approach is not met for both issued and held
  - ✓ For reinsurance contracts held, the entity and the reinsurer **do not share in the returns** on underlying items and so the VFA criteria is not met.
  - ✓ The returns from a pool of underlying items is part of the compensation that the entity charges the primary policyholder for the service provided by the insurance contract and this logic does not apply to reinsurance contracts issued

- Mismatches expected

Building Block Approach



Measurement (2/3)

1st
Building Block

2nd
Building Block

3rd
Building Block

Fulfilment Cashflows

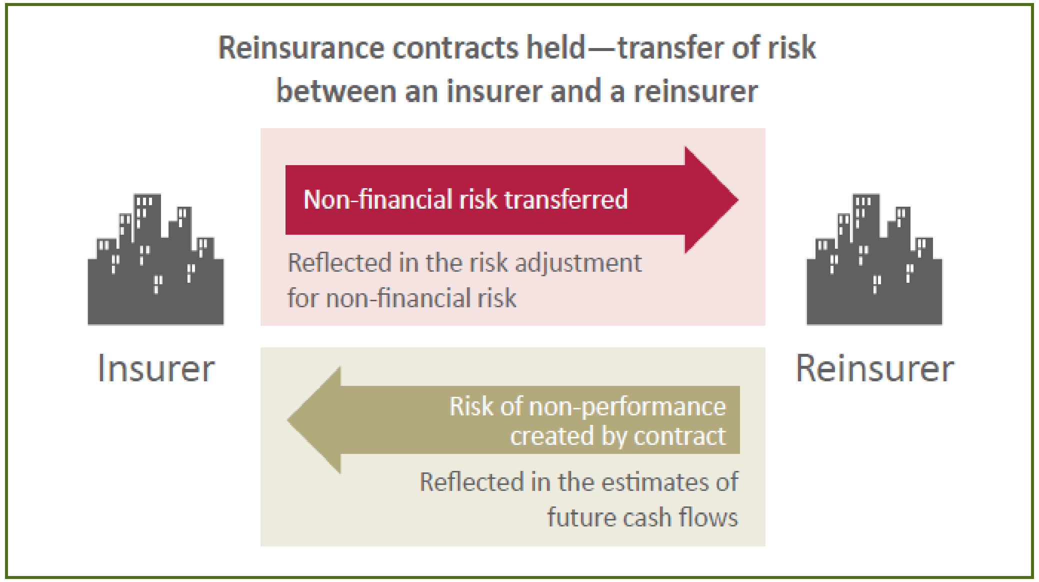
- The reinsurer's share of the risk-adjusted expected present value of the best estimate cash flows generated by the underlying insurance contracts

Discounting and other assumptions

- Assumption are chosen so that they are consistent to underlying insurance contracts. Some deviations may be due to recognition differences (e.g. discount rate)

Risk Adjustment

- Amount of risk transferred by the entity to the reinsurer and
- an adjustment for risk of non performance of the reinsurer

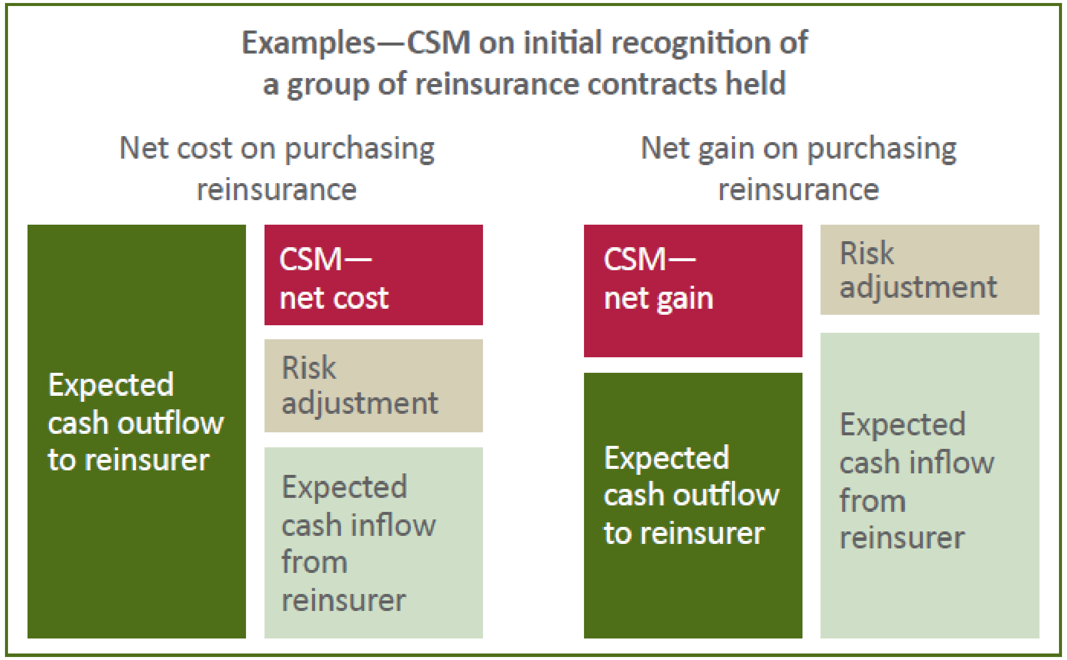


Measurement (3/3)

4th
Building Block

Contractual Service Margin

- CSM for a reinsurance contract held represents the **cost of purchasing reinsurance** vs CSM for underlying insurance contracts which represents **unearned profit.**
- The amount an entity pays for reinsurance typically exceeds the expected present value of cash flows generated from that reinsurance plus the risk adjustment for non-financial risk.



- There is no immediate recognition of **Day 1 losses** as for insurance contracts. Any net gain or net cost is spread over the reinsurance contract coverage period.
- As an exception, when the net cost relates to events that happened **before** the purchase of reinsurance, the net cost is **recognised immediately** in profit or loss.
- When underlying contracts become **onerous** after initial recognition the corresponding gain on reinsurance contracts held is recognised on a **'matched'** basis.

- The standard allows **offsetting of losses of onerous insurance contracts** against the gains on corresponding **proportional reinsurance** contracts held

Initial Measurement – Example 1

Profitable underlying contract

On Initial Recognition

	Group of insurance contracts	Reinsurance contract held – Scenario 1	Reinsurance contract held – Scenario 2
Present Value of cash inflows	1000 Premium received	320 Claim Recovery	320 Claim Recovery
Present Value of cash outflows	800 Claims	400 Premium Paid	300* Premium Paid
Risk Adjustment#	50	(20)	(20)
Fulfilment cash flows	(150)	60	(40)
CSM	150 Profitable	(60) Net Cost	40 Net Gain
Amount recognized in P&L	0	0	0

- Proportional Reinsurance – 40% claims covered
- Insurance contract – Profitable & Reinsurance contract – Net Cost (Scenario 1), Net Gain (Scenario 2)
- CSM for the insurance contract and net cost/net gain on reinsurance contract will be spread over the respective coverage periods.

#For simplicity, risk of non performance is assumed to be negligible.
** A discounted premium is assumed*

Initial Measurement – Example 2

Onerous underlying contract and Net Gain on Reinsurance

On Initial Recognition

	Group of insurance contracts	Reinsurance contract held
Present Value of cash inflows	1000 Premium received	600 Claim Recovery
Present Value of cash outflows	1200 Claims	500 Premium Paid
Fulfilment cash flows#	200	(100)
CSM	0 Onerous	0 Net Gain
Amount recognized in P&L	(200)	100

- Proportional Reinsurance – 50% claims covered
- Insurance contract – Onerous & Reinsurance contract – Net Gain
- Loss on the insurance contract is offset by the net gain on reinsurance contract by booking the gains in P&L immediately

#For simplicity, risk adjustment is assumed to be negligible.

Subsequent Measurement

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CSM
Opening Balance

CSM for new contracts

Accretion of Interest

Changes relating to future service

- *Changes to be flown in reinsurance CSM only if the same change alters the underlying insurance contract CSM otherwise to flow through P&L consistent with underlying contracts*
- *Changes due to changes in the reinsurers credit rating do not relate future service and so do not adjust CSM but P&L when it occurs*

Insurance service received – recognized in P&L

CSM
Closing Balance

Change in Future Service - Example (1/2)

Scenario - Change related to future services that does not adjust the CSM of reinsurance contract held

On Initial Recognition

	Group of insurance contracts	Reinsurance contract held#
Present Value of cash inflows	100 Premium received	85 Claim Recovery
Present Value of cash outflows	110 Claims	80 Premium Paid
Fulfilment cash flows	10	(5)
CSM	0 No CSM	5 Net Gain
Amount recognized in P&L	(10)	0

#Consider a insurance contract group with a non proportional reinsurance arrangement

- As the Reinsurance contract is non proportionate , the net gain is not recognized for onerous contract.
- The expected net gain on the reinsurance group is held as CSM and amortized over the reinsurance coverage

Change in Future Service– Example (2/2)

Scenario - Change related to future services that does not adjust the CSM of reinsurance contract held

On Year 1 - Increase in the claims assumptions at the end of year 1

	Group of insurance contracts	Reinsurance contract held#
Present Value of cash inflows	100 Premium received	89 Claim Recovery
Present Value of cash outflows	115 Claims	80 Premium Paid
Fulfilment cash flows	15	(9)
CSM	0 No CSM	5 Net Gain
Amount recognized in P&L	(15)	4

#Consider a insurance contract group with a non proportional reinsurance arrangement

- The CSM of the underlying insurance contract does not change.
- As a result, the amount of 4 CU, representing the change of the expected claims, has to be recognized in profit and loss (as a gain) rather than adjust the CSM of the reinsurance contract held.

Level of Aggregation

- **Three parameter approach similar to insurance contracts**
  - **Portfolio identification** – similar risks that are managed together; could be composed of one or more treaties
  - **Net gain or Net Cost** at initial recognition
  - **Issuance time**

- A reinsurance contract group might cover underlying contracts that refer to different groups of insurance contracts and vice versa

Contracts no more than one year apart

Portfolio 1

Portfolio 2

Net gain at initial recognition

No significant possibility of a net gain arising subsequently

Remaining Contracts

Exp. PV of Reins Recovery
exceeds
Exp. PV of Reins Prem

Accounting and Presentation

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Statement of Financial Position

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	As at 31 December	
	20X3	20X4
Assets		
Cash and cash equivalents	XXXX	XXXX
Investment assets	XXXX	XXXX
Insurance contract assets	XXXX	XXXX
Reinsurance contract assets	XXXX	XXXX
Other assets	XXXX	XXXX
Total Assets	**YYYY**	**YYYY**
Liabilities		
Current liabilities	XXXX	XXXX
Investment contract liabilities	XXXX	XXXX
Insurance contract liabilities	XXXX	XXXX
Reinsurance contract liabilities	XXXX	XXXX
Provisions	XXXX	XXXX
Total Liabilities	**ZZZZ**	**ZZZZ**

- An entity is required to show its position i.e. assets and liabilities for insurance and reinsurance contracts separately
- Prohibited from offsetting reinsurance contract assets held against related underlying insurance contract liabilities

Statement of Profit & Loss

Companies have two options to present the reinsurance results in the P&L

- ✓ **Net Presentation** – Net Income/ Expense from reinsurance presented as single amount
- ✓ **Gross Presentation** – Amounts recovered from reinsurer and premiums paid presented separately.
  - ➢ Cash flows **contingent on claims** are treated as part of claims that are expected to be reimbursed from the reinsurance contract held.
  - ➢ Cash flows that the entity expects to receive from the reinsurer that are **not contingent on claims** are treated as reductions in the premiums paid.

Net Presentation	
In Currency Units	**2021**
Insurance revenue	xx
Insurance service expenses	xx
Net expense from reinsurance contracts	xx
Insurance service result	**xx**

Gross Presentation	
In Currency Units	**2021**
Insurance revenue	xx
Insurance service expenses	xx
Amounts recovered from Reinsurance	xx
Reinsurance Premiums	xx
Insurance service result	**xx**

Challenges and Considerations

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Accounting Mismatch

Difference in Measurement Model	o Underlying contract measured using VFA while the reinsurance held is measured using either GM or PAA o Reinsurance contract eligible for PAA while underlying is not and vice versa
Coverage units & CSM Release	o The period and pattern for the release of the CSM might be different due to the different coverage units pattern.
Loss Deferment	o For Non-Proportional reinsurance treaties, day one gains and costs are deferred for reinsurance contracts held o While only day one gains are deferred for the underlying insurance contracts and day one losses are recognized immediately
Level of granularity	o Mismatches could arise if a reinsurance treaty covers underlying contracts that refer to different Groups of insurance contracts (onerous or not).
Retrocession	o Profits or losses from retrocession are amortised over the coverage period (unlike inwards losses which are recognised immediately)
Discount rate	o The discount rate used to calculate the CSM for underlying contracts may differ from that used for the reinsurance, for example, due to differences in the recognition dates of the reinsurance and underlying contracts.

Amendments

In order to reduce the accounting mismatches the following amendments were brought out

Onerous Contract

- For proportional reinsurance, recognition of gain on inception to reduce mismatch. Non proportional the issue persist.

Risk Adjustment for underlying VFA contract

- There is mismatch due to underlying insurance contracts being measured under VFA and the reinsurance contract attached to being measured under BBA. This causes accounting mismatch because the financial risk changes on the insurance contract flows through CSM vs for the reinsurance contract where it flows through the P&L.
- The amendment allows for this mismatch to some extent to be taken care by allowing risk mitigation option to reinsurance, allowing the financial risk changes to reflect in P&L of the insurance contract. Key challenges/considerations for using this
  - A written policy documenting risk management objective and strategy needs to be in place at the onset which should outline in sufficient detail how the financial risk is mitigated
  - When treaty covers multiple lines of business disaggregation of the economic offset is a challenge. Consistency also needs to be demonstrated in analysis of change

Points for Consideration

Level of Aggregation

- ✓ To the extent offsetting is required for onerous base contracts (proportional reinsurance), there has to be correspondence in grouping of reinsurance contracts
  - ✓ Some of the contracts are not reinsured in surplus treaty. That may trigger further grouping of base contracts

Coverage Period

- ✓ For UL contract where Sum At Risk (SAR) becomes zero during the term of the contract, what should be the coverage period? SAR can again become positive

System Requirements

- ✓ Reinsurance contracts held require similar calculations (involving aggregation, measurement etc). What does this mean to systems? Has this been adequately thought through in gap analysis?

Points for Consideration

Consistency of Assumptions

- ✓ Standard requires consistency of assumptions between underlying contracts and reinsurance contracts
  - ✓ In case of surplus treaty with say, a retention of 50lakhs, the reinsured portfolio above 50lakhs may have better mortality experience as compared to the underlying overall portfolio. Since experience of underlying portfolio is not necessarily tracked separately for contracts above 50lakhs, how do you justify consistency?
  - ✓ Since it is possible for reinsurance treaty to cover different underlying contract groups with different set of assumptions, how do you justify the consistency?

Consequences of explicit presentation of reinsurance numbers

- ✓ Does this bring additional transparency and hence re-negotiation of reinsurance treaties by either party?

Points for Consideration

How much time have you spent thinking about IFRS 17 from reinsurance point of view?

Questions ?