

GIRO Convention

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Use and Abuse of Reinsurance Under IFRS Phase II

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Agenda

- IFRS Phase I vs. Phase II comparison and changes;
- How will outwards reinsurance be accounted for?
- Will discounting change reinsurance products?
- Long term relationships between the cedant and reinsurer
- Premium strippers and profit smoothers
- Non contractual terms, side letters and all that

IFRS Phase II – Recap

- Current exit value
- Three building blocks
 - 1. Current estimates. Explicit, unbiased, market-consistent, probability-weighted and current estimates of the contractual cash flows
 - 2. Time value of money. Current market discount rates that adjust the estimated future cash flows for the time value of money
 - 3. Margins. An explicit and unbiased estimate of the margin that market participants require for bearing risk margin and other services, if any – for example, service margin.

IFRS Phase II - Transfer of significant insurance risk

- Under the IFRS4 definition of insurance all contracts accounted for as insurance and reinsurance contracts must transfer significant insurance risk
- This definition is not expected to change under Phase II

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IFRS Phase II – Reinsurance Liabilities

Current proposals:

- Same requirements for inwards reinsurance liabilities as for direct
- Current exit value

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IFRS Phase II – Reinsurance Assets 1

No intention to change the existing requirements of IFRS 4:

- No offsetting
- Current exit value

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IFRS Phase II – Reinsurance Assets 2

Key issues:

- Margins
- Impairment
- Gains/Losses

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IFRS Phase II – Reinsurance Assets: Risk Margin

- Increases the CEV
- RM equals the RM for the corresponding part of the underlying insurance
- Reference transaction for CEV is simultaneous transfer of both the reinsurance contract and related underlying contract

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IFRS Phase II – Reinsurance Assets: Impairment

- Risk of reinsurer default or dispute
- Two possible approaches: Incurred loss or expected loss model
- IFRS 4 uses incurred loss model
- Proposed change to expected loss model
- CEV to allow for **expected** default/dispute and **risk margin** that defaults/disputes exceed expected value

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IFRS Phase II – Reinsurance Assets: Gains/Losses

- Usually due to difference in basis of measurement e.g. undiscounted liability vs. reinsurance premium based on PVs
- Using CEV, these distortions expected to be largely eliminated
- No 'mirror accounting' – differences in value between cedant and reinsurer for the same contract

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Discounting and reinsurance

- Phase II will require explicit discounting of all insurance liabilities
- Finite risk reinsurance where the substantive effect is to achieve the effect of discounting provisions without disclosing that they have been discounted will reduce
- It may still have a role if reinsurers offer benefits in excess of the risk free rate

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Effect of Phase 11 discounting on R/I

	data	Before R/I phase 1	After R/I phase 1	Before R/I phase 11	After R/I phase 11
Gross reserves due over say 10 years	500	500	500	500	500
effect of discounting at risk free rate	100			100	100
Discounted gross reserves	400			400	400
Potential Reinsurance Premium	210				
Expected reinsurance recoveries (260 excess of 240)	260		260		260
Effect of discounting on reinsurance	60				60
Discounted reinsurance recoveries	200				200
Reserves net of reinsurance		500	240	400	200
P&L account					
R/I premium			-210		-210
R/I recoveries			260		200
net benefit of R/I			50		-10
Discount on gross reserves				100	100
Overall p&L effect		nil	50	100	90

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Premium strippers

- Premium stripper reinsurance is structured with significant reinsurance premium, significant claims expected to arise and to transfer limited (but still significant) insurance risk
- Its effect is to reduce net premiums and claims but have limited effect on the result. Accounting disclosure requirements for reinsurance reduce this effect
- Where regulatory capital requirements are based on gross premium (or reinsurance credit taken into account in capital requirements is not fully utilised) it can reduce capital requirements
- Regulatory developments such as the ICA in UK and Solvency 11 will reduce this role for reinsurance

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Profit smoothers or cash flow?

- These are longer term contracts designed to mimic actual long term relationships between reinsurer and reinsured.
- As the experience surplus or deficit is a contractual feature it is taken into account in determining accounting results so these contracts now have a cash flow effect only – they cannot be used to smooth results
- This will not change under Phase 11

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Non contractual terms and side letters

- Accounting practice requires that all associated agreements (e.g. side letters or other contracts taken out in conjunction the reinsurance) are considered in conjunction with the reinsurance contract in determining its accounting treatment.

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Reinsurance under IFRS Phase 11

- Reinsurance will continue to provide risk transfer, access to business and arbitrage opportunities
- Potential for some regulatory benefit from reinsurance in the short term
- Significant risk transfer consideration will continue
- Mandatory discounting will reduce demand for some reinsurance
- Mandatory credit risk consideration in valuing reinsurance