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The treatment of reinsurance under IFRS 17 and how reinsurance solutions may develop going forward

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19 November 2019

Agenda

1. IFRS 17 refresher
2. Why do companies reinsure?
3. Reinsurance under IFRS 17
4. Impact on reinsurance strategy

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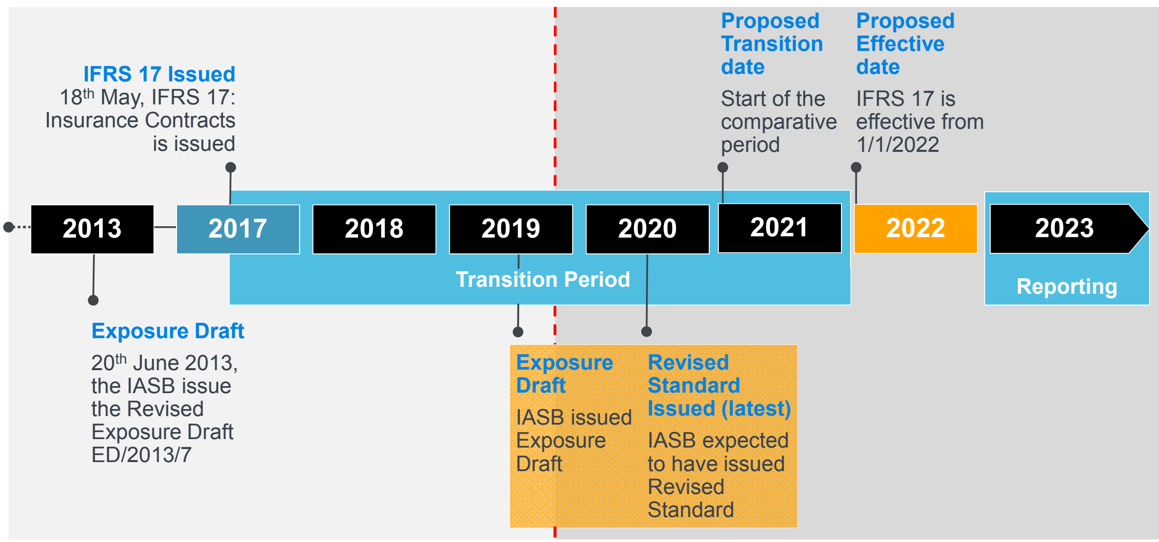
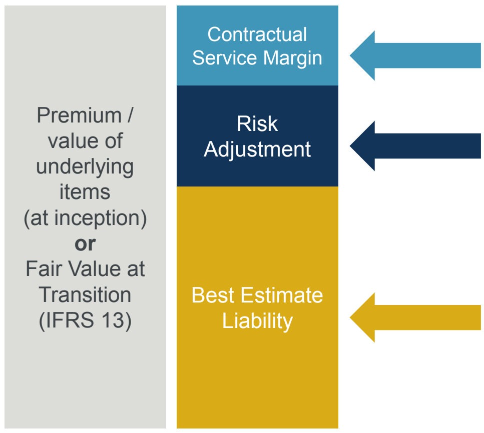
IFRS 17 timeline



IFRS 17 refresher



Unearned profits, balancing item
GM: measured at discount rates locked in from inception
VFA: measured at current rates

Adjustment for the non-financial risk inherent in the cashflows

Present value of future cash flows

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Why do companies reinsure?

	Traditional reinsurance	Structured reinsurance

Motivation	• Risk mitigation
	  • smooth volatility of earnings
	  • lock into profits at an attractive level
	  • capital optimisation
	  • cover against extreme events
	• Underwriting / claims / product development support
		• Typically capital or liquidity considerations are the primary driver
		• To a lesser extent also risk mitigation

UK e.g.	• Risk premium reinsurance covering new protection business, e.g. term assurance products • Longevity swaps to support BPA market growth	• Original terms reinsurance of protection business with high upfront commission to cover new business strain • Cash financing to support M&A activity

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Reinsurance under IFRS 17 (currently!)

- Reinsurance contracts held measured separately to the underlying contracts
- Therefore reinsurance impact is more visible in financial statements
- Some specific principles apply to reinsurance under IFRS 17
  - Must be measured using the General Model regardless of measurement of gross contracts
  - CSM is allowed to go negative, thereby smoothing losses on reinsurance
  - Contract boundaries on reinsurance are independent of the contract boundary of the underlying contracts => cashflows to include expected future new business
- Some of these points have been contentious and the focus of intense lobbying activity.

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1 Allowance of reinsurance held as a risk mitigation option

Issue raised by the industry

- Entities may use derivatives or reinsurance contracts to mitigate the financial risk associated with contracts with direct participation features
- Reinsurance contracts held (or issued) are specifically excluded from the scope of the variable fee approach
- Risk mitigation option applies for entities that have used derivatives but it does not apply for reinsurance contracts held

IASB decision

- For contracts with direct participation features, the risk mitigation option can be extended to include reinsurance contracts held that mitigate financial risks

ED feedback

- Many cases where reinsurance contracts held would satisfy the VFA criteria
- Intra-group "Brexit" transfers are a clear example

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2 Mismatches arising from reinsurance held on onerous underlying contracts

Issue raised by the industry

- Where an group of insurance contracts are onerous at initial recognition they are recognised as a loss in the P&L
- Where such contracts are reinsured, any gain on the reinsurance contract is recognised over the coverage period of the reinsurance contract
- Mismatches arise as a result

IASB decision

- Extend Paragraph 66(c)(ii) to allow the same offset for underlying contracts that are onerous at outset, for proportionate reinsurance contracts only
- Only applies in the reinsurance contract was entered into at the same time, or prior, to the underlying contracts

ED feedback

- Definition of “proportionate” reinsurance is too narrow
- In many cases this amendment does not solve the accounting mismatch

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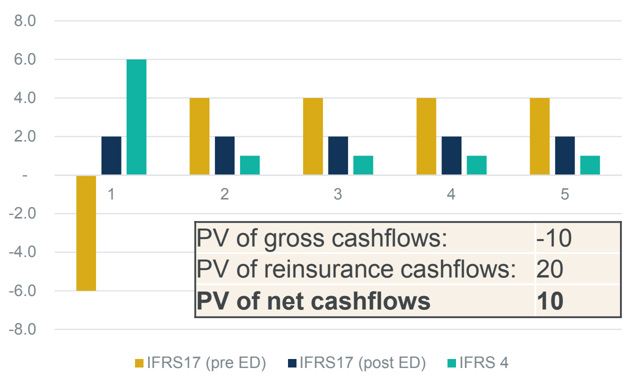
Example 1 – Simplified expected P&L 100% reinsurance

5-year Term Assurance (gross loss making / reinsurance value adding / net profitable)



IFRS17 (pre ED):
- Initial gross loss recognised upfront
- Reinsurance profit spread via CSM

IFRS17 (post ED):
- Initial gross loss of £10 recognised upfront but fully offset by assumed profit upfront from Reinsurance held
- Residual value added by reinsurance (£10) spread over CSM

IFRS4:
- Benefit of reinsurance is immediately recognised through reinsurers share of reserve
- Subsequent profits primarily relate to release of prudence in reserves

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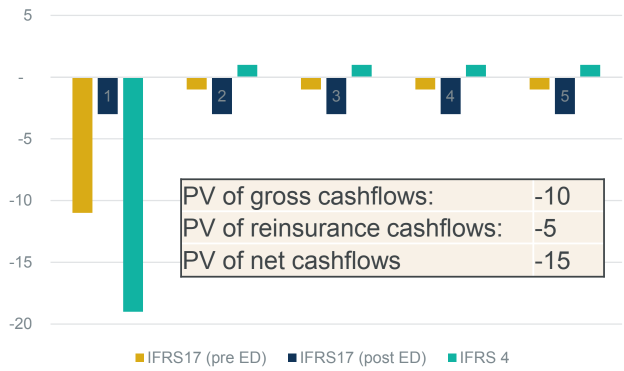
Example 2 – Simplified expected P&L 100% reinsurance

5-year Term Assurance (gross loss making / reinsurance value detracting / net loss making)



IFRS17 (pre ED):
- Initial gross loss recognised upfront
- Reinsurance losses spread via CSM

IFRS17 (post ED):
- Initial gross loss of £10 recognised upfront but fully offset by assumed profit upfront from Reinsurance held
- Reinsurance CSM of -£15 to back out initial profit recognised and to ensure "real" value emerges smoothly

IFRS4: as per Example 1

POST ED: main items		Year 1	Year 2+
GROSS	Loss component	10	
REINSURANCE HELD	Loss component	-10	
REINSURANCE HELD	CSM release	-3	-3

Now there are complex interactions between gross and reinsurance cashflows

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Impact on existing reinsurance strategy (1)

Gross contracts are profitable	Gross contracts are onerous
• Profitable gross contracts are unaffected by the amendment – both profits on the gross side and value added or detracted by reinsurance emerge smoothly over time via CSM mechanism	• Reinsurance impact does not depend on the value it adds or detracts, but rather ***the reinsurance impact at inception is tied to the gross impact and set to eliminate the relevant proportion of the gross loss***. • The Reinsurance CSM is set as a balancing item and has the effect of ensuring the "real" value from reinsurance emerges smoothly.

- Assuming relevant conditions can be met, reinsurance can be used to reduce losses from onerous cohorts of business at initial recognition. This is regardless of whether the price of reinsurance is cheap or expensive!
- This may give insurers more office pricing flexibility if reinsurance is in place relative to the scenario where there is no reinsurance

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Impact on existing reinsurance strategy (2)

- There's arguably more need for reinsurance under IFRS17 than currently:
  - more volatility due to greater granularity and accounting mismatch of recognising losses and spreading profits via CSM
  - cross subsidisation between segments of business much reduced
- Generally high quota shares across the Protection market and there's nothing to suggest that IFRS17 will change this.
- Has to be weighed against cost of reinsurance and how reinsurance fits into risk appetite and impacts on other metrics – Solvency II, other GAAPS etc
- Watch out for: additional volatility caused by different recognition dates, locked-in rates, coverage periods between gross business and reinsurance held

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New Structured Reinsurance solutions?

- In the past reinsurance has been used to accelerate accounting profits for insurance business (e.g. Original Terms with high upfront commission in excess of DAC); this has been less popular of late
- There may be ways of doing this under IFRS17 but it's uncertain how these would be viewed by auditors and accounting bodies
- **Watch this space** – there may be more focus on this when rules are finalised and insurers' commercial workstreams gain momentum. Up to now focus has been on practical implementation and how current reinsurance arrangements are affected

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Questions

Comments

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