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Reinsurance under IFRS 17

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Reinsurance under IFRS 17

Introduction



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Fundamentals of IFRS 17 Reinsurance



- Reinsurance accepted is relatively straightforward under IFRS 17 with limited changes in rules to direct business.
- Reinsurance ceded under IFRS 17 is more complicated for a number of reasons:
 - Existence of positive/negative CSM for profitable/loss-making reinsurance.
 - Reinsurance recognition date.
 - Separate Risk Adjustment required for reinsurance asset.
 - Reinsurance unit of account / aggregation.
- Variable Fee Approach (“VFA”) not allowed on reinsurance ceded or accepted (B109).
- Existence of reinsurance does not affect the fulfilment cashflows on the underlying direct contract.



IFRS 17 refresher

- IFRS 17 has an **effective date** of 1 January 2021 [TBC].
- The new standard will be applied **retrospectively** and different approaches can be used to transition.
- Will **apply across the world** with notable exceptions of USA, Japan and Switzerland.
- Calculate liabilities as **best estimate liabilities, risk-adjustment** for non-financial risk and Contractual Service Margin (**CSM**).
- The CSM **removes initial profit** and spreads profit over contract term.
- Assumption changes impact CSM and hence **more stable** profit release.
- Should provide **clearer picture** of Insurers performance.





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Overview of treatment

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Reinsurance accepted

Reinsurance accepted approach

- Limited explicit IFRS 17 rules on Reinsurance accepted.
- Variable Fee Approach "VFA" is not allowed – this can cause issues for example when there is internal reinsurance of Unit Linked business.
- Need to value future business expected to be written under treaty. Potential changes to treaties to manage extent new business must be included.
- Changes to income statement, commission not contingent on claims will now be deducted from premiums reducing reinsurers revenue.
- Mandatory reinstatement premiums recognised as a reduction in claims.



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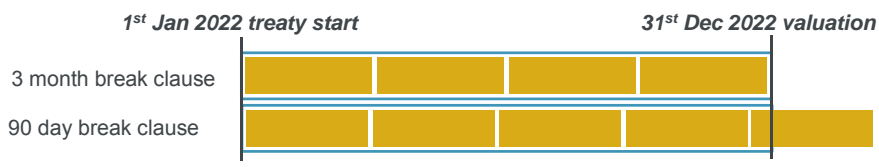
Reinsurance ceded recognition

Reinsurance ceded recognition date

- The IFRS 17 Reinsurance recognition date may be different to under current IFRS and also differ between reinsurance ceded and corresponding direct business.
 - For **proportional business** the point of initial recognition is the later of the coverage period of the reinsurance contract and the first underlying contract.
 - For **non-proportionate business** contracts are recognised at the beginning of the coverage period.

Reinsurance ceded allowance for future new business

- Proportional reinsurance allows for business not yet written up to treaty break clause.
- Latest thinking is would divide up into separate tranches for CSM and treaty dates may be refined (Sept 18 TRG AP05).

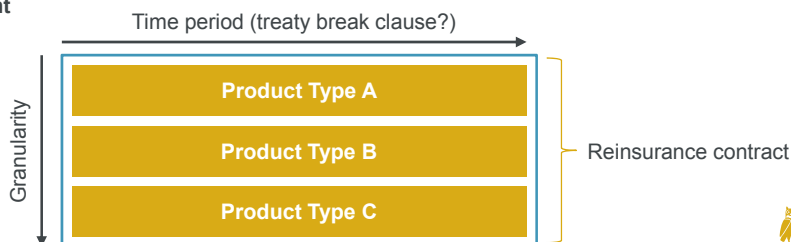


Reinsurance ceded unit of account / aggregation

Typically under IFRS 17 unit of account is reinsurance treaty and presumption against unbundling

- Can we unbundle reinsurance contracts which cover different products? Relevant consideration in the assessment of unbundling will include (AP01 from Feb 2018 TRG).
 - Whether the risks covered by the treaty are interdependent.
 - Whether components of the treaty can lapse together.
 - Whether components of the treaty can be priced separately.

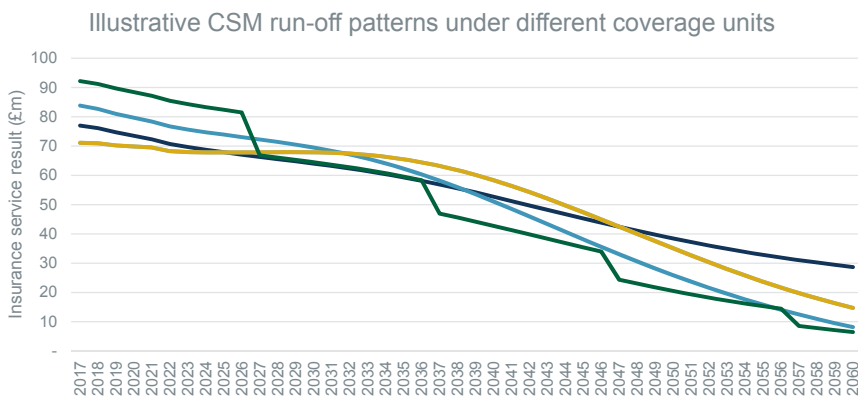
CSM unit of account



Reinsurance ceded coverage unit

Should coverage unit align to that on underlying direct business?

- Appropriate coverage unit may differ for different types of reinsurance and could materially change profit profile.



Reinsurance ceded CSM

Initial recognition

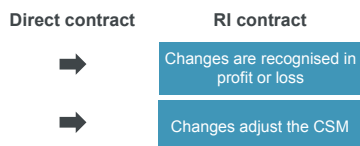
	Direct contract	Reinsurance contract
Gains	CSM (spread)	CSM: net gain (spread)
Losses	Recognise immediately	CSM: net cost (spread)

Reinsurance contracts are considered to have either a net gain or a net cost at inception. This is held as a contractual service margin measured at an amount equal to the sum of the fulfilment cash flows. Losses are therefore treated differently for reinsurance contracts.

! An issue arises where an insurer has a loss making direct contract and enters into a reinsurance contract which it expects to be profitable. This is because at inception of the **two contracts, the insurer will not be able to offset** the loss on the direct contract with the expected profit on the reinsurance contract entered into.

Subsequent measurement

The treatment of changes in estimates relating to the reinsurance contract mirrors the treatment of the change in estimates relating to the underlying direct contract:

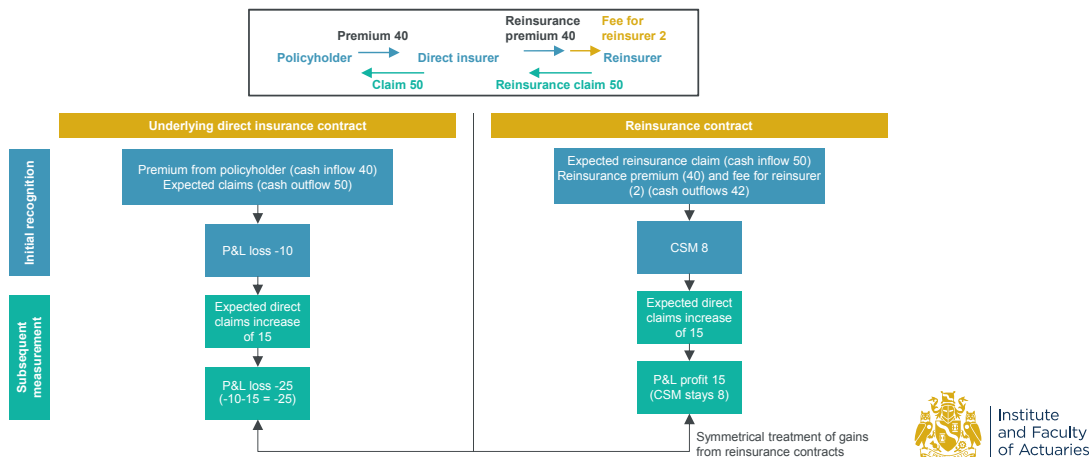


The treatment of changes in estimated fulfilment cash flows for reinsurance contracts mirrors the treatment of the underlying direct contract.



Reinsurance ceded CSM

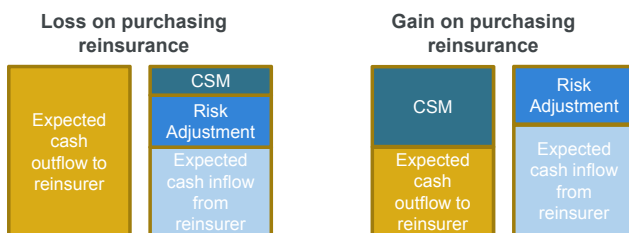
Below is an example of calculation of CSM on a reinsurance contract held with **onerous** underlying direct contracts.



Reinsurance ceded CSM

Modelling considerations

- Challenging to link the CSM between direct and reinsurance business CSM, potentially many to many mapping.
 - Different granularity of CSM calculation?
 - Different coverage unit?
 - Different timeframe?
- Treatment in period when direct business becomes onerous – could use proportional approach but alternative interpretation is no P&L change for reinsurance asset (*IFRS 17 Standard para 63*).



Reinsurance ceded valuation assumptions

Demographic assumptions

- The assumptions used to value the Reinsurance (e.g. mortality, lapses etc.) should be consistent with those used to value the underlying contract (*IFRS 17 Standard para 63*).

Discount rate assumption

- Discount rate should be consistent derivation in general but the actual assumption can be different due to the difference in initial recognition date and cohorts
- Currently under IFRS 4 firms typically use yield on assets backing net liabilities to calculate valuation discount rate. Under IFRS 17 the discount rate should consider the characteristics of the reinsurance cashflows (*IFRS 17 Standard para 36*).

Credit risk assumption

- Reinsurance should be adjusted for non-performance (credit default risk) of reinsurer (*IFRS 17 Standard para 63*).
- Can be done via adjustment to discount rate or via adjustment to cashflows. Approach could align to current IFRS 4 or Solvency II approach.
- Changes in the fulfilment cash flows that result from changes in the risk of default of the reinsurer do not relate to future coverage or other future services and shall be recognised immediately in P&L.



Reinsurance ceded Risk Adjustment

Risk Adjustment

- Reinsurance Risk Adjustment should capture only the Risk Transferred to Reinsurer under the Reinsurance contract (*IFRS 17 Standard para 64*).
 - Different approach to Solvency II where Risk Margin is calculated on a net basis.
 - Need to consider which risks are transferred and potentially different risks covered to direct.
 - Need to disclose confidence level for reinsurance Risk Adjustment.
 - Will need calculate Risk Adjustment for business not yet written.



Reinsurance ceded disclosure requirements

IFRS 17 Reinsurance disclosure

An entity presents separately in the statement of financial position (*IFRS 17 Standard para 107*):

- (a) insurance contracts issued that are assets;
- (b) insurance contracts issued that are liabilities;
- (c) reinsurance contracts held that are assets; and
- (d) reinsurance contracts held that are liabilities.

Similarly income / expenses must be disclosed separately for reinsurance and reinsurance income / expenses can be disclosed as a combined amount or separately (*IFRS 17 Standard para 98*).

Sensitivities have to be disclosed pre and post reinsurance (*IFRS 17 Standard para 128*).

Profit commissions are to be deducted from revenue if not contingent on claims experience, or included in claims if contingent on claims experience. Profit commissions may create a non-distinct investment component.



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Areas where changes to the standard are hoped for

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Recent developments on Reinsurance

EFRAG wrote a public letter IASB on 3rd September 2018 to highlight certain aspects of IFRS 17 that they believe merit further consideration. On the aspects mentioned was reinsurance:

“The EFRAG Board has reviewed the concerns raised and has considered the evidence obtained during our outreach activities. The EFRAG Board has identified the following topics that, in our view, merit further consideration by the IASB:

(c) Reinsurance (onerous underlying contracts that are profitable after reinsurance, contract boundary for reinsurance contracts where underlying contracts are not yet issued);”

Source: <http://www.efrag.org/News/Project-329/Letter-to-IASB-on-IFRS-17>

In October 2018 the IASB Board tentatively agreed criteria for potential changes to the standard:

“At this meeting, the Board agreed on the criteria it will use in evaluating potential changes to IFRS 17, namely that any changes should not:

- result in less useful information for investors;*
- disrupt existing implementation processes; and*
- risk undue delays in the effective date of a Standard that is much-needed to address inadequacies in the current wide range of insurance accounting practices.”*

Source: <https://www.ifrs.org/news-and-events/2018/10/iasb-discusses-next-steps-in-implementation-support-for-ifrs-17/>

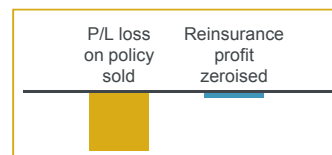


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No offset of Day 1 losses



What's the problem?

- Under IFRS 17 losses on new contracts are recognised immediately, whilst profits are deferred.
- Where contracts are reinsured by proportional reinsurance, if the underlying contract is onerous on initial recognition this loss is recognised immediately, but any offsetting profit on the reinsurance is deferred.
- This situation can arise on life protection business in the UK. Because globally reinsurers main exposure is to non-life risks, reinsurers are able to offer favourable terms for life protection business, which is reflected in the premiums policyholders are charged.
- As it stands under IFRS 17 new protection business in the UK may be shown as unprofitable at inception, although this is not the case net of reinsurance.

How might this be addressed?

- If a contract reinsured by proportional reinsurance is onerous (but the reinsurance is profitable):
- A negative contractual service margin (up to the lesser of that on the reinsurance, and the loss on the direct contract) could be included in the measurement of the direct contract.



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Reinsurance asset allows for direct business not written yet M

Valuation date



Valuation includes treaty expected new business till notice period

What's the problem?

- For IFRS 17 the unit of account is usually the contract.
- As there is normally not right of offset for insurance liabilities and reinsurance assets, reinsurance treaties are (for the most part) recognised and measured separately from the underlying contracts.
- If a cedant is obliged to cede a share of new direct contracts to the reinsurer (and the reinsurer is obliged to accept them) cashflows on these new contracts are included within a cedant's reinsurance asset.
- Commonly proportional reinsurance treaties have a 3 month (or in some case 1 year) notice period.
- A cedant's reinsurance asset would then allow for 3 months (or 1 year) business that the cedant has not yet written.
- Leaving aside the operational difficulties, the gross liability and reinsurance asset would be measured inconsistently. In particular because the risk adjustment for reinsurance includes the transfer of risk on contracts not written yet, the net risk adjustment (being the gross less reinsured risk adjustments) would understate the non-financial risk borne.

How might this be addressed?

- Proportional reinsurance cashflows only to allow for direct contracts that have been recognised.



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(In)eligibility for variable fee approach (VFA) M

What's the problem?

- IFRS 17 has two measurement models for long term business. The general measurement model (GMM) applies for annuity and protection and the variable fee approach (VFA) applies for most unit linked and with profits
- The GMM recognises investment variances in the period they occur, similar to existing UK GAAP for annuity and protection
- The VFA in effect spreads the impact on profit and loss of changes in expected future annual management charges or shareholders share of with profit bonuses, similar to existing UK GAAP for unit linked and with profits business. IFRS 17 specifically prohibits the VFA for reinsurance ceded and accepted
- This is a major problem for inter group reinsurance, where post Solvency II (and post Brexit) unit linked and with profits liabilities are commonly reinsured within groups. Inconsistent measurement of gross liabilities and reinsurance assets could lead to volatile P&L at individual entity level, with adverse tax consequences and dividend traps.

How might this be addressed?

- Allow VFA for reinsurance (and in any case for inter group reinsurance), where the underlying contracts are within the scope of VFA, and the reinsurance transfers the investment as well as insurance risk on the underlying.



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Deposit back and funds withheld arrangements



What's the problem?

- To reduce a cedant's credit risk, a reinsurer's reserves are often deposited back with the cedant
- Under IFRS 4 these deposited back assets are usually unbundled from the reinsurance asset, and accounted for under IAS 39 as a (reinsurance) payable
- Under IFRS 17 deposit back or funds withheld assets (which represent a withheld premium, on which an investment return is paid to the reinsurer) are likely to be included in the measurement of the liabilities.
- The implications of this remain unclear. Is the problem solely presentational (so the deposit back assets are netted off the reinsurance asset), or is the measurement of the deposit back assets affected?

How might this be addressed?

- IFRS 17 includes premium receivables within the liability measurement, even premiums overdue or with intermediaries (which most preparers would like to present as a financial receivable within the scope of IFRS 9)
- IFRS 17 should permit premium receivables to be separated and within the scope of IFRS 9 where this leads to more useful information to users.



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Profit commissions + non-distinct investment components



What's the problem?

- Under IFRS 4 "revenue" accounting is usually applied to the income statement for (re)insurance contracts.
- This sees premiums and claims recognised in full.
- Under IFRS 17 so called "non-distinct" investment components are unbundled in the income statement.
- So for a unit-linked endowment with a sum assured on death, for a death claim only the sum at risk would be recognised in the income statement.
- Where reinsurance treaties have profit commissions, even if the expected value of these is small, this might mean there is a material minimum amount which will be recovered by the cedant.
- Consequently reinsurance premiums and recoveries would be reduced by the amount of this minimum recovery. Reinsurance premiums and claims would be inconsistent with reinsured proportion of gross premiums and claims.

How might this be addressed?

- Non-distinct investment components are a wider problem under the standard.
- Insurers have the option to present reinsurance net on the income statement. This may be simpler than presenting reinsurance premiums and recoveries which are in any case misleading.



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Conclusions

- Still lots of uncertainty on IFRS 17 reinsurance treatment particularly on reinsurance ceded and mismatches to underlying business.
- Some of preparers concerns have been recognised by EFRAG, but not clear for which areas changes are likely.
- Reinsurance is often behind other areas of firms IFRS 17 projects in both terms of defining methodology and setting up models.
- Potentially changes required to Reinsurance structuring to make it more efficient under IFRS 17. Not clear the extent to which this would be possible.
- Likely to be bigger issue for UK than for other markets, as UK has more extensive reinsurance of life insurance than most other territories (with quota share reinsurance of protection contracts, and longevity swaps on annuity contracts common in the UK).

Still lots of uncertainty and potentially quite material changes to current approach on Reinsurance!



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Questions

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