

Setting consistent assumptions for reinsurance contracts held

[This article is one in a series of articles (which can be found [here](#) and [here](#)) published on behalf of the [IFRS 17 CSM Working Party](#). Members are Antoon Pelsser, Asim Ghosh, Clarence Er, James Thorpe, Joanna Stansfield, Kruti Malde, Natalia Mirin (Deputy Chair), Richard Dyble, Rob Walton, Timothy Berry, Weihe Qin and Wijdan Yousuf (Chair).]

1. Overview

IFRS17.63 requires assumptions used to value reinsurance contracts to be consistent with those used for valuation of the underlying insurance contracts. The precise meaning of the consistency requirement may result in different interpretations. Largely, the view is that the consistency requirement does not mean the assumptions have to be the same, but rather the differences, if any, need to be clearly justified. Indeed, using the same assumptions will require a justification as well. Assumptions used affect the key aspects of IFRS 17 valuation: cash flow projections and calculation of present values. As such, this will directly impact calculation of the CSM.

2. Background

Consistent assumptions for the measurement of reinsurance contracts held are required for the calculation of present values of future cash flows. The consistency of assumptions between reinsurance contracts in IFRS17.63 refers to the application of paragraphs 32 – 36. As such, the consistency requirement will be applicable to the assumptions used to derive the best estimate cash flow projections and the discount rates for measuring reinsurance contracts on initial recognition.

Consistent does not necessarily mean the same. But where is the fine line between assumptions still being consistent and becoming inconsistent? This is clearly an area of judgement requiring clear justifications.

Further consistency and justification of changes will be required in subsequent measurement. It would be a natural expectation to adjust or reset assumptions going forward in line with experience or market movements. If these parameters turn out to be different and diverge over time between the ones applicable to a group of insurance contracts and the ones that are applicable for corresponding reinsurance treaties, these differences and divergence should be appropriately documented and justified.

Additionally, it is worth noting that an additional P&L mismatch within a combined statement may occur in cases where assumptions are not consistent between reinsurance contracts held and their corresponding underlying insurance contracts.

3. Examples

This section describes two simple examples on what it might mean to use consistent assumptions between the underlying contracts and the corresponding reinsurance contracts held. By no means should these examples be considered exhaustive. Note, the examples below may or may not be suitable examples for your business.

Example 1

Mortality assumptions

The underlying insurance contract assumes mortality follows 65% AXC00 mortality tables. Reinsurance contract premiums to be paid under the treaty are set based on a separate age-dependent rate table provided by the reinsurer.

If the firm believes the mortality table used for the underlying insurance contracts is the best estimate of the future mortality experience for this block of business, these same mortality rates should be taken to project the future reinsurance cash flows under the reinsurance treaty (for both premiums payable and claim recoveries).

IFRS 17 requires reinsurance contract fulfilment cash flows to allow for the risk of non-performance by the reinsurer.

There are various ways to adjust for the non-performance risk, with the most common approach probably being to allow for it as an explicit item. However, an alternative method could be to adjust the mortality assumptions with the resulting proportion being, say, 64.5% of AXC00 mortality tables and using the adjusted assumptions for projecting reinsurance cash flows.

This example starts with the same mortality assumption for the insurance and reinsurance agreements, but the assumption used for the reinsurance agreement is adjusted for the risk of non-performance by the reinsurer. Documentation of this adjustment would serve as an explanation of the differences in the assumption and justification. Consistency of these two mortality assumptions will still be in place.

Example 2

Discount rate assumptions

The underlying term assurance group of contracts has a risk-free discount rates curve at initial recognition. (The liquidity premium is set to zero due to the contracts being able to lapse any time.) The discount rates curve is set as a simple average of discount rates at the inception date of each contract within the group over the cohort year.

At a later date (more than a year later), a quota share reinsurance contract is taken out to manage the mortality risk of this business. The reinsurance contract just covers the in-force term assurance business.

The discount rates at the inception of this reinsurance contract held may be set based on the risk-free discount rates available at the start date of the reinsurance coverage.

In this example, the underlying groups of term assurance contracts will have different discount rates compared to the corresponding reinsurance contract held. However, the methodology used to derive the discount rate curves for the insurance and corresponding reinsurance contracts is consistent (i.e. based on the risk-free curve at recognition of the contract(s)).

4. Conclusion

Assumptions used for deriving cash flows and calculating their present values for insurance and reinsurance contracts will directly impact the fulfilment cash flows and therefore the CSM values for these contracts.

The consistency of assumptions requirement does not imply the assumptions have to be the same, but rather any differences in the values and/or methodologies need to be, explainable, justifiable and well documented.

The examples within this article by no means intend to be exhaustive and conclusive. Neither do these examples intend to be appropriate for any firm's actual contract groups. A large number of other examples will exist that would satisfy the consistency requirement.

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