Level of aggregation of 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, Huina Zhang, James Thorpe, Joanna Stansfield, Kruti Malde, Natalia Mirin (Deputy Chair), Richard Dyble, Rob Walton, Timothy Berry, Weihe Qin and Wijdan Yousuf (Chair).]

1. Overview

This article explores how reinsurance contracts held could be aggregated into groups of contracts under IFRS 17. There are several considerations here. Unlike (re)insurance contracts issued, reinsurance contracts held can have a positive or negative CSM. Further, underlying business written may in practice be covered by more than one reinsurance contract. In some instances, a single complex reinsurance programme may be structured through a combination of basic reinsurance arrangements. What are the implications of the level of aggregation requirements on how these considerations interact? This question is discussed below supplemented with some examples.

2. Background

Aggregation of contracts, i.e. grouping, impacts the size of the CSM in each group and its behaviour. Each contract, by its size, coverage structure and expected profitability will be adding its own contribution to the CSM in terms of present value of expected profits and CSM release pattern. Therefore, the behaviour of the CSM for a group of contracts will directly depend on the contracts aggregated within the group.

In the context of IFRS 17's level of aggregation requirements, reinsurance contracts issued are treated in the same way as insurance contracts issued (as per paragraphs 3 and 4 of IFRS 17) but different requirements apply to reinsurance contracts held. For reinsurance contracts held, paragraphs 60 –70 state that:

"An entity shall divide portfolios of reinsurance contracts held applying paragraphs 14–24, except that the references to onerous contracts in those paragraphs shall be replaced with a reference to contracts on which there is a net gain on initial recognition. For some reinsurance contracts held, applying paragraphs 14–24 will result in a group that comprises a single contract."

Applying the above, reinsurance contracts held would be aggregated in the following three profitability groups:

(a) groups of reinsurance contracts are in net gain position at initial recognition;
(b) groups of reinsurance contracts that at initial recognition do not have a significant possibility to be in a net gain position; and
(c) all other reinsurance contracts.

In terms of the year of issue, paragraph 22 applies to reinsurance contracts held in the same way that it is applied to insurance contracts issued. More details on this topic will be included in another article by the Working Party.

One further point of relevance: Agenda Paper AP01 of the February 2018 Transition Resource Group (TRG) meeting sets out a useful background to the possibility of disaggregating reinsurance components within a single reinsurance contract held. The paper acknowledges the possibility under IFRS 17 of justifying a contract not being the lowest unit of aggregation and instead being set at lower units, e.g. individual components of a contract, provided the legal form of the contract does not reflect the substance of its contractual rights and obligations. Consequently, situations where reinsurance contracts held could be disaggregated into lower units should be rare and significant judgement, including consideration of all the relevant facts and circumstances, will need to be applied to do and no single factor should be considered determinative. An assessment of potential unbundling of components of a contract needs to include considerations:

- whether the risks covered by components of a contract are independent;
- whether components of a contract can lapse separately; and

- whether components of a contract can be repriced separately.

If answers to all three questions above are positive, it may mean that a justification could be set out for separating components within such a contract. A possible scenario is presented in example 3.

3. Examples

This section looks at basic examples to demonstrate the IFRS 17 requirements of aggregating reinsurance contracts held. The examples are not exhaustive and it is acknowledged that, in practice, other simpler or more complex examples of reinsurance contracts held will exist where different facts and circumstances applying may result in different answers.

Example 1

An insurer enters into two reinsurance contracts in the same reporting year:

- a quota share contract for a term assurance block of business that is "net cost" at initial recognition; and
- a longevity swap for a book of annuities in payment that is "net gain" at initial recognition

Even though these reinsurance contracts have been purchased in the same reporting year, they cover risks of different natures and are likely to be managed separately. Applying paragraphs 14 to 24, the insurer will consequently recognize two separate groups of reinsurance contracts; each group will comprise one reinsurance contract held. The first reason is the requirement not to group together contracts with different profitabilities and the second is the requirement not to group together contracts with different risks and that are managed separately.

Example 2

An insurer enters into two reinsurance contracts with the same reinsurer for the same cohort of term assurance business in the same reporting year:

- a quota share contract that is net cost at initial recognition; and
- a multi-year stop loss reinsurance that is net cost at initial recognition (the reinsurer pays all claims in excess of £Xm in a year if the insurer's total claims outgo for the underlying business, after reinsurance recoveries from the quota share cover, exceeds £Xm)

The insurer models cashflows for these two reinsurance contracts together as recoveries under the stop loss arrangement depend on recoveries under the quota share cover. In this example, an argument could be presented for these two reinsurance contracts to be grouped together as they have similar risks and will likely be managed together as part of an overall mortality risk management strategy. However, the insurer will need to consider some issues if it wishes to group these contracts this way, e.g. the determination and aggregation of coverage units (and therefore the way the CSM will be released over the length of the coverage period for the group). Other examples of considerations can include identifying and allocating reinsurance premium variances, determination of the risk adjustment for such a group of reinsurance contracts that would reflect the amount of risk transferred, etc.

Example 3

An insurer enters an overarching reinsurance treaty with a single reinsurer that covers multiple books of annuities in payment. The treaty provides annuity payments for underlying policyholders if their longevity exceeds a certain number of years. Each reinsured book is managed separately and the reinsurance commencement date for each book is different. Each book is priced separately under the overarching treaty and reflects the demographics of the underlying policyholders. Reinsurance arrangements for each book can be renegotiated or lapsed separately from other books without lapsing the overarching treaty.

In this scenario, a justificatory argument could be set that the legal form of the overarching reinsurance treaty does not reflect the actual nature, operation and management of the contract. Therefore, the components of this treaty can be disaggregated and the reinsurance of each annuity block could be treated as a separate reinsurance contract held with separate inception dates.

4. Conclusions

In summary, the key points about the specifics of aggregation of reinsurance contracts held are as follows:

- Each level of aggregation determination should be considered individually and separately from other cases.
- Many groups of reinsurance contracts held are expected to consist of a single individual reinsurance contract however facts and circumstances may exist in which a group of reinsurance contracts held or may include more than one reinsurance contract.
- On certain rarer occasions, a single reinsurance contract held may be justifiably disaggregated and split into multiple units of account.

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