Challenges of measuring proportionate 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. Introduction

The IASB released the "Amendments to IFRS 17" Exposure Draft in June 2019 proposing consequential amendments across several areas. One such amendment will enable entities to recognize immediate gains from proportionate reinsurance contracts held (irrespective of whether they are net cost or net gain overall) to offset immediate losses recognized at initial recognition of an onerous group of underlying contracts. No such change in treatment has been proposed for non-proportionate reinsurance contracts held though several bodies continue to voice their concerns on this topic – non-proportionate reinsurance contracts held are consequently not discussed any further.

Whilst the proposal is expected to provide relief in some instances, the narrow definition of a "reinsurance contract held that provides proportionate coverage" is noted as an obstacle that limits the scope of application. Much has been said on this topic already that will not be repeated in this article but an outline is included in section 5 for those less familiar with the issue.

Instead, the aim in this article is to focus on some of the interpretive, technical and operational challenges arising from the specific wordings of the proposed amendments. For ease of reference, key paragraphs from the Exposure Draft relevant to this discussion are included in section 6.

2. Illustrative example of the change

Figure 1 illustrates the impact of the proposal through a simple example. It compares the net-of-reinsurance IFRS 17 profit profiles based on the existing standard and the proposed amendment.

<u>Fact pattern for figure 1:</u>

- Underlying business is onerous, reinsurance contract held is net cost
- Reinsurance contract held is 'plain vanilla' 100% quota share
- Interest rates assumed to be zero
- Risk adjustment assumed to be zero

Figure 1

Previously, entities could not offset losses recognized at inception despite holding a proportionate reinsurance contract. The proposed amendment results in a deferred recognition of some or all of these losses.

Observation 1: The proposed mechanism functions as a trade-off. After the reinsurance CSM is adjusted, and a gain is recognized, all reinsurance contracts (irrespective of whether they are net cost or net gain overall) look worse in subsequent P&Ls than would be the case if no adjustment were made. This 'worsening' can present itself in the P&L either as a smaller reduction or as an increased generation of insurance service expenses. Either way, the result is a depression of subsequent periods' profits (or accentuation of losses) and consequently an understatement of the insurer's future profit profile. The higher the percentage of onerous business (proportionally) ceded to reinsurers, or the larger the loss component for the new business recognized, the larger the loss-recovery component that will be established and consequently the larger the negative contribution from reinsurance to future P&Ls. See BC83 for reference.

Observation 2: In extreme examples, it is possible that reinsurance contracts held that are net gain overall may only end up generating insurance service expenses in all future P&Ls (after the initial gain has been recognized). This is possible if the loss-recovery component established is larger than the balance of the reinsurance CSM at the time.

Observation 3: A concomitant of the requirement will be the need to recognize and amortise both a reinsurance CSM and a loss-recovery component which makes the interpretation of financial statements difficult. Note that the establishment of a loss-recovery component does not affect the liability for remaining coverage at any point in time for the reinsurance contract (as the loss-recovery component and the adjustment to the CSM will be equal and opposite).

It is noted that this requirement is not avoided for companies planning to use paragraph 86 (that enables income or expenses, from reinsurance contracts held, to be presented as a single amount). This is because of the need to systematically allocate a portion of the "reinsurance finance income or expenses" which, as per paragraph 86, still has to appear in the insurance finance income or expenses line (i.e. not presented as part of the single amount).

It is also noted that even though BC74 implies that no additional *external* disclosures need to be prepared, in practice this amendment will be expected to result in additional *internal* disclosures to be prepared in order to analyse, interpret and forecast results.

Observation 4: Paragraphs 66A-B imply (and paragraph BC85 confirms) that whilst entities can recognize gains to offset losses from onerous new business under a (proportionate) reinsurance contract already held (provided it covers the new business), no such offset is possible for entities who reinsure such onerous business subsequent to writing it (notwithstanding the ambiguous requirements of paragraph 62(a)(ii)).

3. A closer look at the wording

Paragraphs 66A-B make it clear that adjusting the reinsurance CSM and establishing a loss-recovery component is **mandatory** when an entity recognises a loss **at initial recognition** of an onerous group of underlying insurance contracts.

This presents several problems.

First, by making the requirement, and the prescribed method of application, mandatory instead of optional, entities may be forced to explain and justify unintuitive financial results (see ***Observation 2***) to users of financial statements when they otherwise could have avoided this if the decision were optional for each reinsurance contract held. There is no discussion on whether optionality was considered for this purpose: it may be supposed that optionality introduces lack of comparability however the existence of important options elsewhere in the Standard does not support that supposition.

Second, paragraphs B119F and BC74 indicate that the relief gained through the establishment of a loss-recovery component comes at a further price: the operational and technical complexity of having to amortise the loss-recovery component down to zero by the end of the lifetime of the group of contracts. But how should this be done?

Challenge 1: It is not clear how the wording of the requirements, with respect to amortising the loss-recovery component, are to be interpreted. Are B119F and BC74 complementary or contradictory?

Consider two onerous groups of contracts recognized more than one year apart but covered by the same reinsurance contract.

One interpretation of B119F could be that the amount by which the loss-recovery component is amortised is itself just a simple sum of the amounts by which the two underlying loss components are being (independently) amortised. This route would be practically simpler and relatively easier to follow in the financial statements. However, this seems *too* simple. A follow-up question could be whether it would be necessary or appropriate, to be consistent with how the loss-recovery component was established, to multiply these amortisation amounts by the fixed percentage of claims that the reinsurance covers. A possible response could be that this is spurious accuracy for a component that is itself heavily dependent on approximations and assumptions.

On the other hand, one reading of BC74 seems to suggest a possibly contradictory approach. Rather than amortising the loss-recovery component based on amounts by which the underlying loss components are amortised (as B119F could be suggesting as noted above), BC74 can be read as requiring the systematic amortisation of the loss-recovery component *to be treated similarly* to loss components *by way of similar methodologies being applied* in both instances. In this case, the amortisation of the loss-recovery component would be an entirely separate calculation altogether but one that applies the same underlying methodology principles as that used for amortising the loss-components. This is operationally and technically more complex but one that could be argued is a technically more superior method. In addition, only minor changes would be required to adapt the loss-component methodology into one that can be applied to loss-recovery components.

All options have competing technical, operational and financial consequences.

Third, whilst there is always a risk of outcomes favouring technical accuracy to become disproportionately costly, some discussion of conceptual difficulties is always worth having to gain a fuller appreciation of limitations.

Challenge 2: Paragraph BC79 shows that the method prescribed by the IASB for determining the loss-recovery component was swayed in favour of practical expediency rather than technical accuracy. Is this justified? Even though it is granted that many insurance contracts will have claims as the primary cash outflow, it does not follow that most will.

Consider a group of onerous underlying contracts that have been identified as onerous in virtue of *any other reason* than the expected size of the claims (as has been stated by the IASB to be a reasonable practical assumption to the extent that the loss does not exceed those claims). The group may be onerous because of high acquisition or maintenance expenses or simply because of the risk adjustment that is set up.

On technical grounds, it seems inappropriate, and potentially dangerous to make this practical assumption. Consider unscrupulous entities that now have a tactical incentive to increase market share through unsustainably low premiums or unjustifiably high commissions because shareholders don't need to pay for these losses immediately. What impacts might this have on the market dynamics? How might competitors respond? How might the regulator respond?

Once more we come back to the challenge on whether this is the price stakeholders are willing to pay to purchase the relief that preparers and users seek.

Challenge 3: It is not clear on what grounds B119D does not require any allowance in respect of the risk of non-performance. Allowing 100% of future reinsurance recoveries to be recognized as immediate gains is not 'best estimate' and is inconsistent with other paragraphs in the Standard that discuss the measurement of reinsurance contracts held. There are hints in BC78-BC83 that the non-allowance of the risk of reinsurer's non-performance in this calculation is a deliberate and necessary consequence of what it means to allow an early recognition of recoveries but at any rate such a conclusion is best argued for explicitly and not presumed.

Challenge 4: Similarly, it is not obvious what the justification is when B119D requires the use of the loss component on underlying contracts *simpliciter* to calculate the loss-recovery component.

Consider a reinsurance contract held that is recognized in year 20X1 and locks-in to yield curve A, and consider an onerous direct contract that is written in year 20X2 and locks-in to yield curve B. The loss component is calculated using yield curve B and the reinsurance CSM will be calculated using yield curve A.

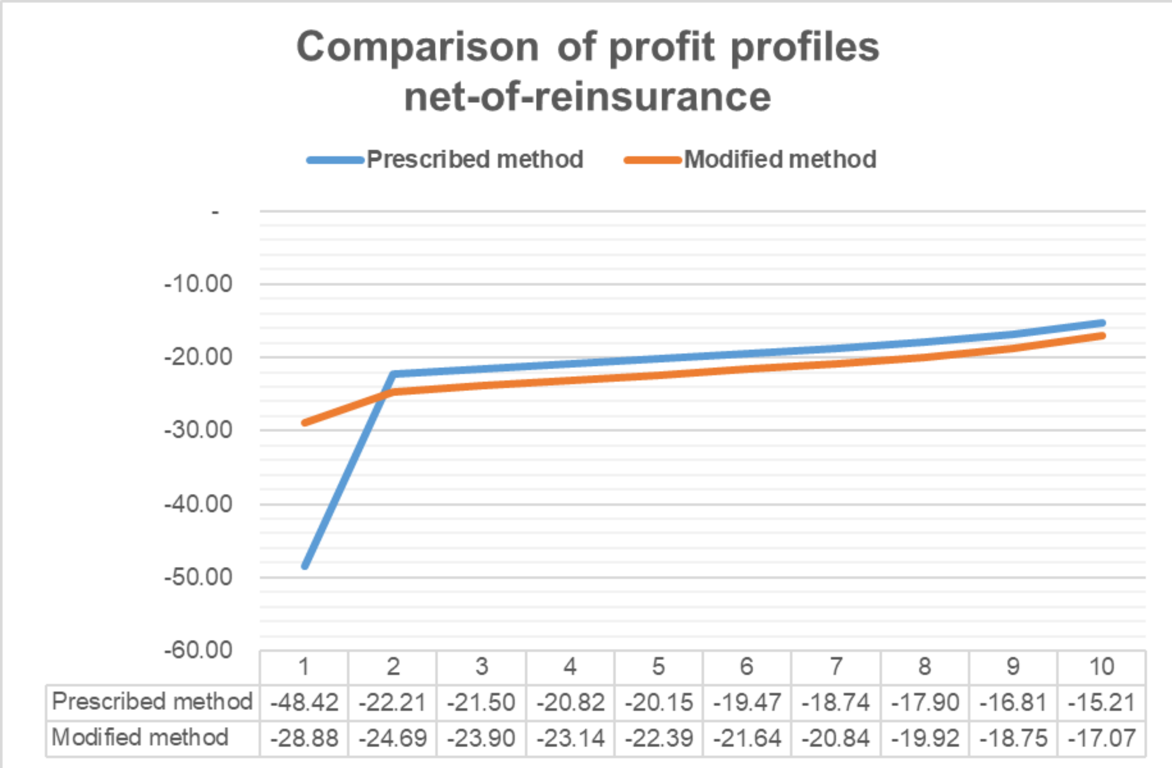
When adjusting the reinsurance CSM as per paragraph B119D, entities will have to do this based on loss components that have been calculated based on different yield curves. This has the consequence of marginally distorting the amounts presented in insurance service expenses and the insurance finance expenses lines. There seems to be no rationale for why the IASB has considered it appropriate to allow this.

Figure 2 illustrates the impact of modifying B119D by comparing the net-of-reinsurance IFRS 17 profit profiles under two methods.

Fact pattern for figure 2:

- Underlying business is onerous, reinsurance contract held is net cost
- Reinsurance contract held is 'plain vanilla' 90% quota share
- Locked-in interest rate for underlying contract: flat 2% throughout
- Locked-in interest rates for reinsurance contract held: flat 1% throughout
- Risk adjustment assumed to be zero

Figure 2



	1	2	3	4	5	6	7	8	9	10
Prescribed method	-48.42	-22.21	-21.50	-20.82	-20.15	-19.47	-18.74	-17.90	-16.81	-15.21
Modified method	-28.88	-24.69	-23.90	-23.14	-22.39	-21.64	-20.84	-19.92	-18.75	-17.07

The **prescribed method** is based on an application of B119D as written.

The **modified method** recalculates the underlying loss component using the locked-in yield curve for *the reinsurance contract held* before multiplying by 90% (the fixed percentage of claims that the insurer can recover from the reinsurer in this example).

4. Conclusion

It is no surprise that the proposed amendments demand careful consideration from all stakeholders as relief comes with further challenges and interpretations. Stakeholders will need to carefully consider the operational complexities of delivering this change within their design plans. As this article has attempted to demonstrate, there are several aspects that need to be considered for a deceptively simple amendment of its kind. There are deep interpretative issues that the industry will need to reach a consensus on and several areas where further work remains to be done. Technical accuracy comes at the price of operational complexity and stakeholders need to think carefully on whether the proposed amendment is the optimum compromise. It is not known where the matter will eventually settle but it is vital that concerned stakeholders respond to the IASB before the 25th of September to share their views.

5. Narrow definition of ‘proportionate’ reinsurance coverage

The definition proposed by the Exposure Draft of a ‘reinsurance contract held that provides proportionate coverage’ is:

“A reinsurance contract held that provides an entity with the right to recover from the issuer a percentage of all claims incurred on groups of underlying insurance contracts. The percentage the entity has a right to recover is fixed for all contracts in a single group of underlying insurance contracts, but can vary between groups of underlying insurance contracts.”

This definition means that only plain-vanilla quota shares will qualify for relief under the proposed amendment. In practice, most quota share arrangements tend to have some sort of retention and upper limits in place; these will not qualify for relief.

Non-proportionate coverages will not fit the definition outright even if, theoretically, retention limits are low enough such that the arrangement functions as a proportionate arrangement.

6. Relevant paragraphs from Amendments to IFRS 17

62(a)(ii)
Instead of applying paragraph 25, an entity shall recognize a group of reinsurance contracts held that provide proportionate coverage: if the entity recognises an onerous group of underlying contracts before the beginning of the coverage period of the group of reinsurance contracts held – at the same time as the onerous group of underlying contracts.

66A
An entity shall adjust the contractual service margin of a group of reinsurance contracts held that provides proportionate coverage and as a result recognise income when the entity recognises a loss on initial recognition of an onerous group of underlying insurance contracts or on addition of onerous underlying insurance contracts to that group. The amount of the adjustment and resulting income is determined applying paragraph B119D.

66B
An entity shall establish (or adjust) a loss-recovery component of the asset for remaining coverage for a group of reinsurance contracts held depicting the recovery of losses recognised applying paragraph 66A (see paragraphs B119E–B119F).

86 (extract)
An entity may present the income or expenses from a group of reinsurance contracts held (see paragraphs 60–70A70), other than insurance finance income or expenses, as a single amount; or the entity may present separately the amounts recovered from the reinsurer and an allocation of the premiums paid that together give a net amount equal to that single amount…[contd.]

B119D
An entity shall determine the adjustment to the contractual service margin and the resulting income recognised applying paragraph 66A by multiplying:

(a) the loss recognised on the group of underlying insurance contracts; and

(b) the fixed percentage of claims on the group of underlying insurance contracts the entity has a right to recover from the group of reinsurance contracts held.

B119E
Applying paragraph 66B, an entity shall establish (or adjust) a loss-recovery component of the asset for remaining coverage for a group of reinsurance contracts held. The loss-recovery component determines the amounts that are presented in profit or loss as reversals of recoveries of losses from reinsurance contracts held and are consequently excluded from the allocation of premiums paid to the reinsurer.

B119F
After an entity has established a loss-recovery component applying paragraph 66B it shall:

(a) adjust the loss-recovery component to reflect changes in the loss component for the group of underlying insurance contracts recognised applying paragraphs 50(a) and 51–52; and

(b) allocate subsequent changes in fulfilment cash flows described in paragraph 66(c)(ii), which arise from onerous groups of underlying insurance contracts, to that loss-recovery component until it is reduced to zero.

BC74
The Board decided that it does not need to propose additional disclosures as a result of the proposed amendment in paragraph 66A of the Exposure Draft. The Board noted that the requirement in paragraph 98 of IFRS 17 that an entity adapt the disclosure requirements for insurance contracts issued to reflect the features of reinsurance contracts held would be sufficient. Applying the proposed amendment, the recovery of a loss on a reinsurance contract held would be treated similarly to the loss component on insurance contracts issued.

BC79
With respect to paragraph BC78(a), the Board observed that for all reinsurance contracts held there is a link between the expected recoveries and the loss recognised on underlying onerous contracts: they both depend on expected claims. The Board concluded that a reasonable practical assumption would be that the loss on underlying insurance contracts issued is caused by claims cash flows, rather than by any other fulfilment cash flows included in the measurement of

the contracts (to the extent that the loss does not exceed the claims cash flows included in the measurement of the contracts).

BC83
Consequently, the proposed amendment results in the pattern of recognition of recoveries differing from the pattern of recognition of the cost of recoveries. An entity will recognise in profit or loss the recovery of a loss (that is, the expected reinsurance claims) immediately and the cost of recovering that loss (that is, the reinsurance premiums) as reinsurance services are received. This, in itself, could be regarded as an accounting mismatch. Essentially, an entity will recognise a benefit immediately and a larger cost over the service period.

BC85
To apply paragraph 66A of the Exposure Draft, the reinsurance contract held must be recognised before or at the same time that the loss is recognised on the onerous group of underlying insurance contracts. The Board concluded that such a condition was necessary to ensure that the recovery of losses are recognised at the same time as the losses.

[END]