

IFRS 17 – impact on reinsurance

This article from the IFRS 17: Transversal working party introduces some key issues (re)insurers may face when implementing IFRS 17 for business affected by reinsurance. The working party intends to explore some of these issues more deeply over the coming months and would be happy to receive feedback from members on topics of particular interest.

Requirements of the standard

The IFRS 17 standard has been written primarily from the perspective of a direct writer of insurance business. This perspective introduces significant interpretation, technical and practical challenges when considering reinsurance, both in terms of reinsurance held and reinsurance issued.

Furthermore, the specific rules under IFRS 17 which do relate to reinsurance may result in inconsistencies between the direct business and associated reinsurance held.

These key issues are discussed in more detail below:

Contracts for reinsurance issued

One of the fundamental concepts of IFRS 17 is that of the "contract". In the context of reinsurance issued, the "contract" could be viewed as the underlying policyholder contract (i.e. the arrangements and obligations between the individual policyholder and the direct insurance company) or the reinsurance treaty (i.e. the arrangements and obligations between the direct insurance company and the reinsurance company). Depending on how issuers of reinsurance interpret this area, related policies will be affected. Similarly, any considerations at the treaty level will mean companies need to estimate future new business volumes covered by treaty, which would be a new requirement. This also introduces a mismatch between the measurement of direct insurance (containing only in-force businesses) and the corresponding reinsurance held (also containing future business not yet written).

It is common practice for reinsurance treaties to have terms which allow either party to close the treaty to new business by giving 90 days' notice. This right to close the treaty to new business creates a theoretical contract boundary 90 days after every financial reporting date. In turn this raises the question of how to account, at a given reporting date, for the next 90 days' new business when neither party has exercised its right to close the treaty to new business. One option is to interpret every 90-day period as a new contract, which can thus be grouped into annual cohorts. However, such an approach forces a move to policy rather than treaty issue date based cohorts.

Unit of account for reinsurance issued

Under IFRS 17, the unit of account is the contract "group", and is defined by considering:

1. "Portfolios", meaning contracts that are subject to similar risks and managed together;
2. "Onerousness", where portfolios are grouped depending on being either i) onerous (or loss making) at initial recognition, ii) at initial recognition have no significant possibility of becoming onerous or iii) remaining portfolios; and
3. "Annual cohorts", where contracts in a group must be no more than a year apart.

In the context of reinsurance issued, this can introduce the apparent anomaly of grouping risks which are not managed together (for instance, a reinsurance contract may cover both life and health protection business which are managed separately, but which could be grouped together in the same portfolio). Furthermore, the notion of annual cohorts may have implications for the commercial practice of the reinsurance model, in order to avoid unsustainable data requirements.

An example of this could be moving to the practice of renegotiating reinsurance treaties on a calendar year basis.

Cash flow asymmetries for reinsurance held

The separate valuation of direct and ceded business may lead to asymmetries between the two cash flows which do not exist today. For example, the discount rate to use for the Best Estimate Liabilities could be assessed separately and the risk adjustment could be calculated separately. Furthermore, the Variable Fee Approach, whilst permissible on certain gross business, is not allowed for the associated reinsurance held.

Contractual Service Margin (“CSM”) for reinsurance held

The CSM exists for both direct and ceded business, however there could be some difference in how they are valued. For direct business, the CSM can only be positive (loss making direct contracts do not have a CSM, with the loss being recognised in the income statement at contract inception). For reinsurance contracts held, the CSM can be either positive (i.e. the reinsurance contract held is at a net gain for the insurer) or negative (i.e. a net loss reinsurance). Whilst the June 2019 IASB Exposure Draft seeks to address this inconsistency for proportional reinsurance held, it remains an area of challenge and discussion.

The calculation of the CSM is further complicated when mapping the result between the gross and the ceded business with “one:one”, “one:many”, “many:one” etc. options available. Finally, the rate at which the CSM accretes interest may also be determined separately.

Other considerations

For many UK insurers, whilst granular data and appropriate methodologies are used to value the direct business, typically approximations are made to produce the reinsurance held results. This simplified approach will not be acceptable under IFRS 17. Where the reinsurance result could previously be simplified to be Gross result minus Net result, this will no longer be the case. Subsequently, we expect operational challenges in valuing and reporting reinsurance contracts held.

The considerations listed herein will equally apply to intragroup reinsurance. Hence circumstances may arise where there is no issue for Group level reporting, but complications at the sub-entity level.

Finally, from the perspective of the direct writer, it is a common requirement to hold capital against the risk of a reinsurer default. The calculation of the capital required will vary by local statutory jurisdictions and may well be influenced by the accounting value placed on the reinsurance asset. Hence the changes introduced by IFRS 17 may well impact statutory as well as economic valuations.

Summary

Given the complexities of the standard, there will be significant technical and operational implications for firms reporting IFRS 17 and affected by reinsurance. More generally, there remains a great deal of uncertainty on the economic value of reinsurance within the IFRS 17 accounting framework.

Further articles from the IFRS 17: Transversal Working Party will discuss these and other with-profits issues further, see <https://www.actuaries.org.uk/practice-areas/life/research-working-parties/ifrs-17-transversal> for details.