Dive into the detail

The measurement of reinsurance contracts under IFRS 17 can be complex, but an initial assessment can put the task into perspective.

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After almost 20 years in the making, IFRS 17 *Insurance Contracts* was published in May 2017. The new standard introduces a prescribed valuation basis for liabilities for the first time. IFRS 17 does not only affect the liability measurement and financial reporting and disclosures of an insurer only; this new standard also has a significant impact on data and systems and processes, therefore requiring greater levels of system complexity and a greater level of interaction between the actuarial function and others within the organisation. Significant effort is required in getting an entity to full compliance. This is compounded by a challenging deadline of 1 January 2021 for insurers with a full set of comparatives as at 31 December 2020 also required.

One of the key considerations for insurers as they navigate the requirements of the new standard is the treatment of reinsurance under IFRS 17. In this article, we consider the key differences between the treatment of direct business and reinsurance business under IFRS 17, and highlight some of the challenges faced by insurers in modelling reinsurance contracts under the new standard.

Inwards vs outwards reinsurance

A reinsurance contract under IFRS 17 is defined as an insurance contract issued by one entity (the reinsurer) to compensate another entity for claims arising from one or more insurance contracts issued by that other entity (underlying contracts).

There is a difference between the treatment of inwards and outwards reinsurance under IFRS 17. Inwards reinsurance, or insurance from the point of view of the company receiving the premium to assume the risk, is treated in the same way as the direct insurance contracts. However, there are a number of differences from the base requirements when measuring the contract liabilities for outwards reinsurance, i.e. insurance from the point of view of the company paying the premiums to cede the risk. Refer to Table 1 for more information.

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Measurement model

The three measurement models available to measure insurance contracts are the Building Block Approach, which is the base model under IFRS 17, and two variations of the Building Block Approach – the Premium Allocation Approach and the Variable Fee Approach.

As a reminder, the Building Block Approach is a measurement approach based on a number of building blocks:

- Present value of future cash flows;
- An adjustment to reflect the time value of money and the financial risks related to the future cash flows;
- A risk adjustment to reflect the non-financial risks; and
- A Contractual Service Margin, which is a mechanism by which profit is recognised over the coverage period.

A reinsurance contract issued or held cannot be a direct participating contract. The variable fee approach therefore cannot be applied to reinsurance contracts, as illustrated in Table 1. It is, however, possible to use the Premium Allocation Approach to measure the liabilities for reinsurance contracts. The assessment of eligibility for the Premium Allocation Approach is carried out separately from the underlying insurance contract, in line with the overall requirements of accounting for the reinsurance contracts separately from the underlying insurance contracts. Eligibility for the Premium Allocation Approach will depend on whether the contract is on a 'losses occurring' or a 'risks attaching' basis. For single year losses occurring contracts, it is straightforward to prove that the coverage period is less than a year; the same cannot be said for risks attaching contracts. For risks attaching contracts, an entity will have to look to the underlying contracts to determine whether there are any multi-year contracts present. If this is the case, the contract will not be automatically eligible for the Premium Allocation Approach.

An entity may therefore end up in a scenario whereby the Premium Allocation Approach is used for the underlying insurance contract but the reinsurance contract is measured using the Building Block Approach (for example, a short-term insurance contract with a risks attaching reinsurance contract that covers multiple years).

In the sections that follow, we will look at the adjustments made to elements of the Building Block Approach for measuring reinsurance contracts under IFRS 17.

Table 1

Inwards reinsurance contracts	Outwards reinsurance contracts
Measurement	
• Two potential measurement models: Building Block Approach or Premium Allocated Approach	• Two potential measurement models: Building Block Approach or Premium Allocated Approach • Measured separately to underlying insurance contracts
Cash flows	
• Explicit, unbiased and probability weighted estimate of fulfilment cash flows	• Use assumptions consistent with underlying contracts • Cash flows adjusted to reflect credit risk of reinsurer
Contractual service margin	
• Contractual Service Margin can only be positive at initial recognition • Contracts aggregated into profitable, onerous or no significant possibility of becoming onerous	• Contractual Service Margin can be positive or negative at initial recognition • Contracts aggregated according to whether they produce a net cost or gain on initial recognition

Risk adjustment

There is a distinct difference between the risk adjustment for insurance contracts and the risk adjustment for outwards reinsurance contracts. The risk adjustment for the underlying insurance contract reflects the uncertainty around the amount and timing of future cash flows. In contrast, the risk adjustment for the outwards reinsurance contract should represent the amount of risk being transferred by the holder of the group of reinsurance contracts to the issuer of those contracts.

When considering the modelling techniques and data available, it may be easier to assess the risk associated with the insurance contracts gross and net of reinsurance, and use that information to calculate the transfer of risk under the outwards reinsurance contracts, rather than trying to directly determine the risk adjustment associated with the outwards reinsurance contracts. Using a net approach to indirectly determine the risk adjustment associated with the outwards reinsurance contracts is consistent with the requirements of IFRS 17.

Contractual Service Margin calculation

Can an outwards reinsurance contract have a Contractual Service Margin? The answer is yes if the contract is measured under the Building Block Approach. However, the Contractual Service Margin calculation is modified slightly to allow for the fact that, for a group of outwards reinsurance contracts, there is no unearned profit on initial recognition, but instead, a net cost or net gain on initial recognition. A net cost arises when the expected cash outflows exceed expected cash inflows, and the reinsurance contract produces a net gain when the expected cash inflows exceed the expected cash outflows. Therefore, in contrast to the underlying insurance contracts where the Contractual Service Margin must be positive, the reinsurance Contractual Service Margin can either be negative or positive at inception, but is still equal and opposite to the sum of the fulfilment cash flows and the risk adjustment.

As a result, the concept of an "onerous" outwards reinsurance contract does not exist. The rationale being that the net cost of reinsurance is an expense that should be spread over the coverage period. Outwards reinsurance contracts are therefore aggregated according to whether they produce a net cost or net gain on inception, rather than whether they are profitable or onerous.

Recognition criteria

One of the key differences in the treatment of outwards reinsurance contracts relates to the point at which an outwards reinsurance contract is recognised. For proportional reinsurance, a contract is recognised at the later of:

- The beginning of a coverage period of group of reinsurance contracts; or
- Initial recognition of underlying contracts.

For all other types of reinsurance (excess of loss, stop loss etc.), a contract is recognised at the beginning of the coverage period of the group of underlying contracts.

The difference in recognition criteria between the outwards reinsurance contract and the underlying insurance contract may lead to asymmetry between the two in terms of how they are accounted for in the financial statements.

For example, consider an outwards non-proportional reinsurance contract with the coverage period beginning on 1 January, the same point at which the coverage of the underlying insurance contract begins. The reinsurance contract would therefore be recognised on 1 January. However, the first payment on the underlying insurance contract is due on 1 December, which means the underlying insurance contract will be recognised on 1 December. There will therefore be a mismatch of one month between the recognition of the reinsurance contract and the underlying insurance contract.

Interaction with underlying insurance contracts

Under IFRS 17, reinsurance cash flows must be presented separate to gross cash flows as the netting of cash flows is not permitted under the new standard. This will be a significant change for general insurers in particular as previously, reinsurance amounts were often approximated through the use of ratios. Under IFRS 17, insurers will now have to calculate discounted cash flows (allowing for the risk of non-performance of the reinsurer), risk adjustment (reflecting the risk transferred from underlying insurance contracts rather than the variability of the reinsurance cash flows) and a Contractual Service Margin for their outwards reinsurance contracts.

This separation of the reinsurance contract from the underlying insurance contract means that, in the case of an insurance contract that is onerous at inception on a gross basis, this insurance contract would still be considered onerous, and accounted for as such, even where reinsurance contracts are in place that cede 100% of this risk to another party on an original terms co-insurance basis. However, although the reinsurance assets are presented separately from the gross insurance contract liabilities, the assessment of the fulfilment cash flows is clearly linked through the requirement for consistent assumptions between the reinsurance contract and the underlying insurance contract.

Retrospective reinsurance

Some reinsurers write reinsurance covering events that have already occurred, but for which the effect is still uncertain – adverse development cover for incurred claims, for example. When recognising these contracts at inception, the cost relating to the retrospective component is immediately recognised as a loss in the profit and loss account.

Other considerations

Data issues are frequently more prevalent for reinsurance business. In the case of outwards reinsurance contracts, the entity has to rely on the reinsurer for information on recoveries or commission, for example, and there is often a delay in the delivery of this data. Similarly, for inwards reinsurance contracts, the entity is further removed from the underlying risks and is reliant on the ceding company for data on the underlying insured risks. This means that there is frequently more use of approximations, both in terms of the data and modelling approach, which may be an issue in meeting the requirements under the new standard.

If the reinsurance contracts contain options and guarantees, then these may need to be explicitly modelled. Options may include choosing which underlying contracts or loss events attach to the reinsurance cover available, while guarantees may include links to indices. Entities will also need to consider reinsurance-specific items such as reinstatements or funds withheld arrangements. There is a wide range of complex reinsurance structures and entities will need to carefully consider how these are to be modelled under IFRS 17.

Conclusion

It is clear that the requirements introduced by IFRS 17 will bring significant change to the way in which insurers and reinsurers will model and account for reinsurance contracts; data will be required at a greater level of granularity and reinsurance cash flows, risk adjustment and contractual service margin will need to be modelled separately from the underlying insurance contracts.

An initial assessment of both the financial and business impacts of IFRS 17 is a good first step for insurers in identifying areas of focus to ensure compliance with the new regulation.

Remember, reinsurance is just one element of the considerations insurers need to assess under IFRS 17. Significant change is ahead and insurers need to start putting the wheels in motion now to meet the challenges the new standard is sure to bring.

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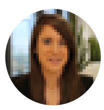

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