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Complexity Abounds for Reinsurers Adopting IFRS 17 Insurance Contracts

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Despite the changes proposed to the IFRS 17 accounting standard (originally issued in May 2017), reinsurers continue to feel disadvantaged by some of its aspects. There has been lots of press coverage highlighting the issues for reinsurance from a direct writer's perspective ("reinsurance held"), so this article intends to focus on the issues from a reinsurer's perspective ("reinsurance assumed").

As we know, the insurance industry is plagued with complex processes, legacy systems and—more often than not—limitations in data. These issues are pronounced for reinsurers, particularly the lack of data given that they receive data from the direct writers. This complicates the implementation of a standard that already requires a significant volume of data to produce the balance sheet, income statement and corresponding disclosures. While many of the standard's requirements should work for reinsurers, inherent complexities of how business works make implementation of the standard a challenging task.

Typically reinsurers suffer from both a lack of data and delays in receiving those data.

- **Lack of data.** It is common for reinsurers to have an incomplete picture of all the data attributes associated with the underlying policies originally written by the direct insurer, particularly where seriatim data are not available. Such attributes can include, but are not limited to, sum assured and underwriting year for the inception of the underlying policy. Reinsurers currently use a range of techniques to derive these data points, when required, for current IFRS, capital and internal reporting purposes. For example, for risk premium business, reinsurers use risk premium rates to derive the sum assured. The standard is principles based and does not prescribe whether such techniques are appropriate for IFRS 17 purposes; therefore, leveraging existing techniques makes a lot of sense. Firms will need to explore the financial impact of such techniques as well as the impact on the financial reporting process, assuming such work is performed by separate teams and/or out of cycle.

- **Delays in receiving data.** The standard points to calculations at the time of the insurance contract being sold, particularly to support requirements such as the onerous contracts test. This introduces added complexity for reinsurers as they have to estimate anticipated volumes expected to attach within the contract boundary. While this may

already be done for pricing purposes, the process will need to be robust for financial reporting as expected profitability on new contracts is likely to be an area of interest both internally (to management) and externally (to shareholders, analysts and other interested parties).

This extends to valuation at subsequent reporting dates, where reinsurers continue to work with delays in receiving information. Delays in receiving the cedant's statement of accounts necessitates more estimation techniques, adding further complexity to the calculation of the insurance asset or liability. While there is always a degree of estimation in today's world, the granularity at which this calculation will need to be performed will probably be more detailed than firms have been used to in the past. This, coupled with the standard pointing to the use of actual cash flows, adds further practical difficulty and strain to a firm's architecture and reporting processes. As a result, we understand firms are exploring simplification, for example, using the cedant's statement of accounts as a proxy for cash, introducing further judgment.

The inherent complexities faced by reinsurers has resulted in much lobbying by the industry by both reinsurers and direct insurers. Although some in the industry have flagged a number of requirements that they consider should be re-examined, we see the focus being on three particular requirements:

- **Annual cohorts.** The standard requires an entity to separate contracts issued more than one year apart into separate groups. While the treaty is the "contract" for reinsurers, and therefore the annual cohort should be set according to the year of the treaty's inception, there remains some degree of ambiguity in how to apply this requirement to treaties that are open-ended. Long-term treaties can remain open to new business for more than one accounting year, which means the underlying policies can attach over a number of accounting years. Interpreting this requirement using the underwriting year of the treaty means the policies would be written into one annual cohort, even if they have attached over more than one accounting year. Some argue that this contravenes the standard since the annual cohorts contain policies that have been issued and attached over more than one year.

  An alternative approach is to split the treaty into annual cohorts based on the underwriting year of the underlying policies. This approach can add a significant amount of complexity to the modeling process for reinsurers, particularly when they don't typically have this data. This also introduces complications for features such as profit commissions that can also span multiple accounting years. In this case, firms have to align the underlying policies to their respective annual cohort as well as the profit commission cash flows.

  While the challenges in applying the annual cohorts requirement differs slightly depending on whether you are an insurer or a reinsurer, as well as the measurement model used (general measurement model or the variable fee approach), many in the industry have been challenging the relevance and usefulness of annual cohorts, arguing that the operational complexities of complying with the requirements outweigh the benefits. This is compounded for those who argue that this is not aligned to the way they manage their business. Up to now, there has been a strong push from insurers writing participating business eligible for the variable fee approach to remove the annual cohorts requirement when there is mutualization across generations. Reinsurers appear to have been less vocal, although one may argue that there are some parallels between long-term treaties open to new business, particularly when there is profit sharing spanning more than one accounting year and participating contracts where profit sharing spans multiple generations.

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- **Contract boundaries.** In September 2018, the Transition Resource Group (TRG), a forum set up by the International Accounting Standards Board (IASB) to debate implementation of the standard, discussed how cash flows outside the boundary of the contract relate to future contracts. Practically speaking, this means that for a treaty with a 90-day termination clause, a reinsurer would set up four contracts, assuming a January 1 inception date, which many argue is operationally burdensome and not in line with how reinsurers manage their business. More fundamentally, for long-term treaties open to new business that span one or more accounting years, to apply this requirement as described and meet the grouping requirements by separating contracts issued more than one year apart, a reinsurer would need to know the underwriting year of the underlying policies. As explained earlier, reinsurers do not necessarily have this information, so complying with this requirement may be challenging.

  Furthermore, a reinsurance treaty differs from an insurance contract in that if no notice has been served by either party, the reinsurer is obliged to accept policies up to the next termination date. By splitting into four quarterly contracts and recognizing at the beginning of each quarter, one does not recognize the reinsurance contract asset/liability that covers the policies expected to attach up to the next termination date. Some argue that this is out of line with more fundamental accounting principles as well as undervaluing (for profitable business) the contractual service margin at any given valuation date where notice has not been served.

- **Profit commissions.** The reclarification of the definition of an investment component by the TRG and the IFRS 17 Exposure Draft issued in June 2019 has received a mixed response. The difficulty in implementing this requirement should not be understated. A topical area is in relation to profit commissions. The recent clarification points to a profit commission being a non-distinct investment component (NDIC) when considering the interplay with claims—that is, in any scenario, there is always a minimum amount that is repaid back to the policyholder (in this case, the cedant). While the concept of removing an NDIC from insurance revenue is understandable and works for contracts where a minimum amount is always paid to the policyholder (such as a deposit), many question why profit commissions fall into this category. Reinsurers often use profit commissions as a mechanism for sharing experience, both positive and negative. These mechanisms are particularly useful when there is a lack of experience that serves to prevent one party benefiting excessively at the cost of the other party. Some argue that if the experience were known, this would equate to a corresponding increase (or decrease) in premiums more akin to a premium refund.

  Many continue to argue that treating profit commissions as NDICs provides little benefit to the users of the financial statements. Further, there is a concern in determining the minimum amount that is payable in all scenarios. When the NDIC is a deposit or lump sum, determining the minimum amount is fairly straightforward; however, when the minimum amount can represent a combination of profit commission and claims, establishing the minimum amount becomes inherently more complex. The need for stochastic modeling becomes an increasing possibility, which may require a sizable investment for organizations that do not have stochastic capability.

With these points in mind, it is difficult not to be sympathetic to the industry. That said, it is evident the standard setters have taken steps to alleviate some of the concerns raised, even though some may think more is required. With the go-live date for IFRS 17 fast approaching, our advice is for firms to continue to work through the requirements of the standard, considering both the operational and financial implications, rather than expecting further material changes to those requirements. If they are not already doing so, reinsurers should engage with their cedants to work through the data required and, where applicable, develop sensible techniques to derive the attributes required, leveraging work that is done for current reporting, whether it is for capital or internal purposes.

Reinsurance is a complex area of the standard. The cliché that the devil is in the details seems to ring true here. With many ways of interpreting the requirements, particularly for reinsurance, it will be interesting to see where the industry eventually lands and the extent of convergence between firms. ■

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