Article from

Reinsurance News

July 2018

Issue 91

IFRS 17: Implications for Reinsurance Contracts Held

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Editor's note: The references marked by [ ] represent the text or extraction from the IFRS 17 Standard and Basis for Conclusions.

After a very long journey, the International Accounting Standards Board (IASB) issued IFRS 17 "Insurance Contracts" (IFRS 17).[1] IFRS 17 replaces IFRS 4 that was issued in 2004. The overall objective is to provide a more useful and consistent accounting model for insurance contracts among entities issuing insurance contracts globally.

UNDERLYING INSURANCE CONTRACTS AND REINSURANCE CONTRACTS HELD

An entity shall also apply IFRS 17 to reinsurance contracts it holds (i.e., as cedant). All references in IFRS 17 to "insurance contracts" also apply to "reinsurance contracts held," except for references to "insurance contracts issued" and some specific modifications related to recognition and measurement (as noted in paragraph 60 to 70). In order to give a faithful representation of the entity's rights and obligations and the related income and expenses from both underlying insurance contracts and related reinsurance contracts held, IFRS 17 requires a reinsurance contract held to be accounted for separately from the underlying insurance contract to which it relates. This is because an entity that holds a reinsurance contract does not normally have a right to reduce the amounts it owes to the underlying policyholder by amounts it expects to receive from the reinsurer.

This article summarizes the main IFRS 17 requirements of the accounting for reinsurance contracts held, focusing on how these differ with the requirements for the underlying direct insurance contracts.

HOW DOES IFRS 17 APPLY TO REINSURANCE CONTRACTS HELD

(1) What are the level of aggregation requirements for reinsurance contracts held?

The same grouping requirements apply for the reinsurance contracts held, except the onerous contract grouping requirements. IFRS 17 replaces the "onerous contracts" by "contracts in which there is a net gain on initial recognition." The level of aggregation is assessed with reference to reinsurance contracts held. The grouping requirements suggested in IFRS 17 may result in a group that comprises of a single contract. These can cause differences in grouping between reinsurance contracts held and the related underlying insurance contracts.

(2) Does the onerous contract testing apply to reinsurance contracts held?

Reinsurance contracts held cannot be onerous [IFRS17.68], hence the onerous contract test is not required accordingly. Instead of profitable or onerous contracts, IFRS 17 views them as the net cost or gain on purchasing the reinsurance contracts. Both positive and negative contractual service margin (CSM) are allowed for reinsurance contracts held, except if the reinsurance coverage relates to events that occurred before the purchase of the reinsurance (retroactive cover). This may cause a mismatch in profit or loss, if the underlying contracts are onerous at inception. In such cases, the loss recognized immediately from the underlying contracts is not dampened by the expected recovery from related reinsurance contracts held. Please refer to question 10 on the subsequent measurement logic.

Table 1
CSM (as reinsurance asset) at Initial Recognition for Reinsurance Contracts Held

Fulfilment cash flows are …	Cover relates to future events	Cover relates to past events
… negative (cost on purchasing reinsurance)	• Accounted for as positive CSM • CSM is amortized in P/L over coverage period	• Recognized immediately in P/L
… positive (gain on purchasing reinsurance)	• Accounted for as negative CSM • CSM is amortized in P/L over coverage period	• Accounted for as negative CSM • CSM is amortized in P/L over coverage period

(3) When shall a group of reinsurance contracts held be recognized?

[IFRS17.62] A group of reinsurance contracts held shall be recognized:

(a) If the reinsurance contracts held provide proportionate coverage—at the beginning of the coverage period of the group of reinsurance contracts held or at the initial

recognition of any underlying contract, whichever is the later; and

(b) in all other cases — from the beginning of the coverage period of the group of reinsurance contracts held.

(4) Can the VFA be applied to reinsurance contracts held?

No. Reinsurance contracts held (or issued) cannot be insurance contracts with direct participation features for the purposes of IFRS 17 [IFRS17.B109]. Hence, the VFA cannot be applied. This may result in a mismatch of the measurement model with the related underlying insurance contracts.

(5) How is the contract boundary being defined according to paragraph 34?

There have been ongoing discussions on the contract boundary definition for reinsurance contracts held, given its operational challenges and implications. According to the IASB Transition Resource Group (TRG) 2018 February meeting summary, cash flows are within reinsurance contracts held boundary if they arise from substantive rights and obligations that exist during the reporting period. This would be the case if the entity is compelled to pay amounts to the reinsurer, or if the entity has a substantive right to receive services from the reinsurer. Hence, it is possible that the contract boundary of reinsurance contracts held include cash flows from related underlying contracts that are expected to be issued by the cedant in the future. This is a change from existing practices where the cash flows of related future underlying insurance contracts are generally not required to be estimated.

(6) What assumptions should be used for measurement of reinsurance contracts held?

IFRS 17 requires the use of consistent assumptions to estimate the present value of future cash flows for both reinsurance contracts held and the related underlying insurance contracts. In addition, the entity shall reflect the effect of non-performance risk by the issuer of the reinsurance contract, including the effect of collateral and losses from disputes.

(7) Should the entity use the identical discount rate for both reinsurance contracts held and the related underlying insurance contracts?

This question was raised by the industry for the February 2018 IASB TRG discussion. The IASB staff replied that "consistent" as mentioned in question 6 above does not necessarily mean "identical." The extent of the dependency between the cash flows of the reinsurance contracts held and the related underlying insurance contracts should be evaluated.

(8) How is the change in non-performance risk of reinsurers being treated?

IFRS 17 prohibits changes in expected credit losses adjusting the contractual service margin [IFRS17.BC309]. Changes in expected credit losses are economic events that do not relate to future service. Hence the impact should be reflected as gains and losses in profit or loss when they occur.

(9) What is the risk adjustment for the reinsurance contracts held?

The risk adjustment for non-financial risks represents the risk being transferred by the holder of the reinsurance contracts held to the issuer of those contracts.

(10) How is the CSM for the reinsurance contracts held being calculated in subsequent measurement?

The CSM roll forward of the reinsurance contracts held is similar to the general model logic, but an entity should also consider its linkage with the related underlying contracts. Changes in the fulfilment cash flows that relate to future service are adjusted to reinsurance contracts CSM, unless they are stemming from changes that do not adjust the CSM of the related underlying contracts. This means that, when the underlying contracts issued becomes onerous during subsequent measurement, the expected recovery from the reinsurance contracts held can be recognized and only the net amount will impact profit or loss. This is different from the treatment of onerous contracts at initial recognition as explained in question 2.

(11) Are there any specific presentation requirements for the reinsurance contracts held?

In the statement of financial position, reinsurance contracts held and insurance contracts issued are presented separately. An entity shall also present separately the carrying amount of the reinsurance contracts held that are assets; and reinsurance contracts held that are liabilities.

In the statement of comprehensive income, an entity shall present income or expenses from the reinsurance contracts held separately from the expenses or income from insurance contracts issued. An entity may present the income of expenses from a group of reinsurance contracts held, other than insurance finance income or expenses, as a single net amount; or the entity may present separately the reinsurance recovery received and reinsurance premium paid.

(12) What are the key disclosure requirements for the reinsurance contracts held?

Separate reconciliations (of liabilities or assets) shall be disclosed for insurance contracts issued and reinsurance contracts held [IFRS17.98]. Also, the entity is required to disclose certain risks for reinsurance contracts held and insurance contracts issued separately.

CONCLUSION

IFRS 17 states that all references to insurance contracts also apply to reinsurance contracts held with some exceptions as noted in IFRS17.4. There are a number of areas where judgment will be needed and there are certain mismatches possible between the IFRS 17 treatment of the reinsurance contracts held and the related underlying insurance contracts, such as the CSM recognition at inception, contract boundaries and the applications of different measurement models.

Similar to the Solvency II experience, it is generally expected that certain market consensus will converge for these application areas. The related methodology and considerations should be properly documented and approved within the entity's governance structure, and agreed with by the entity's auditor. It is also important for individual entities to understand both the financial and operational impacts of the reinsurance contracts held at the beginning of the implementation journey.

The views reflected in this article are the views of the authors and do not necessarily reflect the views of the global EY organization or its member firms. ■

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ENDNOTE

1 Please refer to EY's "Applying IFRS 17" for an IFRS 17 overview; *http://www.ey.com/Publication/vwLUAssets/ey-Applying-IFRS-17-Guidelines/$File/ey-Applying-IFRS-17-Guidelines.pdf.*