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IFRS 17 – A New Approach to Reinsurance Contracts Held

BACKGROUND

The new accounting standard for insurance contracts (IFRS 17) aims to bring greater comparability and transparency to insurers' financial reporting. For most insurers, it involves a radical change from current reporting practices and a shift from reporting book values to an approach more based on market value. Under the current accounting standard (IFRS 4), insurers often look at their business from a net perspective, by subtracting the reinsured liability (ceded risks) from the gross liability to the policyholder and netting the financial results. IFRS 17 modifies this approach and introduces a new setting where insurers are required to account for reinsurance contracts held as standalone contracts, with specific obligations and benefits that should be assessed independently from the underlying contracts. Although this is also common practice under Solvency II, IFRS 17 poses specific requirements on accounting for reinsurance contracts. This article aims to address the potential impacts of moving from the current framework to the new accounting standard, suggesting a number of steps that, taken in a timely manner, could aid in the process of moving from today's perspective to the IFRS 17 world.

FINANCIAL IMPACTS – PROFIT AND LOSS RECOGNITION

IFRS 17 takes into account the fact that insurers cannot reduce their obligations to the policyholder as a result of the amounts to be received from the reinsurer. Consequently, underlying insurance contracts should be measured and reported separately from reinsurance contracts covering the associated risks. Insurers are compelled to perform separate cash flow projections and risk adjustment determination taking into consideration the characteristics of the different contracts, approaching insurance contracts from a gross perspective, while attempting to determine the appropriate Contractual Service Margin (CSM), the 'unearned profit' at the start of the contract. For reinsurance contracts held, insurers are obliged to determine the expected cash flows of the reinsurance contract as a whole, taking into consideration the full expected coverage of the contract, not only for the existing underlying contracts but also for any expected future business to be covered by the reinsurance contract, as well as the risk of non-performance by the reinsurer. Also, for the determination of the appropriate measurement model, IFRS 17 suggests a separate analysis to be performed for reinsurance contracts, considering the General Measurement Model (GMM) as the default model but allowing for the simplified Premium Allocation Approach (PAA) to be used for reinsurance contracts meeting specific eligibility criteria. The Variable Fee Approach, however, is excluded as an option, as reinsurance contracts are not perceived as providing investment-related services to the insurer. As a result, measurement model choice may be at the root of accounting mismatches, with different models resulting in differences in profit recognition.

As one of its main principles, IFRS 17 requires profits on direct insurance contracts to be gradually earned over the period in which the coverage is provided, by means of the CSM, whereas a loss should be recognized immediately when it is expected, so there will be no negative CSM. However, for reinsurance contracts held, IFRS 17 requires an exception. CSM can be positive or negative, in both cases being released gradually over time. The above, and in line with the initial version of IFRS 17[1], will then result in a negative impact in the profit or loss statement, as insurers are not allowed to immediately take into consideration the compensation effects provided by reinsurance contracts. To summarize, losses on underlying contracts are recognized immediately, whereas recognition of the offsetting gains on reinsurance contracts is deferred due to the gradual CSM release, causing a timing mismatch in result recognition.

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This premise is expected to be amended in the new version of the Standard[2], to allow for reinsurance contract profits to be brought forward, as an adjustment to the reinsurance CSM, resulting in the partial offset of the negative results originated by the underlying contract's loss component. The potential relief of financial impacts will nevertheless depend on the complexity of the methodology used for calculation of this adjustment.

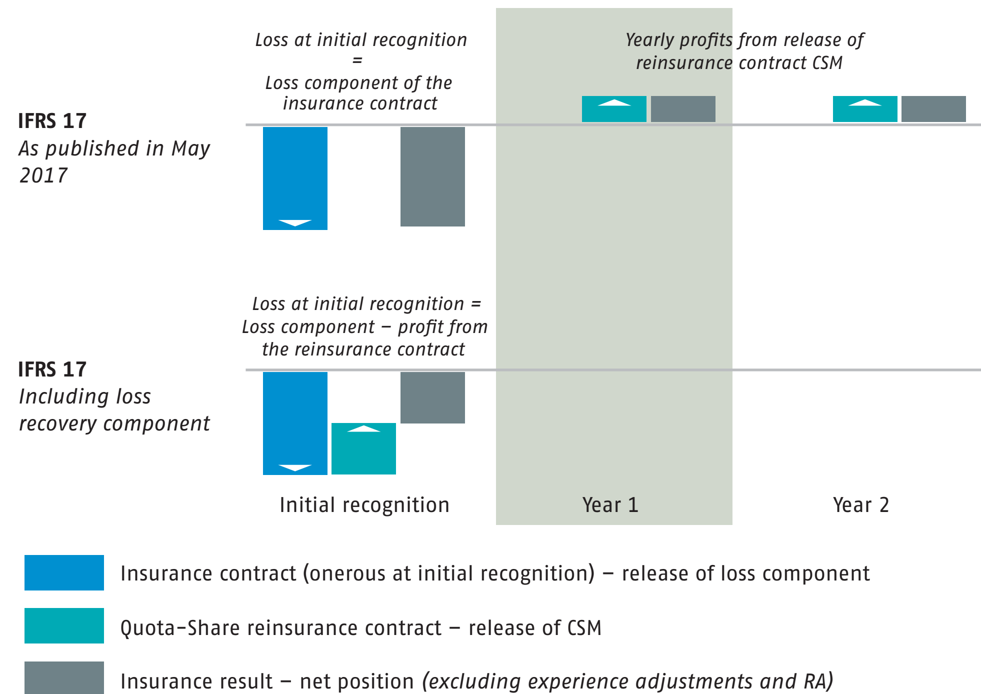

Figure 1 – Loss Recovery Component as a way to reduce accounting mismatch for losses at initial recognition on underlying insurance contracts

Note that this potential relief is only applicable for losses identified at initial recognition of the insurance contract and not for losses occurring during subsequent reporting periods.

FINANCIAL IMPACTS – ASSUMPTIONS

IFRS 17 requires insurers to use consistent assumptions in modelling of reinsurance contracts held and underlying insurance contracts. An exception to this rule is the topic of expenses, for which a separate analysis should be performed to identify expenses considered to be attributable to reinsurance contracts, which should be classified and treated as a liability. In addition, IFRS 17 requires the determination of a risk adjustment for non-financial risk for reinsurance contracts held, unlike Solvency II that uses risk margin on a net basis. The defined methodology may result in a higher or lower IFRS 17 risk adjustment, with direct impact on CSM at inception.

FINANCIAL IMPACTS – CONTRACT BOUNDARY

Also, contract boundaries of reinsurance contracts and the underlying business should be determined separately. This will potentially result in differences in terms of the profit recognition pattern between the two, as well as dissimilarities between expected claims amounts within the coverage period of underlying insurance contracts and compensation expected to arise from reinsurance, which may not be within the coverage period of the reinsurance contracts held or, in the opposing situation, may cover risks that are not yet part of the portfolio.

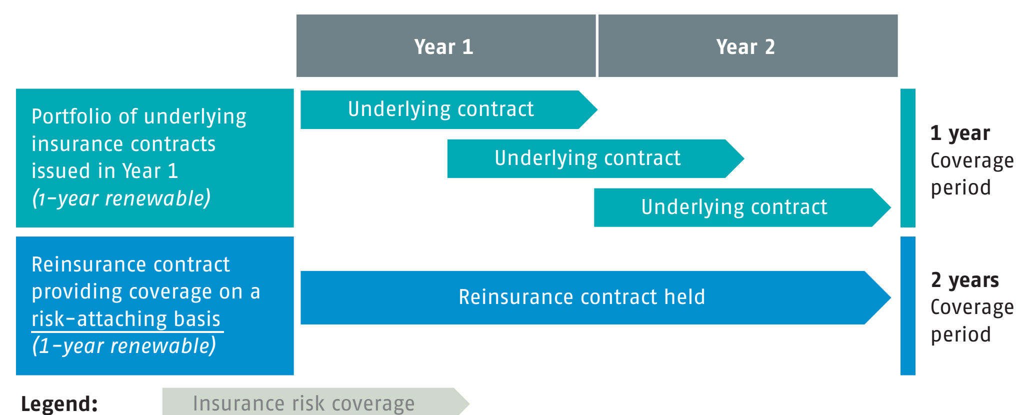

Figure 2 – Possible differences in contract boundaries under IFRS 17

Due to the differences in the coverage period in the underlying contracts and the reinsurance contracts held, accounting differences can't be avoided entirely.

OPERATIONAL IMPACTS

IFRS 17 will have impact on the way insurers model and account for reinsurance contracts held. It requires a projection of all expected cash flows within the boundary of the contract, including those associated with future underlying business, which is a new concept, not known under Solvency II. Further, IFRS 17 introduces the requirement to track differences between expected cash flows in the period and actual cash flows, to be featured as part of the financial statements exercise.

Due to differences in coverage periods between the reinsurance contracts and the underlying contracts, the risk adjustment can't be calculated as a difference between the risk adjustment on a gross basis and on a net basis, as could be expected for proportional reinsurance contracts. A separate calculation using the reinsurance coverage period is necessary. For excess of loss contracts, a separate model is required for the calculation of the risk adjustment.

Also, for the release of the CSM, additional investigation is necessary for the definition of the appropriate coverage units to be applied to the group of reinsurance contracts, with the need to create the necessary mechanisms for tracking and release either through developments in current, often very simple, models or by investing in new systems already prepared for the complexity of the new accounting standard.

All of these will generate complexity as a result of the need to significantly strengthen current models, ensure that all necessary data is available, that systems are ready and that processes are set-up, including the necessary control frameworks, to respond to the redesigned actuarial and accounting setting for reinsurance contracts.

NEED FOR ACTION

With the transition date approaching, insurers should address the issues raised throughout this article, aiming to minimize impacts and allow for a smooth transition into the new accounting framework. This could be achieved by taking a series of steps towards the application of the standard to reinsurance:

- Analyze the current reinsurance contracts held from an IFRS 17 perspective, getting a better understanding on features and financial effects under IFRS 17;
- Contemplate potential quick-wins in reinsurance negotiation to simplify measurement or guarantee a fair evaluation of the associated benefits;
- Consider and discuss the need to purchase new systems / evolve current systems to support modelling and postings in line with the new standard;
- Assess overall impacts on current data and processes in place for reinsurance contracts held.

SUMMARY

In this article we discuss a series of financial and operating impacts arising from the requirements IFRS 17 poses on reinsurance contracts held. Some of them are unavoidable, and some represent situations for which, if sufficient preparation is in place, effects can be reduced. Although there is a lot to do, entities still have time to act, and should take this time to investigate their own reinsurance portfolios and start working on their individual approach to the treatment or reinsurance contracts under the new accounting framework. ■

1 – Published in May 2017

2 – Expected in June 2020

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