This paper has been prepared by the EFRAG Secretariat for discussion at a public meeting of EFRAG TEG. The paper forms part of an early stage of the development of a potential EFRAG position. Consequently, the paper does not represent the official views of EFRAG or any individual member of the EFRAG Board or EFRAG TEG. The paper is made available to enable the public to follow the discussions in the meeting. Tentative decisions are made in public and reported in the EFRAG Update. EFRAG positions, as approved by the EFRAG Board, are published as comment letters, discussion or position papers, or in any other form considered appropriate in the circumstances.

Reinsurance under IFRS 17 *Insurance Contracts* Issues Paper

Objective and Introduction

1 The objective of this session is to provide EFRAG TEG with an overview of the EFRAG Secretariat's understanding of the issues raised by EFRAG IAWG members in relation to reinsurance. This overview benefits from the information gathered on the current treatment of reinsurance contracts through responses to the EFRAG IAWG Questionnaire.

2 The outcome of the EFRAG TEG discussion is aimed at updating Appendix II of the endorsement advice of IFRS 17 *Insurance Contracts* relating to reinsurance.

Definition of an accounting mismatch

3 There are concerns that the treatment of reinsurance contracts (mostly with respect to reinsurance contracts held) create accounting mismatches. IFRS 4 *Insurance contracts*, paragraph BC172 describes accounting and economic mismatches as follows:

(a) "accounting mismatch arises if changes in economic conditions affect assets and liabilities to the same extent, but the carrying amounts of those assets and liabilities do not respond equally to those economic changes. Specifically, accounting mismatch occurs if an entity uses different measurement bases for assets and liabilities.

(b) economic mismatch arises if the values of, or cash flows from, assets and liabilities respond differently to changes in economic conditions. It is worth noting that economic mismatch is not necessarily eliminated by an asset-liability management programme that involves investing in assets to provide the optimal risk-return trade-off for the package of assets and liabilities."

Reinsurance contracts as a specific form of insurance

4 As reinsurance can be regarded as insurance for insurers, it means that both insurance and reinsurance contracts are designed to achieve the same basic objective: a transfer of insurance risk in return for a premium.

5 The EFRAG Secretariat acknowledges the dependence and similarities between a reinsurance contract and the underlying insurance contract(s). However, the EFRAG Secretariat is *generally* of the view that they are economically different contracts, which can be demonstrated by way of the following:

(a) Reinsurance contracts are bespoke contracts, where insurance contracts are more standardised;

(b) Reinsurance contracts are written on a treaty basis (covering all business written by the cedant which falls within the specific terms of the contract, i.e. the treaty), where insurance contracts relate to coverage of a single risk or a package of risks;

(c) Reinsurance business may be more volatile than insurance business;

(d) The pricing mechanisms in reinsurance are often adjustable, for insurance this happens to a lesser extent;

(e) Reinsurance business is diversified globally, both geographically and by risk-type, while insurance tends to be more local in nature; and

(f) Reinsurance is characterised by time delays in the receipt of information about contracts entered into, claims reporting and cash flows.

6 Based on answers received to the EFRAG IAWG questionnaire, this overall view requires nuance in particular cases as described as from paragraph 15 below.

Proportional vs non-proportional treaties

7 Proportional reinsurance means that the insurer and reinsurer share liabilities (i.e. sums insured) in a clearly defined proportion as described within the underlying treaty. Premiums and claims are also split up according to the respective share of the risk (i.e. proportionally).

8 Proportional reinsurance normally involves the transfer of the original insurance risk and a significant financing element, relieving the solvency and cash flow strains associated with the acquisition of new business by the primary insurer. Proportional business often includes a significant profit share element.

9 Non-proportional reinsurance is also known as excess of loss reinsurance. In this case, losses above a specified retention limit are paid by the reinsurer, subject to a maximum. Contracts may be continuous or for a specific term.

10 Non-proportional contracts are related mostly to coverage of low probability insured events with high sums assured.

11 For both types of reinsurance, amounts not reinsured (either outside the proportion reinsured for proportional reinsurance or below the retention limit or above the maximum for non-proportional reinsurance) give rise to an economic mismatch.

Description of the issues

12 The following points about the treatment of reinsurance contracts under IFRS 17 were raised by members of the EFRAG IAWG and communicated to the EFRAG Secretariat and subsequently to EFRAG TEG and the EFRAG Board:

(a) For proportional reinsurance held, the treaty is considered as a single contract, even when it relates to underlying contracts not yet written by the cedant. (IFRS 17, paragraph 34)

(b) The treatment of reinsurance contracts leads to accounting mismatches due to:

(i) differing treatment of CSM; and

(ii) the fact that the reinsurance asset does not necessarily equal the liability of the underlying contracts. (IFRS 17, paragraph 65)

(c) Reinsurance contracts held are not eligible for the variable fee approach. (IFRS 17, paragraph B109); and

(d) internal reinsurance.

13 These form the basis of the discussion below. The two points covered in (b) above have been considered separately and an additional point around internal reinsurance contracts has been added for completeness.

Description of current accounting treatment

14 Appendix 1 provides a short overview of the current accounting treatment under different local GAAP.

EFRAG Secretariat analysis

A. Reinsurance as a single contract for proportional reinsurance

The issue

15 For proportional reinsurance held, under IFRS 17 the treaty is considered as a single contract, even when it relates to underlying contracts not yet written by the cedant. Some argue that the definition of the contract boundary for the reinsurance contracts held creates the following issues:

(a) It may affect the reliability of the measurement for the holder of the reinsurance contract;

(b) It may lead to less transparency in the reinsurer's financial statements as the liability will not change as more underlying contracts are written (ignoring estimate changes); and

(c) Where new underlying contracts under the treaty are onerous, the reinsurer will not recognise the onerous impact in profit or loss but merely adjust the CSM.

16 Some consider that a better solution would be 'looking through' the reinsurance contract to the underlying contracts for the accounting treatment, i.e. recognising the reinsurer's share of the individual underlying contracts and aligning the (de)recognition of the reinsurance contract with the (de)recognition of the underlying contracts.

EFRAG Secretariat analysis

17 Many aspects of insurance including the nature of the business, pricing of products as well as the accounting includes uncertainty that requires estimates that require updating as circumstances change or better information becomes available. Negotiations for the reinsurance contract are likely to have been based on a shared understanding of the risks to be underwritten and the circumstances that could impact the arrangement which would be reflected in the reinsurance contract and premium agreement.

18 The EFRAG Secretariat considers that looking through the reinsurance contract to the underlying insurance contracts discounts the fact that the reinsurance contract is a separate legal agreement with different parties. It also ignores the economic aspects of the reinsurance relationship such as quantum and timing of cash flows and the extent to which the original insurer retains the risk in the underlying contract. These factors are likely to differ between the underlying contract and the reinsurance contract.

19 The financial statements of the reinsurer should only take account of the contracts it is a party to and the economic impact of those contracts. The reinsurer is obliged to recognise the losses on an onerous reinsurance contract, but this may not be when a group of the underlying contracts is onerous given the difference in contractual arrangements and unit of account.

20 However, the EFRAG Secretariat acknowledges that an accounting mismatch may exist for reinsurance contracts held and the underlying primary insurance contracts where the accounting outcomes differ such as when:

(a) the proportional reinsurance contract uses the same contractual terms and reflects the same timing/duration and risk as the primary insurance contracts; and

(b) both contracts reflect the same pricing and therefore CSM.

21 Considering the above, the EFRAG Secretariat considers that the mismatch for proportional reinsurance held could be partly an economic mismatch and partly an accounting mismatch. The EFRAG Secretariat expects that disentangling the accounting mismatches from the economic mismatches would add complexity in the accounting.

22 The EFRAG Secretariat is aware of cases in Europe where direct insurance contracts are loss-making and profitability of the portfolio only results from the profit made on the reinsurance. The EFRAG Secretariat is of the view that recognising such economic mismatches provides valuable information to users of financial statements.

B.1. Asymmetry in treatment of CSM

The issue

23 Under IFRS 17, the CSM on underlying contracts cannot be negative, but, at inception, the CSM on a reinsurance contract can be negative. Some argue that the different treatments of the CSM result in an accounting mismatch without an economic mismatch.

EFRAG Secretariat analysis

24 The CSM for reinsurance contracts held differs from that for a group of insurance contracts issued. The former represents the cost or gain resulting from purchasing reinsurance coverage, whereas the latter represents unearned profits. In case where the CSM at inception is the same for both contracts, the EFRAG Secretariat agrees that the recognition in profit or loss over the coverage period will not necessarily be matched.

25 The EFRAG Secretariat acknowledges the importance of cash flow matching in insurance, however when comparing buying reinsurance service with buying any other service, IFRS Standards report the effect of the purchase. That is, IFRS Standards do not require a day one impact to be recorded if the entity buying the service could acquire the service or provide it internally in a cheaper way or if it could have negotiated a discount. Hence, the EFRAG Secretariat supports the need to recognise differences between insurance contracts written and reinsurance contracts held.

B.2. Asymmetry in value of reinsurance asset vs underlying liabilities

The issue

26 The concern raised is that the accounting under IFRS 17 ignores the coverage provided by the reinsurance contract in the financial statements of the insurer. This arises where there is a difference in premium paid/received on the reinsurance contract and the underlying contracts. In such cases, the measurement of the reinsurance asset would not equal the reinsured portion of the underlying contracts.

EFRAG Secretariat analysis

27 The EFRAG Secretariat is of the view that the accounting reflects the economics of the contract between the insurer and the reinsurer rather than a ‘look-through’ approach. Whilst the reinsurance contract is closely related to the underlying insurance contracts, it is still a separate contract with different counterparties. Differences include the number of counterparties/contracts, premiums and claims to be processed, as well as risks and timing and amount of cash flows. These are

ultimately reflected in the difference between premiums paid and received and the accounting reflects the different economics.

28 Where the difference indicates different assumptions by the insurer, estimates may need to be updated to ensure consistency as required by IFRS 17, paragraph 63.

C. Reinsurance and the Variable Fee Approach ('VFA')

The issue

29 The concern is that different accounting for reinsurance contracts held compared to the underlying insurance contracts could reduce comparability – assuming both meet the eligibility criteria for the VFA. The argument is that the accounting would not reflect the economics of the reinsurance transaction as the reinsurer insures both investment and insurance risk. The pricing also reflects the relevant risks with no distinction between insurance and investment risk.

EFRAG Secretariat analysis

30 One could argue that the insurer is unlikely to share in returns of the underlying items under the reinsurance contract. In cases where it does, the returns from underlying items are unlikely to reflect compensation for management services provided by the reinsurer. However, it could be argued that an accounting mismatch is created if the reinsurer provides the same insurance coverage and the same management services with respect to the same pool of underlying items (and receives the same variable fee) as the insurer provides under the underlying insurance contracts

D. Internal reinsurance contracts

The issue

31 Divergent treatment of reinsurance contracts issued by the reinsurer within the same group compared to the underlying insurance contracts issued by the primary insurer within the same group may impact profit and the capacity to pay dividends at individual controlled entity level. This is because under IFRS 17 paragraph B109 neither reinsurance contracts held or issued are eligible for the VFA. For underlying contracts such as unit-linked insurance contracts which are eligible for the VFA, if the primary insurer reinsured a proportion of these contracts to a reinsurer within the same group (and both primary insurer and reinsurer held unit assets which matched their proportion of the underlying contracts) the following would happen:

(a) In the primary insurer the gross liability is measured under the VFA, whilst the reinsurance asset would be measured under the general model. A scenario in which favourable market movements caused unit prices to increase would see unit assets and gross liabilities increase in the primary insurer. Under the VFA the increase in the best estimate liability component of the gross liabilities would reflect the greater expected benefits payable to policyholders, whilst the contractual service margin within the gross liabilities would increase in respect of the higher variable fee expected over the remaining lifetime of the contract.

(b) Within the reinsurance asset, the "best estimate" component would increase, but there would not be an increase in the CSM, as the reinsurance asset is measured under the general model.

32 In consequence the primary insurer would show a loss in the period, despite the fact that it would expect to now earn more over the contract lifetime. Meanwhile in the reinsurer' financial statements, the (re)insurance liability would increase by less than the unit assets, as only the best estimate liability would increase, and there would be no movement in the CSM to offset the higher variable fee expected over the remaining lifetime of the contract.

33 So overall under an economic scenario (favourable market movements leading to an increase in unit prices) which is expected to ultimately lead to greater income in each of the group entities, primary insurer, and reinsurer:

(a) There is no immediate impact on reported profit or equity at a group level; and

(b) For the primary insurer reported profit/equity decreases in the period – despite the fact that over the lifetime of the underlying contracts we would now expect higher income.

34 For primary insurers within a group, the different accounting treatment between gross insurance liabilities and reinsurance assets, may lead to scenarios where profit, equity, and (in the short term) dividend capacity (if dependent on local GAAP retained earnings) moves in the opposite direction to the primary insurer's economic position (as in Solvency II own funds). For primary insurers reinsuring a large proportion of unit-linked insurance to other entities in the group, there may be scenarios where favourable market movements which increase unit prices (and Solvency II own funds), lead to large falls in local GAAP retained earnings, leaving primary insurers unable to pay dividends (despite on an economic basis under Solvency II, being better placed to do so).

35 The impact on the ability to pay dividends may extend to the consolidated level even though the transaction is eliminated from a group perspective.

EFRAG Secretariat analysis

36 The EFRAG's Secretariat analysis is pending subject to the completion of the case study.

37 With regards to the issue on the inability to pay dividends, the EFRAG Secretariat is unclear of the extent is this issue arising from IFRS 17 or from IFRS Standards as a package.

Question for EFRAG TEG

38 Does EFRAG TEG agree with the EFRAG Secretariat analysis on issues (a) to (c) above? Please explain.

Appendix 1: Reinsurance requirements in some national GAAP

French GAAP (Règlement 2015-11, art. 145-1 and 145-2)

Ceded

1 The reinsurers' share of the provisions for unearned premiums and the provision for risks in progress is calculated under the same conditions and using the same methods as those used to calculate the gross reserves subject to the transfer, without being able to exceed the actual amount at the expense of the reinsurers as resulting from the application of the clauses of the treaties,...

German GAAP (RechVersV, paragraph 23)

2 Reinsurers' shares of gross amounts of technical provisions shall comprise the amounts by which the gross amounts of technical provisions are reduced by virtue of contractual agreements with reinsurers.

Italian GAAP (ISVAP Regulation no 22/2008, art. 23bis till 23quater)

Reinsurance contracts held:

3 Amounts ceded to reinsurers from insurance provisions are determined consistently with the reinsurance contractual arrangements, based on gross technical provisions.

Reinsurance contracts issued:

4 The company that exclusively carries out reinsurance activity and the insurers undertaking jointly the insurance and reinsurance activities constitute technical reserves at the end of each year, gross of the downgrades, sufficient in relation to the commitments made for all of their activities. The amount of technical provisions shall be calculated in accordance with articles 23-bis and 23-ter of ISVAP Regulation no 22/2008).

Spanish GAAP (Real Decreto 2486/1998, 20 November, paragraph 29.3)

5 The amount corresponding to the technical provisions of the reinsurance contracts held and issued shall be calculated in accordance with the different technical provisions described [for direct insurance contracts, except the one for ongoing risks].

6 The calculation of provisions for reinsurance operations accepted, shall take as a basis the data provided by the transferor, increasing them as appropriate in accordance with the experience of the entity itself.

UK GAAP (FRS 27, paragraph 12)

7 Amounts recoverable under reinsurance contracts relating to life assurance shall be measured on a basis consistent with the measurement of the related liability, so that the net amount reflects the exposure of the entity. Changing the measurement of the liability may therefore give rise to a change in the related reinsurance asset. The amount of the change in the asset will depend on the terms of the reinsurance contract.

US GAAP (FAS 113, paragraphs 21-26, summarised)

Short-duration contracts

8 Amounts paid for prospective reinsurance shall be reported as prepaid reinsurance premiums and amortised over the remaining contract period in proportion to the amount of insurance protection provided.

9 Amounts paid for retroactive reinsurance that meets the conditions for reinsurance accounting shall be reported as reinsurance receivables to the extent those amounts do not exceed the recorded liabilities relating to the underlying reinsured contracts. If the recorded liabilities exceed the amounts paid, reinsurance receivables shall be increased to reflect the difference and the resulting gain deferred. The deferred gain shall be amortized over the estimated remaining settlement period.

Long-duration contracts

10 Amortization of the estimated cost of reinsurance of long-duration contracts that meets the conditions for reinsurance accounting depends on whether the reinsurance contract is long duration or short duration. The cost shall be amortized over the remaining life of the underlying reinsured contracts if the reinsurance contract is long duration, or over the contract period of the reinsurance if the reinsurance contract is short duration. Determining whether a contract that reinsures a long-duration insurance contract is long duration or short duration in nature is a matter of judgment, considering all of the facts and circumstances. The assumptions used in accounting for reinsurance costs shall be consistent with those used for the reinsured contracts.

11 The difference, if any, between amounts paid for a reinsurance contract and the amount of the liabilities for policy benefits relating to the underlying reinsured contracts is part of the estimated cost to be amortized.