This paper has been prepared by the EFRAG Secretariat for discussion at a public meeting of the EFRAG Board. 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.

IFRS 17 *Insurance Contracts* - Reinsurance Issues Paper

Objective

1 The objective of this paper is to describe the requirements of IFRS 17 *Insurance Contracts* regarding reinsurance and the issues that have been raised by EFRAG IAWG members in this regard.

Definition and terminology used

2 IFRS 17, Appendix A defines a reinsurance contract 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)*."

3 In this paper, a distinction is made between "reinsurance held" and "reinsurance assumed".

(a) *Reinsurance held (or ceded)*: looks at reinsurance contracts from the perspective of the direct insurer that has purchased reinsurance cover for the risks of the insurance contracts it has issued.

(b) *Reinsurance assumed*: looks at reinsurance contracts from the perspective of the reinsurer. The reinsurer has issued reinsurance contracts and assumes the risk that these bring.

4 There are two principal categories of reinsurance:

(a) *Proportional reinsurance*: where the reinsurer agrees to cover a proportionate share of the risks ceded; and

(b) *Non-proportional reinsurance*: where particular risks (on a risk by risk basis or in aggregate) are covered by the reinsurer.

IFRS 17 requirements about reinsurance

5 In simple terms, IFRS 17 requires a primary insurer to recognise:

(a) Insurance contracts issued; and

(b) Reinsurance contracts held (which relates to both insurance contracts already issued **and** insurance contracts expected to be issued which are covered under the reinsurance contract).

6 The contractual service margin (unearned profit) on insurance contracts issued is recognised over the coverage period of the contracts issued. When insurance contracts are onerous at inception, the loss is taken to profit or loss immediately.

7 In contrast, for reinsurance contracts held there is no unearned profit, but only a net cost or net gain that is treated as a contractual service margin (CSM), i.e. spread over the life of the reinsurance contracts held. As an exception, when the net cost relates to events that happened before the purchase of reinsurance, the net cost is

recognised immediately in profit or loss. Also, when underlying contracts become onerous after initial recognition the corresponding gain on reinsurance contracts held is recognised on a 'matched' basis.

8 The detailed technical requirements are included in the Appendix to this paper.

Issues raised by some EFRAG IAWG members

9 The main concerns raised by some EFRAG IAWG members with the reinsurance requirements of IFRS 17 can be summarised as follows:

(a) For primary insurers:

(i) Reinsurance is currently commonly recognised as underlying insurance contracts (that are reinsured) are written (and not when the reinsurance contract that covers these contracts is issued;

(ii) Losses are recognised upfront for primary insurance contracts that are onerous at inception but any net gains on related reinsurance contracts held are recognised over the life of the reinsurance contract held (subject to the exception noted in paragraph 7);

(iii) In some cases where there is a difference in premium paid/received on the reinsurance contract and the underlying contracts, the measurement of the reinsurance asset does not equal the reinsured portion of the underlying contracts. This difference may arise because reinsurers are more diversified than insurers

(b) For both primary insurers and reinsurers, reinsurance contracts are not eligible for the Variable Fee Approach even where the reinsurer covers both insurance and investment risk

(c) For insurers that apply IFRS at individual group entity level and enter into 'internal' reinsurance arrangements, the change in the accounting brought about by IFRS 17 may affect the capacity to pay intragroup dividends. The difference in accounting between insurance contracts in accordance with the Variable Fee Approach and reinsurance contracts in accordance with the General Model may affect the results of the subsidiaries of an insurance group.

(d) The contract boundary from the underlying insurance contracts may differ from the contract boundary of the relating reinsurance contracts.

10 These issues are discussed in more detail in the Appendix.

IASB's rationale for IFRS 17's requirements on reinsurance

11 Broadly speaking, IFRS 17's requirements on reinsurance reflect the IASB's view that reinsurance contracts held and underlying insurance contracts are separate contracts. The accounting should therefore reflect the entity's rights and obligations and the related income and expense separately for each contract (IFRS 17, paragraph BC298). The views of the IASB in relation to the issues raised by some EFRAG IAWG members can be summarised as follows:

(a) For primary insurers:

(i) Recognising the CSM of reinsurance contracts in proportion to the CSM of the underlying insurance contracts would not reflect the economics of the reinsurance. Such an approach would measure reinsurance contracts on the basis of the premium received on the underlying insurance contracts rather than the consideration paid for the reinsurance contracts (IFRS 17, paragraph BC313);

(ii) The CSM for a group of reinsurance contracts held is different in substance to the CSM for a group of insurance contracts issued. This is because the former depicts the expense an entity incurs when purchasing reinsurance coverage rather than the profit it will make by providing services under the insurance contract. Accordingly, there is no limit on the amount of the adjustment to the CSM for a group of reinsurance contracts held, subject to the amount of premium paid to the reinsurer (IFRS 17, paragraph BC314).

(iii) The amount paid to buy reinsurance would typically exceed the expected present value of cash flows generated by the reinsurance contracts held, plus the risk adjustment for non-financial risk. Thus, a debit CSM, representing the net expense of purchasing reinsurance is to be recognised over the coverage period as services are received, except when the reinsurance covers events that have already occurred (IFRS 17, paragraphs BC310, BC312). When a net gain occurs, it is considered as reduction in the cost of purchasing reinsurance and is spread over the coverage period of reinsurance contracts held.

(b) As regards the non-eligibility of reinsurance for the VFA approach:

(i) For reinsurance contracts held, the primary insurer does not share in the returns on the underlying items with the reinsurer so the criteria for the VFA are not met (IFRS 17, paragraph BC248);

(ii) For reinsurance contracts issued, the reasoning that the returns to the entity from a pool of underlying items are part of the compensation received for providing an asset management service does not apply to reinsurance contracts issued (IFRS 17, paragraph BC249).

EFRAG TEG comments

12 EFRAG TEG members discussed the above points in their meeting of December 2017. The following comments were made at that meeting:

(a) One EFRAG TEG member commented on the interaction between reinsurance and derecognition. One member saw reinsurance as being similar to hedging, because the two contracts are accounted for on a gross basis even when the risks are fully covered.

(b) Although most members acknowledged the possibility of accounting mismatches in accounting for reinsurance contracts held and the underlying insurance contracts, a number also commented on the existence of economic mismatches. The question was raised about the relevance and the trade-off of such mismatches in terms of the endorsement advice.

(c) EFRAG TEG did not consider the issue of dividend capacity as an IFRS 17 issue.

(d) Most EFRAG TEG members agreed that reinsurance contracts held and the underlying insurance contracts should be accounted for as separate contracts.

Question for the EFRAG Board

13 Does the EFRAG Board have comments on the issues raised above?

APPENDIX

IFRS 17 requirements about reinsurance

Reinsurance contracts held

Measurement

1 The requirements for primary insurance contracts are modified to reflect that (i) groups of reinsurance contracts held are generally assets, rather than liabilities; and (ii) entities holding reinsurance contracts generally pay a margin to the reinsurer as an implicit part of the premium, rather than making profits from the reinsurance contracts (IFRS 17, paragraph BC302). The modifications are as follows:

   (a) Consistent assumptions are used between reinsurance held and underlying insurance contracts (IFRS 17, paragraph 63);

   (b) The effect of non-performance by the reinsurer is to be included in the measurement of the reinsurance contracts (IFRS 17, paragraph 63). Changes in the risk of non-performance by the reinsurer do not relate to future service and do not adjust the CSM (IFRS 17, paragraph 67);

   (c) The risk adjustment represents risk transferred from the holder of reinsurance contracts to the issuer of those contracts (IFRS 17, paragraph 64);

   (d) At initial recognition, the requirements for the CSM are modified so that there is no unearned profit, but instead a net cost or net gain on purchasing the reinsurance (IFRS 17, paragraph 65(a)). That net cost or gain is recognised as a contractual service margin (CSM) (and consequently spread over time) unless the net cost relates to events that occurred before the purchase of the reinsurance contract. In the latter case, the cost is recognised immediately in profit or loss as an expense (IFRS 17, paragraph 65(b));

   In contrast to what is required for direct insurance contracts, the CSM for reinsurance contracts can be negative (IFRS 17, paragraph BC314);

   (e) Subsequently, the requirements for the CSM are modified by removing the references to creation of a loss component (IFRS 17, paragraph 66). Also, reinsurance contracts held cannot be onerous (IFRS 17, paragraph 68), accordingly the related requirements do not apply to reinsurance contracts held;

   (f) The requirements of the premium allocation approach can be applied to reinsurance contracts held (IFRS 17, paragraph 69).

<u>Gains and losses on buying reinsurance</u>

2 The amount an entity pays for reinsurance coverage consists of premiums the entity pays minus any amounts paid by the reinsurer to the entity to compensate the entity for expenses it incurs. The amount paid for reinsurance coverage by the entity can be viewed as payment for the following:

   (a) the reinsurer's share of the expected present value of the cash flows generated by the underlying insurance contract(s).

   (b) a CSM that makes the initial measurement of the reinsurance asset equal to the premium paid. This margin depends on the pricing of the reinsurance contract held and, consequently, may differ from the contractual service margin arising for the underlying insurance contract(s). (IFRS 17, paragraph BC299)

3 The amount paid to buy reinsurance would typically exceed the expected present value of cash flows generated by the reinsurance contracts held, plus the risk adjustment for non-financial risk. Thus, a debit CSM, representing the net expense

of purchasing reinsurance is to be recognised over the coverage period as services are received, except when the reinsurance covers events that have already occurred (IFRS 17, paragraphs BC310, BC312). In rare cases, a net gain on buying reinsurance can occur, thus a credit CSM. That net gain is to be spread over the coverage period of reinsurance contracts held as the apparent gain at initial recognition represents a reduction in the cost of purchasing reinsurance (IFRS 17, paragraph BC311).

4 The IASB rejected the recognition of the CSM of reinsurance contracts held proportionally to the CSM of the underlying insurance contracts. In the IASB's view, measuring the group of reinsurance contracts held on the basis of the premium the entity receives for the underlying contracts when that premium does not directly affect the cash flows arising from the group of reinsurance contracts held, would be contrary to viewing the group of reinsurance contracts held and the underlying insurance contracts as separate contracts. Also, it would not reflect the underlying economics that the expense of purchasing reinsurance equals the whole of the consideration paid for the group of reinsurance contracts, i.e. it would ignore the purchase price of the reinsurance contracts (IFRS 17, paragraph BC313).

5 Finally, the IASB noted that the CSM of reinsurance contracts held is different from the CSM of insurance contracts issued. The first depicts the expense an entity incurs when purchasing reinsurance, the latter depicts the profit it will make by providing services under the insurance contract. Consequently, the IASB placed no limit on the amount of the adjustment to the CSM for reinsurance contracts held (i.e. the CSM can be negative). (IFRS 17, paragraph BC314).

6 In the situation where an entity recognises a loss on the group of underlying insurance contracts i.e. contracts become onerous subsequent to initial recognition, the corresponding changes in cash inflows from a group of reinsurance contracts held do not adjust the CSM of the reinsurance contracts held, with the result that the entity recognises no net effect of the loss or gain in profit or loss (IFRS 17, paragraph BC315).

Reinsurance contracts and the Variable Fee Approach

7 Reinsurance contracts issued and reinsurance contracts held cannot be insurance contracts with direct participation features (IFRS 17, paragraph B109).

(a) For reinsurance contracts held, the entity and the reinsurer do not share in the returns on underlying items and so the criteria of the Variable Fee Approach are not met. The IASB considered whether to modify the scope of the Variable Fee Approach for reinsurance contracts held but rejected this as such an approach would be inconsistent with separately accounting a reinsurance contract held from the underlying contracts issued (IFRS 17, paragraph BC248).

(b) Similarly, for reinsurance contracts issued, the IASB rejected the idea that such reinsurance contracts could qualify for the Variable Fee Approach, even if some types of reinsurance contracts issued might meet the eligibility criteria. This is because the returns to the entity from a pool of underlying items should be viewed as part of the compensation that the entity charges the primary policyholder for the service provided by the insurance contract and this logic does not apply to reinsurance contracts issued (IFRS 17, paragraph BC249).

Recognition

8 Proportionate reinsurance contracts held are recognised at the beginning of the coverage period of the group of reinsurance contracts or at initial recognition of any underlying contract, whichever is the later. (IFRS 17, paragraph 62, (a))

9 In all other cases (i.e. non-proportional reinsurance contracts held), these are recognised from the beginning of the coverage period of the group of reinsurance contracts held (IFRS 17, paragraph 62, (b)).

Presentation

10 Reinsurance contracts that are assets and reinsurance contracts that are liabilities are presented separately from insurance contracts that are assets and insurance contracts that are liabilities (IFRS 17, paragraph 78). This because the entity that holds the reinsurance contract does not normally have the right to reduce the amounts it owes to the underlying policyholder by amounts it expects to receive from the reinsurer (IFRS 17, paragraph BC298). The IASB acknowledged that such separate accounting might create mismatches that some regard as purely accounting but concluded that separate accounting gives a faithful representation of the entity's rights and obligations and the related income and expenses from both contracts (IFRS 17, paragraph BC298).

11 Similarly, the income and expenses arising from reinsurance contracts held is presented separately from insurance contracts issued (IFRS 17, paragraph 82).

Reinsurance contracts assumed

12 The requirements for insurance contracts apply also to reinsurance contracts issued (IFRS 17, paragraph 3), except that reinsurance contracts issued cannot be insurance contracts with direct participation features (IFRS 17, paragraph B109).

Issues raised by EFRAG IAWG members

Reinsurance as a single contract for proportional reinsurance

13 Reference in IFRS 17, paragraph 34. It is noted that for proportional reinsurance held, the treaty[1] is considered as a single contract, even when it relates to underlying contracts not yet written by the cedant. Some EFRAG IAWG members prefer a "look through" approach whereby only that part of the treaty is recognised that relates to direct insurance contracts already written. The part of the treaty that relates to direct insurance contracts not yet written would not be recognised.

It is noted that reinsurance contracts may be repriced more often than the underlying insurance contracts.

Also, reinsurance contracts typically offer coverage for a limited period, say 5 years. In contrast, the underlying insurance contracts can have a contract duration that is much longer.

Differences in the treatment of the CSM

14 References in IFRS 17, paragraphs 65 and B109. The general requirements that relate to determining the contractual service margin on initial recognition are modified to reflect the fact that for a group of reinsurance contracts held there is no unearned profit but instead a net cost or net gain on purchasing the reinsurance. Some EFRAG IAWG members noted that as a result, while there may be a loss on underlying direct insurance contracts that are onerous, this will not be offset by the recognition of the corresponding gain on the reinsurance contracts as IFRS 17 requires this to be recognised over the coverage period of the reinsurance contracts.

Differences in value of reinsurance asset vs underlying liabilities

15 References in IFRS 17, paragraphs 63-68. Some EFRAG IAWG members are concerned that the accounting under IFRS 17 ignores the coverage provided by the reinsurance contract in the financial statements of the insurer. This arises when

[1] Under treaty reinsurance the reinsurer agrees to accept all business written by the direct insurer which falls within the terms of the reinsurance contract (the treaty).

there is a difference in premium paid/received on the reinsurance contract and the underlying contracts. Further, reinsurance commissions may affect the measurement of the reinsurance contract held. In such cases, the measurement of the reinsurance asset would not equal the reinsured portion of the underlying contracts.

Reinsurance and the Variable Fee Approach

16 References in IFRS 17, paragraphs 65 and B109. Some EFRAG IAWG members noted that reinsurance contracts held should be eligible for the Variable Fee Approach. 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.

Internal reinsurance contracts

17 Reference in IFRS 17, paragraph B109. Some EFRAG IAWG members noted the following issue:

18 In insurance groups, one subsidiary may act as a reinsurer for all the other subsidiaries of the group. The subsidiaries' dividends are paid to the group level. These dividends are determined on an entity basis after consideration of the cost of reinsurance by another entity (in this case a subsidiary within the same insurance group, hence at consolidated level no reinsurance is applied).

19 Furthermore, the difference in measurement between reinsurance contracts held and insurance contracts accounted for in accordance with the Variable Fee Approach may – in particular scenarios - reduce the capacity of the insurance subsidiaries to pay dividends upwards. For example, in a favourable economic situation, the value of the underlying assets is expected to rise. For the insurance liabilities, this would be reflected by an increasing variable fee over the remaining duration of the underlying contracts, whereas for reinsurance contracts held this is not the case. Therefore, the asymmetry may impact the group dividend paying capacity even if the intra-group transactions have been eliminated.

Contract boundary

20 The requirement to consider reinsurance contracts and insurance contracts separately may create implementation difficulties for some insurers. For example, under IFRS 17, situations occur where the contract boundary of reinsurance contracts differs from the one used for the underlying insurance contracts.

(a) Example 1: The insurer buys reinsurance for two years although the underlying insurance contracts have a contract boundary of one year. The insurer has economic reasons for doing so (for example, reinsuring for a longer duration is cheaper) and results in receiving higher commissions from the reinsurer;

(b) Example 2: Some reinsurance contracts have a clause that enables either party to terminate the contract after 90 days. This implies the purchased reinsurance contracts has a contract boundary of 90 days. It is uncertain what happens when on day 91 reinsurance premiums are paid.