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EFRAG Board Presentation

IFRS 17 for reinsurance

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AGENDA

What are we going to discuss today?


Image: Michele Constantini / Corbis

We will focus on reinsurance regarding IFRS 17 and therefore cover only selected beneficial or critical issues

1 Reinsurance as part of the insurance market

2 How reinsurers see IFRS 17

3 Reinsurance issues

4 Selected operational issues

Role of reinsurance for primary insurers

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Year of foundation

1846
Cologne Re

1863
Swiss Re

1880
Munich Re

1933
MAPFRE

1966
Hannover Re

1970
SCOR

Purpose of reinsurance

- Insurers protect their balance sheet and reduce earnings volatility with reinsurance
- Insurers make better use of capital with reinsurance
- Local insurance markets are stabilised by reinsurance due to global risk diversification
- Severe events usually impact the reinsurance sector more than the insurance sector
- Know-how and tool transfer across geographies

Significant reinsured events

1906	The earthquake in San Francisco (Munich Re's liability: US$ 2.5m)
1992	Hurricane Andrew
1999	Winter storm in Europe
2001	World trade center
2006	Hurricanes Rita, Wilma, Katrina
2008	Reinsurance promises were kept during the financial crisis
2011	Earthquake in Japan
2017	Hurricanes Harvey, Irma und Maria

Reinsurance driving the coverage of new risk

- Historical role of reinsurance in development of new insurance products (e.g. insurance of accident, burglary, machines or high risks in life insurance)
- Steady increase in cyber portfolios
- Dynamic growth through joint projects with cedants (including white-label products) in developing markets
- Continuous update of accumulation models (e.g. virus, cloud, critical infrastructure)

Reinsurers have a premium volume of about US$ 280 billion[1]

[1] Gross written premium 2017; estimation based on Munich Re Economic Research

Implications of IFRS 17 for reinsurers

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BENEFITS of IFRS 17

- Better alignment of IFRS with Solvency II
- Better alignment of IFRS and internal steering, due to strong use of economic metrics for steering in reinsurance
- Better comparability of life and non-life valuation due to a consistent valuation approach using current information
- Higher transparency concerning expected profit from in-force business
- Aligned definition of revenue across industries

CONCERNS regarding IFRS 17

HIGHLIGHTED IN TODAY'S PRESENTATION

- Accounting rules for reinsurance held not aligned with underlying business
- Some operational complexity (e.g. accounts payable/receivable and intercompany issues)
- Amortization of contractual service margin requires significant judgement
- Other concerns e.g. transition, level of aggregation, onerous testing, … apply to primary insurers and reinsurers alike

We appreciate EFRAG's comprehensive endorsement process and testing activities

Why is consistent treatment of reinsurance accounting important?

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Two levels of mirroring

Underlying business and reinsurance held within the primary insurers' balance sheet

Treatment of reinsurance from a primary and reinsurer's perspective

IFRS 17 does not support full mirroring

Financial position of a primary insurer may be distorted when mirroring is not provided

Reinsurance mismatches may have an impact on dividend distribution when local GAAP is based on IFRS 17

Reinsurance mismatches may have an unintended impact on performance presentation

Reinsurance mismatches may have an impact on rating when rating models are based on IFRS

Reinsurance mismatches lead to inconsistency between IFRS and Solvency II

As IFRS 17 will also be used for internal steering, consistency in underlying business and reinsurance accounting is indispensable

An accounting mismatch under IFRS 17: Reinsurance held at initial recognition

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How does reinsurance work economically?

P&L of the primary insurer

Loss from underlying business (claim)

Transfer of 100% of risks to reinsurer (quota share)

P&L of the primary insurer

Benefit from reinsurance (recovery)

- Natural hedge position of proportionate reinsurance
- Risk is transferred on contract day 1
- Economic reinsurance benefit available immediately
- Presentation should reflect possible reinsurer-related credit risks

How does IFRS 17 account for reinsurance?

P&L of the primary insurer

IFRS 17
Loss from underlying business

Transfer of 100% of risks to reinsurer (quota share)

P&L of the primary insurer

IFRS 17
No benefit from reinsurance

- Effective risk transfer of reinsurance not reflected properly at initial recognition under IFRS 17
- Benefit is deferred over coverage period of reinsurance contract

Why is transfer of onerous risks to a reinsurer a realistic case?

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Portfolios/segments containing onerous contracts for cedants

mostly is

“Profitable” business for reinsurer

REASONS

Cedant needs to extract single onerous contracts from an overall profitable portfolio, whereas the reinsurance contract issued covers the whole portfolio

Reinsurers benefit from higher diversification effects (wholesale price vs. retail price)

Reinsurers manage an overall client relationship and will accept single onerous contracts / portfolios in an overall profitable relationship

LEADING TO

For the same risk transferred, primary insurer recognizes a loss at inception but does not benefit from reinsurance contract at initial valuation

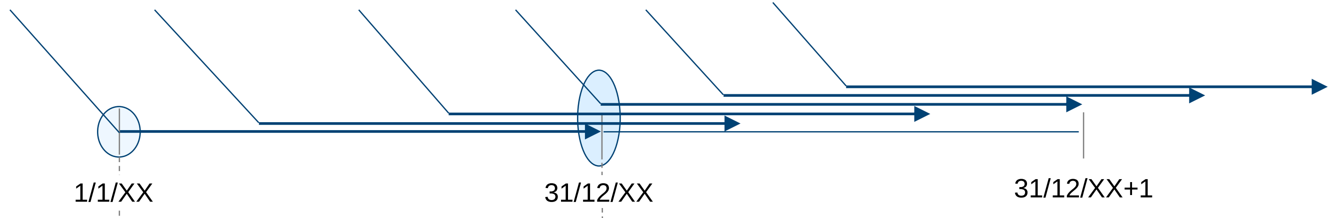
Different granularity between primary insurance contracts and reinsurance contracts

Our EFRAG testing highlighted these observations

Different contract boundaries from a cedant’s perspective

Mismatches resulting from different projection volumes of fulfilment cash flows

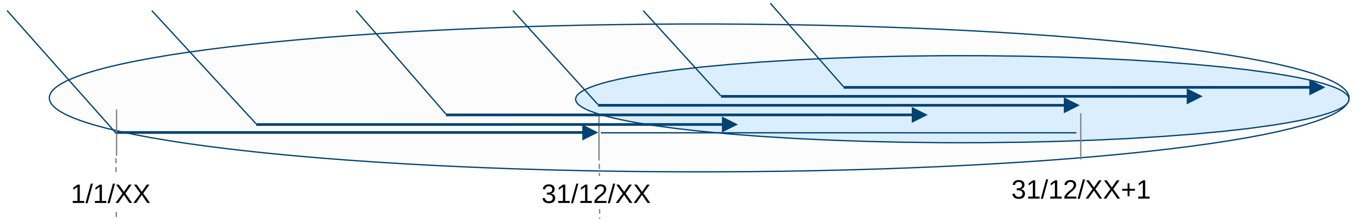
Underlying direct contracts (recognition follows start of coverage of direct contracts)



Initial recognition = only first tranche of underlying business included in measurement

Subsequent measurement = only underlying business already existing included in measurement

Reinsurance contract held (full recognition of coverage of reinsurance)



Initial recognition = all cash flows included even if underlying direct contracts not yet written

Subsequent measurement = all future cash flows included even if direct contracts not yet written

- Accounting mismatch due to different volume of projection
- Reinsurance expenses and coverage shown for contracts not yet in-force
- Mismatches in P&L, balance sheet and buidling blocks
- Projection also challenging for reinsurance issued

Further reinsurance issues identified

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Proportionate reinsurance as an effective natural hedge not reflected (e.g. onerous underlying business)
Slides 6-7

Different contract boundaries and estimation of future new business
Slide 8

Scope of the variable fee approach when reinsurance held is an underlying item

Potentially different measurement models for underlying business and reinsurance contracts held

Retroactive reinsurance: definition of insured event inconsistent

Separate accounting for reinsurance contracts held and underlying direct contracts gives rise to several mismatches

Accounting for accounts payable/receivable

Cost-benefit issue arising from netting with insurance liabilities

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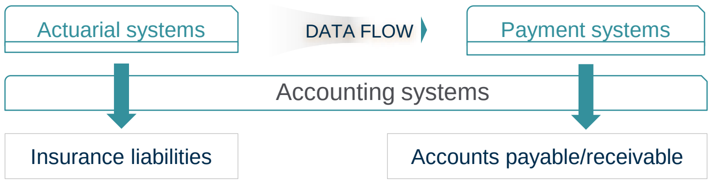
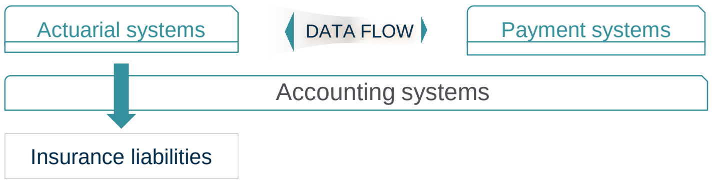
CURRENT SYSTEM LANDSCAPE





IFRS 17 LANDSCAPE

Advantages of separate presentation

- "Due concept" for accounts payable/receivable under current accounting rules and for Solvency II
- Provides relevant and faithful information
- Actuarial systems and payment systems separated
- Follows structure of reinsurance net settlements

Consequences of no separation (IFRS 17)

- Reduced transparency for counterparty and insurance risks
- Significant costs in combining actuarial systems and payment systems
- Complex modelling taking into account policyholder behavior

Intercompany elimination (consolidation) under IFRS 17

Cost-benefit issue arising from reinsurance mismatches

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Possible IFRS 17 differences

- IFRS 17 options applied differently by ceding and assuming entity
- e.g. different contract boundary projection period, different coverage units, different assumptions, applied data/methods, etc.)

Such issues already exist to a limited extent and will substantially increase with IFRS 17

IFRS 17 built-in differences

- Different treatment of reinsurance held and reinsurance assumed with regard to CSM
- Different grouping for ceded and assumed contracts under IFRS 17; grouping rules lead to mechanistical systematic valuation differences

New challenge, does not exist today

Process-driven differences

- Time lag between postings and intercompany invoices
- Misinterpretation of contracts and documents
- …

Already an issue in today's closing processes; will likely increase under complexity of IFRS 17

To manage intercompany consolidation, IFRS 17 creates additional effort and mismatches to be eliminated

Summary

- Munich Re and MAPFRE welcome the introduction of IFRS 17 and have set up considerable implementation programs, expecting costs to be similar to those of Solvency II
- We see many benefits in IFRS 17, in particular with regard to improved transparency vis-à-vis the capital markets, but also regarding the alignment with steering metrics
- Munich Re and MAPFRE benefited from the EFRAG testing phase, achieving a better understanding of the standard but also identifying some of the challenges of IFRS 17
- The field test confirms that IFRS 17 does not properly account for proportionate reinsurance products, resulting in timing differences of earnings recognition in primary insurers' accounts. Many of our clients are concerned about the potential disadvantages for traditional reinsurance products
- Reinsurance accounting is also important for the financial position of insurers, when IFRS 17 forms the basis for local GAAP and rating models
- Interpretation of the standard cannot fully resolve issues from reinsurance accounting

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IFRS 17 for reinsurance

Q&A

Reinsurance from a cedant perspective under IFRS 17: Loss portfolio recognition vs. reinsurance gains recognition

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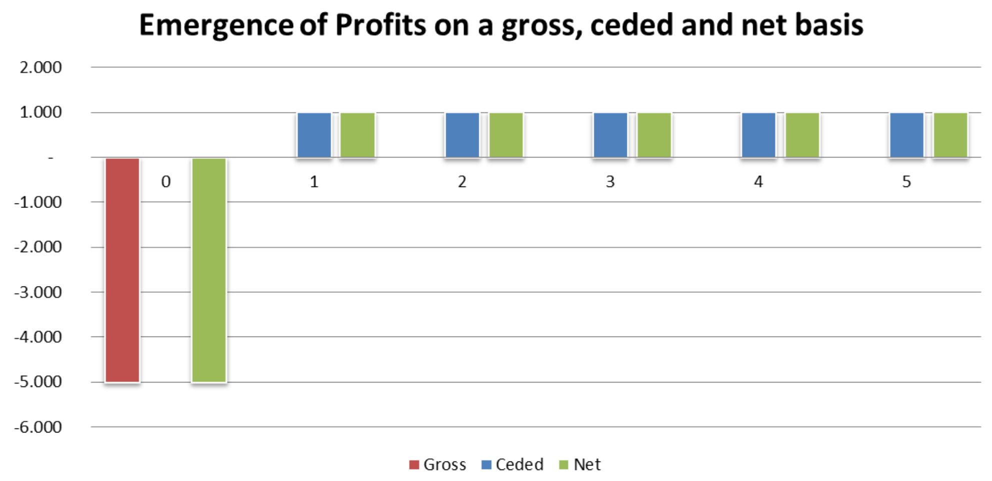

Assumptions:

- Primary insurer with onerous portfolio
- Simple, non-linked protection product
- Contract term is five years
- Premiums of €1,000 paid annually
- Claims of €2,000 expected to be paid annually
- Profit/(loss) gross of reinsurance = (€5,000);
- Profit/(loss) net of reinsurance = 0;
- Contract 100% reinsured

	0	1	2	3	4	5
GROSS OF REINSURANCE	(€5,000)	€0	€0	€0	€0	€0
CEDED TO REINSURANCE	€0	€1,000	€1,000	€1,000	€1,000	€1,000
NET OF REINSURANCE	(€ 5,000)	€1,000	€1,000	€1,000	€1,000	€1,000