Reinsurance: onerous underlying contracts that are profitable after reinsurance
Issues Paper

Introduction

1 Prior to the IASB tentative decisions, onerous contracts issued by the cedant were immediately recognised as a loss in profit or loss, whereas for the reinsurance contract held by the cedant, any net cost or gain was recognised over the coverage period. Preparers have indicated that this IFRS 17 requirement gives rise to accounting mismatches.

Summary of IASB tentative decisions

2 The IASB tentatively decided to amend IFRS 17 to:

(a) expand the scope of the exception in paragraph 66(c)(ii) of IFRS 17 to require an entity to recognise a gain in profit or loss when the entity recognises losses on onerous underlying insurance contracts, to the extent that a reinsurance contract held covers the losses of each contract on a proportionate basis; and

(b) require an entity to apply the expanded exception when the entity measures contracts applying the premium allocation approach (PAA).

Concerns raised

3 The IASB has addressed the issue of the accounting treatment for the net gain on a proportionate reinsurance treaty covering onerous underlying contracts. However, the IASB has not addressed the gains on “non proportionate” reinsurance treaty.

Input from ANC

Distinction between proportionate and non-proportionate reinsurance

4 In a proportional reinsurance a reinsurer takes a part of the cash flows of the individual underlying insurance contracts. IASB has been proposing an accounting treatment for the net gain on a proportionate reinsurance treaty covering onerous underlying contracts.

5 Gains on non-proportionate reinsurance treaty (e.g. on catastrophic risks or where an insurance company takes the first 20% of the losses and the reinsurer anything above that benchmark) have not yet been addressed by IASB.

6 There is no accounting issue with an existing contract becoming onerous: if an existing contract forces the entity to cross the aggregate, then it will show a loss on the underlying and a profit on the reinsurance. An issue first emerges on how to release the reinsurance gain when a new onerous contract is issued. This is because a non-proportionate reinsurance treaty does not relate to one contract but to all. When a new contract is added to a pool of existing contracts making the whole

group going over the top of the reinsurance limit, is it because of the old contracts or of the new added one?

7 Addressing non-proportionate reinsurance may therefore additionally require assessing the existence of a "link" between the reinsured risk and the underlying contracts. Absent such a link it might not be possible to clearly identify which of many risks actually triggers the reinsurance gain (and to what extent). For instance, assuming the flood risk in a city is covered by different insurance policies (car, personal, public utility…), which one leads above the line?

8 Non-proportionate reinsurance could also be dealt by impacting the risk adjustment rather than the CSM. Generally, absent a better risk adjustment, no reinsurer would take certain (non-proportionate) risks.

9 Non-proportionate reinsurance could finally impact the FCF, the risk adjustment or even the P&L. One of these three possibilities might help avoiding a mismatch.

Different views presented

View 1– Agree with the IASB decision to amend IFRS 17 for proportionate reinsurance with the following specific comments

10 Non-proportionate reinsurance and proportionate reinsurance are economically different.

(a) Under proportionate reinsurance the reinsurer participates in all risks the insurer is involved in (to the extent transferred), while under non-proportionate reinsurance the reinsurer takes on excess risk or a capped amount of risk.

(b) A net risk position (i.e. the extent to which the risks have been offloaded to a third party) may exist when relying on some proportionate reinsurance contracts (i.e. quota share treaties where the reinsurer covers a fixed proportion of every risk accepted by the direct insurer, no retention limits are applied), but does not arise when using other reinsurance contracts such as:

(i) Proportionate, surplus treaty (i.e. the reinsurer only reinsures that portion of risk that exceeds the retention limit of the direct insurer); or

(ii) Non-proportionate reinsurance such as an excess of loss or stop loss reinsurance contracts.

11 A specific accounting solution should be defined to solve the issue. However, resolving the issue would create additional complexity and might increase the costs of implementation.

12 While being sympathetic to the "netting"- idea for particular reinsurance contracts held (i.e. deducting the value of the reinsurance contracts from the value of the direct insurance contracts), EFRAG noted that such "netting" does not remove the need for identification of onerous contracts. In case only 40% of the risks is being reinsured, the remaining 60% may still be onerous.

13 IFRS 17 requirements are an important change to the netting practices that prevail today in several local GAAPs.

14 Non-proportionate reinsurance could also be dealt by impacting the risk adjustment rather than the CSM (as discussed in TRG issue S118).

View 2 – Amendment needed to IFRS 17 to add an accounting solution for non-proportionate reinsurance with the following specific comments

15 IFRS 17 is incomplete without a solution for non-proportionate reinsurance.

16 When an insurer has taken non-proportionate reinsurance for its underlying business the accounting in accordance with IFRS 17 shows a mismatch that does not allow the entity to portray that the risks are (to some extent) transferred to a third

party, the reinsurer. In order to solve this, the FCF or the risk adjustment of the underlying contracts or even profit or loss could be adjusted and therefore might help avoiding a mismatch.

17 There is no accounting issue with an existing contract becoming onerous: in such a case, it will show a loss on the underlying and a profit on the reinsurance. An issue first emerges on how to release the reinsurance gain when a new onerous contract is issued. This is because a non-proportionate reinsurance treaty does not relate to one contract but to all the contracts covered. When a new contract is added to a pool of existing contracts with the effect of triggering the reinsurance limit, it is unclear whether this should be attributed to the existing contracts or of the newly added one.

18 While the ANC proposal suggests not to differentiate between proportionate and non-proportionate reinsurance, the CFO Forum suggests do develop a specific accounting solution for non-proportionate reinsurance.

IAWG conclusions (May 2019)

Prevalence of the remaining concerns

19 For one EFRAG IAWG member the non-proportional reinsurance represented 80% of their reinsurance contracts held.

20 In the past EFRAG IAWG members indicated that the occurrence of non-proportional reinsurance was as prevalent as proportional reinsurance.

Nature of the remaining issue

21 One member expressed that in practice risk mitigation strategies use proportional and non-proportional reinsurance treaties without necessarily making this distinction. One EFRAG IAWG member noted that the current IFRS 17 accounting treatment would not allow to reflect in P&L the offsetting of the two components, which was the business objective to have both types of reinsurance: non-proportional reinsurance was used to protect profit or loss at a certain level.

Can the issue be solved without amendments to the standard?

22 Yes, calculation of the risk adjustment considering the existence of non-proportional reinsurance. Two preparers support a change to the standard on non-proportional reinsurance.

23 Other IAWG members did not support a change to the standard.

Definition of non-proportionate VS non-proportional

24 It was unclear whether the word ‘proportionate’ used in IFRS 17 meant the same as the word ‘proportional’ used by the industry. In absence of a definition, preparers were uncertain whether the standard allowed them to apply the IASB’s tentative decision to some non-proportional reinsurance contracts. One EFRAG IAWG member understood that the word ‘proportionate’ was much broader than the word ‘proportional’. For example, a group excess of loss contract was considered proportionate but not proportional.

25 One EFRAG IAWG member noted that non-proportional reinsurance contracts also shared in all the risks of the underlying contracts. However, when commissions were being added (based on bonus-malus structures which were an incentive to the direct insurer only to transfer good quality of risks), the same non-proportional reinsurance contract would not share in all the risks of the underlying contracts.

26 The EFRAG IAWG member noted that the reinsurer looks at the entire business of the direct insurer in reinsuring (and setting commissions for doing so) and also about the future relationship. The reinsurer does not think in underlying groups or portfolios but rather at the total bundle of business.

27 One EFRAG IAWG member (reaction via email) noted that from their perspective IFRS 17.BC304 can be seen defining proportionate reinsurance. He read proportionate as covering losses of separate underlying contracts compared to a non-proportionate reinsurance, where the cover relates to the collective loss of a portfolio/group of underlying contracts. This definition is different from proportional reinsurance, where each underlying contract of a reinsurance cover is to be covered on a proportional basis, and non-proportional reinsurance, where the coverage either of each contract or the portfolio/group is not proportional.

28 Proportional reinsurance covers are quota share reinsurance or surplus reinsurance, whereas Stop Loss, Catastrophe Excess of Loss and Per Risk Excess of Loss /Working Excess of Loss are regarded as non-proportional reinsurance.

29 The difference between proportionate and proportional reinsurance is in their view that e.g. the Per Risk Excess of Loss /Working Excess of Loss covers are included as proportionate covers, as they cover losses of separate underlying contracts whereas they are classified as non-proportional reinsurance covers. Thus, the definition proportionate is broader than proportional.

30 The following example shows a Per Risk Excess of Loss contract (also called Working Excess of Loss or Working Cover):

(a) Per underlying contract, the cedant's insurance contract limits are greater than the reinsurance retention. The reinsurer pays the losses in excess of the retention. The insurance company will insure contracts with limits up to $10 million, and then buy Per Risk Excess of Loss reinsurance with a retention of $5 million. In this case a loss of $6 million on an underlying contract will result in the recovery of $1 million from the reinsurer. A $ 8 million loss would result in a $ 3 million recovery, whereas the primary insurer will be left with a loss of 5 million on each contract. Would 6 or 8 individual underlying contracts of the underlying portfolio have each a loss of $ 1 million, the reinsurance cover would not lead to any recovery from the reinsurer, since the losses are below the $ 5 million retention.

(b) So, the recovery from the reinsurer may not be proportional to the net loss the primary insurer under a Per Risk Excess of Loss. Still, this form of reinsurance does also not cover aggregate losses from a group of underlying contracts. Thus, it is proportionate in the sense of BC304.

Other comments

31 One observer noted that in some circumstances reinsured onerous insurance contracts are underwritten before the start of the coverage period of the reinsurance contract. In those cases, an accounting mismatch could arise if the recognition dates of reinsurance contracts and insurance contracts were not aligned (IFRS 17.62 (a) versus IFRS 17.25 (c)). The observer noted that the tentative decision of the IASB only referred to a change of paragraph IFRS 17.66 (c) about measurement but did not provide a solution for recognition.

EFRAG TEG input April 2019

32 On the topic of onerous underlying contracts that are profitable after reinsurance, EFRAG TEG:

33 Considered the input of EFRAG IAWG that further accounting solutions would be needed for non-proportional reinsurance.

34 Questioned why the accounting treatment is different for proportional and non-proportional reinsurance.

35 Noted the complexity of finding a possible accounting standard solution for aligning the accounting treatment of proportional and non-proportional reinsurance due to the difference in economic substance.

36 Noted that non-proportional reinsurance would require a different and more aggregated unit of account than proportional reinsurance.

37 Considered the view of EFRAG IAWG that the impact of reinsurance could be captured by a risk adjustment for the underlying business. Some members noted that this approach would result in a form of synthetic accounting.

38 Noted that it was necessary to assess the final wording of the Exposure Draft and the definition of proportional and non-proportional reinsurance before reaching a conclusion.

EFRAG TEG input May 2019

39 The EFRAG Secretariat reported the EFRAG IAWG discussion which had revealed (i) that confusion exists about the terms used: proportionate vs proportional reinsurance; and (ii) uncertainty exists about the nature of the difference between proportionate and non-proportionate reinsurance.

40 EFRAG TEG members considered the IASB examples on reinsurance too simplistic as they identified limited differences between insurance and reinsurance contracts (such as the inclusion of acquisition cash flows). A deeper analysis from the IASB would be helpful in this respect.

41 Some EFRAG TEG members suggested that the IASB should be asked for clarification as to why it has limited its solution to proportionate reinsurance. It was clarified that the IASB staff did not see the problem for non-proportionate reinsurance and when examples had been asked from the industry, these had not been received.

42 One observer considered that showing a matching position between the loss on the onerous direct contract and the gain of the non-proportionate reinsurance contract provided reliable information only to the extent that there is technical mirroring. It was first of all necessary to understand the reasons for the direct contract to be onerous and, similarly, for the counterparty of the reinsurance contract, to accept an onerous contract. Examples were needed in practice to better understand the economics behind the risk mitigation strategies.

43 It was noted that insurers would only enter into onerous direct business when they would have reinsurance available.

44 Several EFRAG TEG members mentioned that it was necessary to wait for the final wording of the ED as insurers do not seem to differentiate between proportional and non-proportional reinsurance but use either or both to protect their margin. As such reinsurance cannot be seen as a derivative but as an outsourcing of the risk. So, there is a question as to why additional complexity was necessary.

45 Seven EFRAG TEG members decided to wait for the final wording before taking a firm position. They provisionally supported the decision to amend IFRS 17 for proportionate reinsurance only and not to ask the IASB to develop specific accounting solutions for non-proportionate reinsurance at this stage.

46 The majority of these members were uncomfortable with the changes that were sought, because of the lack of clarity about non-proportional reinsurance fact patterns;

47 Some suggested to consult constituents on relevant fact patterns and information about prevalence; such information could assist the IASB to finalise the wording;

48 One EFRAG TEG member suggested the IASB to include in the Basis for Conclusions an illustration of the difference between proportionate and non-proportionate reinsurance;

49 One EFRAG TEG member considered that in practice there are many different terms and conditions not always symmetrical with the direct contracts. Accordingly, the risk mitigation strategies are difficult to frame into an accounting solution without adding complexity;

50 One EFRAG TEG member considered that the IASB had to consider holistically in a subsequent phase the topic of accounting for risk mitigation instead of adding single exceptions for selected fact patterns.

51 Two EFRAG TEG members (+1 by written response) supported to require an amendment to the standard.

52 One of them proposed to remove the difference between proportionate and non-proportionate;

53 One of them supported to develop a specific form of hedge accounting for non-proportionate reinsurance.

54 One of the EFRAG TEG members that was absent during the meeting provided subsequent written inputs supporting View 2, i.e. to remove the difference between proportionate and non-proportionate reinsurance.

55 Two EFRAG TEG members did not explicitly express a view. An observer noted that in order to be as specific as possible, any proposal made by EFRAG on this topic should spell out what additional/new technical elements should have been taken into account by the IASB as part of its work on the proposed amendments.

Questions for EFRAG Board and TEG

56 Members are invited to note:

(a) the views from IAWG (only 2 members supporting view 2 and the rest of the group supporting view 1);

(b) preliminary views from TEG (7 members preferred to wait for the final wording before concluding and provisionally supported view 1; 2 (+1) members supported view 2 but indicated two different solutions);

(c) the proposal from TEG to consult constituents on relevant fact patterns and prevalence;

(d) the possibility contemplated in the TEG discussion that the IASB addresses holistically in a subsequent phase the topic of hedge accounting.

57 Based on the technical discussions presented above, what are your comments and orientation at this stage of the process?

58 Do members agree that in the draft comment letter EFRAG should consult its constituents on relevant fact patterns and prevalence?

Appendix: background information

Input from ANC

Suggested modifications:

59 IFRS 17.66: Instead of applying paragraph 44, an entity shall measure the contractual service margin at the end of the reporting period for a group of reinsurance contracts held as the carrying amount determined at the start of the reporting period, adjusted for:

(a) the effect of any new contracts added to the group (see paragraph 28). Where newly issued insurance contracts are onerous, the entity shall recognise any net gain on purchasing the group of reinsurance held immediately in profit or loss to the extent the gain relates to losses on the group of underlying insurance contracts that are recognised in profit or loss;

(b) interest accreted on the carrying amount of the contractual service margin, measured at the discount rates specified in paragraph B72(b);

(c) changes in the fulfilment cash flows to the extent that the change:

(i) relates to future service; unless

(ii) the change results from a change in fulfilment cash flows allocated to a group of underlying insurance contracts that does not adjust the contractual service margin for the group of underlying insurance contracts.

(d) the effect of any currency exchange differences arising on the contractual service margin; and

(e) the amount recognised in profit or loss because of services received in the period, determined by the allocation of the contractual service margin remaining at the end of the reporting period (before any allocation) over the current and remaining coverage period of the group of reinsurance contracts held, applying paragraph B119.

Input from CFO Forum

60 For onerous contracts at inception, recognise a gain on proportionate reinsurance to the extent reinsurance covers the loss.

Input received from the extensive case study

Step 4.19. Direct insurance combined with reinsurance

Questions 47, 48

61 Choose one of your direct insurance portfolios selected and combine it with the reinsurance ceded portfolio you have selected. In doing so, note that the reinsurance portfolio should be related to the direct insurance portfolio.

62 Relying on the information gathered in steps:

(a) 4.8. Economic mismatches;

(b) 4.9. Accounting mismatches;

(c) 4.12 CSM allocation patterns;

(d) 4.13. Insurance revenue;

(e) 4.14. Insurance result; and

(f) 4.15. Insurance finance income/expenses

63 Please provide the following information:

(a) CSM release patterns;

(b) Economic mismatches;

(c) Accounting mismatches;

(d) Insurance finance income and expenses.

64 Five respondents noted that the question was not applicable to them. One respondent did not answer the question.

65 Of the respondents providing information:

66 Four respondents provided qualitative and quantitative input. Of these four:

67 Two respondents provided an example relating to protection business that is onerous and becoming profitable after considering external reinsurance. These respondents described that direct protection was written in collaboration of reinsurance partners for that reason.

68 One respondent provided an example relating to a savings fund that was proportionally reinsured for 10%.

69 One respondent supported the exclusion of reinsurance assumed from the VFA. However, for intercompany purposes the respondent deemed it beneficial for reinsurance assumed to mirror the mechanics of the underlying business.

Input received from the simplified case study

Step 4.10 Direct insurance combined with reinsurance

70 Question: Please explain how you account for the combination of direct insurance and ceded reinsurance under your current accounting practices and provide the following information.

71 Of those respondents that answered this question, the following information was provided:

72 Under current accounting, the margins on the direct insurance contracts and the reinsurance ceded are released in line with the liability and risk reduction. The direct insurance contracts are backed with assets. By using current discounting rates the accounting mismatches are eliminated. A longevity swap discounted at current rates is used to limit economic mismatches on the reinsurance ceded. Overall, little economic mismatches occur and no accounting mismatches (one respondent).

73 Under current accounting the premium revenue and reinsurance expense are recognised in line with the pattern of the incidence of risk over the period of the contract. The net outstanding claims provision comprises the gross estimate of expected future claim payments less amounts recoverable from reinsurers on the gross estimate. Under IFRS 17 both indirect insurance and ceded reinsurance contracts will qualify for the PAA and therefore the accounting is expected to be similar. As there are no onerous contracts identified we do not expect to set up a reinsurance CSM gain at inception (one respondent).

74 Under IFRS 17, 10% of our multi-fund portfolio was ceded and measured both applying the general model and VFA. When the general model is used to measure the ceded result of a quota share treaty, the actual percentage of profit ceded to the reinsurer is disconnected from the share of the risks ceded to the reinsurer. When there are changes in the estimates of future fulfilment cash flows triggered by changes in the economic environment, the overall effect is fully immediately recognised in the profit ceded to the reinsurer while it is included in the CSM of the insurer and recognised in P&L over the life of the contract. Exclusion from the scope of Variable Fee Approach of direct participating contracts' proportional reinsurance

must be lifted. IFRS 17 prohibits the use of Variable Fee Approach for ceded / accepted reinsurance. This principle generates an accounting mismatch with reinsured participating contracts accounted for using Variable Fee Approach and does not reflect the economic conditions of related reinsurance scheme. (two respondents)

Step 4.13 Overall impact

75 Reinsurance contracts have a different accounting which leads to accounting mismatches, also reinsurance contracts should qualify for the VFA-approach (eleven respondents). One respondent identified the following issues in relation to reinsurance:

(a) Allowance for future new business;

IFRS17 requires the insurance company to make allowance for reinsurance cash flows over the full term of the policy arising from future new business within the contract boundary of the reinsurance treaty (typically 3 months). The corresponding cash flows in respect of the underlying contract are excluded as the contract with these policyholders will commence in the future, and there is no contractual obligation for these to be written. This results in a mismatch which does not reflect commercial reality; the current IT systems are built to consider such an allowance and doing so will create additional resourcing.

(b) Differences in initial recognition point; and

IFRS17 requires the initial recognition point of the underlying contract and its associated reinsurance element to be assessed independently. If the reinsurance treaty commenced before the policy date of commencement by at least one month (but in practice can be a few years) this can lead to different locked-in rates for the two elements

(c) Offsetting loss component on underlying contract against CSM on reinsurance element

The loss component/CSM on the underlying contracts and the reinsurance element of a policy are calculated independently.

76 One respondent noted a potential complexity for open reinsurance treaties (open to accept new business) and the resulting required cohorts. If the treaty has a clause where both parties can terminate for new business with 90-day notice, this might pose significant operational complexities in identifying cohorts (e.g. 3 months, 6 months or 12 months). Without such a clause, the cash flows might need to include a longer period of new business and even include projected future new business. This will cause a significant mismatch with the underlying business.

Input received from the Economic Study

77 The majority of stakeholders believe that reinsurance contracts are not dealt with appropriately, as this asymmetric, non-economic treatment of reinsurance in the standard could add a non-economic pricing constraint to mitigate perceived losses in the financial reporting due to accounting mismatches. Further, any implications to the pricing of reinsurance which can be acquired will also impact on the pricing of the underlying contract to the policy holder.

Input received from the EIOPA-report

Portrayal of the financial situation (liquidity, profitability, solvency)

78 …Another example could be the difference in treatment between onerous insurance contracts and corresponding reinsurance contracts held, which may be contracted to cover the losses made on the underlying contracts. Yet IFRS does not distinguish

between the different economic circumstances or the rationale for taking up reinsurance and in the described case would not allow for immediate recognition of both the losses from the underlying onerous contracts and the profits made from the reinsurance contract held. In other cases, where the circumstances are different, it is indeed a better reflection on performance if gains from reinsurance are not immediately recognised. Concluding, IFRS 17 does not seem to acknowledge the different economic circumstances and consequently does not allow the insurer to present a matching treatment of gains from reinsurance contracts, where this may be appropriate.