EFRAG
European Financial Reporting Advisory Group

EFRAG Board and EFRAG TEG meeting
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Paper 06-07
EFRAG Secretariat: Insurance team

Reinsurance: Contract boundary of reinsurance contracts held Issues Paper

Introduction

1 Under IFRS 17, cash flows within the boundary of the reinsurance contract held will include cash flows relating to those underlying contracts. However, cash flows within the boundary of the underlying contract issued do not include contracts expected to be issued in the future.

2 The IASB tentatively decided not to amend this IFRS 17 requirement.

3 Some stakeholders are concerned that the requirement is unduly complex, will create a gross up for reinsurance coverage when the underlying contracts have not yet been recognised, creating a mismatch, and they think that the contractual service margin ('CSM') will be recognised in an inconsistent manner as compared to the underlying contract CSM.

View 1– Agree with the IASB tentative decision to retain the IFRS 17 requirements

4 The IASB acknowledged that separate accounting for the reinsurance contracts and their underlying insurance contracts may create mismatches that some regard as purely accounting. However, the IASB concluded that accounting for a reinsurance contract held separately from the underlying insurance contracts gives a faithful representation of the entity's rights and obligations and the related income and expenses from both contracts.

5 Furthermore, the IASB consider that cash flows of uncertain timing and amounts are included in the measurement of all insurance contracts. This is not unique to reinsurance contracts held. For example, for all insurance contracts the entity is required to estimate the probability and amounts of claims that will be incurred.

6 The IASB consider that future underlying insurance contracts are reflected in the cash inflows, cash outflows, risk adjustment for non-financial risk and contractual service margin included in the measurement of the reinsurance contract held. Those amounts sum up to nil until the point that one of the following events occurs:

(a) The entity pays or receives amounts relating to the reinsurance on those future underlying contracts (for example, the entity pays reinsurance premiums); or

(b) Those underlying contracts are issued and the entity starts receiving reinsurance services relating to those contracts.

When one of those events occurs, the amounts included in the measurement of the reinsurance contract held relating to those contracts will no longer sum to nil.

7 It can be noted that situations may occur where contract boundaries differ between reinsurance contracts held and the underlying insurance contracts, due to for example, differences in repricing frequency. This is a direct consequence of treating

insurance contracts issued and reinsurance contracts held as separate contracts and it reflects the contractual positions.

8 Furthermore conceptually, expected future cash flows for reinsurance contracts held and insurance contracts issued should be measured using a similar and consistent approach. This is because for both reinsurance contracts held and the underlying insurance contracts, measurement should reflect the entity's substantive rights and obligations created by the contract. Therefore, the contract boundary, risk adjustment and discount rate used for reinsurance contracts held compared to the underlying insurance contracts may differ as this reflects different counterparties.

9 Reflecting the entity's substantive right to receive services from the reinsurer in the measurement results is a faithful representation of information in the financial statements for users. Also, the general principle under IFRS 17 that all future cash flows within the contract boundary are reflected in the measurement of an insurance contract is respected.

10 The CSM recognised, for reinsurance contracts, held in a reporting period is determined considering the services received in the current period and expected to be received in future periods. This is consistent with the requirements for insurance contracts issued. In circumstances that the service the entity receives from the reinsurer is proportionate to the service that the entity provides to the policyholder, the identification and allocation of coverage units for reinsurance contracts held will result in a pattern of CSM recognition which reflects that symmetry.

11 It is acknowledged that estimating future contracts that will be covered by a reinsurance contract already written will require judgement. However, there will be evidence supporting the judgement, including:

(a) entities are likely to have budgets or forecasts which include expected new business and to have information about how reliable similar estimates were in the past; and

(b) the estimation of these contracts would follow the same measurement principles as IFRS 17, i.e., probability-weighted estimate of the present value of cash flows.

View 2 – Further amendment needed to the standard

12 Treating a reinsurance contract held separately from the underlying insurance contracts issued is inconsistent with the treatment of risk mitigation, for which matching is allowed even if the derivative or reinsurance contract is a separate contract to the insurance contract issued.

13 From an economic point of view, reinsurance held aims at mitigating insurance risks in the underlying insurance contracts. Therefore, the requirements would cause inconsistencies in the following ways:

(a) Applying different discount rates result in mismatches in the financial result;

(b) Differences in the measurement of CSM and differences in allocation periods would lead to mismatches in the insurance result; and

(c) Including estimated underlying future new business within the reinsurance asset leads to disproportionately complex disclosures and mismatches on the statement of financial position.

14 Currently in practice, entities use assumptions that are consistent between the reinsurance contracts held and the underlying contracts. Therefore, entities match reinsurance contract revenue, costs, assets and liabilities to the underlying insurance contracts.

15 There may be a reduction in reliability estimating these contracts expected to be written in the future. Measuring future cash flows that relate to future underlying contracts not yet issued, is operationally complex in terms of estimating the volume of expected contracts and the different types of contracts expected to be sold and therefore there would be significant costs. This will result in measurement being unreliable, given that cash flows relating to future underlying contracts expected to be issued are uncertain.

16 The standard should be amended so that the measurement requirements in of paragraphs 32-36 of IFRS 17 are applied to reinsurance contracts held, only to the extent that the underlying contracts are recognised.

Summary of the EFRAG IAWG discussion – May 2019

Description of the remaining concerns

17 There is a concern that the reinsurance contract held will include cash flows relating to those future underlying contracts. However, cash flows within the boundary of the underlying contract issued do not include these contracts expected to be issued in the future.

18 Some EFRAG IAWG members have indicated that this issue impacts the quality of information, i.e. relevance, for e.g., there would be an impact in P&L and CSM would be blown up on the Balance Sheet. They indicated as well that the resulting accounting would be diverging from Solvency II and managerial reporting, thus adding complexity to derive from the systems the required accounting figures.

19 One member (auditor) highlighted that the entity should look at the substantive rights and obligations related to the contracts. However, other members disagreed and indicated that the reinsurance contract only exists because of the underlying contracts. One member stated that in the application of hedge accounting, even though there is no contractual link, mirroring was achieved. This is not the case with this issue under IFRS 17 and found the accounting outcome to be counterintuitive.

20 Another member indicated that reinsurance could be seen more like outsourcing specific aspects rather than comparing to derivatives.

21 One observer indicated that the issue he heard related more to costs being more than the benefits.

22 Some EFRAG IAWG members indicated that this issue is not a top priority one.

Can the issue be solved without amendments to the standard?

23 Some EFRAG IAWG members indicated that the industry is trying to cope with this IASB requirement.

24 One member indicated that the issue cannot be solved with a marginal change to the standard.

Preparers supporting View 1 or View 2

25 6 preparers supported a change being made to the standard while one did not support a change to the standard.

Other (non-preparers) members supporting View 1 or View 2

26 Two members did not support a change to the standard.

Other comments

27 One EFRAG IAWG member indicated that, in the reinsurance treaty, there is an option to cancel the treaty within a 90-day period.

Summary of EFRAG TEG discussion – May 2019

28 Some EFRAG TEG members indicated that this issue on contract boundary and the reinsurance issue on onerous contracts are linked (for example, a gain on the reinsurance contract held due to the longer contract boundary compared to onerous underlying contracts).

29 **5 EFRAG TEG members** supported the IASB decision to retain IFRS 17, mentioning the following reasons:

(a) The need to depict the rights and obligations under the contract;

(b) The issue is broad as there are many different types of reinsurance contracts (e.g. there could be issues relating to proportionate versus non-proportionate reinsurance) and allowing for an exception could offer structuring opportunities;

(c) There is no impact on the balance sheet but there is a difference in the split between the fulfilment cash flows and CSM for reinsurance contracts held compared to the underlying contracts. The CSM for the reinsurance contracts held would reflect future expected contracts and this provides useful information for investors. The price to obtain reinsurance is more volatile than the price charged to the policyholders. Investors would like to know how well protected the insurers are;

(d) One EFRAG TEG member considered that the linkage with the previous issue (symmetric accounting for non-proportionate reinsurance contracts) related to the possible need for a holistic approach to hedge accounting in a subsequent phase. There is a need for a robust hedging model, instead of fixing single issues.

30 **2 EFRAG TEG members** supported the need to amend the standard in order to align the contract boundary of the reinsurance contracts to that of the underlying contracts. The following reasons were mentioned:

(a) There was a conceptual issue on whether symmetry should be between the reinsurer and insurer or between reinsurance contracts held and the underlying contracts;

(b) There is no impact on the balance sheet and probably not a significant impact on profit or loss. Therefore, one should not increase complexity by adding future contracts within the contract boundary of reinsurance contracts held; and

Some EFRAG TEG members considered that it would be appropriate to consult constituents, as these members needed to understand the magnitude of the issue.

31 **4 EFRAG TEG members** did not explicitly express a view.

32 One of the EFRAG TEG members that was absent from the meeting provided subsequently written inputs supporting the need to amend the standard order to align the contract boundary of the reinsurance contracts to that of the underlying contracts.

33 One observer stated that in order to be as specific as possible, any proposal made by EFRAG 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.

Background information

EFRAG extensive case study

34 Respondents provided the following views:

(a) The quarterly IFRS closings will be different than the aggregated monthly closings;

(b) IFRS 17 bases the accounting on the contract an insurer has with a reinsurer. This is viewed as breaking the matching principle and has effects relating to the recognition of the insurance contracts and the allowance for future new business.

(i) If the reinsurance treaty commenced before the starting date of the direct insurance contracts (which in practice can be a few years) different locked-in rates need to be used for the reinsurance contract and the insurance contract. This is not reflecting commercial realities where the same discount rate is applied to all cash flows arising from a policy to assess profitability;

(ii) The difference in contract boundary has an effect that allowance for reinsurance cash flows over the full term of the reinsurance policy has to be taken, including future new business within the contract boundary of the reinsurance treaty (typically 3 months). This is seen as not reflecting commercial reality as a policy is assessed today in its entirety; will require important changes to the current systems with an expected small financial impact and will require making assumptions for future new business.

(c) Operationally, reinsurance would typically be written at a later date than the front contract due to grouping of risk. This is often in different calendar years.

(d) IFRS 17 differs from local GAAP around the world and Solvency II and would not reflect the actual ceding percentage.

(e) Cashflows in respect of underlying contracts not yet written, will fall within the contract boundary of a reinsurance treaty held, at least up until that point where the cedant is no longer obliged to cede (a proportion of) such contracts, or the reinsurer is no longer obliged to accept (a proportion of) such contracts (or can reprice). When discount rates move the present value of these cashflows would change. As reinsurance held (and assumed) falls outside the scope of the VFA the impact of this interest rate change would flow through the insurance finance result within the income statement.

(f) Three respondents noted areas where IFRS 17 does not appropriately reflect the fundamental economics of their business for reinsurance, e.g., for reinsurance held, future cash flows need to be included in the contract boundary resulting in a mismatch.

EIOPA's analysis of IFRS 17 Insurance Contracts

35 Under Solvency II, as the amounts recoverable from the reinsurance contract held are calculated consistently with the contract boundaries of the underlying insurance contract, insurers may recognise cash flows arising from future, as yet unpurchased, reinsurance contracts that cover obligations recognised on the balance sheet (subject to certain conditions).

36 In the case of a multi-year reinsurance contract, the contract boundary of the reinsurance contract would not extend beyond the contract boundary of the underlying contracts written before the reporting date. However, the part of the reinsurance contract held that is outside of the underlying contracts' contract boundaries or that does not refer to an existing underlying insurance contract, is not be recognised, unless it is a determined commitment, for example general commissions to be paid.

Questions for EFRAG Board

37 EFRAG Board members are invited to note:

(a) that in both EFRAG IAWG and EFRAG TEG both views attracted support of members of that groups (view 1 supported by 2 EFRAG IAWG members and by 5 EFRAG TEG members; view 2 supported by 6 EFRAG IAWG members and by 2 EFRAG TEG members);

(b) that 4 EFRAG TEG members did not explicitly express a view at this stage; and

(c) some EFRAG TEG members suggested to consult constituents on this issue.

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

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

Appendix: Input from ANC and CFO Forum

Input from ANC

1 The reinsurance contract's boundary stems from the substantive right and obligation of the primary insurer which includes receiving service from the reinsurer in exchange for the reinsurance premium. Thus the substantive right to receive services from the reinsurer ends when the reinsurer has the practical ability to reassess the risks transferred and to set a price accordingly. As a consequence, the fulfilment cash flows arising from the reinsurance contracts may include cash flows from contracts not yet written.

2 Hence, the definition of the boundary applicable to reinsurance contracts does not require consistency with the underlying insurance contracts and is rather assessed based on the contractual features of the reinsurance contract itself. Taking into account the expected future insurance contracts reflects the way reinsurers manage their business rather than the way primary insurers do. From an economic point of view, reinsurance held (being proportional or non-proportional, life or non-life) aims at mitigating the insurance risks recorded in the underlying liabilities.

Resulting risk of mismatch

3 Inconsistencies between reinsurance contracts held and related insurance contracts may crystallise in the following accounting treatments:

(a) Applying different discount rates result in mismatches in the financial result;

(b) Differences in the measurement of CSM and differences in allocation periods (coverage units) lead to mismatches in the insurance result (notably linked with the difference between the assessment of future contracts and the assessment of future cash flows when such contracts are eventually recognised, or changes in estimates in key assumptions).

(c) Including estimated underlying future new business within the reinsurance asset leads to disproportionately complex disclosures

4 Recognising reinsurance contracts cash flows relating to insurance contracts not yet written provides information of little relevance whereas it raises significant costs due to the operational complexity to deal with such temporary estimates in the IT systems and their possible discounting effect and subsequent changes. Based on a cost/benefit analysis, we therefore suggest limiting the reinsurance contracts' boundaries to the recognised underlying contracts.

5 In addition, there is no reason for differentiating proportional from non-proportional reinsurance held even if the measurement of the latter may prove more complex.

6 The ANC suggest aligning the boundaries of insurance contracts held with those of recognised underlying contracts.

IFRS 17.63:	~~In applying t~~The measurement requirements of paragraphs 32–36 to reinsurance contracts held apply~~,~~ to the extent that the underlying contracts are recognised. ~~also measured applying those paragraphs , t~~The entity shall use consistent assumptions to measure the estimates of the present value of the future cash flows for the group of reinsurance contracts held and the estimates of the present value of the future cash flows for the group(s) of underlying insurance contracts. In addition, the entity shall include in the estimates of the present value of the future cash flows for the group of reinsurance contracts held the effect of any risk of non-performance by the

issuer of the reinsurance contract, including the effects of collateral and losses from disputes.

Input from CFO Forum

7 In the CFO Forum's view, proportional reinsurance to include cash flows in respect of recognised underlying contracts.

8 The CFO Forum proposes to amend IFRS 17 as follows.

9 IFRS 17.62(a) should read:

if the reinsurance contracts held provide proportionate coverage—at the beginning of the coverage period of the group of reinsurance contracts held or at the initial recognition of ~~any underlying contract~~ the underlying contracts, whichever is the later; and

10 Furthermore, IFRS 17.BC305(a) should read:

when the group of reinsurance contracts held covers the loss of a group of insurance contracts on a proportionate basis, the group of reinsurance contracts held is recognised at the later of the beginning of the coverage period of the group of reinsurance contracts held or the initial recognition of ~~any~~ the underlying contracts. This means that the entity will ~~not recognise the group of reinsurance contracts until it has recognised at least one of the underlying contracts~~ only recognise the group of reinsurance contracts held to the extent that the underlying direct contracts are already recognised.