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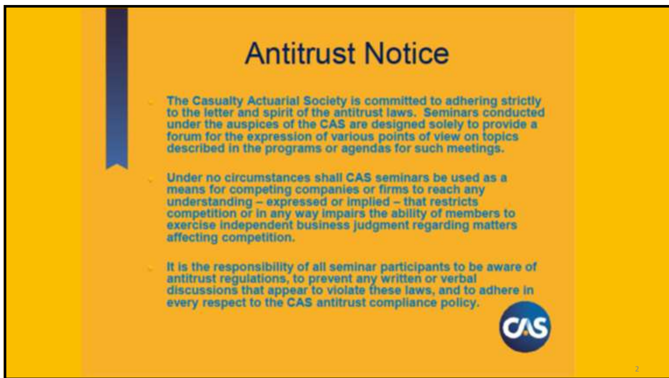

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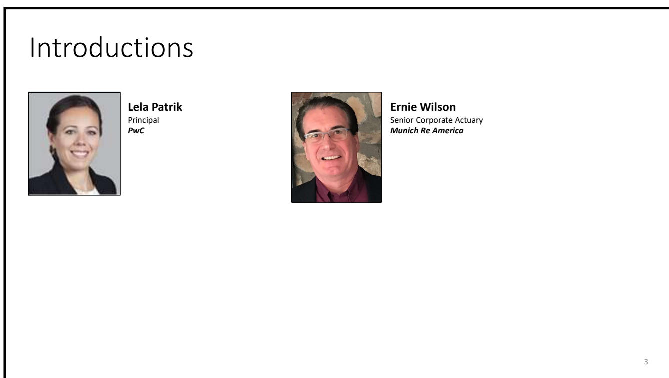

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Agenda

Topic

1 – Overview of IFRS 17

2 – Reinsurance held – potential mismatches

3 – Reinsurance held – complexities

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1 Overview of IFRS 17

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The basics

1 **What is IFRS 17?**
A comprehensive standard to account for insurance contracts applicable to companies that prepare financial statements under IFRS. It replaces IFRS 4, which was not a comprehensive standard

2 **Who/Where affected?**
Applies to (re)insurance contracts issued and certain investment contracts issued by entities applying IFRS

3 **What's required?**
Current value measurement model, with recognition of profit from a 'group of insurance contracts' over the period the entity provides insurance coverage and as the entity is released from risk

4 **When?**
1 January 2023, requiring retrospective adoption, but with options if impracticable; comparative balance sheets needed for both December 31, 2023 and 2022; earlier application permitted

5 **Why?**
To drive consistency and comply with IASB guidance; IFRS 4 was an interim standard that allowed entities to use a wide variety of accounting practices reflecting local accounting practices and variations of those practices

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Polling questions

What will be your IFRS17 reporting requirements?

a) Group reporting
b) Local regulatory reporting
c) Both

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Overview of the guidance

IFRS 17 is the proposed new international accounting standard for insurance contracts which replaces the existing IFRS 4 standard. The new standard provides a single global accounting standard for insurance and reinsurance contracts.

What is changing?

Balance sheet
- IFRS 17 requires a current measurement model, where estimates are re-measured in each reporting period.
- The measurement is based on the building blocks of discounted, probability-weighted cash flows over all possible outcomes, a risk adjustment, and a contractual service margin ('CSM') representing the unearned profit of the contract.

Income statement
- Requirements in IFRS 17 align the presentation of revenue with other industries. Investment components are excluded from revenue and incurred expense.
- Under IFRS 17, entities have an accounting policy choice to recognize the impact of changes in discount rates in profit or loss or in other comprehensive income ('OCI') to reduce some volatility in profit or loss.

Disclosures
- IFRS 17 disclosures will be more detailed than required under current reporting frameworks.
- Disclosures will provide additional insight into key judgments and profit emergence.
- Disclosures are designed to allow greater comparability across entities.

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Measurement models

This model is expected to be **applicable to most P&C** short-duration contracts

This model is expected to be **not applicable to P&C** business

	General Measurement Model	Premium Allocation Approach (PAA)	Variable Fee Approach (VFA)
Why is it needed?	Default model for all insurance contracts	To simplify for short term contracts with little variability	To deal with participating business where payments to policyholders are linked to underlying items like assets
Types of contract	• Long-term and whole life insurance, protection business • Certain annuities • US style universal life • Reinsurance • Certain general insurance contracts	• General insurance • Short-term life and certain group contracts • Reinsurance	• Unit-linked contracts, US variable annuities and certain equity index-linked contracts • Continental European 90/10 contract • UK with profits contracts
Mandatory?	Mandatory	Optional	Mandatory

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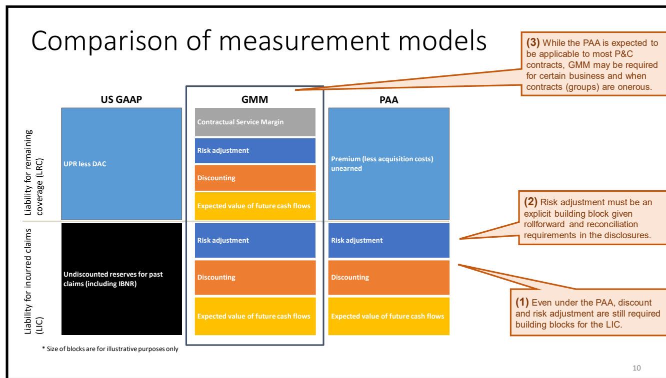

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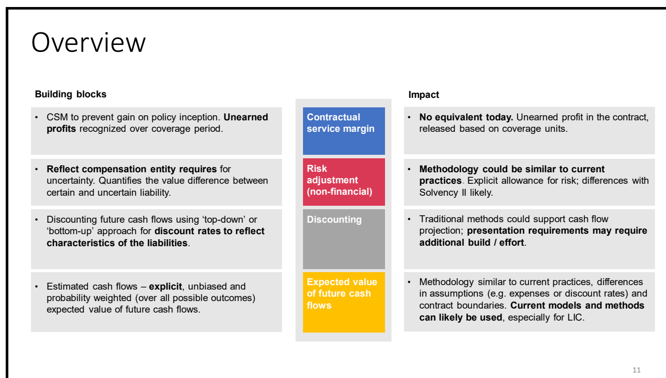

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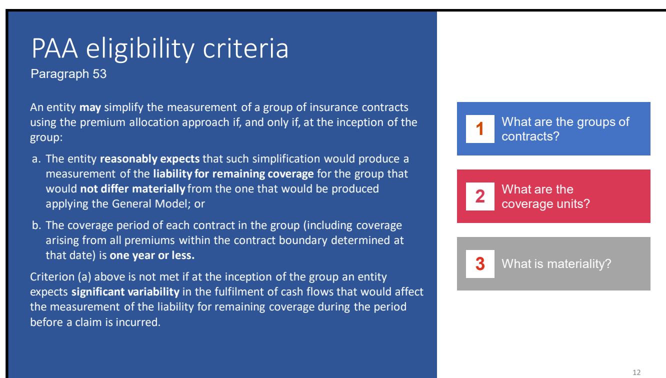

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Key characteristics impacting PAA eligibility

1. **Longer coverage period**, in general
2. Coverages in which the pattern of incurred claims is either **highly seasonal** or otherwise differs significantly from an even release over the coverage period
3. **High level of profitability** expected (i.e., large CSM)
4. **Long payout patterns** for incurred claims, particularly in higher and/or more volatile interest rate environments

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Polling questions

Has your organization started performing PAA eligibility testing?

a) Not started
b) Identified groups of contract that will require eligibility testing
c) Identified product types that will require eligibility testing and have started or performed limited analysis
d) Completed quantitative eligibility analysis
e) Not applicable

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Is the cash flow in the boundary of the contract?

OUT

No — Policyholders obliged to pay related premiums? — Yes

OR

Yes — Practical ability to reprice risks of the particular policyholder to reflect the risk?

No ↓

Practical ability to reprice portfolio of contracts to reflect the risks? — No

Yes ↓

No — Premiums reflect risks beyond the coverage period? — Yes

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Portfolios & groups

The level of aggregation is the combination of contracts into:

- **Portfolios:** comprised of contracts with ***similar risks*** that are ***managed together***
- **Cohorts:** contain contracts written ***no more than one year apart*** (i.e., divide portfolios based on issue date)
- **Groups:** divide portfolios based on onerous, at risk of becoming onerous, and all other contracts (can be determined in **sets** rather than contract by contract)

- Groups formed at initial recognition and are not reassessed upon subsequent measurement.
- Thus, ongoing monitoring for onerous contracts is performed at the group level.

Portfolio: Portfolio A | Portfolio B | Portfolio C | Portfolio D | ...

Cohort: ... | 2021 | 2022 | 2023

Group:

- **Onerous**
  - Set B1
  - Set B3
- **Profitable with no significant risk of becoming onerous**
  - Set B2
  - Set B4
- **All other**
  - Set B5

*Level of aggregation is determined separately for ceded reinsurance.

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Portfolios & groups - when does it really matter?

- **Potential to leverage the same (or very similar) measurement segmentation utilized today under US GAAP & then allocate back, when it matters**
- When does it matter?
  - PAA eligibility testing
  - Onerous contract – recognition of loss in P/L
  - GMM – CSM determination and subsequent amortization
- When is allocation back to group <u>not</u> needed?
  - PAA eligible AND not onerous

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Onerous contract considerations

- A group of contracts is considered onerous when **future service** fulfilment cash flows are loss making (i.e., when the sum of expected cash outflows exceed the sum of expected cash inflows plus the value of LRC, based upon prior cash activity)
- The loss component for onerous contracts is the portion of LRC that is recognized immediately in the Income Statement, and excluded from revenue

	GMM	PAA
How are onerous contracts identified?	Onerous contracts are identified through explicit measurement of each set of contracts	Assume no contracts are onerous unless **facts and circumstances** indicate otherwise
How is the loss component measured on initial recognition of a group of contracts?	The amount by which fulfilment cash outflows exceed fulfilment cash inflows	The loss component is the amount by which fulfilment cash flows exceed the LRC excluding loss component
How is the loss component measured when onerous contracts are first identified on subsequent recognition?	The amount by which unfavorable changes in fulfilment cash flows exceed the CSM	
How are changes in the loss component measured	Changes in fulfilment cash flows are allocated between the loss component and LRC excluding loss component	

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Polling questions

What do you expect the greatest challenge to be?

a) PAA eligibility
b) Implementation of a new system solution
c) Gathering additional data
d) Formulating a risk adjustment approach and managing volatility
e) Additional disclosures

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2 Reinsurance Held - Potential Mismatches

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Why are reinsurance contracts challenging?

There are some basic reasons as to why reinsurance is more challenging to value under IFRS 17, and it is not all due to IFRS 17 requirements. It has a lot to do with how we currently operate.

IFRS 17 requirement	What we do under US GAAP	Implementation issue
Reinsurance is treated as a separate expense and does not reduce revenue.	Reinsurance premiums and losses are netted in the revenue and expense lines of the I/S.	Companies may not have the data or processes set up to do the reinsurance held at the level of granularity required.
Valuation must be contemplated at the group level which reflects the profitability of the contracts (insurance and reinsurance).	We aggregate, mixing loss making and profitable contracts.	Companies may not have the data or processes set up to do the reinsurance calculations separately for reinsurance held at the level of granularity required.

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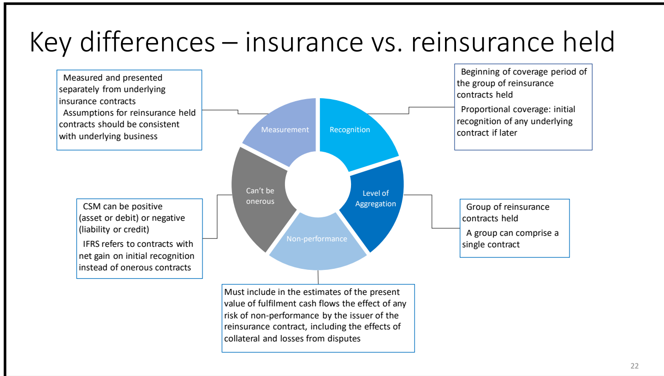
Key differences – insurance vs. reinsurance held



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Overview & challenges

Reinsurance contracts issued (i.e., assumed) = insurance contracts issued

- Note that ceding commissions are netted against premiums, with the net amount treated as revenue under the contract
- There may also be investment components and certain other cash flows that need to be removed from insurance revenue and expenses

<u>Note</u>: An investment component is the amount that an insurance contract requires the entity to **<u>repay</u>** to a policyholder even if an insured event does not occur.

Reinsurance contracts held (i.e., ceded reinsurance) -> special requirements

- F/S presentation is gross (i.e., not netted on the balance sheet or the income statement), thus measurement (& other considerations) are separate for ceded reinsurance.
- This can create challenges:
  - Consistency with gross cash flows - level of aggregation, contract boundary, measurement model, CSM release pattern (if GMM), onerous contract measurement
  - Risk attaching contracts, even when the underlying contracts have coverage periods of 1 year or less, would need to be assessed for PAA eligibility
  - Investment components and net presentation of certain other cash flows – identification, measurement, tracking
  - Program structures with special considerations for net impacts

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Potential differences and mismatches

Feature	Impact
Underlying measured using PAA	• Risk attaching reinsurance will not automatically be eligible for PAA, even when the underlying contracts are automatically eligible.
Multiple underlying contract groups	• Multiple underlying contract groups feed fully or partially into a single reinsurance contract group (assuming no separation) – Wide-ranging implications.
CSM amortization	• Potential for different reinsurance and underlying CSM amortization profiles due to different recognition dates, exposures, locked-in rates, coverage periods, interactions when unlocking etc.
Reinsurance valuation needs to allow for future new underlying business.	• CSM will rely on estimated future business volumes, which may have little relation to actual underlying business.
Complex contracts with addenda	• Careful consideration of the detailed terms of the contract is required (e.g. new risk, past/future events etc.) • Addenda may not meet the requirement to be treated as separate groups, making valuation more complex.
Retroactive reinsurance	• Ceded contract boundary is the claim settlement period regardless of the underlying gross coverage periods.

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Further considerations
Non-proportionate reinsurance

Expected value of future cash flows

- How to determine assumptions for XOL reinsurance?
  - Historical data
  - May be able to consider net and gross and relationship between the two?
- Allocate measurement (as needed)

Risk adjustment

- Can you use the same uncertainty factors for ceded reinsurance if XoL?
  - Dependent on claims distribution and limits profiles
    - How consistent are claims (i.e., frequency and severity)?
    - Lower limits - Gross and Ceded are more likely to follow similar distribution
    - Changing retentions/limits may change distribution
    - While variability is likely higher, risk adjustment does not just take into account higher than expected losses, but lower as well (i.e., if the mean cash flows weigh in highly unlikely but very large losses or loss ratios the risk adjustment may be smaller)
    - May depend on statistic used to determine required capital (e.g., VaR, TVaR)
    - Data credibility - would RA need to be estimated at a higher level?

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Polling questions

What do you anticipate to be the greatest challenge to your organization related to reinsurance held?

a) Data gaps
b) Need to use the GMM
c) Investment component tracking
d) Treatment of LPT contracts
e) All of the above

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3 Reinsurance Held - Some Complexities

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Some complexities

1. Risk transfer
2. Recognition (for proportionate and non-proportionate contracts)
3. Retroactive reinsurance
4. Premium not received (& non-distinct investment components)
5. And more …

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Risk transfer: what is insurance risk?

Let's compare to what (we think) we know

IFRS 17 definition	FAS 113 definition (mirrored in SSAP 62R)
Risk, other than financial risk, transferred from the policyholder to the (re)insurer	The risk arising from uncertainties about both (a) the ultimate amount of net cash flows from premiums, commissions, claims, and claim settlement expenses paid under a contract (underwriting risk) and (b) the timing of the receipt and payment of those cash flows (timing risk) – It is fortuitous, i.e., the possibility of adverse events occurring is outside the control of the insured.
An insurance contract accepts **significant** insurance risk from a policyholder by agreeing to compensate the policyholder if a specified uncertain future event adversely affects the policyholder Insurance risk is **significant** if, and only if, an insured event could cause the issuer to pay additional amounts that are significant in any single scenario, excluding scenarios that have no commercial substance (i.e., no discernible effect on the economics of the transaction).	Indemnification of the ceding enterprise against loss or liability relating to insurance risk in reinsurance requires both of the following: a. The reinsurer assumes significant insurance risk under the reinsured portions of the underlying insurance contracts. b. It is reasonably possible that the reinsurer may realize a significant loss from the transaction. A reinsurer shall not be considered to have assumed significant insurance risk under the reinsured contracts if the probability of a significant variation in either the amount or timing of payments by the reinsurer is remote. Contractual provisions that delay timely reimbursement to the ceding enterprise would prevent this condition from being met.

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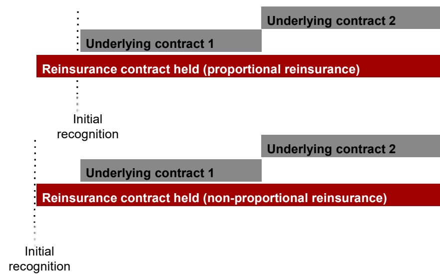
Recognition

Proportionate vs. non-proportionate



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Recognition

Illustrative example – non-proportionate

- An entity holds a reinsurance contract that provides excess of loss protection for a motor insurance portfolio. In exchange for a fixed premium of CU100, the reinsurance contract provides cover for claims arising from individual events in the portfolio in excess of CU500 up to a limit of CU200.
- The reinsurance contract is considered a group for the purpose of aggregation and is effective 1 January 2021. The first underlying motor insurance contract is recognized 1 February 2021. As the reinsurance contract held does not provide proportionate coverage (because neither the premiums nor claims are a proportion of those from the underlying insurance contracts), when would the Company recognize the insurance contract?
    - **The contract is recognized at the beginning of the coverage period, i.e., 1 January 2021**

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Retroactive reinsurance

LPTs and ADCs – more complexity introduced

- For contracts covering events that already have occurred, e.g., an adverse development cover, the insured event is the determination of the ultimate cost of the payments for those claims
- The Transition Research Group of IFRS 17 refined an earlier proposal and recommended two views:
    - Compare the maximum amount that could have been claimed in the period with remaining contractual maximum amount as a constant amount for each future coverage period

      or
    - Compare the expected amount of the underlying claims covered in the period with the expected amount of the underlying claims remaining to be covered in future periods.
- Therefore, for most casualty retroactive reinsurance arrangements, expected payments will fall over many years (and probably decades), which would necessitate employment of the GMM for the LRC

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Premium not received – excluded from revenue

- As a reinsurer, are there portions where the cedent never pays portions of the premium?
    - For quota share arrangements, a ceded pays the reinsurer its share of the premium **net** of the ceding commission to cover the reinsurer's share of the cedent's expenses
    - For treaties with reinstatement premium, the loss paid is **netted** against the premium due, so again, the cedent does not pay the reinsurer
- The Transition Research Group of IFRS 17 stated:
    - Ceding commission is not an investment component even if it is an amount due to the cedant in all circumstances, because it is settled net of premium charged to the cedant
    - Provisional ceding commission is not an investment component as it is settled net of premium charged to the cedant
        - The economic effect of the standard treatment of ceding commissions is equivalent to the effect of charging a lower premium with no ceding commission
    - The economic effect of the reinstatement premium is equivalent to the effect of reimbursing a different claim amount to the cedant

Examples:
- Reinstatement premium (mandatory)
- Ceding commissions

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Premium not received

Example: ceding commission – basic and sliding scale

- Underlying contract premium = $10 million
- Reinsurance contract = 60% QS

- Assumptions underlying Example 1:
  - Ceding commission is 30%
  - Ultimate loss ratio on direct contract = 50%

- Assumptions underlying Example 2:
  - Sliding scale commissions as follows:

Loss Ratio	75%	70%	65%	60%	55%
Commission	20%	25%	30%	35%	40%

  - Provisional commission is 30%
  - Ultimate loss ratios on direct contract:
    - Scenario 1 = 50%
    - Scenario 2 = 70%

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Premium not received

Example: ceding commission – basic

Ceding commission is netted against original premium – thus, revenue is only calculated on a net basis

	scenario 1		scenario 2	
Statement of Comprehensive Income	IFRS 17 net approach	Existing Practice	IFRS 17 net approach	Existing Practice
Insurance Contract Revenue				
Original Premium	6,000,000	6,000,000	6,000,000	6,000,000
Adjustment for Ceding Commission	(1,800,000)		(1,800,000)	
Total	**4,200,000**	**6,000,000**	**4,200,000**	**6,000,000**
Ceding Commission	-	**(1,800,000)**	-	**(1,800,000)**
Claims Incurred	**(3,000,000)**	**(3,000,000)**	**(4,200,000)**	**(4,200,000)**
Underwriting Margin	**1,200,000**	**1,200,000**	-	-

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Premium not received

Example: ceding commission – sliding scale

Again, the provisional ceding commission is netted against original premium – thus, revenue is only calculated on a net basis

In addition, initial premiums are treated as if no losses will be incurred during the coverage period – this is treated as a non-distinct investment component

	scenario 1 *		scenario 2 **	
Statement of Comprehensive Income	IFRS 17 net approach	Existing Practice	IFRS 17 net approach	Existing Practice
Insurance Contract Revenue				
Original Premium	6,000,000	6,000,000	6,000,000	6,000,000
Ceding Commission (provisional)	(1,800,000)		(1,800,000)	
Adjustment for premium w/o loss	(600,000)		(600,000)	
Total	**3,600,000**	**6,000,000**	**3,600,000**	**6,000,000**
Ceding Commission	-	**(2,400,000)**	-	**(1,500,000)**
Claims Incurred				
Quota Share Percentage	(3,000,000)	(3,000,000)	(4,200,000)	(4,200,000)
Adjustment for sliding scale	-	-	900,000	-
Total	**(3,000,000)**	**(3,000,000)**	**(3,300,000)**	**(4,200,000)**
Underwriting Margin	**600,000**	**600,000**	**300,000**	**300,000**

Adjustment is made to incurred claims, rather than ceding commission, when losses exceed the bottom end of the ceding commission sliding scale

** Scenario 1 loss ratio of 50% (i.e., less than 55%) with ceding commission of 40%.*

*** Scenario 2: loss ratio of 70% with ceding commission of 25%.*

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Premium not received

Example: mandatory reinstatement premium

- Original Premium = $250k
- Policy limit = $1M with 1 reinstatement

- Reinstatements are mandatory, terms:
  - Obligatory
  - Proportional in amount, 100% as to time

- Losses
  - Scenario 1 = $500k
  - Scenario 2 = $1.5M

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Premium not received

Example: mandatory reinstatement premium

All mandatory reinstatement premiums are netted against incurred claims, and thus are not considered part of the insurance contract revenue. IFRS 17 views these premiums as an offset to losses incurred on the contract.

	scenario 1		scenario 2	
Statement of Comprehensive Income	IFRS 17 net approach	Existing Practice	IFRS 17 net approach	Existing Practice
Insurance Contract Revenue				
Original	250,000	250,000	250,000	250,000
Reinstatement Premium	-	125,000	-	250,000
Total	**250,000**	**375,000**	**250,000**	**500,000**
Claims Incurred				
Original	(500,000)	(500,000)	(1,500,000)	(1,500,000)
Adjustment for Reinstatement Premium	125,000	-	250,000	-
Total	**(375,000)**	**(500,000)**	**(1,250,000)**	**(1,500,000)**
Underwriting Margin	**(125,000)**	**(125,000)**	**(1,000,000)**	**(1,000,000)**

Recorded incurred claims are reduced from the actual incurred claim amount by the amount of the mandatory reinstatement premium

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