# Reinsurance Contracts Held

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This IFRS17 Working Paper aims to facilitate discussion among actuaries and other stakeholders to capture the range of opinions on the application of IFRS17 in the Singapore context and are not meant to serve as mandatory practice notes.

Any interpretation of IFRS17 set out in this Paper represents a plausible treatment given the text of IFRS17. However, it shall neither be construed as the only possible treatment nor the agreed interpretation for Singapore insurers. Users of this Working Paper shall be mindful that differences in the exact fact pattern and operating context facing each insurer may drive different interpretations. Users shall also be mindful that for the same fact pattern and operating context, there is scope for the substance of same transaction to be articulated differently depending on how the transaction is analysed. (For example, in substance, cash flows from a call option with strike price $X on an asset is equivalent to the combined cash flow from the underlying asset and a put option with strike price $X on the asset, less cash of $X.) Differences in articulation can give rise to a range of plausible treatments. An insurer remains responsible for justifying its choice of treatment after discussion with its auditor. Opinions expressed in the working papers are not representative of that of the Singapore Actuarial Society.

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# 1. Introduction

This discussion paper examines requirements for reinsurance contracts held under IFRS 17 Standard and June 2019 Exposure Draft.

IFRS 17 requires separate accounting for reinsurance contracts held and underlying insurance contracts. This may result in profit fluctuations due to different treatment of reinsurance contracts and underlying contracts. This paper seeks to summarize issues related to reinsurance contracts held under IFRS 17, highlight points that require a decision to be taken, share thoughts on certain methodologies and facilitate discussions among working actuaries.

A list of main paragraphs related to reinsurance contracts held from different sources can be found in Appendix A. We recommend that the reader carry out relevant background reading on the core requirements of IFRS17, beyond which is presented in this paper.

# 2. Interpretation of Standards/Amendments

Generally, all requirements in the IFRS 17 Standard/Amendments to insurance contracts issued are also applicable to reinsurance contracts held. This section will analyse and discuss in more depth on certain requirements set out in the Standard/Amendments which are pertaining to reinsurance contracts held.

## 2.1 Definition

A reinsurance contract is an insurance contract issued by one entity (the reinsurer) to compensate another entity (the insurer) for claims arising from one or more insurance contracts issued by that other entity (underlying insurance contracts).

A significant insurance risk transfer test will be required in order to classify a contract as a reinsurance contract. Generally, a reinsurance contract transfers significant insurance risk if there is **a scenario** that has **commercial substance** in which the issuer (the reinsurer) has a **possibility of a loss** on a present value basis. However, even if a reinsurance contract does not expose the reinsurer to the possibility of a significant loss, it is still deemed to transfer significant insurance risk if it transfers to the reinsurer **substantially all** the insurance risk relating to the reinsured portions of the underlying insurance contracts (IFRS 17 B19).

In order to transfer significant insurance risk, both of the following criteria must be met:

(a) There is at least one scenario (with commercial substance), where an insured event causes the re/insurer to pay significant additional amounts on a discounted basis, regardless of the likelihood of that scenario; and

(b) There is at least one scenario (with commercial substance), where the re/insurer can suffer a loss on a discounted basis.

Lapse, persistency and expense risks do not qualify as insurance risk by itself (IFRS 17 B14). But if the entity transfers these risks which have arisen from insurance contracts via reinsurance contract, the reinsurance contract is considered to bear insurance risk as well (IFRS 17 B15).

For contracts which are in its legal form of a "reinsurance contract" but do not transfer significant insurance risk to the reinsurer (e.g. some financial reinsurance contracts), they are either financial instruments or service contracts and hence outside the scope of IFRS 17.

## 2.2 Recognition

For a group of proportionate reinsurance contracts held, it is recognized at the later of

- The beginning of the coverage period of the group; or,
- The initial recognition of any underlying insurance contract.

*Based on ED on Amendments, the recognition date of a group of proportionate reinsurance contracts held is revised to:*

*A. the later of the beginning of the coverage period of the group or the initial recognition of any underlying insurance contract; Unless,*

*B. At the same time as the onerous group of underlying contracts, if the entity recognizes an onerous group of underlying contracts before the beginning of the coverage period of the group of reinsurance contracts held.*

For a group of non-proportionate reinsurance contracts held, it is recognized at the beginning of the coverage period of the group.

### 2.3 Level of Aggregation

According to Paragraph 61 of the Standard, an entity shall divide portfolio of reinsurance contracts held in a similar way to insurance contracts issued, except that the references to onerous contracts shall be replaced with a reference to contracts on which there is a net gain on initial recognition. Therefore, a portfolio of reinsurance contracts held shall be divided, at a minimum, into the following profitability categories:

- A group of contracts on which there is a net gain at initial recognition
- A group of contracts on which at initial recognition there is no significant possibility of a net gain arising subsequently
- A group of the remaining contracts in the portfolio

### 2.4 Measurement

#### 2.4.1 Measurement Model

- **General measurement model (GMM)**

Default model.

- **Premium Allocation Approach (PAA)**

PAA can be applied to some groups of reinsurance contracts held provided the following criteria are met at the inception of the group:

(a) the entity reasonably expects the resulting measurement would not differ materially from the result of applying the GMM; **or**

(b) the coverage period of each contract in the group of reinsurance contracts held (including coverage from all premiums within the contract boundary) is one year or less.

Risk attaching contracts may not automatically qualify, since all underlying policies can have 12 months coverage, but some underlying can start at different times in the year, leading to a reinsurance coverage to be potentially stretched up to 24 months.

- **Variable Fee Approach (VFA)**

VFA is not applicable for reinsurance contracts held as the cedant and reinsurer do not share in the returns on the underlying items, even if the underlying insurance contracts issued are VFA contracts.

*Based on ED on Amendments, the IASB Board proposes to amend IFRS 17 to permit a company to use the risk mitigation option when the company uses reinsurance contracts held to mitigate financial risks*

*of insurance contracts with direct participation features. The measurement impact of the risk mitigation option will be on the underlying portfolio under VFA, not on the reinsurance.*

### 2.4.2 Contract boundary

The contract boundary of a reinsurance contract held is determined separately and independently of the contract boundaries of the underlying contracts. The determination is performed based on the terms of the reinsurance contract held by applying the same criteria as for insurance contracts issued.

The cash flows are within the boundary of a reinsurance contract held if they arise from the substantive rights and obligations of the entity as the holder of the contract that exists during the reporting period in which:

(c) The insurer has substantive right to receive services from the reinsurer; **or**
(d) The insurer has the substantive obligation to pay premiums to the reinsurer, i.e. the insurer is compelled to pay premiums.

A substantial right of the insurer to receive services from the reinsurer ends when:
- The reinsurer has the practical ability to reassess the risks transfer and set a price or the level of benefits that fully reflect the reassessed risks; **or**
- The reinsurer has a substantial right to terminate coverage.

A substantial obligation of the insurer to pay premiums to the reinsurer ends if the insurer has a substantial right to terminate coverage.

If the execution of a recapture right triggers a recapture fee which is in commercial substance equivalent to be compelled to pay the future premiums, a recapture right does not trigger a contract boundary.

The assessment of a substantial right or obligation needs to consider whether it reflects commercial substance and whether it is practical based on the terms and conditions of the reinsurance treaties, including the Repricing Options, Termination Clauses, Recapture Clauses and etc. For example, a right to terminate coverage that is triggered by the reinsurer's decision to reprice the reinsurance contract is not relevant when considering whether a substantive obligation to pay premiums exists. Such a right is not within the entity's control and therefore the entity would continue to be compelled to pay premiums for the entire contractual term.

An illustrative example on contract boundary of a reinsurance contract held are included below.

**Example Fact Pattern:**
- Proportionate reinsurance treaty issued & recognized on 1/1/2022 and it is open to NB indefinitely.
- Both parties have termination right with 3 months' notice period with respect to new business only.
- Reinsurer has a repricing right for new business with a 3 months' notice period.
- A repricing for new business is performed with effective date 1/11/2023.

**Interpretation:**
- At the initial recognition (1/1/2022), the contract boundary of the contract covers cession issued in the next 3 months (from 1 Jan 2022 to 31 Mar 2022).
- No reassessment of the contract boundary is needed in 1Q2022 under paragraph B64 of IFRS 17 since the contract boundary determination at initial recognition was not based on an assessment of the practical ability to set a price that fully reflected the risks in the contract (AP05 Sep 18 TRG Meeting).
- The cash flows related to underlying contracts that are expected to be issued and ceded in the next 3 month period (from 1 Apr 2022 to 30 June 2022) are cash flows outside the existing contract boundary

as at 31 March 2022 and relate to a future reinsurance contract(s) held on 1 Apr 2022, i.e. no need to be included in 1Q2022 reporting, thanks to a periodic alignment between the quarterly closing period and the quarterly cohort.

- Every three months, a new “IFRS 17” reinsurance contract is artificially created. These “IFRS 17” reinsurance contracts belong to the same signed treaty.
- All contracts issued in the same calendar year would then belong to one yearly cohort.
- The repricing closes the existing treaty and results in new 3 months contracts being recognized starting 1/11/2023 under new terms. The first new reinsurance contract will cover underlying contracts that are expected to be issued and ceded in the next 3 month period starting from 1/11/2023.
- The repricing close does not prevent from the possibility to regroup the newly repriced cohort with the older cohorts into an annual group of contracts.

#### 2.4.3 Estimate of future cash flows

Cash flows involved in a reinsurance contract held include:

- Reinsurance premiums paid to the reinsurer
- Claim recoveries from the reinsurer
- Others such as ceding commissions, experience refunds/profit commissions and etc.

The entity’s expectations about the amount and timing of future cash flows, including with respect to the probability of the reinsurer repricing the contract, would be reflected in the fulfilment cash flows. Consistent (not necessary identical) assumptions are to be used between the estimates of cash flows within the reinsurance contracts held and the cash flows within the underlying insurance contracts.

The estimates of cash flows should also include an adjustment for **the risk of non-performance by the reinsurer**. It may be reflected either as an explicit adjustment to best estimate cash flows (including the effects of collateral and losses from disputes), or as spread applied within the discount rate.

The future cash flows are discounted at a rate that reflects the nature and timing of the cash flows and the liquidity characteristics of the reinsurance contracts held.

#### 2.4.4 Risk adjustment for non-financial risk

If an entity considers reinsurance when determining the compensation it requires for bearing non-financial risk related to underlying insurance contracts, the effect of the reinsurance (both cost and benefit) would be reflected in the (gross) risk adjustment for non-financial risk of the underlying insurance contracts.

TRG Apr 2019 S118: Risk adjustment for non-financial risk for reinsurance contracts held represents the amount of risk being transferred by the holder of the group of reinsurance contracts to the issuer of those contracts. There are two consequences on the risk adjustment for non-financial risk of the reinsurance contract held:

a) It can be calculated as the difference between:

- the amount of risk adjustment to be considered net of reinsurance, and
- the amount of risk adjustment to be considered gross of reinsurance.

b) it could not be nil, unless:

- the entity considers reinsurance when determining the compensation it requires for bearing non-financial risk related to underlying insurance contracts; and
- the cost of acquiring the reinsurance is equal or less than the expected recoveries.

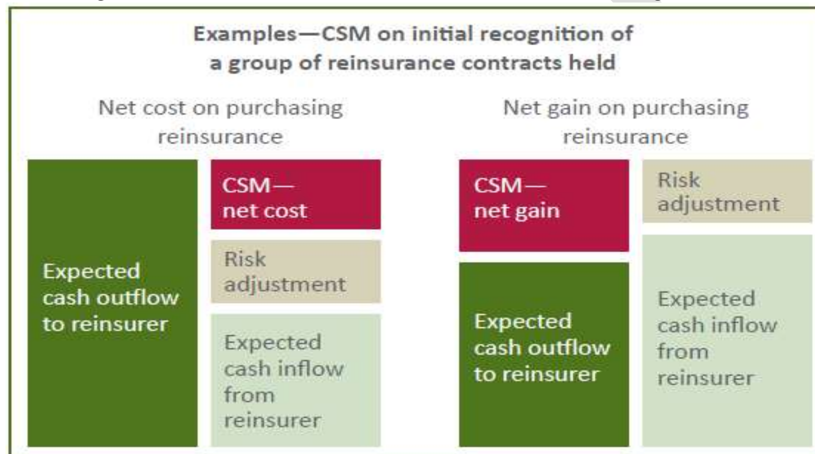
### 2.4.5 Contractual service margin

CSM represents the net cost or net gain of purchasing a reinsurance contract (different from the contractual service margin for insurance contracts issued which represents the unearned profit on those contracts).

Based on IASB meeting on 11 December 2019 following the ED on Amendments, a company that recognises losses on loss-making insurance contracts on initial recognition and subsequent measurement would at the same time also recognise a gain on reinsurance contracts held, to the extent that the reinsurance contracts held are entered into before or at the same time the loss-making insurance contracts are issued.
The gain on reinsurance is accounted under the "loss-recovery component of the asset" for the remaining coverage of the group of reinsurance contracts held.

The net cost or net gain of purchasing a reinsurance contract is then recognised over the coverage period as services are received except in the case of reinsurance contract held that covers events that have already occurred (usually known as the retroactive reinsurance) in which case the net cost (but not the net gain) is recognized immediately in profit or loss.

The diagram below summarises the CSM at initial recognition under the two scenarios.




The CSM for reinsurance contract held is adjusted for changes relating to future services in a similar way as for insurance contract issued, except for the following.

- Unfavourable changes in the estimates of future cash flows for a group of onerous contracts will be recognised immediately in profit or loss (as CSM is zero). For a group of reinsurance contracts held that covers these underlying contracts, the corresponding changes in cash flows will not adjust the CSM and will be reflected in the profit or loss.

- Changes in the fulfilment cash flows that result from the changes in the non-performance risks by the reinsurer do not adjust the CSM and are recognised in the profit or loss when they occur.

### 2.4.6 Coverage Units

For a group of reinsurance contracts held, this is the coverage received by the insurer from those reinsurance contracts held (e.g. SaR), and not the coverage provided by the insurer to its policyholders through the underlying insurance contracts (e.g. SA).

For retrospective coverages (such as LPT/ADC), underlying expected claim settlement pattern can be used as a base for coverage units.

### 2.5 Subsequent Measurements

#### 2.5.1 Interaction with the underlying contracts

A change in fulfilment cash flow related to future services, may lead to a group of underlying contracts to turn from profitable to onerous (or the other way around). Changes that do not impact the CSM on the underlying do not adjust the CSM on the reinsurance held. As a result, onerous losses and reversal of onerous losses, will impact the P&L on both underlying and reinsurance.

#### 2.5.2 Contract Modification

The criteria for recognising a contract modification are listed in paragraph 72 of IFRS 17 standard. If changes to original reinsurance treaty terms or addition of new addendums meet any of the criteria, the existing reinsurance contract should be derecognised and a new reinsurance contract should be recognised. Exercising of options mentioned in treaty wordings are not considered as contract modification. e.g. in case if treaty agreement explicitly allow for change of quota-share percentage.

### 2.6 Disclosure

#### 2.6.1 Presentation

An entity shall present separately in the statement of financial position the carrying amount of:
(a) Groups of contracts issued that are assets;
(b) Groups of contracts issued that are liabilities;
**(c) Groups of reinsurance contracts held that are assets; and**
**(d) Groups of reinsurance contracts held that are liabilities.**

*Based on ED on Amendments, the presentation of (re)insurance contract assets and liabilities in the statement of financial position is determined using portfolios of (re)insurance contracts rather than groups of (re)insurance contracts.*

Accordingly, as defined in Paragraph 82 of the Standard, an entity shall present income or expenses from reinsurance contracts held separately from the expenses or income from contracts issued.

If an entity presents separately the amounts recovered from the reinsurer and an allocation of the premiums paid, the cash flow received which are not contingent on claims shall be treated as a reduction of reinsurance premiums.

#### 2.6.2 Non-distinct investment components

Certain amount of the following payments from reinsurers, may meet the definition of non-distinct investment components(if the entity presents income and expenses from a group of reinsurance contract held separately) and thus cannot be included under insurance service revenue / expense:

- experience refunds,

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- standard profit commissions and sliding-scale commissions (receivable from reinsurers) solely dependent on the financial performance of the period within the contract boundary, i.e. in the case the cedant always receives back an amount, regardless if an insurance event happens.

Below is an example discussed in AP03, TRG Sep 2018 on Profit Commission:

**Fact patterns**:

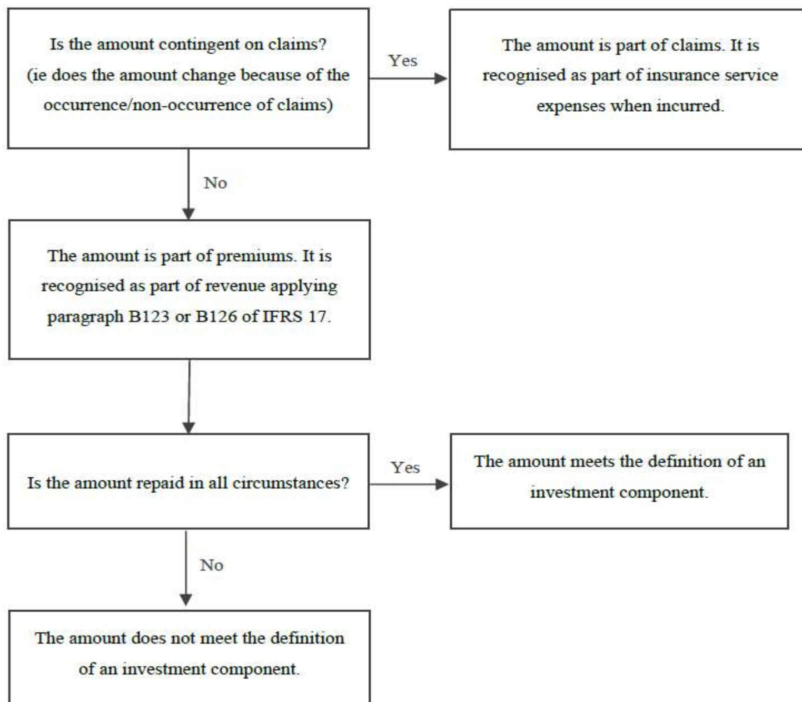
| **Description** | **Amount** |
|---|---|
| Reinsurance premium | 1,000 |
| Profit commission (profit = reinsurance premium minus claims incurred by the reinsurer under the contract) | 25% |

**Interpretation:**

In all circumstances, reinsurer will pay the cedant at least 250. So economically, profit commission is equivalent to charging a lower premium (750) and adjusting claims accordingly to the following formula:
Reinsurance claims= 75% of claims up to 1,000 + 100% of claims above 1,000

Assuming cedant pays the premium of 1,000 at inception, the amount of 250 may meet definition of investment component.

The following flowchart is included in AP03, TRG Sep 2018 to assist the assessment of how to account for exchanges between a reinsurer and a cedant.



## 3. How it applies to Singapore

The table below lists some implications relevant to reinsurance contracts held based on Singapore context.

| Key Issue | Comments |
| --- | --- |
| Proportionate vs Non-proportionate reinsurance contract | The definition suggests that only reinsurance contracts which share in a percentage of all claims incurred for a group of underlying insurance contracts will be in scope. Applying that definition will likely result in many reinsurance contracts to be scoped out. Reinsurance contracts which we see to be scoped out includes:<br>— reinsurance contract where a portion of claims incurred for each underlying insurance contract is retained by the entity and only the claim amount above the retention amount is then share proportionately with the reinsurer (i.e. the reinsurance contract does not share in a percentage of all claims);<br>— reinsurance contract which only covers proportionately one of the underlying insurance risks of the underlying insurance contract (i.e. the reinsurance contract does not share in a percentage of all claims, only some of the claims);<br>— reinsurance contract which covers proportionately some of the underlying insurance contracts within the group but not all contracts within the group; and<br>— reinsurance contract which covers in different percentages the claims incurred for different underlying insurance contracts within the group.<br>In many cases, reinsurance contracts are held to manage an entity's exposure to a variety of risks and cannot always be aligned on a fixed basis to underlying insurance contracts. We view the above definition as unduly restrictive and will limit the extent to which paragraph 66A can be applied in practice.<br>We propose that the definition should be expanded to cover what the insurance industry commonly understands to be proportionate reinsurance contract which include both quota share reinsurance and surplus reinsurance and that consideration for applying this amendment can be done at the insurance contract level instead of the group of contract level. |
| Contract Recognition /<br>Contract Boundary | 1. New addendums may be added to existing reinsurance contracts to add new underlying products or modify existing treaty terms. If the new addendum affects IF block, company should consider if the change is qualified as contract modification.<br>2. Companies doing monthly profit reporting may need to consider if necessary to create a new 3 month reinsurance contract at each reporting period.<br>3. There may be multiple notice periods to NB termination – 90 days, 3 months, 1 quarter or 3 months before the calendar year end. |
| Drivers for Accounting Mismatch | There are various drivers for accounting mismatch between underlying insurance contracts and reinsurance contracts held. Without sufficient understanding, it will be difficult to interpret the results.<br>• Level of aggregation – multiple underlying contracts are reinsured under one reinsurance contract |

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|---|---|
| | • Contract Boundaries<br>• Coverage units – coverage units used may be different for underlying contracts (i.e. SA) and ceded reinsurance contract (i.e. SaR);<br>• Discount rates – different currency yield curve basis or locked-in interest rates, depend on the timing of contract recognition or underlying currencies (also an economic mismatch if the currencies are different);<br>Illiquidity premium applied in discounting.<br>• Measurement Model (VFA is not allowed for reinsurance contracts)<br>• Non-performance risk of the reinsurer in reinsurance contract fulfilment cash flow projection |
| Operational Challenges | 1. Calculation of non-performance risk of the reinsurers. Is there any non-performance risk for retrocession to a related legal entity?<br>2. Separate disclosure on the non-distinct investment components<br>3. Companies may not have the separately projected assumed and ceded CFs at the required granularity under the existing accounting/actuarial systems.<br>4. Operational issues in allowing for reinsurance CSM treatment from changes driven by onerous underlying insurance contracts<br>5. Challenges in measurement for complex reinsurance e.g. Financially motivated reinsurance contract that classified as an insurance contract<br>6. Upgrade of a reinsurance policy management system to include reinsurance dedicated future cash flows, coverage period, discounting and coverage units. |

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## Appendix A: Main paragraphs related to reinsurance contracts

The main paragraphs, which are related to reinsurance contracts held from the different documents, are outlined below:

IFRS 17 Standards/June 2019 Exposure Draft

| No. | Sections | Relevant Paragraphs |
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| | • Changes in the carrying amount of the contractual service margin for insurance contracts with direct participation features | B109 |
|---|---|---|

Basis for Conclusions on IFRS 17

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