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IFRS 17: reinsurance needs careful consideration

A guide to the challenges ahead

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IASB Basis for Conclusions: IFRS 17 Insurance Contracts

"BC298:...The Board acknowledged that separate accounting for the reinsurance contracts and their underlying insurance contracts might create mismatches that some regard as purely accounting, for example on the timing of recognition, the measurement of the reinsurance contracts and the recognition of profit..."

The issue

Is reinsurance getting the focus it needs in IFRS 17 implementation plans? We don't think so. This article runs through some of the implications of the new standard for reinsurance held and why insurers shouldn't underestimate the effort required in this area if they want to avoid implementation issues, or at least some awkward questions, when IFRS 17 starts to bite in 2021.

The application of IFRS 17 to reinsurance held has the potential to have a significant impact on the balance sheet at transition and, beyond transition, the changes may affect the future recognition of profit, which is often a critical consideration for determining dividends and managing investors' expectations. This impact on profit is not just about the timing of emergence however, as total profit over a contract's lifetime may change due to, for example, changes in the quantum of tax paid.

Insurers can be forgiven for overlooking the need for a thorough review of reinsurance, internal and external, and how it is treated in their accounts. Confirmation that it requires special attention is in the body of the standard, but the requirements don't look particularly challenging at first glance even though the potential issues are mentioned in the supporting documents published by the International Accounting Standards Board ('IASB').

The Standard makes it very clear that reinsurance contracts need to be valued and accounted for separately. This is not common practice at the moment. Insurers are accustomed to using approximate methods, often referred to as 'netting down', and one might expect that splitting out the reinsurance will be as simple as deducting net from gross using current methods. Unfortunately, the specific rules including the granularity at which the calculations must be carried out and the rules for the amortisation of the Contractual Service Margin ('CSM') mean that traditional simplified approaches may no longer be valid or helpful.

Many of the issues the new requirements raise may seem quite technical, even relatively minor and potentially contained. However, for many insurers even individual reinsurance contracts are material in the context of the overall balance sheet and many insurers will find when they work through the exact implications of the standard, the requirements have the potential to create a significant and potentially material mismatch between the value placed on reinsurance and the value placed on the underlying risks.

This is not just an accounting problem. It has significant operational and strategic implications too.

Longstanding reinsurance programmes may have to be overhauled in order to meet their objectives. This will require consideration not only of IFRS 17 impacts – any change in reinsurance will also need to take into account the impact on transfer of risk, on capital and on Solvency and potentially tax.

The bespoke nature of reinsurance means that the issues each insurer faces will be different. The impact will be felt across proportional and non-proportional reinsurance.

Mismatching

Mismatches can appear in several places in the valuation process and these mismatches have the potential to increase volatility in the profit and loss, with potential implications for tax and dividends. For example, if the timing of the emergence of taxable profit changes, this may alter the way in which tax losses can be offset depending on the rules in different jurisdictions.

The methods used for valuing reinsurance contracts may differ from the underlying contracts. The Variable Fee Approach ('VFA') is not available for reinsurance and this will be an issue for reinsurance relating to unit linked insurance and traditional life participating contracts. For general insurers who write mainly contracts with a term of one year or less, they cannot assume that risk attaching reinsurance will automatically be eligible for the Premium Allocation Approach ('PAA') because the coverage period will exceed one year. They will either have to demonstrate PAA eligibility or use the general model.

The CSM, a key measure of the inherent profit in a contract, may differ significantly between the reinsurance contract and the underlying contracts reinsured. For most reinsurance held the CSM may be positive or negative, unlike the CSM for an underlying contract which is subject to a minimum of zero. The CSM will run off over the coverage period of the reinsurance contract, often different to the coverage period of the underlying insurance contracts which may be grouped into very different units by risk, 'onerousness' and by time. The discount rates used to calculate the CSM for underlying contracts may differ significantly from that used for the reinsurance, for example, due to differences in the recognition dates of the reinsurance and underlying contracts. The pace at which the CSM runsoff (determined by 'coverage units') may differ between the reinsurance contract and the underlying contracts too. Together these may have a material impact not only on the emergence of profit, but on the amounts recognised in shareholders' equity on transition, and potentially on tax. Only careful consideration of material reinsurance contracts and detailed modelling will determine the overall impact on transition and subsequently on the emergence of profit.

Whilst IFRS 17 is principles based there are instances where it is very specific and insurers need to identify these and make sure they don't get tripped up by not having read the requirements closely enough. Some affect mismatching.

One example is where firms use reinsurance to convert gross losses to a net profit under IFRS 4. This happens more often than one might think.
For example when insurers see the opportunity to benefit from soft pricing in the reinsurance market, or within groups, when a larger entity with greater diversification can support a smaller entity within the same group seeking to grow in a particular market. Under IFRS 17 the gross loss on underlying contracts must be posted up-front while any reinsurance gain will be earned over the coverage period of the reinsurance contract. This delay in the recognition of the offsetting profit is different to current accounting in many countries.

In another example, the standard picks out adverse development cover ('ADC') for specific treatment. The net cost of purchasing reinsurance relating to events that have already occurred must be recognised immediately in the cedant's financial statements, whilst the gain for the reinsurer will be spread in the usual way over the coverage period (which would be the claim settlement period in this case). This may reduce or remove the value of ADC.

Mismatch checklist

Potential causes of mismatch between reinsurance and underlying contracts:

- Different models – reinsurance may be general model when the underlying contract risk is PAA or VFA
- Differences in contract boundaries and allowance for future new underlying business
- Underlying losses need to be recognised on day one but gains on reinsurance purchased must be deferred
- Different level of granularity in assessing the CSM
- Different dates of recognition leading to different discount rates for the CSM
- Pattern of release of CSM does not align
- Differences in expenses
- Foreign exchange, especially where contracts cover risk written in multiple currencies
- For intra-group reinsurance, cost of retrospective reinsurance recognised up-front, but gains on reinsurance deferred
- For intra-group reinsurance, entities domiciled in territories with different accounting standards
- Non-alignment of risk transfer between direct and reinsurance models

The potential for mismatching may be important for fronting insurers. Many insurers carry out some kind of fronting arrangement, sometimes simply to pass on non-core risks to a third party.

Under IFRS 17, 100% quota share reinsurance arrangements will no longer offset the value of the gross liabilities. In particular, difference may arise from:

- Models (the underlying contract may be eligible for PAA, the reinsurance contract may not).
- Coverage period.
- Allowing for the risk of non-performance of the reinsurance contract.

The need to allow for certain underlying future business in the value of the reinsurance and in the earning pattern for the CSM, mean that at certain points in time the value of a 100% quota share reinsurance may be significantly different from the value of the underlying contracts it covers. This difference may be material for insurers who pass on substantial proportions of their risk to reinsurers, such as captives.

Where the cedant and the reinsurer are located in territories with different accounting rules, for example, IFRS 17 versus US GAAP, there may be differences in the treatment of the same contract between the two entities, in particular where one regime requires a profit / loss to be spread over time and the other permits immediate recognition. This needs to be considered by both parties carefully.

Operational and commercial considerations

Theissuesalreadycoveredwillimpact the operational side, especially the data and processes needed to value reinsurance andconsiderationsforthe purchase of future reinsurance.
Considerations around regulatory capital, tax and accounting will continue to be key in decidingwhatreinsurance aninsurerwill buyorinternallyputin place. We may find that accounting becomes a more significant consideration following the effective date of IFRS17.

Insurers will need to make assumptions theyhavenotneededbefore.Unlessthe insurerisabletousethePAAforitsheld reinsurance, once a held reinsurance contractisrecognised,theinsurerwill need to estimate all of the cash flows from the contracts underlying that reinsurance,includingthoserelatedto contractsthathaven'tbeenwrittenyet. This assumption will have to be monitored over time and may well change, affecting the CSM. In other words, there is a lot more to estimate, monitor and update.

Therearealsopotentialconsequences regarding changes to reinsurance contracts. Currently such changes may be made by using addenda, rather than issuinga whole new contract, due to convenience or for other legal, commercial and tax considerations. Under IFRS 17, such changes would need to be assessed carefully as to whether theyareaccountedforasanew contract or as a modification to the existingcontract. Theaccountingmay result in further divergence in the recognition of profit between the reinsurance and underlying contracts (through the measurement of the respective CSMs).

Valuationofreinsurancecontractsthat covermultipletypesofriskorthathave been subject to modification over time may be technically demanding. There may be difficulty in accurately allocating expected recoveries relating to underlying future business to reinsurance contracts. Onemayconsiderseparatingdifferent parts of a reinsurance contract where treatingitasasinglecontractdoesnot reflect the substance of the cover provided,asdiscussedattheFebruary 2018 Transition Resource Group ('TRG') meeting. New ways of linking new business to the relevant reinsurance may have to bedeveloped.

Reconciling reinsurance calculations from one period to the next may be a complex exercise. For efficiency, this should be automated, but complex terms andchoicesregardingwhattheevents the firm may choose to seekrecoveries on (to optimise the recoveries) may defy automation for some contracts.

Things get even more complicated when a reinsurance contract covers risks in multiple currencies.

Non-performance of reinsurance contracts is allowed for within the valuation of the reinsurance contract. Building in this counter-party credit risk will have an impact on the cash flows Current reinsurance bad debt calculationsmaynotbedirectlyusable. Considerationssuchashowoneallows for funds withheld and other security related arrangements, will need to be worked through.

Some elements of the reinsurance calculation cause particular technical challenges. Examples might be profit commissionorslidingscalecommission arrangements – since many reinsurance contracts are bespoke, these may be operationally difficult to identify and recordinaccountingsystemsandmay require more detailed actuarial modelling under IFRS 17. Approximate methods used to allow for these under IFRS 4 may not work under the more specific requirements for the valuation of liabilities.

Solvency IIconsiderations

Evenforfirmsseekingtoleveragetheir SolvencyIIcalculation,theseoperational issues exist. For in-force reinsurance under the general model, the value of the reinsuranceshouldincludethevalueof reinsurance cash flows relating to certain underlying gross business not yet written. This is new, even for firms under Solvency II, and will necessitate estimating future volumes of business to be covered under the reinsurance and correspondinglosses,expensesandan appropriate risk adjustment. These assumptionswillhavetobemonitored over time and may well change, affecting the CSM.Inotherwords,thereisalot more to estimate, monitor and update, beyond functionalitythatmayalready exist for Solvency II.

In addition, the Solvency II risk margin is only assessed on a net of reinsurance basis, so there is an immediate challenge in determiningareinsurance-relatedrisk adjustment even before considering whether the Solvency II method and calibrationmightbeadoptedinIFRS17.

Further,SolvencyIIcashflowsmaybe inappropriate because they may allow for future reinsurance purchases.

Having good quality, clean data is an essential prerequisite to making robust calculationsunderIFRS17.Afocusin IFRS 17 implementation in other areas of the business,ithasnotnecessarilyhad the same attention when it comes to reinsurance. Ensuring the data used for reinsuranceisfitforpurposewillhave benefits across the business.

The complexity of the reinsurance calculations will mean additional training for management, the board and the investmentcommunity.Thistraining will enabletoenablefirmstorelaykey messages about the effectiveness of reinsuranceandforboardstobeableto exert appropriate governance. For those firms operating in a Solvency II environment,therewillbethechallenge of reconciling the valuation of reinsurance under the two different regimes.

Time to act

These issues cannot be overlooked and need addressing now. In particular, changes to reinsurance purchasing may need to be made well ahead of 2021. The considerations are complex and will require time for thinking and modelling in order for firms to make informed decisions around implementation and reinsurance programme structure.

The starting point is challenging the assumption that current modelling is likely to be adequate.

It is important that the treatment of reinsurance is not viewed as purely an accounting issue. It needs a multi-disciplinary approach to identify and tackle issues which may mean restructuring the reinsurance portfolio. Firms will need to draw in expertise from finance, actuarial, capital management, tax, IFRS 17 implementation teams, operational heads and reinsurance purchasing managers with detailed knowledge of the reinsurance contracts and the objectives for the reinsurance programme. The time and effort to do this should not be underestimated.

Many firms are seeing IFRS 17 implementation as an opportunity to overhaul their financial processes and systems, and are focusing on efficiencies. This is sensible, but not at the expense of a thorough analysis of reinsurance. There is the potential to either produce surprises on transition or to increase volatility in the emergence of profit post 2021. Reinsurance needs to be a high priority in IFRS 17 implementation planning.

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