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Impact of cash flow settlement arrangements in accounting for reinsurance contracts

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Agenda

- Impact of cash flow settlement arrangements on reinsurance contract issued
  - Gross vs. net settlement
  - IFRS 17 requirements

- Illustrative example

- Impact of net cash flow settlement arrangements on reinsurance contract held

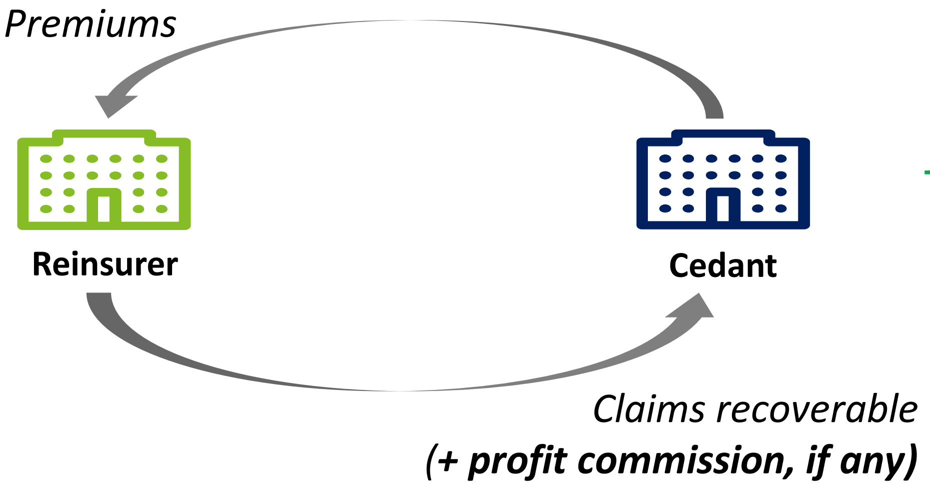
- Practical considerations

Impact of cash flow settlement arrangements on reinsurance contracts issued

Gross vs. net settlement

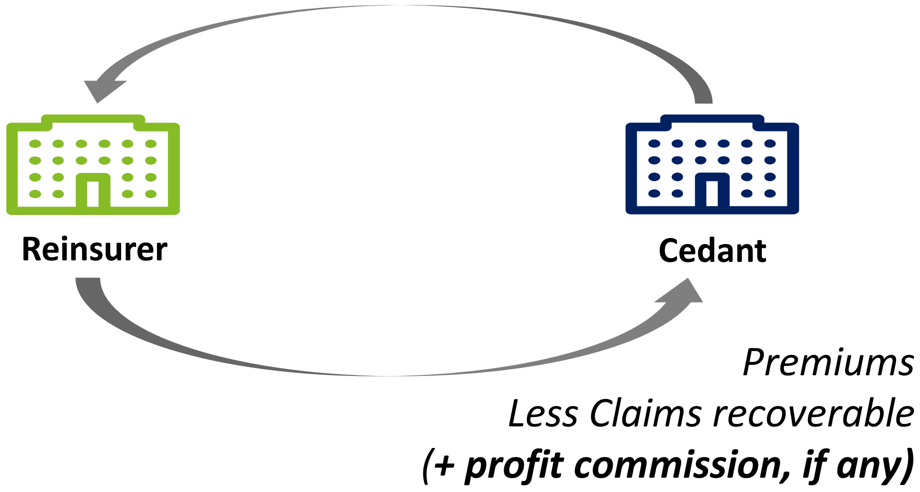
Below are the two commonly observed settlement arrangements in the reinsurance market:

Gross settlement basis



Vs.

Net settlement basis



Premiums cash flows are settled separately from claims cash flows and other contractual cash flows such as profit commission.

All contractual amounts are settled on a net basis at a periodic date stipulated in the contract. Only a net cash flows is exchanged between the parties.

Impact of cash flow settlement arrangements on reinsurance contracts issued

IFRS 17 requirements

IFRS 17:B120

The total insurance revenue for a group of insurance contracts is the amount of ***consideration paid to the entity***, adjusted for financing effect and investment components[1].

IFRS 17:86(a)

reinsurance amounts that are contingent on claims should be treated as ***part of the claims***;

IFRS 17:86(b)

reinsurance amounts that are not contingent on claims should be treated as a ***reduction in the premiums*** to be paid to the reinsurer;

The requirements set out in IFRS 17:86 also applies to reinsurance contracts issued

[1] Amount that is repayable in all circumstances.

Illustrative example

Accounting for and presentation of income and expenses of reinsurance contracts issued

Fact pattern:

- Reinsurer B issues a non-cancellable quota share reinsurance contract, which includes a provision for the payment of a profit commission to Cedant X if certain conditions are met.
- The cash flows are net settled at the end of each agreement year ending 31 March.
- Reinsurer B calculates the profit commission to be equal to 20% of premiums in excess of actual incurred claims. If actual incurred claims exceed premiums for the year, the profit commission is nil.

Illustrative example

Accounting for and presentation of income and expenses of reinsurance contracts issued

We set out below some of the possible scenarios for cash flows on the reinsurance contract issued at the time of initial recognition:

Assumed actual event at end of reporting period

Description / scenarios	1	2	3	4	5	6	7
Cash inflows - Premiums	CU1,000	CU1,000	CU1,000	CU1,000	CU1,000	CU1,000	CU1,000
Cash outflows							
Claims	0	(200)	(600)	(800)	(1,000)	(1,200)	(2,000)
Profit commission	(200)	(160)	(80)	(40)	0	0	0
Net cash flows	**800**	**640**	**320**	**160**	**0**	**(200)**	**(1,000)**
Amount notionally repaid in all scenarios (NDIC*)	(200)	(200)	(200)	(200)	(200)	(200)	(200)

**non-distinct investment component*

Accounting issue:

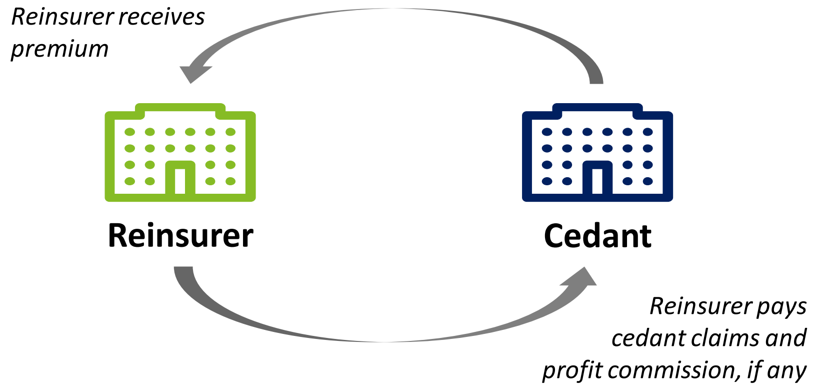
What is the impact of the cash flow settlement arrangements in the accounting and presentation of the reinsurer's income and expenses relating to reinsurance contracts issued?

Illustrative example

Accounting for and presentation of income and expenses of reinsurance contracts issued

In a ***gross settlement*** scenario, if the actual cash flows at the end of the first agreement year are:

		CU
Cash inflows (premiums)		**1,000**
Cash outflows:		
Claims	800	
Profit commission	40	**840**



…then the insurance service result for the same period (assumed to coincide with the contract annual settlement period) would be presented as follows:

Statement of profit or loss	**CU**
Insurance revenue	800
Insurance service expenses	640
Insurance service result	**160**

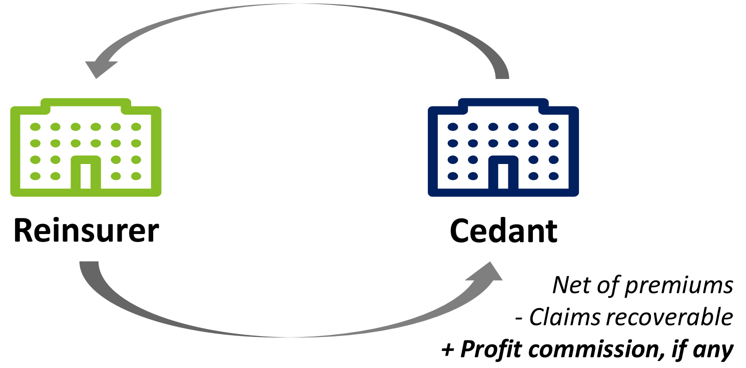
*The NDIC of CU 200 **adjusts** the insurance revenue and insurance service expenses.*

Illustrative example

Accounting for and presentation of reinsurance contracts issued

In a ***net settlement*** scenario, the cash flows would be:

		CU
Premiums amount		**1,000**
Claims amount	800	
Profit commission amount	40	**(840)**
Net settlement cash flow		**160**



In any scenario, the reinsurer will never receive CU200 of the notional premium if the contractual amounts are settled on a net basis.

Description / scenarios	1	2	3	4	5	6	7
Cash inflows - Premiums	CU1,000	CU1,000	CU1,000	CU1,000	CU1,000	CU1,000	CU1,000
Cash outflows							
Claims	0	(200)	(600)	(800)	(1,000)	(1,200)	(2,000)
Profit commission	(200)	(160)	(80)	(40)	0	0	0
Net cash flows	**800**	**640**	**320**	**160**	**0**	**(200)**	**(1,000)**
Amount notionally repaid in all scenarios (NDIC)	(200)	(200)	(200)	(200)	(200)	(200)	(200)

Illustrative example

Accounting for and presentation of reinsurance contracts issued

The insurance service result would be presented as follows:

CU 200 is notional NDIC and therefore, it is excluded from insurance revenue:

	CU
Notional premium	1,000
Notional NDIC	(200)
Insurance revenue	**800**

Statement of profit or loss	**CU**
Insurance revenue	800
Insurance service expenses	(640)
Insurance service result	**160**

In a CU 800 level of notional claims, insurance service expenses is calculated:

	CU
Notional claims	800
Policy excess (notional NDIC)	(200)
Commission amount	40
Insurance service expenses	**640**

Illustrative example

Impact of net cash flow settlement arrangement on reinsurance contract held

Accordingly, equal and opposite amount of cost of reinsurance and reinsurance recoveries will be recognised by the cedant in a ***net settlement scenario***:

The amount due from the cedant is CU 800 given the presence of the notional NDIC (i.e. the policy excess) of CU 200 that will be "credited" back to the cedant under all circumstances.

CU 200 is not contingent on claims and therefore, will be treated as an adjustment to the amount for premiums, decreasing the cost of reinsurance in P&L accordingly.

The notional NDIC of CU 200 operates as a policy excess and is never a cost for reinsurance or income from reinsurance recoveries.

Claim recoveries shall be equal to amount of notional claims incurred *less* the excess of CU 200 *plus* notional profit commission amount.

Statement of profit or loss	**CU**
Reinsurance cost	800
Reinsurance recoveries	(640)
Net reinsurance cost	**160**

Practical considerations

Some practical considerations when implementing the requirements of IFRS 17:

- Consider the impact of net cash flow settlement arrangements when redefining the key performance indicators (KPIs), e.g. revenue-based KPIs, under IFRS 17 given the impact on both the insurance revenue and insurance service expenses

- The possibility for reinsurers to prefer negotiating a revision to existing reinsurance arrangements given the implication of having a net cash flow settlement arrangements for the company’s financials under IFRS 17

- Configure posting rules in the IFRS 17 sub-ledger to allow for the required accounting and presentation of reinsurance amounts (e.g. profit commissions as NDIC, or as adjustments to reinsurance expenses) in the statement of profit or loss

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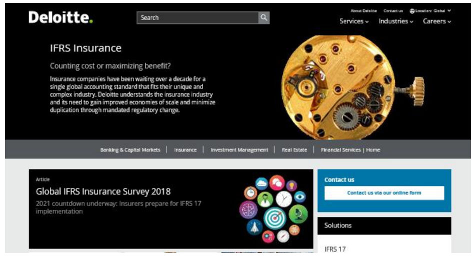

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