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Complexity made simple: accounting for reinsurance protection for onerous contract groups

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Agenda

- Initial recognition of the reinsurance loss recovery component
- Subsequent measurement of the reinsurance loss recovery component
  - Impact of changes in the loss component of underlying group of contracts due to cash flows not covered by the reinsurance contracts held
- Practical considerations

Reinsurance loss recovery component

IFRS 17 accounting logic for reinsurance protection

IFRS 17 accounts for the protection that a cedant receives from reinsurance contracts it holds as a separate item in its financial statements.

The overall principles of IFRS 17 apply to reinsurance contracts held in the same way but a number of differences exist that are necessary to reflect the benefit the cedant receives from the protection it has purchased from a reinsurer. This logic is a policyholder accounting logic.

The most delicate scenario where this logic applies is when the cedant reports a loss making group of contracts and it can benefit from reinsurance protection to mitigate those losses.

The whole framework in IFRS 17 related to the accounting for reinsurance protection has been substantially upgraded in the revised version of IFRS 17 published in June 2020.

One of the principles that the IASB used to design the new accounting rules is that the profit or loss must reflect the correct loss net of reinsurance protection and users must be able to see the quantum of reinsurance protection in the statement of financial position. The accounting for the loss recovery component adopts this principle.

Reinsurance loss recovery component (cont.)

Initial recognition

A **loss recovery component** (LRC) for a group of reinsurance contracts held (RCH) is recognised on initial recognition of an onerous group of underlying insurance contracts or when the addition of onerous insurance contracts to a group makes that group onerous in subsequent periods.

LRC is established **if, and only if,** the RCH are entered into **before or at the same time** as the onerous underlying insurance contracts are recognised.

At initial recognition, the amount of LRC **adjusts the CSM** of a group of RCH and a corresponding gain is recognised in the profit or loss.

LRC is initially **measured** as follows:

LRC	=	loss recognised on the underlying onerous contracts	×	% of claims on underlying onerous contracts expected to be recovered from the RCH ("ratio")

This **mandatory simplification** assumes all categories of cash outflows from the underlying contracts are reinsured at the same ratio.

Illustrative example

Fact pattern – underlying insurance contracts

Entity B issues a **group of onerous insurance contracts** with the following terms :

- a two-year coverage period
- premium is CU1,000 expected to be received immediately after initial recognition.

Entity B expects:

- claims of CU900, and expenses of CU150
- no contracts will lapse before the end of the coverage period.

The groups of underlying insurance contracts is measured on initial recognition as follows [1] :

	CU (Debit)/Credit
Estimates of future cash inflows	(1,000)
Estimates of future cash outflows:	
Claims	900
Expenses	150
Net fulfilment cash outflows	**50**
Contractual service margin (CSM)	**–**
Insurance contract liability[2]	**50**
Loss on initial recognition[3]	**(50)**

1 For illustration purposes, time value of money and risk adjustment are ignored.
2 This relates to the loss component at initial recognition.
3 Amount of loss component recognised in profit or loss statement.

Illustrative example

Fact pattern – reinsurance contract held

Within the same day, Entity B entered into a **quota share reinsurance agreement** [4] with the following terms:

- covers 100% of claims incurred on the underlying group of insurance contracts without reinsuring the expenses incurred;
- reinsurance premium is CU1,000 to be paid immediately after initial recognition.

4 For illustration purposes, the single reinsurance contract represents a group of RCH.

The reinsurance contract held is measured on initial recognition as follows [5]:

	CU (Debit)/Credit
Estimates of future cash inflows (recoveries) [6]	(900)
Estimates of future cash outflows (premiums)	1,000
Net fulfilment cash outflows (net cost)	100
CSM (before any adjustment for LRC)	**(100)**

5 For illustration purposes, time value of money, risk of non-performance of the reinsurer and risk adjustment are ignored.
6 The RCH only reinsures future claims (100% of CU900) and does not cover any portion of the expenses (CU150).

Illustrative example

Initial recognition

At initial recognition, a LRC is recognised for the RCH and calculated as follows:

Applying IFRS 17:B119D, the LRC is determined as follows:

Loss Component **CU50** × % of claims expected to be recovered **100%** = Loss Recovery Component **CU50**

Applying IFRS 17:66A, the **CSM of the RCH is a total of CU150 at initial recognition** comprising the net cost of reinsurance purchased of CU100, plus **CU50 reinsurance LRC**:

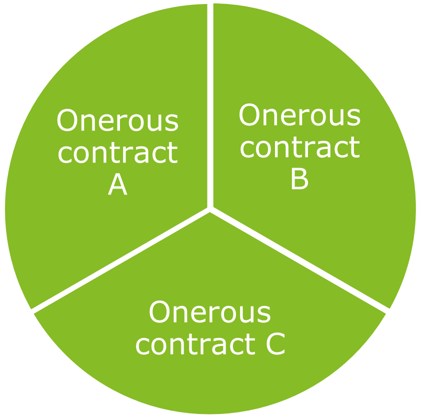
	CU
CSM of the RCH (before adjustment for LRC)	**(100)**
Loss recovery component	**(50)**
CSM of the RCH (including LRC)	**(150)**

Reinsurance loss recovery component

Initial recognition

Where a group of RCH covers only a portion of the group of underlying onerous contracts:

Only Contract A is covered by the RCH



A group of onerous contracts

A **systematic and rational method** shall be applied to determine the portion of losses of the onerous group that relates to the underlying insurance contracts i.e. those covered by the group of RCH.

Reinsurance loss recovery component

Subsequent measurement

The amount of LRC is subsequently **adjusted** for:

LRC, *beg. of period* ± Changes in LRC from changes in the onerous underlying contracts − Systematic and rational allocation of LRC to reinsurance recoveries associated with incurred claims = LRC, *end of period*

At subsequent measurement, the carrying amount of LRC **shall not exceed** the portion of the carrying amount of the loss component that the entity expects to recover from the group of RCH.

The systematic allocation of the LRC would be analogous to the systematic allocation of the Loss Component to the incurred claims from the underlying contracts.

Illustrative example

Subsequent measurement – Scenario 1

At the end of year one, Entity B updates the cash flow estimates for the underlying group of contracts. The entity determined that:

- the estimated expenses for year 2 **decreased** by CU10, resulting in a decrease in the amount of the loss component of the underlying group of contracts by CU10. There are no other changes in the expected cash flows.

Accounting issue:
*How will **decreases in loss component** of underlying onerous contracts arising from cash flows not covered by a RCH impact the amount of the LRC previously recognised?*

The decrease in loss component of the underlying onerous contracts is a change in the cash flows relating to future service, but it is **not covered by the RCH**.

Decreases in loss component arising from non-covered cash flows **results in a reversal** of the LRC applying IFRS 17:B119F, with a debit being recognised in **profit or loss**.

Illustrative example

Subsequent measurement – Scenario 2

At the end of year one, Entity B updates the cash flow estimates for the underlying group of contracts. The entity determined that:

- the estimated expenses for year 2 **increased** by CU10, resulting in an increase in the amount of loss component of the underlying group of contracts by CU10. There are no other changes in the expected cash flows.

Accounting issue:
*How will **increases in loss component** of underlying onerous contracts arising from cash flows not covered by a RCH impact the amount of the LRC previously recognised?*

Increases in loss component due to non-covered cash flows **do not adjust** the LRC.

The initial recognition simplification in IFRS 17:B119D **does not apply in subsequent periods**.

Practical considerations

Some practical considerations when implementing the requirements of IFRS 17 on accounting for the LRC:

- Need to define a **P&L allocation method** to take the LRC down to zero at the same time as the loss component is fully allocated/derecognised. This requires a cedant to calculate the portion that should be allocated against the reinsurance recoveries associated with the incurred claims that are reinsured and the remaining balance which should go to P&L in a systematic and rational way within the period the loss component is also allocated to the associated incurred claims.

- Consider **tracking categories of cash outflows** for subsequent adjustments, e.g. cash flows covered and not covered by RCH.

- Consider if a **more granular level of grouping** is necessary for the underlying onerous group, e.g. onerous group covered by RCH, onerous group not covered by RCH. Although not required this may prove practically useful.

Practical considerations (cont.)

Some practical considerations when implementing the requirements of IFRS 17 on accounting for the LRC:

- Ensure the LRC **does not exceed** the portion of the carrying amount of the loss component that the entity expects to recover from the RCH covering the group of underlying contracts that produced the loss component.

- The considerations above need suggest a cedant to **revisit its existing reinsurance arrangements** to mitigate some operational complexities resulting from the application of IFRS 17.

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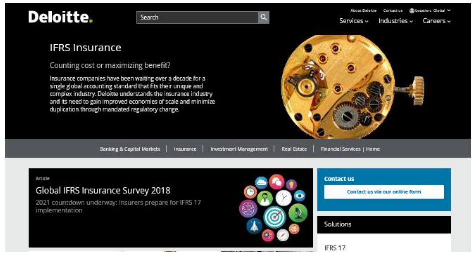

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