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## Contract boundary assessment for reinsurance contracts

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# Contents

- IFRS 17 requirements to identify the contract boundary
- Illustrative examples
- Practical considerations

# Contract boundary

## *Why it is important*

The contract boundary:



is a key parameter for determining which expected cash flows must be considered for measurement under IFRS 17;



marks the future point in time when the entity's rights or substantive obligation under an insurance contract end;



distinguishes whether the cash flows are included in the measurement of a group of contracts or in the measurement of a future group of contracts; and

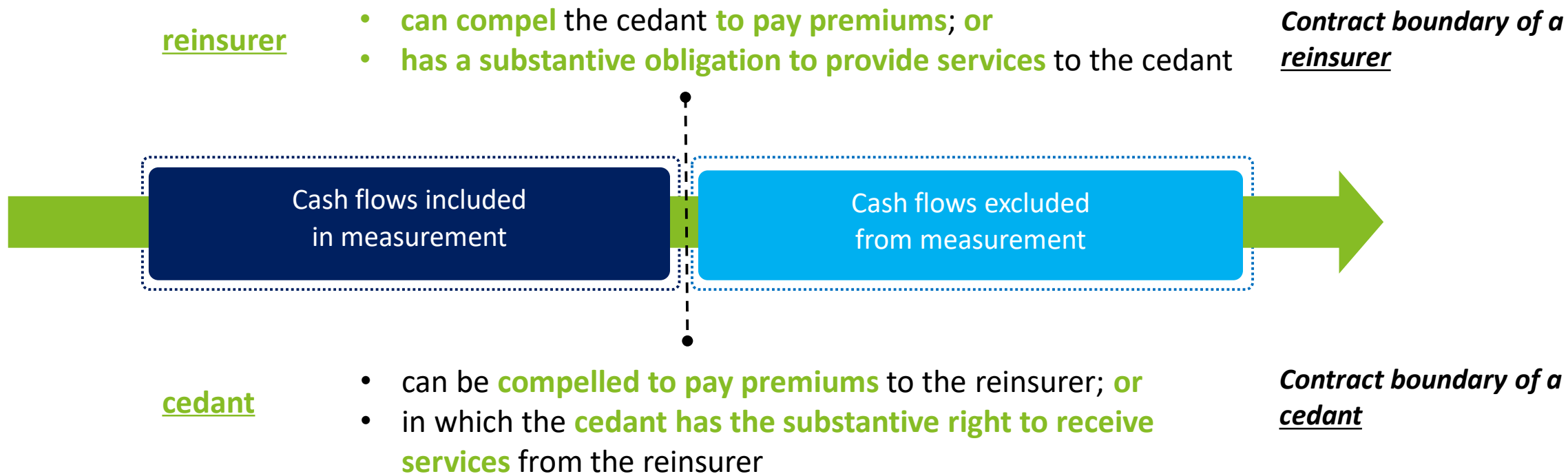


has a consequential effect on the assessment of measurement model to apply, i.e. PAA vs GMM, cohort grouping and timing of recognition e.g. scenarios where, in substance, the contract boundary analysis results in several accounting contracts within a legal contract.

# Contract boundary

## IFRS 17 requirements

Cash flows are within the boundary if they arise from substantive rights and obligations that exist during a period in which the



The contract boundary is set to the **furthest point** in time between substantive rights and obligations

# Contract boundary

## Assessment of practical ability to fully reprice risks

The substantive obligation of an entity (*substantive right of the cedant*) to provide services (*to receive services*) **ends when the entity has:**



the practical ability to **reassess the risks** transferred under the contract and **set a new price or level of benefits** which fully reflects the reassessed risks; or



a substantive right to **terminate the coverage**.



The contract boundary is **reassessed at each reporting date** to include the effect of any changes in circumstances on substantive rights and obligations.

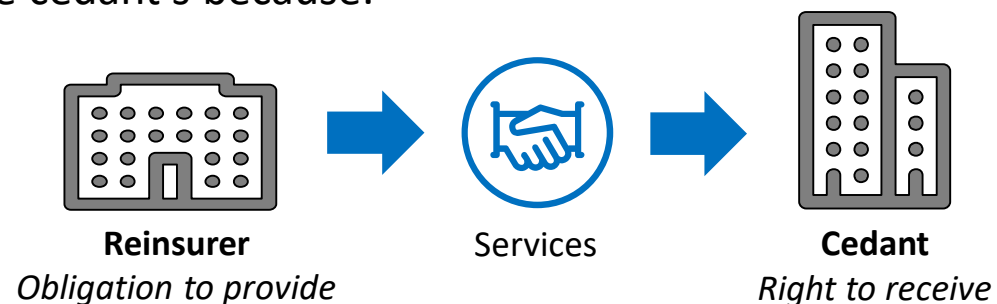
### **When does an entity have the practical ability to fully reprice the risks in the contracts? When the entity is**

- able to set **a new price for an individual existing contract** in the same way it would set the price for a new contract with the same characteristics at that date
- able to **amend the benefits** of an individual contract to be consistent with the price it will charge beyond that date
- able to **reprice (or change the benefits of) a portfolio of existing contracts** so that the price reflects the overall changes in the risks in a portfolio of insurance contracts – this particular ability is necessary but not sufficient for a boundary to exist.

# Contract boundary

## IFRS 17 requirements (cont'd)

The contract boundary is the same date, albeit from the application of a mirror-image logic, for both the reinsurer and the cedant's because:



When the cedant has a right to receive services, the reinsurer has an obligation to provide services



When the cedant has an obligation to pay premiums, the reinsurer has a right to compel the cedant to pay premiums

All relevant facts and circumstances of the contract relating to **both substantive rights and obligations** should be considered in the contract boundary assessment.

# Illustrative example

## *Reinsurance contract with repricing mechanism*

Entity Y (cedant) purchased a quota share reinsurance contract (inclusive of non-proportional profit commission that is not a non-distinct investment component) from Reinsurer B with the following terms:

- one-year coverage;
- reinsurer has the right to fully reassess the cedant's risk (i.e. change the quota ceded or the profit commission rate) by providing 90-days' notice;
- cedant has the right to accept the offer of a new price or to terminate the contract;
- in the absence of such an offer, the cedant is obliged to continue paying premiums at the previously agreed price.



### **Accounting issue:**

***Which cash flows are within the contract boundary of:***

- ***the cedant for a reinsurance contract held; and***
- ***the reinsurer for a reinsurance contract issued***

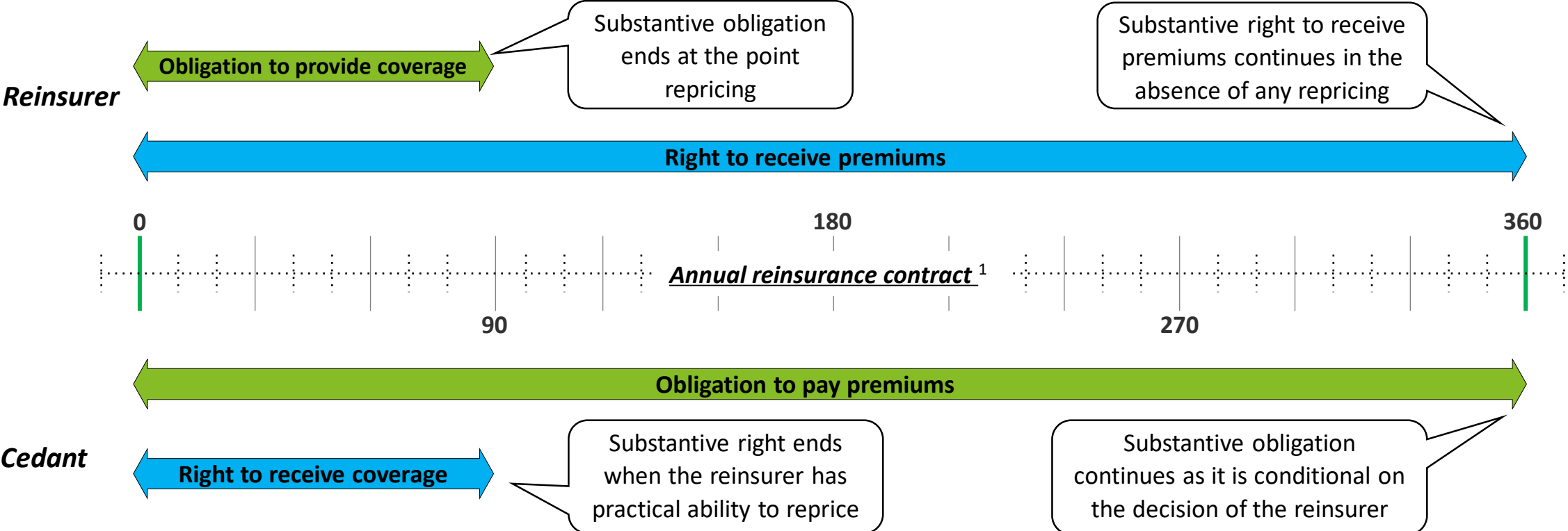
***when the reinsurer has the right to reprice the remaining coverage prospectively?***



# Illustrative example

## Reinsurance contract with repricing mechanism (cont'd)

The contract boundary is set to the **furthest point** in time between substantive rights and obligations:



1 For illustration purposes, 30-day month is assumed

# Illustrative example

## Reinsurance contract with repricing mechanism (cont'd)

The boundary of the reinsurance contract is **one year (i.e. 12 months)** from both the Reinsurer's and Cedant's perspectives.



**Cedant:** All of the cash flows resulting from the underlying insurance contracts that are expected to be issued within the 12 months covered by the reinsurance contract held are included within the boundary of the reinsurance contract held.



**Reinsurer:** All of the cash flows resulting from the underlying contracts of the cedant that are expected to be issued within the 12 months covered by the reinsurance contract are included within the boundary of the reinsurance contract issued.

# Illustrative example

## *Reinsurance contract with the co-existence of two termination clauses*

Entity X (cedant) purchased from Reinsurer B a quota share reinsurance contract to reinsure its five-year 'term assurance' contracts (underlying insurance contracts)

- Both the reinsurer and cedant have the **right to terminate the contract** in respect of any new policies issued by the cedant subject to serving a reciprocal notice period of 30 days;
- The termination right does not affect the underlying policies already issued and ceded before the cancellation notice period;
- The reinsurer has the **practical ability to reprice** to fully reflect the cedant's risk annually;
- Repricing is only for new business ceded after the repricing date.



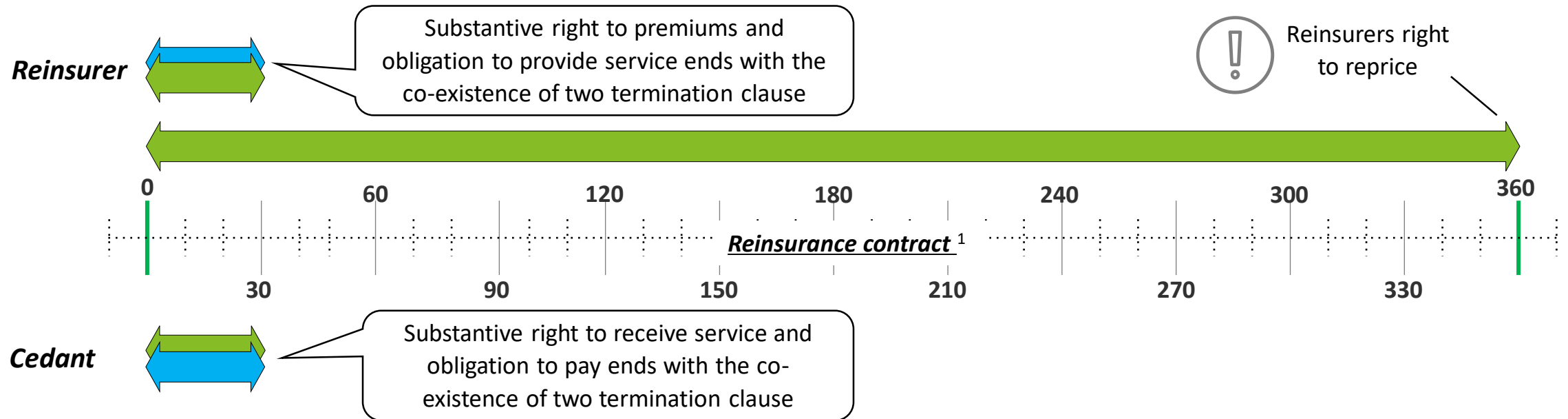
### **Accounting issue:**

***What is the contract boundary of the reinsurance contract from the perspective of the cedant and the reinsurer when both parties have the right to terminate the contract subject to a notice period?***

# Illustrative example

## Reinsurance contract with the co-existence of two termination clauses (cont'd)

Taking all the relevant facts and circumstances of the contract relating to substantive rights and obligations, the assessment follow:



Whilst the effect of the annual repricing clause would indicate that the reinsurer can fully reassess the risks at that date, with repricing being a characteristic of a contract boundary, **there can only be one boundary** for the contract.

1 For illustration purposes, a 30-day month is assumed

# Illustrative example

## Reinsurance contract with the co-existence of two termination clauses (cont'd)

When we have multiple substantive obligations' termination dates (or for the cedant multiple service rights' termination dates) the approach in IFRS 17 requires the identification of the earlier date when substantive obligations cease to exist in the original form set out at initial recognition.

The consideration on the presence of the right to enforce payment of premium (for the cedant an obligation to pay) until a particular date remains in place and the logic of considering the further away date as the boundary between the substantive right date and the substantive obligation date does not change.

The consideration of the reinsurer substantive right to enforce payment (for the cedant an obligation to pay) is also 30 days in this example.



**Cedant:** substantive right to receive services and the substantive obligation to pay the premiums ends after the notice period, *i.e.* 30 days.



**Reinsurer:** right to unilaterally terminate the contract by giving a 30-day notice equates to the practical ability to fully terminate its rights and obligations.

# Practical considerations

Some practical considerations when implementing these requirements of IFRS 17:

- Requires **judgment** in determining the contract boundary, taking into consideration rights and obligations within a contract (contractual, legal, regulatory constraints, customary business practices).
- The combination of the substantive rights and obligations in a reinsurance contract could result to a contract boundary that includes cash flows from underlying contracts that are **yet to be issued at initial measurement date**, which is significantly different from current practice.
- **Design** an IFRS 17 solution that can correctly reflect the IFRS 17 characteristics of **accounting contracts contained within a single legal contract** (i.e. contract boundary, coverage period, assignment to a portfolio/group of contract), with cash flows being included (or excluded) within the relevant contract boundary as appropriate.
- The possibility for cedants and reinsurers to decide that they would **revisit existing reinsurance arrangements** to mitigate some of the operational complexities resulting from the application of IFRS 17.





# Contact details

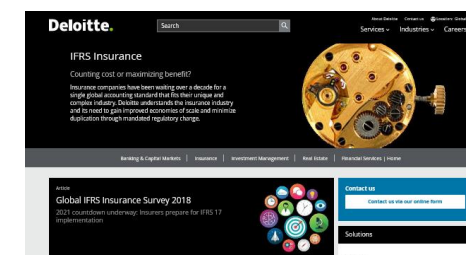
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