STAFF PAPER

May 2018

Project	**Transition Resource Group for IFRS 17 *Insurance Contracts***		
Paper topic	Boundary of reinsurance contracts held with repricing mechanisms		
CONTACT(S)	Laura Kennedy	lkennedy@ifrs.org	+44 (0) 20 7246 0553
	Hagit Keren	hkeren@ifrs.org	+44 (0) 20 7246 6919

Introduction

1. We have received a submission about how the boundary of a reinsurance contract held should be determined when the reinsurer has the right to reprice remaining coverage prospectively. In the fact pattern provided in the submission the reinsurer can choose:

   (a) not to exercise the right to reprice. In this case, the entity (the holder of the contract) is committed to continue paying premiums to the reinsurer; or

   (b) to exercise the right to reprice. In this case, the entity has the right to terminate coverage.

2. The objective of the paper is to provide background and an accounting analysis to support discussion at the Transition Resource Group for IFRS 17 *Insurance Contracts* (TRG).

Structure of the paper

3. This paper includes the following:

   (a) background information;

   (b) implementation question; and

   (c) review of accounting requirements.

4. There are two appendices to this paper:

   (a) Appendix A—Extract: summary of the TRG meeting held on 6 February 2018 with respect to Agenda Paper 3; and

   (b) Appendix B—Fact set provided in the submission.

Background information

5. Paragraph 33 of IFRS 17 states that all future cash flows within the boundary of each contract in a group of insurance contracts shall be included in the measurement of that group.

6. Paragraph 34 of IFRS 17 sets out the following on how to determine whether cash flows are within the boundary of an insurance contract:

   > Cash flows are within the boundary of an insurance contract if they arise from substantive rights and obligations that exist during the reporting period in which the entity can compel the policyholder to pay the premiums or in which the entity has a substantive obligation to provide the policyholder with services. A substantive obligation to provide services ends when:
   >
   > (a) the entity has the practical ability to reassess the risks of the particular policyholder and, as a result, can set a price or level of benefits that fully reflects those risks; or

(b) both of the following criteria are satisfied:

(i) the entity has the practical ability to reassess the risks of the portfolio of insurance contracts that contains the contract and, as a result, can set a price or level of benefits that fully reflects the risk of that portfolio; and

(ii) the pricing of the premiums for coverage up to the date when the risks are reassessed does not take into account the risks that relate to periods after the reassessment date.

7. In February 2018 the TRG discussed Agenda Paper 3 *Boundary of reinsurance contracts held***,** on the topic of reading paragraph 34 of IFRS 17 with respect to reinsurance contracts held. TRG members observed that the application of the requirements in paragraph 34 of IFRS 17 to reinsurance contracts held means that cash flows within the boundary of a reinsurance contract held arise from the substantive rights and obligations of the entity—ie the holder of the contract, therefore:

(a) the substantive right is to receive services from the reinsurer; and

(b) the substantive obligation is to pay amounts to the reinsurer.

The discussion was focused on when the substantive right to receive services from the reinsurer ends. An extract from the meeting summary detailing the outcome of that discussion is included in Appendix A to this paper.

Implementation question

8. The submission asks how the boundary of a reinsurance contract held should be determined when the reinsurer has the right to reprice remaining coverage prospectively. In the fact pattern provided in the submission the reinsurer can choose:

(a) not to exercise the right to reprice. In this case, the entity (the holder of the contract) is committed to continue paying premiums to the reinsurer; or

(b) to exercise the right to reprice. In this case, the entity has the right to terminate coverage.

9. In the fact pattern provided, the reinsurer can adjust premium rates at any time, subject to a minimum notice period of three months.

10. The fact set provided in the submission is included in Appendix B to this paper.

11. The submission expresses two views:

(a) View A—The entity has a substantive obligation to pay premiums to the reinsurer for the full duration of the underlying contracts. Therefore, the contract boundary would reflect the full duration of underlying contracts. The projected future cash flows of the reinsurance contract held could (if considered the best estimate) reflect assumptions including future premium adjustments and recapture decisions.

(b) View B—The contract boundary should end at the first point at which the reinsurer has the right to increase premium rates, as the entity as the holder of the contract has no substantive right to receive service beyond such date.

Review of accounting requirements

12. In the February 2018 meeting, the TRG observed that the cash flows within the boundary of a reinsurance contract held arise from the substantive rights and obligations of the entity as the holder of the contract. Therefore:

(a) the substantive right is to receive services from the reinsurer; and

(b) the substantive obligation is to pay amounts to the reinsurer.

13. Applying paragraph 34 of IFRS 17 to reinsurance contracts held, cash flows are within the contract boundary if they arise from substantive rights and obligations that exist during the reporting period in which the entity is compelled to pay amounts to the reinsurer **or** in which the entity has a substantive right to receive services from the reinsurer [emphasis added]. Therefore, when determining the boundary of the contract an entity needs to consider both the substantive right and substantive obligation.

14. In the February 2018 meeting, the TRG discussed what was meant by the substantive right to receive services from the reinsurer. The TRG observed that a substantive right to receive services from the reinsurer ends when the reinsurer has the practical ability to reassess the risks transferred to the reinsurer and can set a price or level of benefits for the contract to fully reflect the reassessed risk.

15. The TRG also observed that for some reinsurance contracts, the reinsurer can terminate the coverage at any time with a three month notice period. In these circumstances, the contract boundary would exclude cash flows arising from the reinsurance contract held that are related to underlying insurance contracts issued outside of that three month notice period because the entity no longer has a right to receive services from the reinsurer.

16. The staff observe that the above observations are valid in the context of assessing when the substantive right to receive services from the reinsurer ends. The discussion at the TRG was based on a fact pattern where no substantive obligation to pay premiums to the reinsurer exists, and therefore TRG members did not discuss this aspect of the requirements of paragraph 34 of IFRS 17. The fact pattern in this paper considers when the entity must continue to pay premiums to the reinsurer if the reinsurer does not reprice the contract.

17. The staff view is that 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.

18. The staff note that the fact that the entity may receive services for a shorter period because of the reinsurer's right to reprice would not result in a shorter period contract boundary. This is because the entity must consider whether it has either a substantive right to receive services **or** a substantive obligation to pay amounts for each reporting period. In the fact pattern provided, the obligation to pay premiums extends to reporting periods after the entity's right to receive service ceases to exist. Therefore, the staff disagree with View B of the submission.

19. The staff view is that 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. This view is consistent with View A of the submission.

20. The staff observe that this paper considers a reinsurer's right to reprice remaining coverage prospectively. The submission notes that there could be other fact patterns where a reinsurer has the right to reprice all coverage provided by a contract (including coverage already provided). The staff note that in these fact pattern, entities would need to consider whether the reinsurance contract transfers significant insurance risk applying paragraph B27(b) of IFRS 17.

TRG Discussion

Question to TRG members

What are your views on the implementation question presented above?

Appendix A—Extract: summary of the TRG for IFRS 17 meeting held on 6 February 2018 with respect to Agenda Paper 3

Boundary of reinsurance contracts held (Agenda Paper 3)

A.1 Agenda Paper 3 addresses a submission received about how to read paragraph 34 of IFRS 17 regarding the boundary of an insurance contract with respect to reinsurance contracts held.

A.2 TRG members discussed the analysis in Agenda Paper 3 and observed that:

(a) the application of the requirements in paragraph 34 of IFRS 17 to reinsurance contracts held means that cash flows within the boundary of a reinsurance contract held arise from the substantive rights and obligations of the entity—ie the holder of the contract, therefore:

(i) the substantive right is to receive services from the reinsurer; and

(ii) the substantive obligation is to pay amounts to the reinsurer.

(b) a substantive right to receive services from the reinsurer ends when the reinsurer has the practical ability to reassess the risks transferred to the reinsurer and can set a price or level of benefits for the contract to fully reflect the reassessed risk or the reinsurer has a substantive right to terminate the coverage.

(c) accordingly, the boundary of a reinsurance contract held could include cash flows from underlying contracts covered by the reinsurance contract that are expected to be issued in the future.

A.3. TRG members also observed that:

(a) for some reinsurance contracts, the reinsurer can terminate the coverage at any time with a three month notice period. In these circumstances, the contract boundary would exclude cash flows related to premiums outside of that three month notice periods.

(b) there is operational complexity involved in applying paragraph 34 of IFRS 17 to reinsurance contracts held because it is a change from existing practice. Those existing accounting practices for reinsurance contracts held generally:

(i) do not require cash flows related to future underlying insurance contracts to be estimated; and

(ii) net the effect in profit or loss of holding reinsurance in accounting for the insurance contract.

A Board member observed that those existing accounting practices are inconsistent with accounting for reinsurance contracts held separately to the underlying insurance contracts using measurement principles for reinsurance contracts held that are consistent with the measurement of the insurance contracts issued.

A.4. Some TRG members questioned the interaction between paragraphs 34 and 62(a) of IFRS 17. The staff noted that paragraph 62(a) of IFRS 17 is a recognition requirement for reinsurance contracts held that provide proportionate coverage, and is not a measurement requirement.

Appendix B—Fact set provided in the submission

Fact set provided in the submission

B.1 The submission describes a situation whereby the reinsurer has the right to change premium rates for reinsurance contracts already ceded. An increase in premium rates would trigger the right of the entity to recapture the business (ie terminate the reinsurance coverage). These are the facts applicable for this situation:

(a) the reinsurer has the right to adjust the premium rates it will charge for remaining coverage related to underlying insurance contracts that have already been issued and that are covered by the reinsurance contract;

(b) premium adjustments apply prospectively and would not allow the reinsurer to recover losses already incurred for coverage already provided under the contract;

(c) there are no substantive restrictions on the reinsurers ability to reassess the risks of the reinsurance contract and to adjust premium rates to reflect those risks;

(d) the reinsurer can adjust premium rates at any time, subject to a minimum notice period of three months;

(e) if the reinsurer does not increase premium rates, the holder of the contract has no right to recapture the business and must continue to pay premiums to the reinsurer;

(f) if the reinsurer provides notice that it intends to increase premium rates, the entity as the holder of the contract has the right to recapture the business; and

(g) if the entity recaptures the business, the entity would cease paying premiums and the reinsurer would cease providing coverage as of the recapture date. There is no financial settlement associated with the recapture (besides the refund of paid but unearned premium).

B.2 The submission expresses two views:

(a) View A—The entity has a substantive obligation to pay premiums to the reinsurer for the full duration of the underlying contracts. Therefore, the contract boundary would reflect the full duration of underlying contracts. The projected future cash flows of the reinsurance contract held could (if considered the best estimate) reflect assumptions including future premium adjustments and recapture decisions.

(b) View B—The contract boundary should end at the first point at which the reinsurer has the right to increase premium rates, as the entity as the holder of the contract has no substantive right to receive service beyond such date.

Staff view

B.3 Based on the facts in B.1(c)–(d), the entity has no substantive right to receive services from the reinsurer after the first three months of coverage. This is because at any time, with three months' notice, the reinsurer has the practical ability to reassess the risks transferred to the reinsurer and can set a price or level of benefits for the contract to fully reflect the reassessed risk. Therefore, whether or not the boundary of the contract extends beyond the first three months of coverage depends on whether the entity has a substantive obligation to pay amounts to the reinsurer.

B.4 Based on the facts in B.1(f)–(g), the entity is not compelled to pay amounts to the reinsurer after the three month notice period if the reinsurer increases premium rates. However, based on the facts in B.1(e), in this scenario it is assumed that the entity is compelled to pay amounts to the reinsurer if the reinsurer does not increase premium rates. This is not in the control of the entity. Therefore, it is the staff view that the entity has a substantive obligation to pay amounts to the reinsurer for the full contract term (ie for the duration of the underlying insurance contracts).

B.5 For this example, the staff view is that the boundary of the contract reflects the full contract term. The reinsurers right to reprice the contract, and the entity's resulting right to recapture the business will be reflected in the estimates of future cash flows. This view aligns with View A in the submission.