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STAFF PAPER

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Project	**Amendments to IFRS 17 *Insurance Contracts***		
Paper topic	Reinsurance contracts held—onerous underlying insurance contracts		
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Purpose

1. This paper discusses the accounting for reinsurance contracts held when the underlying insurance contracts are onerous.

2. Agenda Paper 2C is an appendix to this paper. That paper includes examples of accounting for reinsurance contracts held when the underlying insurance contracts are onerous.

Summary of staff recommendations

3. The staff recommend the International Accounting Standards Board (Board) amend IFRS 17 *Insurance Contracts* to:

   (a) expand the scope of the exception in paragraph 66(c)(ii) of IFRS 17 to require an entity to recognise a gain in profit or loss when the entity recognises losses on onerous underlying insurance contracts, to the extent that a reinsurance contract held covers the losses of each contract on a proportionate basis; and

   (b) require an entity to apply the expanded exception when the entity measures contracts applying the premium allocation approach (PAA).

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Structure of the paper

4. This paper provides:

   (a) an overview of the requirements in IFRS 17 (paragraphs 5–10 of this paper);

   (b) a summary of the Board's rationale for setting those requirements, including an overview of the Board's previous discussions (paragraphs 11–15 of this paper);

   (c) an overview of the concerns and implementation challenges expressed since IFRS 17 was issued (paragraphs 16–25 of this paper); and

   (d) the staff analysis, recommendations and a question for Board members (paragraph 26–68 of this paper).

IFRS 17 requirements

5. Insurance contracts issued and reinsurance contracts held are measured applying a consistent measurement approach based on fulfilment cash flows. To reflect that reinsurance contracts held are not issued by the entity, paragraphs 60–70 of IFRS 17 modify the general requirements. Paragraphs 6–10 of this paper summarise the requirements relating to the contractual service margin.

6. For *insurance contracts issued*, the contractual service margin represents unearned profit. IFRS 17 prohibits the contractual service margin from becoming negative and therefore expected losses on a group of insurance contracts issued are recognised immediately in profit or loss.

7. At the end of each reporting period, the carrying amount of the contractual service margin for a group of insurance contracts issued is adjusted to reflect changes in estimates relating to future service. The contractual service margin cannot be negative.

8. For *reinsurance contracts held*, the entity is receiving services rather than providing them. Therefore, the contractual service margin is different. It represents the net cost of purchasing reinsurance. The contractual service margin can be in a net cost or a net

gain position. In either case, it is recognised over the coverage period as services are received.[1]

9. The amount an entity pays for a reinsurance contract typically exceeds the expected present value of cash flows generated from that reinsurance contract plus the risk adjustment for non-financial risk. As such, the contractual service margin for a group of reinsurance contracts held at initial recognition is typically in a net cost position. However, in some cases the contractual service margin for a group of reinsurance contracts held may represent a net gain on purchasing reinsurance. In these cases, IFRS 17 treats the apparent gain on initial recognition as a reduction in the net cost of purchasing reinsurance. This means that gain is recognised over the coverage period of the reinsurance contract.

10. At the end of each reporting period, the carrying amount of the contractual service margin for a group of reinsurance contracts held is adjusted to reflect changes in estimates relating to future service, similarly to a group of insurance contracts issued. However, the contractual service margin can be in a net cost or a net gain position. There is one exception that relates to adjusting the contractual service margin for reinsurance contracts held. The exception relates to situations when an underlying group of insurance contracts becomes onerous after initial recognition because of adverse changes in estimates of fulfilment cash flows. In those circumstances, to the extent that there are corresponding changes in estimates of fulfilment cash flows for the reinsurance contract held, those changes do not adjust the contractual service margin of the reinsurance contract held, but are instead recognised in profit or loss. The result is that the entity recognises no net effect of the loss and gain in the profit or loss for the period to the extent that the change in the fulfilment cash flows of the underlying group of insurance contracts is matched with a change in the fulfilment cash flows of the group of reinsurance contracts held. Example A in Agenda Paper 2C illustrates the application of this exception.

[1] As an exception, if the reinsurance contract held covers events that have already occurred, the net cost at initial recognition is recognised immediately in profit or loss.

Board's rationale

11. In the 2010 Exposure Draft *Insurance Contracts*, the Board proposed symmetric treatment between the contractual service margin of reinsurance contracts held and insurance contracts issued. Because the contractual service margin for insurance contracts issued could not be negative, the Board proposed that the contractual service margin for reinsurance contracts held could never be in a net gain position.

12. However, some respondents to the 2010 Exposure Draft disagreed with the consequence that entities would recognise day one gains on reinsurance contracts held. This would not reflect that the insurer has not yet received reinsurance services from the reinsurer. In response to those concerns, the Board decided that the net gain or net cost of purchasing reinsurance should be recognised over the coverage period. This approach was first exposed for comment in the 2013 Exposure Draft *Insurance Contracts*.

13. Some respondents to the 2013 Exposure Draft said that an asymmetrical treatment between the contractual service margin of a reinsurance contract held and the reinsured portion of underlying insurance contracts would not appropriately depict the relationship between those contracts.

14. In response to those concerns, as an exception, the Board modified the requirements for subsequent measurement of the contractual service margin relating to *changes* in cash flows for reinsurance contracts held, as set out in paragraph 10 of this paper. The Board was persuaded by the view that changes in estimates of cash outflows on underlying insurance contracts that have corresponding changes in cash inflows from a reinsurance contract held should have no net effect in profit or loss for the period.

15. When the Board added this exception, it did not reconsider the measurement of the contractual service margin for a reinsurance contract held when an underlying group of contracts is onerous on initial recognition. The Board thought it would be rare for both:

    (a) a group of underlying insurance contracts to be onerous on initial recognition; and

    (b) the reinsurance contract held to result in a net gain.

Concerns and implementation challenges expressed since IFRS 17 was issued

16. Some stakeholders are concerned that although IFRS 17 includes an exception for reinsurance contracts held that is intended to avoid accounting mismatches, the requirements still give rise to accounting mismatches. Those stakeholders think that the scope of the exception is too narrow because:

    (a) it applies when an underlying group of insurance contracts become onerous after initial recognition because of adverse changes in estimates of future cash flows; but

    (b) does not apply:

        (i) when an underlying onerous group of insurance contracts is initially recognised; and

        (ii) when further insurance contracts are issued and join the onerous group, if that does not result in a *change* in the fulfilment cash flows of the reinsurance contract held (ie when underlying insurance contracts are reflected in the measurement of the reinsurance contract held before they are issued and are later issued as expected).

17. Those stakeholders have identified the following requirements in IFRS 17 as the source of an accounting mismatch when a group of insurance contracts is issued and reinsured. An entity issuing a group of contracts that are onerous at initial recognition is required to recognise:

    (a) a loss for the underlying insurance contracts immediately in profit or loss when expected; and

    (b) the gain in a reinsurance contract held over the period that reinsurance services are being received, even if the cash flows of the reinsurance contract held match those of the underlying insurance contracts.

    Agenda Paper 2C includes examples that illustrate the application of the requirements in IFRS 17.

18. During the implementation of IFRS 17 some stakeholders have identified that the accounting mismatch may be significant in many circumstances. Those stakeholders note that the Board had expected accounting mismatches arising from the

asymmetrical treatment between the contractual service margin of a reinsurance contract held and the reinsured portion of underlying insurance contracts to be rare, because a reinsurance contract held is not expected to often be in a *net gain* position. However, those stakeholders think that the requirements also give rise to an accounting mismatch when a reinsurance contract held is in a *net cost* position and covers both onerous groups of underlying insurance contracts and profitable groups of underlying insurance contracts.

19. For example, an insurer might purchase a reinsurance contract that provides proportionate cover on all motor insurance contracts it sells over a one-year period. Most of the motor insurance contracts are likely to be profitable, but some might be onerous—for example, contracts sold to younger drivers at a premium that does not fully reflect the insurance risk in those contracts. IFRS 17 requires the insurer to group the onerous contracts separately to the other contracts and to recognise the loss on the onerous contracts immediately. However, in this example the reinsurance contract held covers all of those insurance contracts and is accounted for as a single contract. The contractual service margin for that contract is recognised over the coverage period of the reinsurance contract held. Example C in Agenda Paper 2C illustrates the application of IFRS 17 in this scenario.

20. Stakeholders note that even if the reinsurance contract held is a net cost to the entity overall, the reinsurer has accepted the risks of each underlying contract on a proportionate basis—including the onerous contracts. This means that for each cash outflow the insurer expects to pay to the underlying policyholder, it also expects a cash inflow from the reinsurer equal to a percentage of that cash outflow. For that reason, many stakeholders view reinsurance as a type of risk mitigation and think that the accounting should be similar to hedge accounting applying IFRS 9 *Financial Instruments*. Some stakeholders view proportionate reinsurance contracts as providing the insurer with an economically fully effective hedge for the reinsured portion of the insurance contracts. Contrary to this view, other stakeholders note that the measurement of the insurance contracts or the reinsurance contract held might include cash flows that are not proportionate. Examples of such cash flows include insurance acquisition cash flows or reinsurance commissions.

21. Some stakeholders observe that an accounting mismatch similar to the one described in paragraph 19 of this paper could arise when the entity applies the PAA (ie the optional simplified measurement approach).

22. Some stakeholders have suggested amendments to IFRS 17 that they think would address their concerns.[2] The two suggested amendments are to:

    (a) amend the requirements for underlying onerous groups of insurance contracts. This amendment would defer expected losses on the statement of financial position, to the extent that those losses are covered by a reinsurance contract held that provides proportionate coverage (referred to as 'the deferred loss solution'); or

    (b) amend the requirements for groups of reinsurance contracts held that provide proportionate coverage. This amendment would recognise a gain in profit or loss in the same period that losses are recognised on the underlying insurance contracts, to the extent that a reinsurance contract held covers those losses on a proportionate basis (referred to as 'the immediate loss mitigation solution').

23. Some stakeholders that have suggested the deferred loss solution for underlying onerous groups of insurance contracts think that the insurer is acting like an agent for the reinsured portion of the underlying insurance contracts. Proponents of this view think:

    (a) the insurer is released from risk immediately at the time that it issues an insurance contract that is covered by a reinsurance contract that provides proportionate coverage; and

    (b) the insurer delivers services for the reinsured portion of the underlying insurance contracts at the point in time that the insurance contract is issued.

24. Those stakeholders think that it would be consistent with IFRS 15 *Revenue from Contracts with Customers* to recognise the associated fee immediately. Thus, they have suggested that in addition to amending the requirements for onerous underlying

[2] These suggested amendments reflect input that was coordinated under the initiative of a group of national standard-setters.

contracts, a related amendment should also be made for profitable underlying contracts. In summary, those stakeholders have suggested:

(a) for onerous groups of insurance contracts—the reinsured portion of the loss is deferred on the statement of financial position; and

(b) for profitable groups of insurance contracts—the reinsured portion of the unearned profit is recognised immediately in profit or loss.

25. Some stakeholders have suggested that IFRS 17 is amended for circumstances when the reinsurance contract held is entered into *before or at the same time* as the onerous underlying insurance contracts are issued, and not in circumstances when the reinsurance contract held is entered into *after* the onerous underlying insurance contracts are issued. Those stakeholders noted that if an amendment was to apply also to reinsurance contracts entered into after the underlying contracts are issued, an entity might enter into a reinsurance contract at a later date to achieve a particular accounting outcome.

Staff analysis and recommendation

26. The staff analysis includes the following sections:

(a) applying IFRS 17:

(i) scenario 1—when a reinsurance contract held is in a net gain position and provides coverage for an underlying onerous group of insurance contracts; and

(ii) scenario 2—when a reinsurance contract held is in a net cost position and provides coverage for an underlying onerous group of insurance contracts and an underlying profitable group of insurance contracts.

(b) possible amendments to IFRS 17:

(i) possible amendment A—deferred loss solution; and

(ii) possible amendment B—immediate loss mitigation solution.

(c) premium allocation approach.

(d) staff recommendation.

Applying IFRS 17

27. The requirements for reinsurance contracts held, including the treatment of the contractual service margin, are consistent with the Board's general conclusions that:

    (a) a reinsurance contract held is a separate contract to the underlying insurance contracts issued; and

    (b) the net cost of purchasing reinsurance is recognised as the reinsurance service is received.

28. However, these requirements result in asymmetrical treatment between the contractual service margin of a reinsurance contract held and the reinsured portion of onerous underlying insurance contracts. The asymmetrical treatment creates a mismatch that occurs purely because of an accounting measurement inconsistency (ie an accounting mismatch).

29. When the Board considered whether an exception was justified in response to comments to the 2013 Exposure Draft, it considered the trade-off between:

    (a) being consistent with the Board's general conclusions in paragraph 27 of this paper; and

    (b) avoiding accounting mismatches.

30. There are two circumstances described in this paper for which stakeholder concerns arise. In this analysis the staff consider both circumstances to identify whether an amendment to IFRS 17 could be justified. Those two circumstances are:

    (a) when a reinsurance contract held is in a net gain position and provides coverage for an underlying onerous group of insurance contracts (scenario 1); and

    (b) when a reinsurance contract held is in a net cost position and provides coverage for an underlying onerous group of insurance contracts and an underlying profitable group of insurance contracts (scenario 2).

Scenario 1—when a reinsurance contract held is in a net gain position and provides coverage for an underlying onerous group of insurance contracts

31. Example B in Agenda Paper 2C illustrates scenario 1. In that example, the entity issues onerous insurance contracts with a coverage period of two years and measures the loss component at initial recognition as 200. At the same time, the entity enters into a reinsurance contract that provides 50% proportionate coverage for those onerous contracts. Applying IFRS 17, the insurance service result is calculated as:

(Dr)/Cr	**Year 1**	**Year 2**
Insurance contracts issued	(200)	0
Reinsurance contracts held	50	50
Insurance service result	**(150)**	**50**

32. The Board discussed scenario 1 when it decided to add an exception relating to adverse changes in estimates of future cash flows after initial recognition. At that time, the Board decided not to add an exception for the treatment of a net gain on reinsurance contracts held with respect to the initial recognition of underlying onerous insurance contracts, as explained in paragraph 15 of this paper.

33. The staff think that the Board added the exception relating to adverse *changes* in estimates of future cash flows because the accounting mismatch that would have arisen is one that would occur frequently and could be significant in size. Thus, on balance:

    (a) that accounting mismatch would likely reduce the faithful representation of information reported; and

    (b) the benefit of avoiding the accounting mismatch outweighs the cost of creating an exception that is contrary to the general principles for accounting for reinsurance contracts held.

34. The staff think that the Board did not add a similar exception for the treatment of a net gain on reinsurance contracts held with respect to the *initial recognition* of underlying onerous insurance contracts because the circumstance in which a reinsurance contract

held is in a net gain position and covers underlying insurance contracts that are onerous on initial recognition was expected to be rare. As such, any resulting accounting mismatch on initial recognition was expected to occur infrequently.

35. The staff observe although some stakeholders continue to be concerned about scenario 1, the main concerns expressed since IFRS 17 was issued relate to accounting mismatches that stakeholders have identified could arise more often and be significant in size in scenario 2.

Scenario 2—when a reinsurance contract held is in a net cost position and provides coverage for an underlying onerous group of insurance contracts and an underlying profitable group of insurance contracts

36. Example C in Agenda Paper 2C illustrates scenario 2. In that example, the entity issues insurance contracts with a coverage period of two years. Some of the contracts are expected to be profitable and some are expected to be onerous. The entity recognises two groups of contracts: an onerous group with a loss component of 100; and a profitable group with a contractual service margin of 200. At the same time, the entity enters into a reinsurance contract that provides 50% proportionate coverage for both groups of contracts. Applying IFRS 17, the insurance service result is calculated as:

(Dr)/Cr	**Year 1**	**Year 2**
Profitable group of insurance contracts issued	100	100
Onerous group of insurance contracts issued	(100)	0
Insurance contracts issued	0	100
Reinsurance contracts held	(25)	(25)
Insurance service result	**(25)**	**75**

37. The Board did not discuss scenario 2 when it decided to add the exception relating to adverse changes in estimates of future cash flows after initial recognition. The likely significance of the accounting mismatch in scenario 2 has been identified by stakeholders in their implementation of IFRS 17. The staff think that the same trade-

off that the Board considered when it added the existing exception is relevant when considering the accounting mismatch in scenario 2.

38. The staff think that, consistent with the Board's decision to add an exception relating to adverse changes in estimates of future cash flows, considering both scenario 1 and scenario 2, an amendment to IFRS 17 could be justified in respect of the initial recognition of underlying onerous contracts. The accounting mismatch that arises is likely to occur more frequently and could be significant in size.

Possible amendments to IFRS 17

39. The staff observe that the requirements in IFRS 17 for reinsurance contracts held are based on the following principles:

    (a) reinsurance contracts held are separate contracts to the underlying insurance contracts issued;

    (b) reinsurance contracts held and insurance contracts issued are accounted for applying a consistent measurement approach;

    (c) the contractual service margin for a reinsurance contract held represents the net cost of purchasing reinsurance (ie it does not represent a profit or a loss); and

    (d) the net cost of purchasing reinsurance is recognised over the period that the entity receives services from the reinsurer.

    There are two exceptions to these principles in IFRS 17. One of those is the exception discussed in this paper.[3]

40. The staff observe that to meet the criteria set by the Board, any amendment to IFRS 17 would not change the fundamental principles for accounting for reinsurance contracts held.

41. This paper considers amendments that would resolve the accounting mismatch that is created on initial recognition of onerous underlying insurance contracts if a

[3] The other exception is that if the reinsurance contract held covers events that have already occurred, the net cost at initial recognition is recognised immediately in profit or loss.

reinsurance contract held is *entered into before or at the same time* as the onerous underlying insurance contracts are issued.

42. Consequently:

    (a) for the losses on the underlying insurance contracts and corresponding gains in the reinsurance contract held to be recognised at the same time, the amendment would need to be applied *at the time the underlying insurance contracts are issued and not before*; and

    (b) any amendment would apply at the initial recognition of a new onerous group of insurance contracts, when further onerous contracts are issued and join an existing onerous group and would continue to apply when there are adverse changes in fulfilment cash flows as explained in paragraph 10 of this paper.

43. The staff agree with stakeholder concerns that if an amendment was to apply also to reinsurance contracts entered into *after* the underlying contracts are issued, an entity might enter into a reinsurance contract after the underlying contracts are issued to achieve a particular accounting outcome. Therefore, this paper does not consider any amendments that would apply in those circumstances.

Possible amendment A—deferred loss solution

44. One way to amend IFRS 17 would be to change the accounting for underlying insurance contracts to the extent that those contracts are covered by a reinsurance contract.

45. The requirements could be amended to require that an expected loss on an onerous group of insurance contracts is recognised as services are provided instead of when the expected loss is identified, to the extent that the expected loss is covered by a reinsurance contract that has been entered into before or at the same time as the underlying insurance contracts are issued.

Assessing whether possible amendment A would meet the criteria set by the Board

46. The staff think that to defer loss recognition on underlying groups of onerous insurance contracts would resolve the accounting mismatch. However, this

amendment would be a fundamental change to the IFRS 17 accounting model for insurance contracts issued and the staff think this amendment would:

(a) result in a significant loss of information about the profitability of insurance contracts issued; and

(b) introduce complexity for users of financial statements because the accounting for onerous groups of insurance contracts will be different depending on whether and when the entity purchases reinsurance.

47. For those reasons, the staff do not recommend the Board amend the requirements for underlying onerous groups of insurance contracts as described in paragraphs 44−45 of this paper.

48. The staff observe that some stakeholders that have suggested a deferred loss solution have also suggested a related amendment for underlying *profitable* groups of insurance contracts, as explained in paragraph 23 of this paper. This suggested amendment is to recognise profit immediately in profit or loss on those contracts, to the extent that a reinsurance contract held covers each contract on a proportionate basis.

49. The staff observe that the views expressed by proponents of this related amendment fundamentally differ from the principles that the IFRS 17 requirements for reinsurance contracts held are based on because:

(a) proponents of this view think that the insurer is relieved of insurance risk for the reinsured portion of the underling insurance contracts and is acting similarly to an agent making a fee; whereas

(b) IFRS 17 regards a reinsurance contract held as providing services to the holder of the contract over time. While a reinsurance contract mitigates the insurers risk exposure, it does not typically relieve the insurer of its primary obligations under the insurance contracts it has issued to policyholders. For example, if the reinsurer defaulted on the reinsurance contract, the insurer would still be obligated to pay the full amount of claims to the policyholder of the insurance contract.

50. The staff observe that paragraph 75 of IFRS 17 deals with circumstances in which an insurer is no longer at risk and can no longer be required to transfer any economic resources to satisfy an insurance contract in any single scenario. Paragraph 75 of IFRS 17 explains that when an entity buys reinsurance, it shall derecognise the underlying insurance contracts when, and only when, the underlying insurance contracts are extinguished (ie when the obligation specified in the insurance contract expires or is discharged or cancelled).

51. The staff also observe that in circumstances that an entity is acting solely as an agent it is not issuing insurance contracts for the purposes of applying IFRS 17.

52. For those reasons, this paper does not consider further the amendment suggested by stakeholders to recognise an immediate profit for the reinsured portion of underlying profitable groups of insurance contracts.

Possible amendment B—immediate loss mitigation solution

53. An alternative way to amend IFRS 17 would be to change the accounting for reinsurance contracts held. The scope of the existing exception in paragraph 66(c)(ii) of IFRS 17 could be expanded to require an entity to recognise a gain in profit or loss when the entity recognises losses on onerous underlying insurance contracts, to the extent that a reinsurance contract held covers the losses of each contract on a proportionate basis.[4]

54. This possible amendment would adjust the contractual service margin for reinsurance contracts held when losses are recognised on onerous underlying insurance contracts, to the extent that the reinsurance contract covers the losses of each contract on a proportionate basis.

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[4] Applying this amendment, an entity would also be required to recognise a *loss* in profit or loss when it recognises *reversal of losses* on onerous underlying insurance contracts, to the extent that a reinsurance contract held covers the losses of each contract on a proportionate basis.

55. The following table illustrates the effect of this possible amendment on the accounting for reinsurance contracts held entered into before or at the same time as the underlying onerous contracts are issued:

Does the exception apply when:	**IFRS 17**	**IFRS 17 with amendment**
an underlying onerous group of insurance contracts is initially recognised?	no	yes
further onerous insurance contracts are issued and join the onerous group?	in some circumstances	yes
an underlying group of insurance contracts become onerous after initial recognition because of adverse changes in estimates of future cash flows?	yes	yes

56. The staff observe that the measurement of insurance contracts includes cash outflows other than insurance claims. For example, allocations of general overheads and insurance acquisition cash flows. Those other cash flows might not be recovered from the reinsurer in the same proportion as claims, if recovered at all. Equally, the measurement of reinsurance contracts held might include cash inflows other than reimbursement of claims, such as reinsurance commissions. Those other cash flows might not be proportionate to cash flows included in the measurement of the underlying insurance contracts. Therefore, even when a reinsurance contract provides proportionate coverage for insurance claims, not all cash flows included in the measurement of that contract are necessarily proportionate to the underlying insurance contracts.

57. For example, assume an entity issues an onerous contract with an expected loss of 100. The measurement of the onerous contract includes expected claims and insurance acquisition cash flows. At the same time, the entity purchases a reinsurance contract that covers all insurance contracts the entity issues, providing 50% proportionate

coverage for claims. The measurement of the reinsurance contract held includes expected claims reimbursements and reinsurance commissions.

58. Applying this possible amendment, the entity would recognise an immediate loss of 100 on the onerous insurance contract, and a corresponding gain of 50 on the reinsurance contract held at the same time. The entity would not be required to identify whether the reinsurance commissions relate to the insurance acquisition cash flows, and, if so, to what extent (for example, whether or not they are 50% proportionate).

59. In other words, this possible amendment makes an assumption that the loss recognised on the onerous insurance contract is caused by the insurance claims that are covered by the reinsurance contract held on a proportionate basis. The staff observe that this assumption is arbitrary. However, the staff think that if an alternative approach was taken, that alternative approach would likely require an entity to identify whether and to what extent all cash flows are proportionate. This could be both complex and arbitrary. Therefore, the benefits of that alternative approach would likely not outweigh the costs.

60. To recognise a gain on reinsurance contracts held as described in the example in paragraph 58 of this paper, an entity would credit profit or loss and debit the contractual service margin of the reinsurance contract asset. If the contractual service margin is in a net cost position, this debit would increase the net cost. If the contractual service margin is in a net gain position, this debit would reduce the net gain. This adjusted contractual service margin would, in effect, relate to the profitable underlying insurance contracts. The adjustment reflects that the entity is essentially giving up some of its profit on profitable contracts to the reinsurer (ie the cost of purchasing reinsurance) in exchange for the reinsurer taking on some of the loss on onerous contracts (ie the gain on purchasing reinsurance).

61. The staff think the accounting mismatch identified by stakeholders could be resolved by requiring an entity to recognise a gain on a reinsurance contract held when losses are recognised on the onerous underlying contracts, to the extent that the reinsurance contract held covers the losses of each contract on a proportionate basis. Example B and Example C in Agenda Paper 2C illustrate the application of IFRS 17 with and

without this possible amendment for Scenario 1 and Scenario 2 discussed in this paper. The following tables show the calculations of the insurance service result for each scenario.

Scenario 1—when a reinsurance contract held is in a net gain position and provides coverage for an underlying onerous group of insurance contracts

(Dr)/Cr	**IFRS 17**		**IFRS 17 with amendment**	
	Year 1	**Year 2**	**Year 1**	**Year 2**
Insurance contracts issued	(200)	0	(200)	0
Reinsurance contracts held	50	50	100	0
Insurance service result	**(150)**	**50**	**(100)**	**0**

Scenario 2—when a reinsurance contract held is in a net cost position and provides coverage for an underlying onerous group of insurance contracts and an underlying profitable group of insurance contracts

(Dr)/Cr	**IFRS 17**		**IFRS 17 with amendment**	
	Year 1	**Year 2**	**Year 1**	**Year 2**
Profitable group	100	100	100	100
Onerous group	(100)	0	(100)	0
Insurance contracts issued	0	100	0	100
Reinsurance contracts held	(25)	(25)	0	(50)
Insurance service result	**(25)**	**75**	**0**	**50**

Assessing whether possible amendment B would meet the criteria set by the Board

62. On balance, the staff think this possible amendment would:

    (a) avoid significant loss of useful information relative to that which would be provided by IFRS 17 for users of financial statements. The accounting for the underlying insurance contracts issued would be unaffected. The accounting for the reinsurance contracts held would change but IFRS 17 already provides an exception to the general requirements for reinsurance contracts held to avoid some accounting mismatches. This possible amendment would expand the scope of the existing exception.

    (b) not be contrary to the general principle in IFRS Standards that gains should not be recognised before service is provided. This was a concern expressed by some stakeholders in response to the 2010 Exposure Draft. The staff think that this possible amendment would not result in an overall gain being recognised in profit or loss because a gain on the reinsurance contract held would only be recognised to the extent that the reinsurance contract held covers a loss that is also recognised in profit or loss at the same time.

63. The staff observe that exceptions, by nature, add complexity. However, in this circumstance, expanding the existing exception could reduce complexity in applying the requirements in IFRS 17 because it would introduce consistency between the accounting treatment relating to the initial recognition of underlying onerous contracts and adverse changes in underlying onerous contracts subsequently. It could also reduce complexity for users of understanding the accounting, by eliminating accounting mismatches.

64. The staff think that this possible amendment might disrupt implementation for entities that have already begun to develop their systems. However, the staff think that the disruption could be justified given stakeholder feedback about the likely significant impact of the accounting mismatch which some stakeholders suggest reduces the usefulness of the information provided by IFRS 17.

65. The staff observe that recognising a gain for the reinsurance contract held that reflects the loss mitigation, when the reinsurance contract held is actually in a net cost position overall, is inconsistent with the principle that a reinsurance contract held is a separate contract to the underlying insurance contracts issued.

66. On balance, the staff think that the benefits of expanding the existing exception in IFRS 17 to resolve the accounting mismatch that is currently outside of the scope of that exception outweigh the costs of that possible amendment. The staff observe that this approach links the accounting for the reinsurance contract held to the accounting for the underlying insurance contracts, and that the existing exception already introduces this link. The staff think that the possible amendment would meet the criteria set by the Board.

Premium allocation approach

67. The staff observe that, as noted by stakeholders in paragraph 21 of this paper, a similar accounting mismatch could arise when the underlying insurance contracts are measured applying the PAA, or the reinsurance contract held is measured applying the PAA, or both. Therefore, the staff think that the expanded exception should apply both for contracts measured applying the general model and the PAA. Example D in Agenda Paper 2C illustrates applying IFRS 17 with and without the possible amendment when an entity applies the PAA.

Staff recommendation

68. The staff recommend the Board amend IFRS 17 to:

    (a) expand the scope of the exception in paragraph 66(c)(ii) of IFRS 17 to require an entity to recognise a gain in profit or loss when the entity recognises losses on onerous underlying insurance contracts, to the extent that a reinsurance contract held covers the losses of each contract on a proportionate basis; and

    (b) require an entity to apply the expanded exception when the entity measures contracts applying the PAA.

Questions for Board members

Do you agree the Board amend IFRS 17 to:

(a) expand the scope of the exception in paragraph 66(c)(ii) of IFRS 17 to require an entity to recognise a gain in profit or loss when the entity recognises losses on onerous underlying insurance contracts, to the extent that a reinsurance contract held covers the losses of each contract on a proportionate basis; and

(b) require an entity to apply the expanded exception when the entity measures contracts applying the PAA?