
IFRS 17 will affect how reinsurers conduct business

A guide to the challenges ahead

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Introduction

Reinsurance has been one of the hottest topics arising from IFRS 17. Detailed considerations, from the perspective of ceding companies, can be found in the 'IFRS 17 Pocket Guide on reinsurance contracts held',¹ released in July 2018 by the International Accounting Standards Board ('IASB'), and our paper titled 'IFRS 17: reinsurance needs careful consideration'². We now consider IFRS 17 from the perspective of reinsurers; its impact will be felt not only by accountants, actuaries, IT and systems teams, but also by front office and business staff, such as underwriters, structurers, originators, product development and pricing actuaries. Reinsurance arrangements and operations will likely be affected in ways that have not been fully worked through. This article considers some of

the implications specific to the reinsurance industry and why the effort required to understand these challenges should not be underestimated.

The efforts made by reinsurers to understand the strategic implications of the upcoming IFRS 17 standard for their inwards reinsurance business and operations have been varied, ranging from players simply targeting compliance to getting involved in the development of the standard and seeking to use the accounting change to make the most of it and to prompt strategic thinking. For instance, whilst the most advanced reinsurers across the world have raised issues which they hope will lead to changes to the standard, and they are working on the implementation and testing of IFRS 17

at the same time, others are lagging with little progress made to date on impact and gap assessments. Overall, some reinsurers are quite far from engaging with their insurance clients on the implications for existing and new reinsurance arrangements. Since not all cedants/insurers are fully aware of the challenges posed in the accounting for their reinsurance held, there is an opportunity for the primary and reinsurance markets to work together and adapt to this accounting change.

IFRS 17 applies to both reinsurers and insurers, so what is specific to reinsurers?

One key difference is that IFRS 17 not only affects the accounts and balance sheets of the reinsurers themselves, but it will also directly impact those of many of their clients. The risk appetite and reinsurance needs of reinsurers' customers might evolve as they become familiar with IFRS 17, and this could result in opportunities or additional challenges for issuers of reinsurance contracts. The most advanced reinsurers will be looking to position themselves and capture IFRS 17-related competitive benefits, while also managing the clients which do not report under IFRS (some of whom might also be facing other accounting changes, such as revision to long duration contracts under US GAAP).

IFRS 17 will also have different implications for reinsurers. Insurers typically write a high volume of contracts with similar features, which enables grouping in the actuarial models and relatively large sets of data to calibrate them. Conversely, reinsurers write relatively few but more material contracts, usually highly bespoke to the needs of each individual client. For example, reinsurance business can be written under various bases (such as treaty and facultative, proportional and non-proportional, risk attaching/natural expiry basis and loss occurring during, closed and open blocks), with a greater level of complexity than the underlying insurance business.

The lower-level granularity required by IFRS 17 will pose challenges to reinsurers for grouping those bespoke contracts; portfolios of 'similar risks' for a reinsurer might not be all that similar for IFRS 17.

¹ <https://www.ifrs.org/news-and-events/2018/07/ifrs-17-implementation-new-support-materials-on-reinsurance-contracts-held-now-available/>

² <https://www.pwc.co.uk/services/audit-assurance/capital-markets-accounting-advisory-and-structuring/insights/ifrs-17-and-reinsurance.html>

What should reinsurers be thinking about?

There are steps that reinsurers (including third party and intra-group reinsurers) and alternative risk transfer solutions providers can take to navigate the IFRS 17 changes. They should be thinking about their clients at the same time as they assess the impacts on their own financial statements, data, systems and processes.

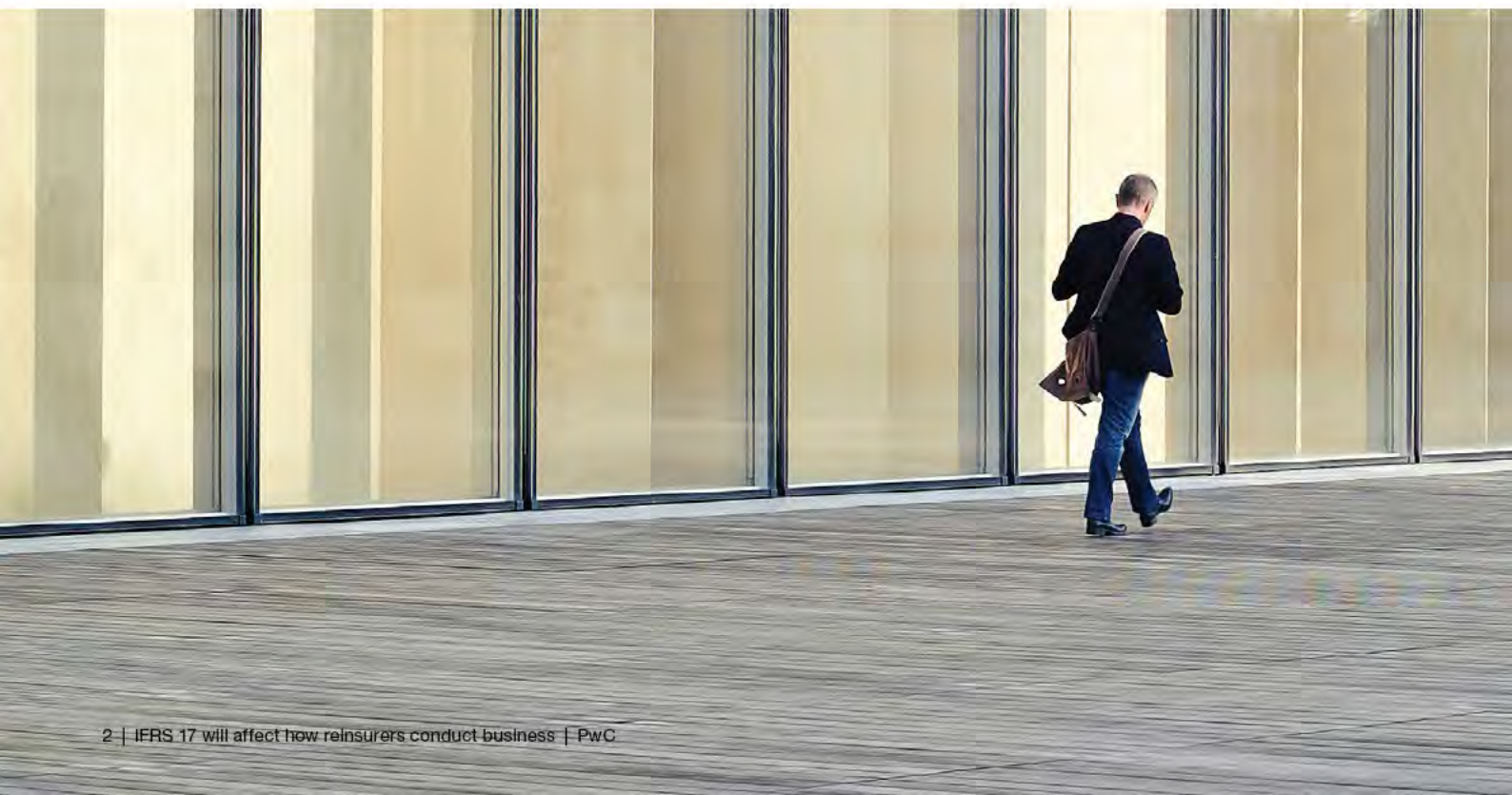
IFRS 17 will impact cedants' reinsurance needs and the potential for future new reinsurance business. Under IFRS 17, earnings volatility incurred by the insurers might increase, for example, as a result of potential mismatches between treatment of the underlying business written and the purchased reinsurance, use of current best estimate assumptions and discounting. This might support reinsurance business and favour demand for reinsurance covers. Conversely, the cost-benefit of reinsurance might not be as worthwhile to cedants, which might result in a reduction in cedants' demand for certain types of reinsurance. In addition, IFRS 17 might modify insurers' risk appetite for diversifiable risks, for example, to optimise their risk adjustment 'charge' (net of risk adjustment associated with the reinsurance contracts held).

Reinsurers should also review their existing reinsurance solutions (including traditional and financial products, such as whole account reinsurance), challenge the current approach and ensure that these remain efficient under IFRS 17 from their clients' perspectives and for themselves (for example, with regard to the recognition of profit over time and the associated volatility). They might well find that the historical motivations for designing some arrangements in certain ways will no longer meet their cedants' needs. Materiality and criticality of the reinsurance arrangements and/or business lines should be key in deciding the level of effort to put into these reviews. To do so, reinsurers should consider methods which are proportionate to the nature, scale and complexity of the reinsurance arrangements.

Not only existing reinsurances with third parties should be reviewed but also existing intra-group reinsurances.

From a cedant's perspective, the accounting will change, and inwards contracts will be less likely aligned with the reinsurance purchased to mitigate it, and a disconnect might arise between the economic objectives of the reinsurance and its accounting treatment (see above). When considering the same contract from both parties' perspectives, the treatment might differ (for example, differing measurement models and profit recognition).

Transition is important. Insurers and reinsurers hold arrangements in run-off (sometimes very old ones, notably in life reinsurance). Like insurers, reinsurers will need to consider these for the transition balance sheet. Some opportunities might arise, such as to collapse, commute, recapture and/or restructure some run-off reinsurance arrangements for both financial and operational benefits.



Tax considerations might also prove important. Depending on the jurisdictions and the tax rules, IFRS 17 might change the expected tax profile of cedants and reinsurers, and impact on cash, deferred tax, loss utilisation, regulatory capital and balance sheets.

Reinsurers should ensure that their front office operations and business staff, such as underwriters, structurers, pricing actuaries and originators, who might not normally have an in-depth understanding of the accounting policies of their clients, are up to speed on IFRS 17 matters. This will help to improve their understanding of the potential challenges faced by their clients when scoping, structuring and implementing reinsurance in an IFRS 17 environment, and to identify the areas for new opportunities and solutions. In addition to new business opportunities and restructuring of existing arrangements, this might also enable them to better understand the dynamics of the underlying reinsured business, the expected profitability of their business

(such as onerous contracts at inception) and related uncertainties (such as contracts with a risk of becoming onerous). This could lead to more accurate pricing and justifications of the commercial reasons why they enter into a contract with a client whereby, at inception, they expect to make a loss. Reinsurers will need to think about the information that they request from their cedants to assess, price and monitor the reinsurance business, as well as the relevance and documentation of the expert judgements used when setting assumptions (such as for pricing and reserving). Additional and more granular reinsurance data which could be beneficial to reinsurers could soon become available from cedants.

IFRS 17 has given rise to many questions on interpretation of the standard. A lot of areas of detail specific to reinsurers are likely to emerge as the industry digs deeper into the implementation and testing of IFRS 17. Issues raised at the Transition Resource Group ('TRG') meetings have largely been answered; however, because it is a principles-based standard, many topics will require judgement in implementing IFRS 17. This will require efforts from reinsurers' management to fully work out the impact that their interpretations of the standard will have on their underwriting and risk strategy.



IFRS 17 will directly affect reinsurance contract design

The scope and structures of the reinsurance arrangements should be the starting points when reviewing the implications of IFRS 17. Examples of points to be considered include the contract boundaries and the requirement to combine and separate contracts. Depending on the size of the reinsurance arrangement, its terms and the homogeneity of reinsured risks, reinsurers use one or several actuarial models (potentially with allowances for interdependencies), and they might need to combine or separate their participations, depending on how they have documented their underwriting and the agreements with their clients.

To manage the long-term relationships with their customers, reinsurers often accept deals based on overall commercial terms. The structure and overall commercial effect of such contracts will need to be considered carefully, to assess whether they meet the criteria needed for combination under IFRS 17, as discussed at the TRG meeting in May 2018. Otherwise, reinsurers might be faced with recognising significant initial losses

from one contract in an overall deal, with profits emerging slowly from other contracts with the same customer.

The complexity of individual contracts will also require careful consideration. The February 2018 TRG meeting discussed whether individual contracts should be separated into their underlying components. Reinsurers need to be aware that there might be facts and circumstances which require them to separate contracts to reflect the substance over form. For instance, reinsurers often participate on several (sub)layers of non-proportional programmes. They should also consider individual reinsurance treaties spanning different ceding companies, territories, currencies (and yield curves), lines of business and/or classes of risk (such as co-cedant arrangements with differences between cedants in respect of expenses, claims experience and levels of profitability for the reinsurer). It is also worth noting that IFRS 17 requires separation of the certain distinct investment components and

services. Reinsurance arrangements are not always driven by risk mitigation (such as reduction in earnings volatility or protection of the solvency and financial strength), and they might also support other purposes such as funding or provision of specific services (for example, access to underwriting expertise, product development, fund management and/or hedging capabilities). Other accounting standards might be applicable for reinsurance arrangements that do not transfer significant insurance risks (or lapse or expense risks), as is currently the case – for example, IFRS 9.

Other complications include reinsurance contracts with notice of cancellation clauses and/or repricing clauses, and the consequent implications on contract boundaries and recognition of the reinsurance asset, depending on how these clauses are worded. Collateral, deposit and funds withheld arrangements should also be considered.

Pricing and commission structures should also be considered

Some implications of IFRS 17 on pricing and underwriting have already been mentioned. These are not the only ones. Discounting factors might not be the same for a reinsurer and its customers, and reinsurance premium structures can include many specific features (such as settlement in advance or in arrears, minimum deposit and adjustment premiums, free or payable reinstatement premiums, and swing rating). Reviewing and restructuring the expected cash flows patterns might therefore benefit the reinsurer while having little accounting impact for its

customers – for example, reducing the risk for the reinsurer of writing an onerous contract by increasing the proportion of minimum deposit premiums received up front at the inception date and correspondingly reducing the adjustment premiums received later at the end of the reinsurance cover period.

Accounting for reinsurance commissions will change, and reinsurers might benefit from reviewing existing deposit, ceding and profit commission structures.

Certain commissions might meet the definition of an investment component in IFRS 17 and would be excluded from insurance revenues. Reinsurers should also interrogate their systems to separate, for example, the timing and circumstances under which commissions are paid, and ensure that they have the ability to model these cash flows in line with IFRS 17. This is easier said than done, because many reinsurers' systems do not differentiate between commissions.

IFRS 17 prompts the market to rethink some retrospective reinsurance solutions

IFRS 17 has the potential to change the landscape of non-traditional and/or retrospective reinsurance solutions, such as adverse development covers, value in force monetisation arrangements and/or longevity swaps. For ceding companies, the net cost of these reinsurance coverages continues to be recognised immediately under IFRS 17 in profit or loss as an expense at initial recognition, so they might still find these solutions appropriate.

However, they might face a reduced appetite from acquirers of run-off books or increases in associated costs; this is because profits which are usually recognised upfront in total under the current standards might be much slower to emerge under IFRS 17.

The change in accounting treatment of retrospective reinsurance solutions could significantly reduce the immediate benefit to reinsurers of acquiring business through these types of solutions; how will they adapt their businesses in an IFRS 17 world, together with balancing regulatory implications?

IFRS 17 might affect reinsurance capacity

IFRS 17 might affect reinsurers' risk appetite because of its implications not only for their revenues and earnings, but also for their retrocession purchase and other outward arrangements (such as insurance-linked securities). In particular, some retrocession held arrangements might no longer be fit for purpose under IFRS 17, or they might give rise to significant operational complications. For instance, the scarcity

of available data (and significance of expert judgements) is even greater for reinsurers than for insurers, and it will affect 'the amount of risk being transferred' by the reinsurers to the retrocessionaires. Another example of possible implications for retrocession purchase relates to the risk adjustment saved due to non-proportional retrocession (for example, how a high-layer catastrophe reinsurer

calculates its retroceded risk adjustment in cases where its expected claims are very small). The extent of the impact on the overall capacity that reinsurers provide to their customers remains to be seen.

What now?

These challenges cannot be overlooked and need addressing now. The industry is lobbying for delays and/or changes to the standard, thus throwing potential uncertainty over whether the go-live date for IFRS 17 will actually be 2021. However, changes to reinsurance scoping, structuring and pricing should be discussed by the parties well ahead of 2021, notably for material and/or critical arrangements, because opening balance sheets as at 1 January 2020 will be needed (at year end 2021 or for 2021 interims) and the parties will need to ensure the appropriateness of the

business forecasts that they will produce before the IFRS 17 implementation date. Further, many multi-year reinsurance contracts and natural expiry basis arrangements currently being discussed will still be in force at transition, thus bringing the timeline into rather sharp perspective. The considerations are complex and will require time for thinking, commuting or overhauling long-standing reinsurance programmes, modelling them so that the parties could make informed decisions, and going through all the potential impacts, such as incentive plans for management and

reinsurers' business staff. IFRS 17 needs to be a high priority for reinsurers and their clients, who need to get these discussions started as soon as possible to articulate the end goal and begin to execute change.

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