Paper 4

Impact of cash flow settlement arrangement in a reinsurance contract and presentation of insurance revenue and insurance service expenses in the profit or loss statement (Deloitte)

This paper is in two parts. The first part deals with the perspective of the issuer while the second part deals with the perspective of the cedant. The author believes that the conclusion of the discussion on this paper is equally applicable to insurance contracts issued.

1. Impact of cash flow settlement arrangement (net vs. gross) in assessing insurance revenue and insurance service expense on an issued reinsurance contract

Background

The purpose of this paper is to discuss whether the cash flow settlement arrangement in a reinsurance contract issued is a relevant fact for determining the presentation of insurance revenue and insurance service expenses in the profit or loss statement ("P&L"). Specifically, a question arises on the appropriate P&L presentation when the parties to an insurance or reinsurance contract exchange net payments at the end of coverage period, as opposed to gross payments of premiums and claims.

This paper does not consider whether the example arrangement described below includes an investment component – the author believes that it has previously been established that for such an arrangement there is no investment component, as there is nothing first received by the issuer, which can then be subsequently "repaid", in line with the definition of investment component in IFRS 17 Appendix A.

In IFRS 17 references to insurance contracts apply to reinsurance contracts in all cases except in cases where there is a specific requirement for reinsurance contracts. The paper follows the same convention used in IFRS 17 in that references to insurance contracts are not changed to refer to a reinsurance contract when the requirements are identical.

In addition to net-settlement terms, reinsurers often issue contracts which include different types of contractual cash inflows and outflows beyond the basic premiums and claims. A frequent additional cash outflow is a reinsurance commission payable to the cedant under certain conditions. One commonly used type of reinsurance commissions is a "profit commission" which is due to the cedant (i.e. holder of a reinsurance contract) in the event that the premium received exceeds the claims paid or incurred under the treaty during a defined period. If the claims are nil, the maximum amount of the profit commission would be payable. If the claims are payable for a positive amount, there will be a reduction in the profit commission payable, but a resulting increase in the amount of claims payable.

Consider the following fact pattern. At the end of each Agreement Year (e.g. 31 March of each year), the cedant calculates the balance between "premium due" and "claims payable" by reference to contractually identified underlying reinsured insurance contracts. In the event that premiums due from the cedant exceed the claims payable to the cedant from the reinsurance contract, the reinsurer shall calculate a profit commission based on a sliding scale percentage. However, if the claims payable exceed the premiums due, the profit commission for that particular Agreement year is nil.

At initial recognition the reinsurance contract has the following scenarios and probability of occurrence:

Description/Scenarios	1	2	3	4	5	6	7
Notional Claims	0	-200	-600	-800	-1000	-1200	-2000
Notional Premium	1000	1000	1000	1000	1000	1000	1000
Notional Commission	-200	-160	-80	-40	0	0	0
Cash flow	**800**	**640**	**320**	**160**	**0**	**-200**	**-1000**
Probability	**0.05**	**0.1**	**0.1**	**0.5**	**0.1**	**0.1**	**0.05**

Note: a positive cash flow indicates a cash flow paid to the reinsurer by the cedant and a negative cash flow indicates a cash flow paid to the cedant by the reinsurer.

Taking scenario 4 as an example the cash flow at 31 March is calculated as follows:

	CU
Ceded Premiums – notional amount based on underlying contracts	1,000
Claims recoverable by the cedant – notional amount based on actual claims on underlying contracts	(800)
Profit /(Loss) [for the purposes of the profit commission calculation]	**200**
Profit Commission @ 20% [no sliding scale in this example]	(40)
Net Settlement Amount	**160**

Considering the example above, the settlement terms of the arrangement could be constructed in either of two ways, also graphically illustrated in the Appendix 1, which (dependent on the view taken below) could potentially drive a different accounting treatment:

A. Net settlement contractual terms: cedant settles all contractual components (notional premium, claims and reinsurance commission) on a net basis at the end of each Agreement year/reporting period. In this case the reinsurer will receive CU 160 from the cedant. This view is based on the only actual cash flows from the contract; or
B. Gross settlement contractual terms: the reinsurer receives the premium, settles the claims payable and settles the profit commission separately at the end of each Agreement year. Note that if the reinsurer were to receive an amount of stated premium of CU1,000 before paying back claims and profit commission, CU200 of these amounts would be an non-distinct investment component (NDIC), provided such an amount would also be repayable on cancellation. This is because if the claims are nil, profit commission is CU 200 = (1,000-0)*20%. If CU 200 is also always repayable on termination, the amount is always repayable, meeting the definition of NDIC. Accordingly, it would be excluded from both insurance revenue and insurance service expense.

The initial measurement under scenario A would produce a probability weighted present value of future cash flows that would have a fulfilment positive inflow of 146 (assuming discount rate is 0% and that risk adjustment is nil) against which the reinsurer would recognise a CSM of 146.

Under scenario B the figures would be the same. However, the fulfilment cash flows would include a probability-weighted present value of inflows for 946 and a probability-weighted present value of outflows for 800.

This paper considers scenario A above, where the notional cash flows under the arrangement will be settled on a net basis at the end of the coverage period. For simplicity, the implications of time value of money / insurance finance income and expense are disregarded.

Question

What is the amount of insurance revenue and insurance service expenses for the issuer of the reinsurance contract when the contractual amounts are based on scenario A above?

Views

View 1 – Insurance Revenue = CU 160; Insurance Service Expenses = nil; (Net = CU 160)

Insurance revenue should be recorded at an amount that reflects the consideration to which the entity expects to be entitled (and updated each period to reflect actual entitlement as an experience adjustment) in exchange for the provision of insurance services (i.e. the amount paid to the entity) in accordance with IFRS 17:83 and IFRS 17:B120.

Where the entity expects to receive a positive amount of cash (the amount determined from the notional premiums, claims and reinsurance commission outlined above) at the end of the arrangement, that amount should be recorded as insurance revenue – in this case, CU 160. As there is no outgoing payment made, insurance service expenses are considered to be nil given that there are no claims incurred. Additional costs that may have been incurred to administer the arrangement are ignored for simplicity purposes.

Supporters of this view note that as a result of the net settlement terms, the reinsurer does not receive gross settlement of CU 1,000 or CU 800 = 1000 - 200 in cash. It only receives a payment of CU 160, i.e. it is not entitled to 1,000, and the cash received is 160. IFRS 17:83 and B120 require that insurance revenue reflect the amount of consideration to which an entity expects to be entitled (the amount of premiums paid to the entity) and so the revenue recorded must align to the amount of cash expected to be received.

Supporters of this view note that this is a case where the reinsurer accepts a variable consideration and that consideration can be nil. Movement in the notional claim amount will trigger subsequent changes in expected fulfilment cash flows. For example, when the expected amount of notional claims exceeds the expected amount of notional premiums the reinsurer would estimate a final cash outflow rather than an inflow. This would unlock the remaining CSM and move the contract to an onerous state with an onerous loss reported in P&L. No additional insurance revenue would be reported beyond this date if the estimate of cash flows does not change again to estimate an expected inflow.

View 2 – Insurance Revenue = CU 800; Insurance Service Expense = CU 640; (Net = CU 160)

Revenue is CU 800, as opposed to the policy-stated notional premium of CU 1,000 because the reinsurer will never receive CU 200 of the CU 1,000 notional premium and this amount is not contingent on claims. Accordingly, applying by analogy IFRS 17:86 this amount is an adjustment to premium, decreasing revenue. This is because if claims are nil, the commission payable is 200 = 20% * (1,000-0), meaning that the reinsurer is entitled to a notional net premium of 800. If the notional claims are a positive amount then the notional net premium amount the reinsurer is entitled to would be even smaller. For example, if notional claims are 200, the notional profit commission is 160 = 20% * (1,000 – 200), so the reinsurer is entitled to a notional net premium of CU640 = (1,000 – 160 – 200).

Proponents of this view consider that the mechanism by which consideration is settled should not affect the amount of insurance revenue (other than because of the effect of financing, which is disregarded in this example). The amount to record as revenue should reflect the value of the

service rendered by the entity in standing-ready to settle claims, in accordance with the underlying premium amount specified in the contract prior to netting of claims amounts. The value of that service is independent from the actual amount of claims ultimately incurred.

Proponents of this view consider that the wording of B120 is not intended to limit the interpretation of “consideration” and “premiums paid” to mean only amounts of cash received by the entity, but rather extends to other forms of consideration such as payments-in-kind. In this scenario, the agreement to allow the cedant to withhold the amounts of cash it would have otherwise been required to pay had a gross-settlement mechanism been agreed upon, represents a payment-in-kind.

With regards to the impact of the profit commission term – in the context of reinsurance contracts held – IFRS 17:86 states that amounts that are contingent on claims, should be treated as claims; amounts not contingent on claims should be treated as adjusting the premiums for the reinsurance held. The September 2018 TRG AP3 Staff paper contained a conclusion that the same holds true for insurance and reinsurance contracts issued. Supporters of this view believe that to be a correct interpretative analogy of IFRS 17 requirements.

Given the above, the amount of premium that varies because of the amount of claims, is in itself an amount of claims. The amount that does not vary is because it relates to service, and so it is premium, even if settled net against notional claims. Provided that CU 200 is also not received on cancellation, the reinsurer is never entitled to CU 200, so that amount does not vary with level of claims. Accordingly, applying IFRS 17:86, the amount of CU 1,000 premium is adjusted by that amount to determine revenue of CU 800. Of the claims of CU 800, CU 200 is a policy excess and is never paid, whereas the amount of commission of CU 40 is contingent on the level of claims, so adjusts the claim amount increasing it. Accordingly, claims are CU 640 = 800 – 200 + 40. This can be expressed in this example by a formula:

Insurance service expenses = Amount of claims – excess of CU200 + commission amount

Claims	0	-200	-600	-800	-1000	-1200	-2000
Premium	1000	1000	1000	1000	1000	1000	1000
Commission	-200	-160	-80	-40	0	0	0
Net cash	**800**	**640**	**320**	**160**	**0**	**-200**	**-1000**
Revenue	800	800	800	800	800	800	800
Expense	0	-160	-480	-640	-800	-1000	-1800
Service result	**800**	**640**	**320**	**160**	**0**	**-200**	**-1000**

In response to the potential risks that insurance revenue and expenses would be judgemental or open to manipulation – proponents of this view note that in an arms-length, commercially rational transaction, the cedant would not agree to inflate the underlying level of premiums (and correspondingly greater underlying amount due to the reinsurer in the event of no claim). Accordingly, the underlying premium amount that is not contingent on claims set in the contract would be ordinarily be at arm's length under both the arrangements described as scenarios A and B thus reinforcing the requirement to present them in the same way in the statement of comprehensive income.

2. Impact of cash flow settlement arrangement (net vs. gross) in assessing the presentation of reinsurance service expense on a reinsurance contract held based on IFRS 17:86

Background

This paper considers the same scenario described above, but from the cedant's perspective. In addition, this paper notes that reinsurance contracts often have net settlement terms, referred to as 'funds withheld' arrangements. The substance of these arrangements is for the cedant and the reinsurer to minimise the contractual cash flows between them through the withholding of funds at the cedant's level. Reinsurers often issue contracts that include different types of contractual cash inflows and outflows beyond the basic premiums and claims. A frequent additional cash outflow is a reinsurance commission payable to the cedant under certain conditions. One very commonly used type of reinsurance commissions is a "profit commission" which is due to the cedant in the event that the premium received exceeds the claims paid under the contract during a defined period. If the claims are nil, the maximum amount of the profit commission would be payable. If the claims are payable for a positive amount, there will be a reduction in the profit commission payable, but a resulting increase in the amount of claims payable.

This paper considers scenario A from part 1 above, where the cash flows under the arrangement will only be settled on a net basis. For simplicity, the implications of time value of money / insurance finance income and expense are disregarded.

Question

What is the amount of reinsurance service expenses disaggregated into the cost of reinsurance and reinsurance claim recoveries to be presented in the profit or loss statement, applying the split presentation choice in IFRS 17:86, where the rights and obligations under the arrangement are settled net per scenario A above?

View 1 – Reinsurance Recoveries = nil; Cost of reinsurance = CU160 expense; (Net reinsurance service expense= CU160)

IFRS 17:86(a-b) states that:

"An entity may present the income or expenses from a group of reinsurance contracts held (see paragraphs 60–70A), other than insurance finance income or expenses, as a single amount; or the entity may present separately the amounts recovered from the reinsurer and an allocation of the premiums paid that together give a net amount equal to that single amount. If an entity presents separately the amounts recovered from the reinsurer and an allocation of the premiums paid, it shall:

- *(a) treat reinsurance cash flows that are contingent on claims on the underlying contracts as part of the claims that are expected to be reimbursed under the reinsurance contract held;*
- *(b) treat amounts from the reinsurer that it expects to receive that are not contingent on claims of the underlying contracts (for example, some types of ceding commissions) as a reduction in the premiums to be paid to the reinsurer; […]"*

In a net-settled arrangement (sometimes called a "fund withheld" arrangement), the cedant always receives or pays a single cash flow. So the guidance in IFRS 17:86 about the treatment of cash flows refers only to the classification of that single cash flow as either a reimbursement of claims paid or an allocation of cost of reinsurance premiums. Given that the single cash flow amount always varies with the level of claims incurred, it is always contingent on claims.

Accordingly, a cedant choosing to do a split presentation must present the amounts (both payable and receivable) as recoveries under reinsurance contract held. Changes in the amount payable or receivable under the reinsurance arrangement either adjust fulfilment cash flows and CSM, if they relate to future service, or they adjust profit and loss as experience variances. This has the same effect as if the entity has applied a net presentation of reinsurance amount, permitted by IFRS 17:86.

Supporters of this view argue that the cedant does not have positive claim recoveries until the level of notional claims exceeds CU 1,000, and presenting imputed amounts (as in view B) is inconsistent with the economic substance of the contract. Additionally, when the notional claims incurred are lower than CU 1,000, the cost of reinsurance to the cedant varies with the level of claims, and the net presentation reflects that.

View 2 – Cost of reinsurance = CU 800; Reinsurance recoveries = CU 640; (Net reinsurance service expense = CU 160)

The cost of reinsurance is CU 800, as opposed to the policy-stated notional premium of CU 1,000 because the cedant will never pay CU 200 of the CU 1,000 notional premium and this amount is not contingent on claims. Accordingly, applying IFRS 17:86(b) this amount is an adjustment to premium, decreasing the cost of reinsurance. This is because if notional claims (claims on underlying reinsured contracts) are nil, the commission payable is 200 = 20% * (1,000-0), meaning that cedant pays CU800. If claims are a positive amount, the net amount paid to the reinsurer is even smaller, by the amount of claims e.g. if claims are 200, the profit commission is 160 = 20% * (1,000 – 200), so cedant pays net CU 640 = (1,000 – 160 – 200).

Supporters of this view consider that the mechanism to settle the consideration to purchase the contract should not affect the amount of the cost of reinsurance (other than because of the effect of financing, which is disregarded in this example). The cost of reinsurance should reflect the value of the service received by the cedant from the reinsurer standing-ready to settle claims, in accordance with the notional premium amount specified in the contract prior to netting of notional claims amounts. The value of that service is independent from the actual amount of claims and recoveries ultimately incurred.

With regards to the impact of the profit commission, in the context of reinsurance contracts held, IFRS 17:86(a) states that amounts that are contingent on claims, should be treated as claims; amounts not contingent on claims should be treated as adjusting the premiums for the reinsurance held.

Given the above, the amount of reduction in the cost of reinsurance premium that varies because of the amount of claims, is in itself an amount of claim recoveries. The amount that does not vary is because it relates to service, and so is a reduction in the cost of reinsurance premiums, even if settled net. Provided that CU 200 is also not payable on cancellation, the cedant never pays CU 200, so that amount does not vary with the level of claims. Accordingly, applying IFRS 17:86, the amount of CU 1,000 premium is adjusted by that amount to determine cost of reinsurance of CU 800. When the cedant incurs actual claims from the underlying reinsured contracts, CU 200 operates as policy excess and is never recovered, whereas the amount of profit commission of CU40 is contingent on the level of claims and it adjusts the claim recovery amount by increasing it. Given the above, claim recoveries are CU640 = (800 – 200 + 40). This can be expressed in this example by a formula:

Notional claims recoveries = Amount of notional claims incurred – excess of CU200 + notional commission amount

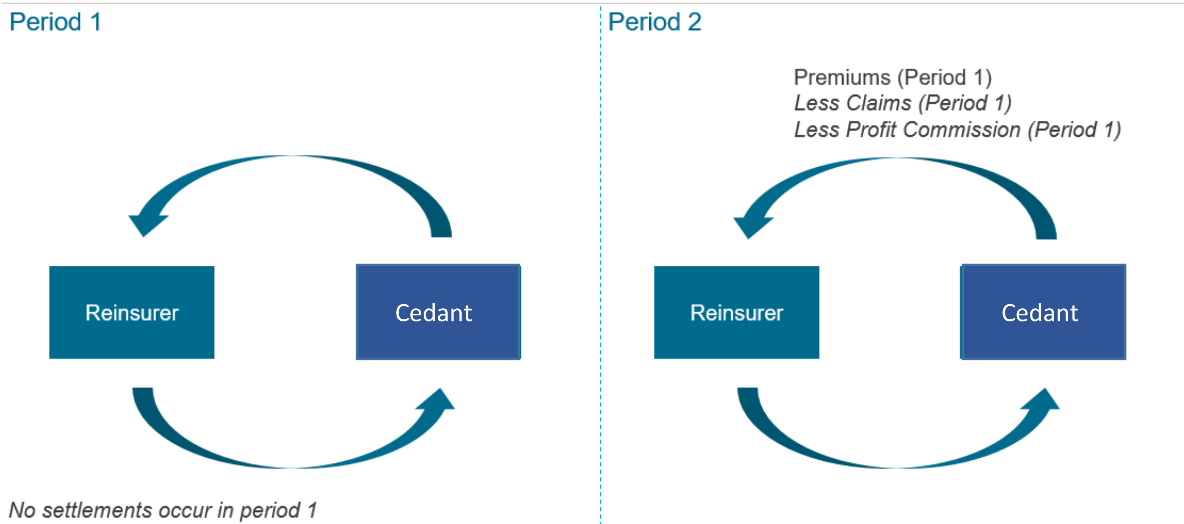
This has the disclosure benefit that when claims incurred are nil there are no claim recoveries reported and claim recoveries are reported whenever the notional claims incurred are a positive amount.

Alternative scenarios at the end of the coverage period (actual claim amounts on reinsured contracts)							
Notional Claims Recoveries	0	-200	-600	-800	-1,000	-1,200	-2,000
Notional Premium Payable	1,000	1,000	1,000	1,000	1,000	1,000	1,000
Notional Profit Commission Receivable	-200	-160	-80	-40	0	0	0
Net cash	**800**	**640**	**320**	**160**	**0**	**-200**	**-1,000**
Reinsurance cost	800	800	800	800	800	800	800
Reinsurance recoveries	0	-160	-480	-640	-800	-1,000	-1,800
Net reinsurance cost/recovery	**800**	**640**	**320**	**160**	**0**	**-200**	**-1,000**

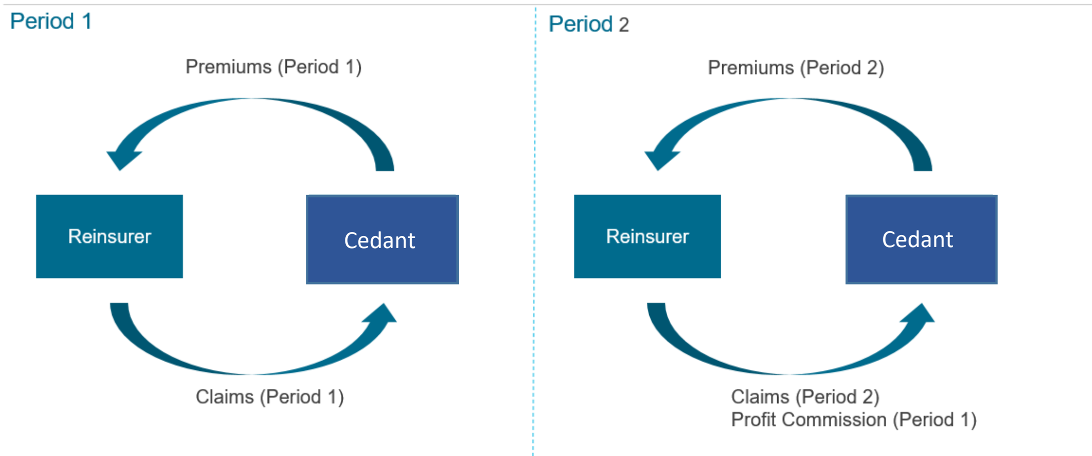
All notional amounts are derived from the underlying reinsured contracts of the cedant.

Appendix 1 – Illustrative presentation of the settlement patterns under the two basis

A. **Net Settlement basis**



B. **Gross settlement basis**



Appendix 2 – Technical References

Summary of the Transition Resource Group for IFRS 17 Insurance Contracts meeting held on 26–27 September 2018 Page 5 of 16

14. TRG members discussed the analysis in Agenda Paper 3 and observed that: (a) the requirements set out in paragraph 86 of IFRS 17 for the presentation of income or expenses from reinsurance contracts held are based on the economic effect of exchanges between the reinsurer and the cedant, and it would be appropriate to apply an assessment of the economic effect of such exchanges to reinsurance contracts issued as well.

trg-for-ifrs17-meeting-summary.pdf

ap03.pdf

IFRS 17

IFRS 17:83

An entity shall present in profit or loss insurance revenue arising from the groups of insurance contracts issued. Insurance revenue shall depict the provision of services arising from the group of insurance contracts at an amount that reflects the consideration to which the entity expects to be entitled in exchange for those services. Paragraphs B120–B127 specify how an entity measures insurance revenue.

IFRS 17:86

An entity may present the income or expenses from a group of reinsurance contracts held (see paragraphs 60–70A), other than insurance finance income or expenses, as a single amount; or the entity may present separately the amounts recovered from the reinsurer and an allocation of the premiums paid that together give a net amount equal to that single amount. If an entity presents separately the amounts recovered from the reinsurer and an allocation of the premiums paid, it shall:

(a) treat reinsurance cash flows that are contingent on claims on the underlying contracts as part of the claims that are expected to be reimbursed under the reinsurance contract held;

(b) treat amounts from the reinsurer that it expects to receive that are not contingent on claims of the underlying contracts (for example, some types of ceding commissions) as a reduction in the premiums to be paid to the reinsurer;

(ba) treat amounts recognised relating to recovery of losses applying paragraphs 66(c)(i)–(ii) and 66A–66B as amounts recovered from the reinsurer; and

(c) not present the allocation of premiums paid as a reduction in revenue.

IFRS 17:B120

The total insurance revenue for a group of insurance contracts is the consideration for the contracts, ie the amount of premiums paid to the entity:

(a) adjusted for a financing effect; and
(b) excluding any investment components.

Summary of the Transition Resource Group for IFRS 17 *Insurance Contracts* meeting held on 26–27 September 2018

1. The Transition Resource Group for IFRS 17 *Insurance Contracts* (TRG) held its third meeting on 26–27 September 2018 at the London office of the IFRS Foundation. These notes summarise the discussions.

2. Agenda Paper 2A for the October 2018 meeting of the International Accounting Standards Board (Board) provides the Board with a copy of this summary.

3. The discussions at the TRG meetings are based on agenda papers that provide an accounting analysis of implementation questions submitted to the TRG. These agenda papers provide a basis for TRG members, as industry experts involved in IFRS 17 implementation, to understand the implementation questions and share their views on the accounting analysis. Some agenda papers include specific fact patterns. The analysis in an agenda paper may be relevant to other fact patterns but all the specific facts and circumstances of those fact patterns need to be evaluated when applying IFRS 17.

4. TRG members discussed the following 10 topics:
    - (a) insurance risk consequent to an incurred claim;
    - (b) determining discount rates using a top-down approach;
    - (c) commissions and reinstatement premiums in reinsurance contracts issued;
    - (d) premium experience adjustments related to current or past service;
    - (e) cash flows that are outside the contract boundary at initial recognition;
    - (f) recovery of insurance acquisition cash flows;
    - (g) premium waivers;
    - (h) group insurance policies;
    - (i) industry pools managed by an association; and
    - (j) annual cohorts for contracts that share in the return of a specified pool of underlying items.

5. TRG members received a report on other questions submitted.

Insurance risk consequent to an incurred claim (Agenda Paper 1)

6. Agenda Paper 1 addresses submissions about a situation in which an incurred claim under an insurance contract creates insurance risk for the entity that would not exist if no claim were made.

7. The submissions ask whether the entity's obligation to pay amounts subject to insurance risk after an incurred claim should be treated as:

   (a) a liability for incurred claims; or

   (b) a liability for remaining coverage.

8. The paper uses two examples to illustrate alternative applications of the relevant definitions in IFRS 17:

   (a) insurance coverage for disability that provides an annuity for the period in which the policyholder is disabled; and

   (b) insurance coverage for fire that provides compensation for the cost of rebuilding a house after a fire.

9. TRG members discussed the analysis in Agenda Paper 1 and observed that:

   (a) the classification of an obligation as a liability for incurred claims or a liability for remaining coverage does not affect the determination of the fulfilment cash flows. However, the classification does affect the determination of the coverage period. Consequently, the classification affects whether some changes in the fulfilment cash flows adjust the contractual service margin and the allocation of the contractual service margin.

   (b) the definitions of IFRS 17 allow an entity to use judgement when determining whether the obligation to pay an annuity after a disability event and the obligation to pay the costs of rebuilding a house after a fire event are part of a liability for remaining coverage or a liability for incurred claims.

(c) thus, it is a matter of judgement for an entity to develop an accounting policy that reflects the insurance service provided by the entity to the policyholder under the contract in accordance with IFRS 17. The requirements of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* apply. Hence, the entity should apply an approach consistently for similar transactions and over time.

(d) whichever approach an entity applies, IFRS 17 requires disclosure of significant judgements made in applying the Standard and requires disclosures relating to the contractual service margin, which will enable users to understand the effects of the approach applied.

(e) these observations are also relevant when law or regulation impose a requirement for an entity to settle a claim by life-contingent annuity payments.

Determining discount rates using a top-down approach **(Agenda Paper 2)**

10. Agenda Paper 2 addresses submissions about how an entity applies a top-down approach to determine the discount rates for insurance contracts with cash flows that do not vary based on the returns of underlying items. The submissions question whether:

    (a) an entity could use the assets it holds as a reference portfolio of assets;

    (b) an entity could ignore the liquidity characteristics of insurance contracts; and

    (c) changes in the assets the entity holds result in changes in the discount rates used to measure insurance contracts under specific circumstances.

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

    (a) IFRS 17 does not specify restrictions on the reference portfolio of assets used in applying a top-down approach to determine discount rates. Also, IFRS 17 does not define 'a reference portfolio of assets'. Consequently, a portfolio of assets that an entity holds can be used as a reference portfolio of assets to determine the discount rates as stated in paragraph B81 of IFRS 17, provided

that the discount rates achieve the following objectives set out in paragraph 36 of IFRS 17:

   (i) reflecting the characteristics of the insurance contracts; and

   (ii) being consistent with observable current market prices.

(b) as an overall principle, paragraph 36 of IFRS 17 requires that discount rates reflect, among other factors, the liquidity characteristics of the insurance contracts. However, when using the top-down approach, as a simplification, paragraph B81 of IFRS 17 permits an entity not to adjust the yield curve derived from a reference portfolio of assets for differences in liquidity characteristics of the insurance contracts and the reference portfolio. The Board expected a reference portfolio of assets typically to have liquidity characteristics closer to the liquidity characteristics for a group of insurance contracts than would be the case for highly liquid, high-quality bonds as reflected in the Basis for Conclusions on IFRS 17.

(c) in applying paragraph 36 of IFRS 17 to determine the appropriate discount rates for cash flows that do not vary based on the returns on underlying items, an entity ensures that at each reporting date those discount rates reflect the characteristics of the insurance contracts, even when the entity chooses to use a portfolio of assets that it holds to determine the discount rates.

(d) to achieve the objectives in paragraph 36 of IFRS 17 an entity needs to make adjustments to the yield curve of the reference portfolio of assets at each reporting date to eliminate any effect on discount rates of credit risk and differences in liquidity characteristics of the insurance contracts and the reference portfolio. However, if the entity uses the simplification related to liquidity, fluctuations in the liquidity of the reference portfolio are mirrored in the changes in the discount rates used to measure the group of insurance contracts.

12. TRG members also observed that, when an entity uses the simplification related to liquidity, small changes in discount rates that result from changes in the composition of the reference portfolio or the liquidity characteristics of the reference portfolio could result in significant changes to the insurance contract liabilities measured using those rates, particularly with respect to long-term insurance contracts. The following disclosure requirements of IFRS 17 are particularly helpful in these circumstances for users of financial statements to assess the effect that insurance contracts have on the entity's financial position, financial performance and cash flows:

    (a) the methods used to determine discount rates and the processes for estimating the inputs to those methods, including the identification of a reference portfolio, the adjustments to the yield curve to determine the discount rates and the use of the simplification mentioned in paragraph B81 of IFRS 17; and

    (b) the effect of a change in the composition of the assets in the reference portfolio on discount rates used to measure insurance contracts, if material.

Commissions and reinstatement premiums in reinsurance contracts issued (Agenda Paper 3)

13. Agenda Paper 3 addresses submissions about amounts exchanged between the issuer of a reinsurance contract (the reinsurer) and the holder of a reinsurance contract (the cedant). The submissions question how the following features should be accounted for in the financial statements of the reinsurer:

    (a) common types of commissions due to the cedant; and

    (b) reinstatement premiums charged to the cedant following the occurrence of an insured event.

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

    (a) the requirements set out in paragraph 86 of IFRS 17 for the presentation of income or expenses from reinsurance contracts held are based on the economic effect of exchanges between the reinsurer and the cedant, and it would be appropriate to apply an assessment of the economic effect of such exchanges to reinsurance contracts issued as well.

(b) the economic effect of amounts exchanged between a reinsurer and a cedant that are not contingent on claims is equivalent to the effect of charging a different premium. Therefore, those amounts would be recognised as part of insurance revenue applying paragraph B123 or B126 of IFRS 17.

(c) the economic effect of amounts exchanged between a reinsurer and a cedant that are contingent on claims is equivalent to reimbursing a different amount of claims than expected. Therefore, those amounts would be recognised as part of insurance service expenses applying paragraph 42(a) of IFRS 17.

(d) unless the cedant provides a distinct service to the reinsurer that results in a cost to the reinsurer for selling, underwriting and starting a group of reinsurance contracts that it issues, a ceding commission is not an insurance acquisition cash flow of the reinsurer.

(e) amounts exchanged between the reinsurer and the cedant that are not contingent on claims may meet the definition of an investment component if they are repaid to the cedant in all circumstances (including on cancellation of the contract).

15. Some TRG members also observed that applying the requirements in IFRS 17 for amounts exchanged between a reinsurer and a cedant has practical implications because the requirements are different from existing practice. TRG members also observed that applying the requirements of IFRS 17 may affect some key performance measures currently used to assess the performance of reinsurers.

Premium experience adjustments related to current or past service (Agenda Paper 4)

16. Agenda Paper 4 addresses submissions about how differences between expected premiums and actual premiums (ie premium experience adjustments) which relate to current or past service should be accounted for. Should those differences:

(a) adjust the contractual service margin; or

(b) be recognised in the statement of profit or loss immediately as part of either:

(i) insurance revenue; or

(ii) insurance service expenses?

17. TRG members discussed the analysis in Agenda Paper 4 and observed that:

(a) applying the general model, experience adjustments arising from premiums received in the period that relate to future service adjust the contractual service margin according to paragraph B96(a) of IFRS 17. Premium experience adjustments related to current or past service should be recognised immediately in the statement of profit or loss as part of insurance revenue applying paragraphs B120 and B123 of IFRS 17.

(b) the purpose of paragraph B124 of IFRS 17 is to demonstrate an alternative analysis of insurance revenue as determined by paragraph B123 of IFRS 17. Hence, applying the requirements in IFRS 17 should result in premium experience adjustments relating to current and past service being included in insurance revenue despite the lack of a specific reference to them in paragraph B124 of IFRS 17.

(c) for the premium allocation approach, the requirements in paragraph B126 of IFRS 17 apply to expected premium receipts, including premium experience adjustments.

18. TRG members also observed that:

(a) given that an entity is required by paragraph 106 of IFRS 17 to disclose an analysis of the insurance revenue recognised in the period, an additional line item may be necessary in the reconciliation to reflect the effect of premium experience adjustments on the revenue recognised in the period.

(b) in some circumstances, judgement may be required to determine whether premium experience adjustments relate to future service and, therefore, adjust the contractual service margin applying paragraph B96(a) of IFRS 17.

Cash flows that are outside the contract boundary at initial recognition (Agenda Paper 5)

19. Agenda Paper 5 addresses submissions about how to account for cash flows that, at initial recognition, are outside the boundary of the contract when facts or circumstances change over time. The paper addresses both an insurance contract issued and a reinsurance contract held.

20. TRG members discussed the analysis in Agenda Paper 5 and observed that:

    (a) the requirements in paragraphs 35 and B64 of IFRS 17 are different because they address different circumstances.

    (b) paragraph 35 of IFRS 17 applies to cash flows that are outside the boundary of a contract and that relate to future contracts. When paragraph 35 of IFRS 17 applies, additional cash flows will be recognised as a new contract when the recognition criteria of a new group of contracts are met.

    (c) paragraph B64 of IFRS 17 discusses the assessment of the practical ability of an entity to reprice a contract considering constraints that might limit that ability and, therefore, applies to the reassessment of the contract boundary in this context. When paragraph B64 of IFRS 17 applies, the fulfilment cash flows are updated to reflect changes in cash flows that are within the (revised) contract boundary. When such changes relate to future service they are recognised by adjusting the carrying amount of the contractual service margin of the group of contracts to which the contract belongs.

21. TRG members expressed different views as to the applicability of the distinction between paragraphs 35 and B64 of IFRS 17 in circumstances where cash flows that are outside the contract boundary at initial recognition relate to an additional type of coverage that may be provided over the coverage period of the contract.

Recovery of insurance acquisition cash flows (Agenda Paper 6)

22. Agenda Paper 6 addresses a submission about whether insurance acquisition cash flows and the related revenue are recognised in the statement of profit or loss, applying paragraph B125 of IFRS 17, if those cash flows cannot be recovered from

the cash flows of the portfolio of contracts. Agenda Paper 6 also addresses the accounting for changes in insurance acquisition cash flows applying paragraphs B123 and B125 of IFRS 17.

23. TRG members discussed the analysis in Agenda Paper 6 and observed that:

    (a) paragraphs B123 and B125 of IFRS 17 work together to achieve an insurance revenue that reflects the total premium (adjusted for a financing effect and excluding any investment component), as required by paragraph B120 of IFRS 17. An entity is not required separately to identify whether it will recover insurance acquisition cash flows at each reporting date.

    (b) paragraph B125 of IFRS 17 assumes that the portion of premiums relating to the recovery of insurance acquisition cash flows is equal to the current estimate of total expected insurance acquisition cash flows at each reporting period.

24. TRG members also noted that experience adjustments arising from premiums received in the period that relate to future service, and the related cash flows such as insurance acquisition cash flows, adjust the contractual service margin applying paragraph B96(a) of IFRS 17.

Premium waivers **(Agenda Paper 7)**

25. Agenda Paper 7 addresses a submission about whether terms in an insurance contract that waive premiums in specified circumstances create insurance risk. An example of such a waiver is one that allows a policyholder to avoid paying premiums in specified circumstances, for example, if the policyholder has been disabled for six consecutive months. The policyholder continues to receive the benefits originally promised under the insurance contract despite the waiver of premiums.

26. The submission asks whether the risk related to the premium waiver is a pre-existing risk of the policyholder transferred to the entity by the contract and is, therefore, an insurance risk, or a new risk created by the contract.

27. TRG members discussed the analysis in Agenda Paper 7 and observed that:

(a) there is an insurance risk when an entity provides a waiver of premiums if a specified event occurs;

(b) a waiver of premiums differs from situations discussed in paragraphs B21(a)–(b) of IFRS 17; and

(c) the consequences of a waiver of premiums are:

(i) the inclusion of such a waiver in an investment contract makes the investment contract an insurance contract; and

(ii) the inclusion of such a waiver in a contract that would be an insurance contract without the waiver may affect the quantity of benefits provided by the contract and the coverage period, both of which could affect the recognition of the contractual service margin in profit or loss. The recognition of the contractual service margin was discussed in Agenda Paper 5 of the February 2018 TRG meeting and Agenda Paper 5 of the May 2018 TRG meeting.

Group insurance policies (Agenda Paper 8)

28. Agenda Paper 8 addresses a submission about the boundary of a contract for an arrangement between an entity and an association or a bank (referred to as a 'group insurance policy') under which the entity provides insurance coverage to members of an association or to customers of a bank (referred to as 'certificate holders').

29. TRG members discussed the analysis in Agenda Paper 8 and observed that:

(a) for group insurance policies, an entity should consider whether the policyholder is the association or bank, or the certificate holders. IFRS 17 defines a policyholder by its right to compensation if it is adversely affected by an insured event. This is the case regardless of whether that compensation is received directly or indirectly by paying amounts on the policyholder's behalf.

(b) for group insurance policies, an entity should consider whether the arrangement reflects a single insurance contract or multiple insurance contracts (ie with each certificate holder). Rebutting the presumption that the

contract is a single contract by separating components involves judgement and careful consideration of all facts and circumstances.[1]

(c) for the group insurance policies described in the submission, the following facts and circumstances are indicative that the arrangement reflects multiple insurance contracts (ie an insurance contract with each certificate holder) for the purpose of applying IFRS 17:

(i) the insurance coverage is priced and sold separately;

(ii) other than being members of the association or customers of the bank the individuals are not related to one another; and

(iii) purchasing the insurance coverage is an option for each individual.

(d) an entity should assess the boundary of each insurance contract. For the group insurance policies described in the submission, the entity's substantive obligation to provide services under a contract ends at the point that the entity can terminate the contract. The certificate holder's expectation that the group insurance policy will not be terminated earlier than the end of the contract term is not relevant to the assessment of the contract boundary applying paragraph 34 of IFRS 17.

30. TRG members noted the specific fact pattern discussed in Agenda Paper 8 and that the analysis relates to that fact pattern. TRG members observed that in practice there are many group insurance policies with different terms. The assessment of whether a group insurance policy arrangement reflects a single insurance contract or multiple insurance contracts should be applied to group insurance policies considering all relevant facts and circumstances.

[1] Separation of insurance components of a single insurance contract was discussed at the February 2018 TRG meeting.

Industry pools managed by an association (Agenda Paper 9)

31. Agenda Paper 9 addresses a submission about the level at which the risk adjustment for non-financial risk should be determined for insurance contracts that are within industry pools managed by an association.

32. The submission asks whether, for insurance contracts that are within either of the two industry pools described in the submission, the risk adjustment for non-financial risk should be determined at either:

    (a) the association level; or

    (b) the individual member entity level.

33. TRG members discussed the analysis in Agenda Paper 9 and observed that:

    (a) in some cases, the parties to the contract are clear from the legal form of the contract. In other cases, the terms of the contract require analysis to identify the substance of the rights and obligations—including who is the issuer of the contract. For insurance contracts in an industry pool the issuer could be:

        (i) the individual member entity that writes the contracts;

        (ii) each member entity for its respective share of each contract in the pool; or

        (iii) the collective comprised of all member entities.

    (b) IFRS 17 applies to insurance contracts issued by an entity and does not have specific requirements for insurance contracts issued by more than one entity. Entities should assess whether an arrangement under which an insurance contract is issued by more than one entity is also within the scope of another IFRS Standard, for example IFRS 11 *Joint Arrangements*. IAS 8 includes requirements for an entity to apply in the absence of a Standard that specifically applies to a transaction, other event or condition.

(c) in some cases, an individual member entity may write an insurance contract and then subsequently transfer the contract to the industry pool. If that member entity is the issuer of the contract applying IFRS 17, the entity should consider whether the transfer:

   (i) is a contract that meets the definition of a reinsurance contract applying IFRS 17; or

   (ii) extinguishes the individual member's obligations to the policyholder applying paragraph 74 of IFRS 17.

34. TRG members noted the specific fact pattern discussed in Agenda Paper 9 and observed that the assessment of identifying the issuer of insurance contracts within an industry pool arrangement and the accounting for an insurance contract that is issued by more than one entity should be applied consistently to similar arrangements considering all relevant facts and circumstances.

35. In relation to the risk adjustment for non-financial risk, TRG members observed that paragraph B88 of IFRS 17 requires the risk adjustment for non-financial risk to reflect the degree of diversification benefit included in the compensation required for bearing non-financial risk.

36. The analysis in Agenda Paper 9 distinguished between contracts issued by an individual member entity of an industry pool and contracts issued by the collective comprised of all members. In the former case, the risk adjustment for non-financial risk is determined by individual member entity. In the latter case it is determined by the collective. Some TRG members expressed the view that applying paragraph B88 of IFRS 17, each entity would consider the compensation it would require for bearing the non-financial risk, rather than the compensation required by the association. This is consistent with their differing views as to whether for a group of insurance contracts the risk adjustment for non-financial risk at the consolidated group level could differ from the risk adjustment for non-financial risk at the individual issuing entity level (see summary of the TRG meeting held on 2 May 2018 on determining the risk adjustment for non-financial risk in a group of entities).

Annual cohorts for contracts that share in the return of a specified pool of underlying items **(Agenda Paper 10)**

37. Agenda Paper 10 addresses a submission about annual groups of contracts with policyholders that all share in the return on a specified pool of underlying items, with some of the return contractually passing from one group of policyholders to another.

38. The submission notes that paragraph BC138 of the Basis for Conclusions on IFRS 17 explains:

> … the requirements specify the amounts to be reported, not the methodology to be used to arrive at those amounts. Therefore, it may not be necessary for an entity to restrict groups in this way to achieve the same accounting outcome in some circumstances.

39. The submission asks in what circumstances measuring the contractual service margin at a higher level than an annual cohort level, such as a portfolio level, would achieve the same accounting outcome as measuring the contractual service margin at an annual cohort level applying paragraph 22 of IFRS 17.

40. TRG members discussed the analysis in Agenda Paper 10 and observed that:

    (a) paragraph BC138 of the Basis for Conclusions on IFRS 17 explains the effect of the requirements of IFRS 17 and does not change those requirements.

    (b) when a specified pool of underlying items consists of the insurance contracts issued to the policyholders that share in the returns of that pool, the criteria in paragraph B67 of IFRS 17 are met regardless of whether the policyholders share in 100% of the return on the pool of underlying items or only part of the return on the pool of underlying items.

    (c) for contracts that share in 100% of the return on a pool of underlying items consisting of the insurance contracts, the contractual service margin will be nil. Therefore, measuring the contractual service margin at a higher level than the annual cohort level, such as a portfolio level, would achieve the same accounting outcome as measuring the contractual service margin at an annual cohort level applying IFRS 17.

(d) when contracts share to a lesser extent in the return on a pool of underlying items consisting of the insurance contracts, an entity could be affected by the expected cash flows of each contract issued. Therefore, the contractual service margin of the groups of contracts may differ from the contractual service margin measured at a higher level, such as the portfolio level. To assess whether measuring the contractual service margin at a higher level would achieve the same accounting outcome as measuring the contractual service margin at an annual cohort level, an entity would need to determine what the effect would be of applying the requirements in IFRS 17. To be able to measure the contractual service margin at a higher level, the accounting outcome would need to be the same in all circumstances, ie regardless of how assumptions and experience develop over the life of the contract.

41. TRG members also observed that the examples in Agenda Paper 10 were not representative of many situations in practice. TRG members observed that in practice, cash flows would be determined at a higher level than in the examples, and that paragraph B70 of IFRS 17 would apply for allocating cash flows to the groups. Therefore, there may be some situations where the same accounting outcome is achieved using annual cohorts or a higher level of aggregation when applying the requirements of IFRS 17 to contracts that share 90% in the returns on a pool of underlying items consisting of the insurance contracts.

Reporting on other questions submitted (Agenda Paper 11)

42. Agenda Paper 11 considered submissions to the TRG that:

(a) can be answered applying only the words in IFRS 17;

(b) do not meet the submission criteria; or

(c) are being considered through a process other than a TRG discussion.

43. TRG members made the following observations:

(a) *S56 and S67 Reporting frequency*

TRG members noted the requirements in paragraph B137 of IFRS 17. However, some TRG members expressed concerns over the operational complexity involved with applying these requirements.

(b) *S33 Scope of IFRS 17*

Some TRG members expressed concerns that when applying IFRS 17 an entity might be required to account for loans and other forms of credit that include a relatively small insurance component entirely as insurance contracts.

Next steps

44. The next meeting of the TRG is currently scheduled to be held on 4 December 2018. Submissions of implementation questions received after 26 October 2018 are unlikely to be discussed at the meeting on 4 December 2018. Given the timing of the September 2018 TRG meeting relative to the December 2018 TRG meeting and depending on the number and the nature of the submissions that are received for the December 2018 TRG meeting, an assessment will be made as to whether to postpone the December 2018 TRG meeting to early 2019.

IFRS

STAFF PAPER

September 2018

Project	Transition Resource Group for IFRS 17 *Insurance Contracts*		
Paper topic	Commissions and reinstatement premiums in reinsurance contracts issued		
CONTACT(S)	Laura Kennedy	lkennedy@ifrs.org	+44 (0) 20 7246 6437
	Hagit Keren	hkeren@ifrs.org	+44 (0) 20 7246 6919

This paper has been prepared for discussion at a public meeting of the Transition Resource Group for IFRS 17 *Insurance Contracts* and does not represent the views of any individual member of the International Accounting Standards Board or staff. Comments on the application of IFRS® Standards do not purport to set out acceptable or unacceptable application of IFRS Standards.

This agenda paper is reposted for corrections to the examples included in paragraphs 39-44, B3(b) and B5(d). Those corrections do not change the accounting analysis provided in this paper.

Introduction

1. We have received a number of submissions about amounts exchanged between the issuer of a reinsurance contract (the reinsurer) and the holder of a reinsurance contract (the cedant). The submissions question how the following should be accounted for in the financial statements of the reinsurer:

   (a) common types of commissions due to the cedant; and

   (b) reinstatement premiums charged to the cedant following the occurrence of an insured event.

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).

The International Accounting Standards Board is the independent standard-setting body of the IFRS Foundation, a not-for-profit corporation promoting the adoption of IFRS Standards. For more information visit www.ifrs.org.

Structure of the paper

3. This paper includes the following:

   (a) background information (paragraphs 5–14).

   (b) implementation question (paragraphs 15–17).

   (c) review of accounting requirements:

      (i) commissions that are not contingent on claims (paragraphs 18–35);

      (ii) commissions that are contingent on claims (paragraphs 35–46); and

      (iii) reinstatement premiums (paragraphs 47–58).

4. This paper includes two appendices:

   (a) Appendix A—Flowchart; and

   (b) Appendix B—Examples of commissions and other contract features contingent on claims.

Background information

5. Paragraph 42(a) of IFRS 17 requires an entity to recognise insurance service expenses for claims incurred in the period.

6. Paragraph 83 of IFRS 17 states:

> An entity shall present in profit or loss insurance revenue arising from the groups of insurance contracts issued. Insurance revenue shall depict the provision of coverage and other services arising from the group of insurance contracts at an amount that reflects the consideration to which the entity expects to be entitled in exchange for those services. Paragraphs B120–B127 specify how an entity measures insurance revenue.

7. Paragraph 86 of IFRS 17 sets out the requirements for presenting income or expense from a group of reinsurance contracts held. It states:

> An entity may present the income or expenses from a group of reinsurance contracts held (see paragraphs 60–70), other than insurance finance income or expenses, as a single amount; or the entity may present separately the amounts recovered from the reinsurer and an allocation of the premiums paid that together give a net amount equal to that single amount. If an entity presents separately the amounts recovered from the reinsurer and an allocation of the premiums paid it shall:
>
> (a) treat reinsurance cash flows that are contingent on claims on the underlying contracts as part of the claims that are expected to be reimbursed under the reinsurance contract held
>
> (b) treat amounts from the reinsurer that it expects to receive that are not contingent on claims of the underlying contracts (for example, some types of ceding commissions) as a reduction in the premiums to be paid to the reinsurer; and
>
> (c) not present the allocation of premiums paid as a reduction in revenue.

8. Paragraph B123 of IFRS 17 requires that insurance revenue for a period relating to the provision of services is determined based on the changes in the liability for remaining coverage excluding changes that do not relate to services expected to be covered by the consideration received by the entity. Changes that do not relate to services expected to be covered by the consideration received by the entity include changes that do not relate to services provided in the period, such as changes resulting from the receipt of cash for premiums and changes that relate to investment components in the period. Insurance revenue for a period relating to insurance acquisition cash flows is determined as set out in paragraph B125 of IFRS 17.

9. Paragraph B126 of IFRS 17 states that when an entity applies the premium allocation approach, insurance revenue for the period is the amount of expected premium receipts (excluding any investment component and adjusted to reflect

the time value of money and the effect of financial risk, if applicable) allocated to the period.

10. Appendix A of IFRS 17 defines insurance acquisition cash flows as:

> Cash flows arising from the costs of selling, underwriting and starting a group of insurance contracts that are directly attributable to the portfolio of insurance contracts to which the group belongs. Such cash flows include cash flows that are not directly attributable to individual contracts or groups of insurance contracts within the portfolio.

11. Appendix A of IFRS 17 defines an investment component as:

> The amount that an insurance contract requires the entity to repay to a policyholder even if an insured event does not occur.

12. Paragraph BC34 of the Basis for Conclusions on IFRS 17 explains that the International Accounting Standards Board (Board) decided that an investment component should be defined as the amount that is paid to the policyholder in all circumstances, regardless of whether the insured event occurs. In the Board's view, the insurance benefit is the additional amount that the entity would be required to pay if an insured event occurs.

13. Paragraph BC299 of the Basis for Conclusions on IFRS 17 explains:

> The amount an entity pays for reinsurance coverage consists of premiums the entity pays minus any amounts paid by the reinsurer to the entity to compensate the entity for expenses it incurs, such as underwriting or acquisition expenses (often referred to as 'ceding commissions'). […]

14. Paragraph BC346 of the Basis for Conclusions on IFRS 17 provides explanation about the economic effect of the commissions describes in paragraph 86 of IFRS 17:

> […] IFRS 17 allows an entity to present income or expenses from reinsurance contracts held either as a single net amount or as separate amounts recovered from the reinsurer and an allocation of the premiums paid. If it presents separate amounts, IFRS 17 requires the entity to treat:

(a) cash flows contingent on the claims or benefits in the underlying contracts, including ceding commissions, as part of the claims that are expected to be reimbursed under the reinsurance contract held, unless those cash flows need to be accounted for as investment components. In the Board's view, the economic effect of changes in those cash flows is equivalent to the effect of reimbursing a different amount of claims than expected.

(b) ceding commissions that are not contingent on claims of the underlying contracts as a reduction of the premiums to be paid to the reinsurer. The economic effect of such ceding commissions is equivalent to the effect of charging a lower premium with no ceding commissions.

Implementation question

15. The submissions describe common types of commissions due from a reinsurer to a cedant and question how these should be accounted for in the financial statements of the reinsurer. The submissions describe both:

    (a) commissions that are not contingent on claims; and

    (b) commissions that are contingent on claims.

16. The submissions ask:

    (a) for each type of commission, whether it is considered part of the premium or part of claims.

    (b) whether all or some of the amounts related to these commissions meet the definition of:

        (i) insurance acquisition cash flows; or

        (ii) an investment component.

17. The submissions also describe reinstatement premiums charged to a cedant of a reinsurance contract following the occurrence of an insured event. The submissions question how these reinstatement premiums should be accounted for

in the financial statements of the reinsurer. One of the submissions distinguishes between mandatory and voluntary reinstatement premiums.

Review of accounting requirements

Commissions that are not contingent on claims

18. The commission is described in the submissions as an amount due from the reinsurer to the cedant with the following characteristics:[1]

    (a) the amount of the commission due to the cedant is often settled net with the premium charged to the cedant (or otherwise paid upfront); and

    (b) the amount of the commission due to the cedant is not dependent on claims or is otherwise fixed.

19. One of the submissions provides the following example:

Cash flow	Description	Amount
Reinsurance premium	60% of premium on underlying insurance contracts	6,000
Ceding commission	30% of reinsurance premium (6,000 x 30%)	1,800
Net amount	Amount received from the cedant (reinsurance premium minus ceding commission)	4,200

20. Exchanges between a reinsurer and a cedant need to be identified as either part of claims or part of premiums for the reinsurer that issues the contract to either recognise these amounts within claims incurred as insurance service expenses

[1] The submissions note that the existing practice for these types of commissions is to present the commission separately as an acquisition expense, ie it is not netted against the premium.

applying paragraph 42(a) of IFRS 17 or recognise these amounts as insurance revenue applying paragraph B123 or B126 of IFRS 17.

21. IFRS 17 does not provide specific requirements for determining whether exchanges between the entity and the policyholder are part of the premium or part of claims, except with respect to the presentation of income or expenses from reinsurance contracts held in paragraph 86 of IFRS 17.

22. The staff observe that the requirements for the presentation of income or expenses from reinsurance contracts held are based on the economic effect of exchanges between the reinsurer and the cedant, and therefore the staff consider that an assessment of the economic effect of such exchanges would be appropriate to apply to reinsurance contracts issued as well.

23. The staff observe that the economic effect of ceding commissions that are not contingent on claims, such as in the example in paragraph 19 of this paper, is equivalent to the effect of charging a lower premium with no ceding commission. Therefore, the ceding commission is part of the premium and, applying paragraph B123 or B126 of IFRS 17, insurance revenue for the reinsurer in this example should be 4,200 for the contract.

24. For the example in paragraph 19 of this paper, assume that the group of insurance contracts comprises a single reinsurance contract and that the group is recognised on the day that the premium (net of commission) is settled. The expected claims are 3,500. For simplicity, the risk adjustment for non-financial risk is nil and the discount rate is 0%. The entity determines the following:

    (a) the liability for remaining coverage at initial recognition is 4,200 consisting of fulfilment cash flows of 3,500 and a contractual service margin of 700 (4,200 - 3,500). Applying paragraph B123 of IFRS 17, the change in the liability for remaining coverage during the coverage period is 4,200, reflecting the insurance revenue. If, alternatively the commission was expected to be paid after the day of initial recognition, the same revenue of 4,200 would be recognise because the total change in the liability for remaining coverage would be 6,000 and applying

paragraph B123(a) of IFRS 17 the change that relates to the commission of 1,800 would be considered related to premium and therefore would be eliminated from the total change to arrive at the insurance revenue.

(b) alternatively, insurance revenue of 4,200 can be analysed applying paragraph B124 of IFRS 17 as consisting of the expected insurance service expenses of 3,500 and the contractual service margin recognised in profit or loss of 700.

(c) applying paragraph B126 of IFRS 17, the amount of expected premium receipts allocated over the coverage period as revenue is 4,200.

25. The submission also considers whether the ceding commission in the example in paragraph 19 of this paper meets the definition of insurance acquisition cash flows.

26. Another submission notes that in some reinsurance contracts such ceding commissions are fixed, not adjusted subsequently and not repaid in any circumstances. This submission considers whether these ceding commissions meet the definition of insurance acquisition cash flows, noting that the commission would be paid even if no premium is ceded eventually, and therefore may not be considered as an adjustment to the premium for the contract.

27. Insurance acquisition cash flows are defined as cash flows arising from costs—the costs of selling, underwriting and starting a group of insurance contracts. The staff observe that unless the cedant provides a distinct service to the reinsurer that results in a cost to the reinsurer for selling, underwriting and starting a group of reinsurance contracts that it issues, the ceding commission reflects a reduction in the transaction price, and not insurance acquisition cash flows of the reinsurer. The ceding commission may reflect compensation that the reinsurer provides the cedant for acquisition costs that the cedant incurs for underlying insurance contracts, but this does not make the commission an acquisition costs of the reinsurer. While the activities taken by the cedant to sell, underwrite and start a group of underlying insurance contracts may benefit the reinsurer, the cedant

undertakes these activities in its own right in order to sell insurance contracts to its policyholders, rather than to provide a distinct service to the reinsurer. If the cedant were to undertake activities and incur costs in order to provide a distinct service to the reinsurer, those costs may not meet the definition of insurance acquisition cash flows from the cedant's perspective.

28. The staff observe that unlike insurance acquisition costs that are usually paid, for example, to a third-party intermediary, ceding commissions are paid by the reinsurer to the cedant who is the customer buying the contract.

29. The staff observe that for circumstances in which ceding commissions are fixed, not adjusted subsequently, not repaid in any circumstances and the reinsurer expects that no premium would be ceded or that the expected premium is insufficient to recover the costs of fulfilling the contracts (including the commission), the reinsurance contract issued would be considered an onerous contract.

30. One of the submissions also considers whether the ceding commission in this example is an investment component. An investment component is an amount that an insurance contract requires the entity to repay to a policyholder even if an insured event does not occur and is excluded from the insurance service expenses and insurance revenue. The staff observe that ceding commissions may meet the definition of investment component if they are *repaid* to the cedant in *all circumstances*.

31. However, for the fact pattern provided, the staff view is that the ceding commission is not an investment component even if it is an amount due to the cedant in all circumstances. This is because it is settled net of premium charged to the cedant. In this example, no payment to the reinsurer or from the reinsurer after the premium is received includes amounts that the reinsurer is required to *repay* to the cedant in all circumstances. If, alternatively, the ceding commission was paid to the cedant at a later date than the premium is received, the ceding commission may meet the definition of an investment component. This is because in this case it would reflect a financial component within the insurance contract recognised,

similar to a deposit. The outcome, in terms of excluding the commission from the contract revenue would be the same, however in this case, additional disclosures related to investment components may be required applying paragraph 103(c) of IFRS 17.

32. One of the submissions questions whether ceding commissions that are fixed, not adjusted subsequently and not repaid in any circumstances can be considered a compensation for a distinct service that the cedant is providing to the reinsurer. The submission notes that the cedant may have promised the reinsurer to manage sales and underwriting, claims handling and other administrative matters related to the contract, and that judgement should be applied to consider whether a distinct service is provided to the reinsurer and an intangible asset may be recognised with respect to the commission.

33. Although the staff agree that entities should consider all relevant facts and circumstances and apply judgement to determine whether a separate service is being provided to the reinsurer within the reinsurance contract, the staff do not think a service is being provided in the specific fact pattern provided. While managing sales, underwriting and handling claims of the contract may benefit the reinsurer, it is not a service provided by the cedant to the reinsurer, rather it is an activity the cedant undertakes in its own right to fulfil the insurance contracts it has issued.

34. In summary, the staff observe that amounts exchanged between the issuer of an insurance contract and the policyholder that are not contingent on claims:

    (a) are part of the premium and would therefore be recognised as part of the insurance revenue; and

    (b) if paid after the premium is received, may meet the definition of an investment component, provided the amounts are repaid to the policyholder in all circumstances.

Commissions that are contingent on claims

35. Commissions that are contingent on claims are commissions that are adjusted according to the claims that are incurred. One of the submissions refers to contracts with such commissions and other contracts with similar features as retrospectively rated contracts, noting that those features are common in reinsurance contracts and commercial line insurance contracts. That submission notes that these types of commissions can be used when the reinsurer and the cedant cannot agree on a fixed price for the risk or when the cedant wants to participate in the benefits of controlling its claims.

36. The submissions provide a number of examples. The discussion in this paper uses a sliding scale commission as an example to facilitate the analysis. Additional examples are provided in Appendix B to this paper.

37. The submission describes the sliding scale commission as an amount due from the reinsurer to the cedant.[2] The terms of the sliding scale commission are as follows:

    (a) the commission amount is dependent on the loss experience of the contract, while a minimum amount is due to the cedant regardless of the loss experience of the contract;

    (b) a provisional commission amount is settled net with the premium charged to the cedant; and

    (c) the final commission amount is determined, and any adjustments to the provisional amount are settled several years after the coverage period, when all claims are fully paid.

[2] The submission notes that the existing practice for these types of commissions is to present the commission separately as expense, ie it is not netted against the premium.

38. The submission provides the following example:

Cash flow	Description	Amount
Reinsurance premium	60% of premium on underlying insurance contracts	6,000
Provisional commission	30% of reinsurance premium assuming a 65% loss ratio[3] (6,000 x 30%)	1,800
Net amount initially received	Amount received from the cedant (reinsurance premium minus provisional ceding commission)	4,200

The commission due to the cedant is between 20% and 40% of the reinsurance premium, contingent on the loss ratio of the contract. Adjustments to the provisional commission amount based on the ultimate loss ratio of the contract are determined and settled several years after the coverage period as follows:

Loss ratio	Commission as % of reinsurance premium	Amount
Above 75%	Minimum commission of 20%	1,200
55%–75%	Commission in the range of 20%–40%	Sliding scale
Below 55%	Maximum commission of 40%	2,400

39. Considering the economic effect of the ceding commission, the staff have analysed the cash flows from the ceding commission as not contingent on claims—in this example the amount that is due to the cedant regardless of the loss experience of the contract is 2,400. If there are no claims, cash flows of 2,400 are due to the cedant.[4] If there are claims, the cedant receives 2,400 plus a portion of

[3] Loss ratio is a measurement reflecting the loss experience of a contract.

[4] If claims are 0 the commission is 2,400 because the loss ratio is below 55%.

the amount claimed.[5] It does not matter whether the amounts are described as commissions or as claims, or as a combination depending on insurance outcomes.

40. Consistent with the analysis in paragraphs 22–23 of this paper, for this example the staff view the economic effect of the ceding commission as equivalent to the effect of charging a lower premium.

41. In other words, for this example, the economic effect of the commission is equivalent to the effect of charging a premium of 3,600 rather than 6,000. The analysis provided in paragraphs 22–23 of this paper for commissions that are not contingent on claims is therefore relevant.

42. Therefore, applying paragraph B123 of IFRS 17 or paragraph B126 of IFRS 17, insurance revenue for the reinsurer in this example should be 3,600 for the contract.

43. The submission considers whether the ceding commission in this example is, or includes, an investment component. Consistent with the analysis in paragraphs 30–31 of this paper, the staff observe that in this example the provisional ceding commission is not an investment component. In the fact pattern provided, the provisional ceding commission is settled net of premium charged to the cedant. The excess of 2,400 over the provisional commission of 1,800 will meet the definition of an investment component if it is an amount that will be repaid at a future date to the cedant in all circumstances (for example, also on cancellation of the contract).

44. Treating the additional amount that the reinsurer is required to repay to the cedant as an investment component reflects that the contract with the cedant includes a financial component, similar to a deposit.

45. The staff observe that the ceding commission, or any part of it, is not an insurance acquisition cash flow as discussed in paragraphs 27–28 of this paper, nor does it

[5] For example, if there are claims of 5,000 the commission is 1,200 because the loss ratio is above 75%.

reflect a distinct service provided by the cedant to the reinsurer as discussed in paragraph 33 of this paper.

46. In summary, the staff observe that amounts exchanged between the issuer of an insurance contract and a policyholder that are contingent on claims (ie the amounts excluding any minimum amounts that are, in effect, non-contingent) are part of claims and would therefore be recognised as part of insurance service expenses.

Reinstatement premiums

47. The reinstatement premium is described in the submissions as an amount charged to the cedant following an insured event occurring in order to continue coverage. One of the submissions distinguishes between mandatory and voluntary reinstatement premiums. The analysis in this paper is provided separately for each type of reinstatement premium.

Mandatory reinstatement premiums

48. One of the submissions provides a fact pattern of a mandatory reinstatement premium. The reinstatement premium is predetermined. This means that no additional underwriting or repricing can be done. It is assumed that the reinstatement premium is compulsory and it is assumed that the contract cannot be terminated before the end of its contractual term. The submission also provides the following information about the reinstatement premium:

   (a) the reinstatement premium amount is contingent on the claim amount;

   (b) if no insured event occurs, no reinstatement premium is charged to the cedant (ie there is no minimum reinstatement premium amount that is paid in all circumstances); and

   (c) the reinstatement premium is settled net with the claims paid to the cedant (reduces claims).

49. The submission provides the following example:[6]

Cash flow	Description	Amount
Reinsurance premium	Amount charged for coverage (see limit per claim and aggregate limit below)	250
Claim limit	Maximum amount that can be claimed per claim event	1,000
Aggregate claims limit	Maximum amount that can be claimed under the contract	2,000

The reinstatement premium is charged when a claim is incurred. The amount is based on a percentage of the premium charged and the amount of claims made. The following are examples of possible scenarios under the contract:

Scenario	Reinstatement premium	Amount
No claims	The cedant will not be charged an additional reinstatement premium	0
Claim of 100	The reinstatement premium is determined as 250 reinsurance premium x 10% of claim limit used (100/1,000)	25
Claims of 1,500 (from two events)	Maximum reinstatement premium of 250 (using all of the claim limit of 1,000 would require 100% of additional premium to be paid).	250

[6] The submission notes that the existing practice for this example is that the reinstatement premium is treated as a separate cash flow and presented separately to the premium for the contract. It is not netted against claims incurred.

50. The staff considered the economic effect of the reinstatement premium in this example to determine whether it reflects an additional premium or a reduction in the amount paid for claims.

51. The staff observe that the economic effect of the reinstatement premium is equivalent to the effect of reimbursing a different amount of claims to the cedant. In other words, for this example, the economic effect of a reinstatement premium is equivalent to the effect of charging a premium of 250 and paying 75% of the claims up to 1,000 and 100% of additional claims up to 2,000.

52. Therefore, applying paragraph B123 of IFRS 17 or paragraph B126 of IFRS 17, insurance revenue for the reinsurer in this example should be 250 for the contract. Any reinstatement premium would be recognised as part of insurance service expenses when incurred.

53. One of the submissions considers whether mandatory reinstatement premiums represent a premium of a new reinsurance contract. The staff observe that cash flows related to claims are within the contract boundary of the reinsurance contract issued, as well as the reinstatement premiums that accompany them. Therefore, mandatory reinstatement premiums cannot be considered cash flows related to a future contract.

Voluntary reinstatement premiums

54. A voluntary reinstatement premium is an amount charged to the cedant, on predetermined terms, following an insured event occurring. However, in contrast to the mandatory reinstatement premium, the cedant can decide not to pay the reinstatement premium and in this case the contract terminates. This means that voluntary reinstatement premiums are not contingent on claims as the cedant may decide to avoid paying those premiums and terminate the coverage instead.

55. The reinsurer is required to accept reinstatement premiums and to provide the related coverage.

56. One of the submissions considers whether voluntary reinstatement premiums represent a premium of a new reinsurance contract.

57. The staff observe that the economic effect of a voluntary reinstatement premium is equivalent to the effect of charging a higher premium to extend the contract coverage to an additional period/higher level of exposure.

58. The staff observe that applying paragraph 34 of IFRS 17, the reinstatement premium and related cash flows are within the boundary of the initial reinsurance contract. In the fact pattern provided, the reinsurer has no right to exit the contract and has no right to reprice the contract (the reinstatement premium is at predetermined rates). Therefore the expected cash flows related to the reinstatement premium are within the boundary of the initial reinsurance contract and voluntary reinstatement premiums cannot be considered cash flows related to a future contract.[7]

TRG Discussion

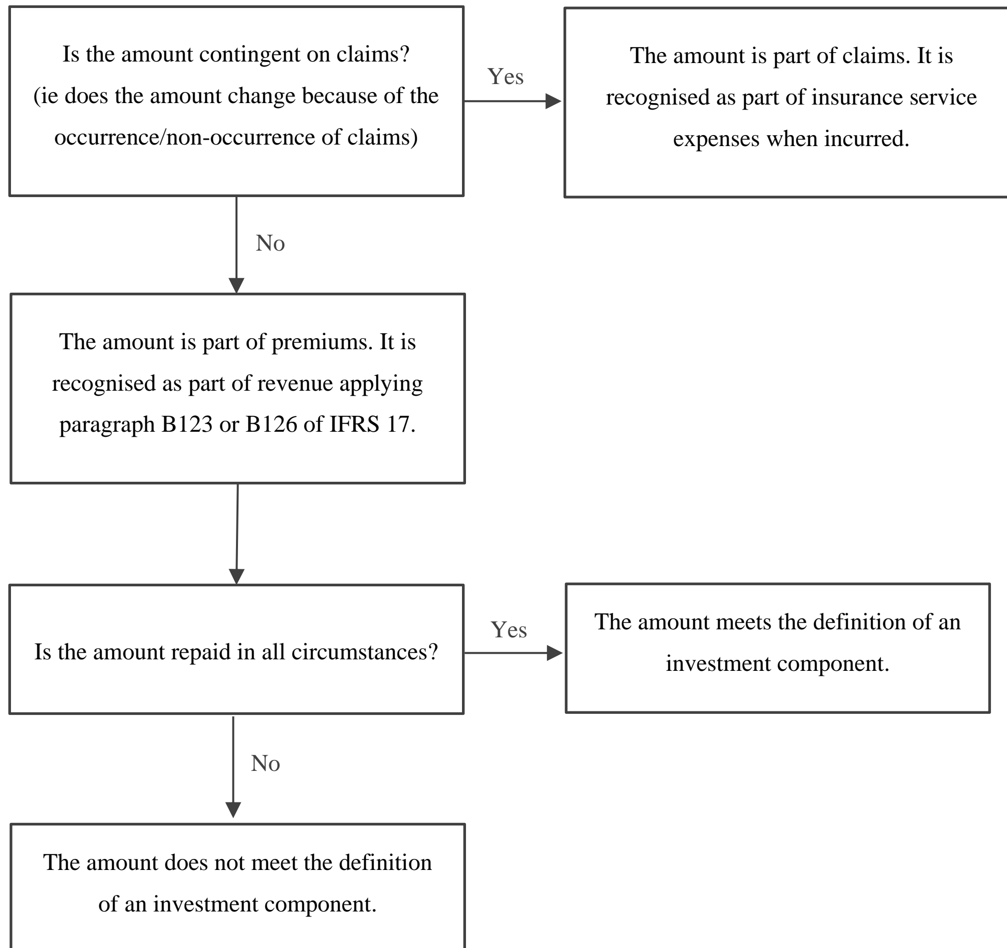
Question to TRG members

What are your views on the implementation question presented above?

[7] Agenda paper 3 *Cash flows within the contract boundary* from May 2018 TRG meeting and Agenda paper 5 *Cash flows that are outside the contract boundary at initial recognition* of the September 2018 TRG meeting discuss the topic of the boundary of an insurance contract in more detail.

Appendix A—Flowchart

A1. The following flowchart may assist the assessment of how to account for exchanges between a reinsurer and a cedant.[8]



[8] It is assumed that amounts due to the cedant are not compensation paid to it for a distinct service it provides to the reinsurer.

Appendix B—Examples of commissions and other contract features contingent on claims

Profit commission

B1. In the example, the profit commission is determined as 25% of the profit under the contract. The profit under the contract is the difference between the premiums and losses assumed by the reinsurer. The commission cannot be negative. The fact pattern is as follows:

Description	Amount
Reinsurance premium	1,000
Profit commission (profit = reinsurance premium minus claims incurred by the reinsurer under the contract)	25%

B2. The profit commission is contingent on the amount of losses assumed by the reinsurer under the contract, for example:

Claims	Calculation of commission	Profit commission	Total payment to cedant
0	(1,000 – 0) x 25%	250	250
100	(1,000 – 100) x 25%	225	325
500	(1,000 – 500) x 25%	125	625
1,500	1,000 – 1,500 = 500 loss	0	1,500

B3. Staff analysis applying IFRS 17:

(a) in all circumstances, the reinsurer will pay to the cedant a minimum amount of 250. All other payments to the cedant are contingent on claims.

(b) the staff observe that the economic effect of the profit commission is equivalent to the effect of charging a lower premium to the same extent. In other words, for this example, the economic effect of the profit commission is equivalent to the effect of charging a premium of 750 and paying 75% of the claims up to 1,000 and 100% of claims above 1,000.

(c) therefore, applying paragraph B123 of IFRS 17 or paragraph B126 of IFRS 17, insurance revenue for the reinsurer in this example should be 750 (1,000 - 250) for the contract. In the third scenario shown in which the claims are 500, the claims incurred applying IFRS 17 should be 375 (500 x 75%) for the contract and there would not be an additional/separate expense of 125 for the profit commission paid as this amount is part of the premium.

(d) assuming the cedant paid the premium of 1,000 at the inception of the contract, an amount of 250 may meet the definition of investment component.

Adjustments to premiums in a retrospectively rated insurance contract

B4. One of the submissions provides two examples of retrospectively rated contracts:

(a) contract 1—a premium of 200 is paid at the beginning of the coverage period, however an additional premium of 80% of claims is charged to the policyholder, up to a maximum additional premium of 800.

(b) contract 2—a premium of 1,000 is paid at the beginning of the coverage period, however the insurer will refund the policyholder 80% of any profit on the contract.

B5. Staff analysis applying IFRS 17:

(a) contract 1—a premium of 200 paid at the beginning of the coverage period is the contract premium applying IFRS 17 as this amount is not contingent

on claims. An additional premium up to a maximum of 800 is contingent on claims as it is charged to the policyholder only if claims incur under the contract. The additional premium therefore is part of the claims and shall be recognised as part of insurance service expenses.

(b) contract 2—the premium of 1,000 paid at the beginning of the coverage period is the contract premium applying IFRS 17, however an amount of 800 may meet the definition of an investment component. An amount of 800 is not contingent on claims because it would be refunded to the policyholder if no claims occur (assuming 80% of the profit equals 80% of the premium in this simplified example) and it would be refunded to the policyholder if the maximum amount of claims occur (if the amount of claim is, for example, 1,500 – 800 of which is a premium refund). If an amount of 800 would be repaid to the policyholder in all circumstances it would meet the definition of investment component and therefore the insurance revenue for the contract would be 200.

(c) the staff observe that both contracts seem economically similar and therefore the contract revenue for both is the same. However, if contract 2 contains an investment component, it has a financial component that contract 1 does not have, and this would impact the financial income or expenses of contract 2.

(d) the staff observe that if under contract 2, the amount of 800 is not repaid to the policyholder in all circumstances (for example, if the contract is cancelled) this amount would not meet the definition of investment component.