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IFRS 17 : Risk Transfer Test for Reinsurance

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Agenda

- IFRS 17 requirements for Reinsurance Contracts
- Risk Transfer – the criteria
- Risk Transfer Assessment - Process Flow
- Potential methods for testing
- Further considerations

IFRS 17 Requirements

As per IFRS17.3, an entity shall apply IFRS 17 to:

(a) insurance contracts, including reinsurance contracts it issues;

(b) reinsurance contracts it holds; and

(c) investment contracts with discretionary participation features it issues, provided the entity also issues insurance contracts.

A reinsurance contract **is an insurance contract** issued by one entity (the reinsurer) to compensate another entity for claims arising from one or more **insurance contracts** issued by that other entity (underlying contracts).

A contract under which one party (the issuer) accepts **significant insurance risk** from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder.

Risk Transfer – the criteria

A contract transfers significant insurance risk only if there is a scenario that has commercial substance in which the issuer **has a possibility of a loss on a present value basis**.

As per IFRS17 § B19

Risk Transfer Assessment

Process Flow

1. **Review of the Contract**
2. **Categorization of Contract**
3. **Decision Assessment**
4. **Document & Disclose**

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Review of Contract Document

Stage 1

Review of the Contract

- Understand the contract and all related agreements
- Review accounting memoranda or any relevant documents
- Review transection background, business purpose
- And discussions with key personnel, as required

Categorization of Contract
Stage 2

Exempt	Quota Share contract with no risk limiting feature and with fixed ceding commission
Reasonably self evident	Facultative and treaty per risk excess of loss arrangements with premium well below the present value of the aggregate limit of coverage
Not Reasonably self evident	Contracts with loss sensitive or risk-limiting features Multiple-year contracts have features that adjust the terms of subsequent years of the contract, explicitly or implicitly, based on results of the earlier years

Decision Assessment

Stage 3

Exempt

Reasonably Self Evident

Categorization criteria of contracts that are exempt or reasonably self- evident

Not Reasonably Self Evident

Cashflow Testing

- Methods
- Considerations

Overlay Contract Terms

Document & Disclose

Stage 4

Document & Disclose

- Reinsurance Attestation
- Documentation of models and assumptions
- Supporting documents

Potential methods for testing

1. “10 -10” guideline

$$\text{Potential Loss to Reinsurer} = \frac{\text{NPV of Premiums, Losses, Commissions}}{\text{NPV of Amounts paid to Reinsurer}}$$

“10 – 10” rule implies a 10% chance of a 10% loss.

Potential methods for testing

2. Expected Reinsurer Deficit (ERD)

$$\text{Expected Reinsurer Deficit} = \frac{p * T}{P}$$

where

p = Probability of Net Income Loss;
T = Average Severity of Net Economic Loss when it occurs; and
P = NPV of Amounts paid to Reinsurer

Comparing with the "10 – 10" rule, this corresponds to an ERD threshold of 1%.

Potential methods for testing

3. Risk Coverage Ratio (RCR)

$$\text{Risk Coverage Ratio, \% form} = \frac{p * T}{E(G)}$$

where

p = Probability of Net Income Loss;
T = Average Severity of Net Economic Loss when it occurs; and
E(G) = Expected economic gain across all possibilities

RCR doesn't respond to premium size.

Further considerations

- Qualitative considerations:
  - Business purpose of the contract
  - Maximum loss under the contract to the assuming company

- Contract specific features:
  - Risk limiting features – contingent and/or sliding scale commissions, profit commissions, retrospective experience rating
  - Caps and loss corridors
  - Side agreements and/or related party contracts
  - Non-standard terms that allow reinsurer to limit risk
  - Unusually high premium for value of coverage obtained

- Assumptions used for determining risk transfer – consistency and reasonableness

Thank you!

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Disclaimer

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- This document has been prepared to aid with a training on: Risk Transfer Test for Reinsurance Contracts under IFRS 17.
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