

IFRS Transition Resource Group for IFRS 17 *Insurance Contracts* (TRG)

Submission form for potential implementation question

Submission date	21/03/2018
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Stakeholder group	Choose an item.

Potential implementation question

There is no guidance in the standard for situations where the coverage period for “Liability for Remaining Coverage” is indeterminable and/or not reliably estimable. This could occur for many adverse loss covers, loss portfolio transfers and for claim liabilities acquired under a business combination for property/casualty insurance, particularly where the coverage is for tort claims in a litigious environment. How should a company amortize the Contract Service Margin (CSM) in these cases?

Paragraph of IFRS 17 *Insurance Contracts*

B5 Some insurance contracts cover events that have already occurred but the financial effect of which is still uncertain. An example is an insurance contract that provides coverage against an adverse development of an event that has already occurred. In such contracts, the insured event is the determination of the ultimate cost of those claims.

Analysis of the question

The analysis of the question should include a detailed description of the different ways the new Standard may be applied, resulting in possible diversity in practice

In the February 2018 staff paper “Determining Quantity of Benefits for Identifying Coverage Units”, paragraph A10 states “... the pattern of quantity of benefits is straight line over the life of the contract which would end at the date of the last expected settlement payment. If the contract has an upper limit that is expected to be reached, the expected duration would be the expected time the last cash payment would be made to reach the limit.”

Some adverse loss covers are never expected to be attached, but are “sleep at night” covers to comfort the buyer of a property/casualty insurance coverage in case the unexpected does occur. The underlying claims that are the subject of the cover can have payments over decades, with no absolute limit on when the potential for claims ends. (For example, asbestos claims were still being made in 2017 that triggered coverage on 1950s commercial liability policies in the U.S.. Some of the claims were from the surviving heirs of the party alleged to be exposed to asbestos, thereby extending the time for potential claims to beyond the lifetime of the potentially exposed parties.)

In such situations there is no “date of the last expected settlement payment”. There is no clear date when potential claims are no longer possible.

Similarly, for claim liabilities (“liability for incurred claims”) acquired via a business combination, as these are to be treated by the acquirer as if it was a loss portfolio transfer. In such a case there is no aggregate limit, and the payment period uncertainty is very similar to the adverse loss cover mentioned above. For some of these liabilities, payments could end in a few years, in a decade, or in a period longer than a lifetime. To the extent that latent liability potential exists, the time period for complete runoff of such liabilities is not reliably estimable for the purposes of the accounting proposed in the February 2018 staff paper.

Where a range of possible outcomes can be produced, possible guidance choices for the time period for CSM amortization would be basing it on the low estimate, basing it on the high estimate, or basing it on the midpoint of the low and high. There can also be situations where ranges do not exist. In any event, the lack of guidance is likely to result in significant diversity in practice.

With regard to the pattern of amortization, it is uncertain as to what the amortization pattern should be where there is no regular pattern of payment activity. Should it be straight line even if no regular payment activity occurs?

Is the question pervasive?

Explain whether the question is expected to be relevant to a wide group of stakeholders

This issue would affect nearly all medium to large property/casualty insurance companies in countries with litigious environments. Hence a majority of the premiums and claim liabilities in the global property/casualty industry are represented by companies likely to be interested or directly affected by this question.

In addition to the form, attachments (such as memos) may be included with the submission.

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Potential implementation question

For companies assuming reinsurance, are the following common contract features accounted for as separate cash flows, net cash flows, or is either approach acceptable under IFRS 17?

- 1) Ceding commissions, which are common in quota share contracts?
- 2) Compulsory reinstatement premiums, which are common in catastrophe covers?
- 3) Ceding commission adjustments (i.e., sliding scale) for changes in loss ratios?
- 4) Profit commissions?

Paragraph of IFRS 17 *Insurance Contracts*

Paragraph 86(b) states that, for reinsurance contracts held, “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.” However, there is no similar explicit guidance for reinsurance contracts written.

Paragraphs 84, 85 and B120 discuss the income statement treatment of investment components. The guidance in Paragraph 85 is representative of the guidance in the standard, stating “insurance revenue and insurance service expenses presented in profit or loss shall exclude any investment components.”

The term “investment components” is defined in the standard as “the amounts that an insurance contract requires the entity to repay to a policyholder even if an insured event does not occur.”

Analysis of the question

The analysis of the question should include a detailed description of the different ways the new Standard may be applied, resulting in possible diversity in practice

There is significant potential for diversity in practice as regards how insurance entities writing assumed reinsurance present the Insurance Service results in the Performance Statement. For example:

- Assuming companies may account for ceding commissions on a net basis (i.e., treat the premium net of the ceding commission as the contract premium, and have acquisition expenses be 0) to align with the guidance for reinsurance contracts held, or they may present such amounts gross (i.e., treat the premium gross of the ceding commission as the contract premium, and treat the ceding commission as an acquisition expense) since this is both consistent with current practice and this point is not explicitly addressed in the guidance.

- Assuming and ceding companies may interpret “investment components” differently when accounting for certain loss sensitive contractual terms in a reinsurance agreement. The question is whether compulsory reinstatement premiums, loss sensitive adjustments to ceding commissions, and profit commissions are investment components or not. Current practice treats reinstatement premiums, loss-based profit commission adjustments and profit commissions as separate cash flows (i.e., not netted against the premium), while an interpretation of investment components under IFRS 17 could cause some preparers to account for such cash flows on a net basis.

Below are several examples of how the assuming entity might account for this. They compare current practice to an approach that nets both ceding commissions and items that could be considered to be investment components. The first example shows the Insurance Service result under current practice and under an approach that nets ceding commissions and treats adjustments to sliding scale premiums as an investment component. The second example shows the Insurance Service result for a compulsory reinstatement premium under current practice versus an approach that nets such reinstatement premiums against the loss cash flows. The third example is similar except it reflects a profit commission.

Ceding Commission Example – the IFRS 17 net approach treats ceding commissions as a reduction to revenue, as well as adjustments to such commission to the extent losses vary under the contract. This results in the insurance contract revenue being the same under both loss scenarios and no acquisition expenses reflected, with such loss sensitive adjustments accounted for as Claims Incurred. This compares to existing practice as shown in the attachment, sheet “Sliding Scale Commission Quota Share”.

Reinstatement Premium Example – the IFRS 17 net approach treats compulsory reinstatement

premiums as a reduction in claims incurred. Under this approach, revenue remains unchanged under various loss scenarios, which is different from current practice. See Attachment, sheet “Reinstatement Premium”.

Profit Commission – the IFRS 17 net approach would reflect that the profit commission is being returned to the policyholder, either as a commission or as a loss payment. This compares to existing practice as shown on the attached, worksheet “Profit Commission”.

Is the question pervasive?

Explain whether the question is expected to be relevant to a wide group of stakeholders

This question is pervasive and would impact many stakeholders, and it affects nearly all life and general insurance entities that assume reinsurance.

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Premium Allocation Approach
Investment Component Example - **Sliding Scale Commission Quota Share**

Underlying Premium	\$10,000,000
Quota Share	60%
Ceding Commission	Provisional 30% at 65% loss ratio, slide 20% to 40% 1 for 1
Loss Ratio - Scenario 1	50%
Loss Ratio - Scenario 2	70%

Scenario 1 (Loss Ratio 50%)		
	IFRS 17 net approach	Existing Practice
Statement of Comprehensive Income		
Insurance Contract Revenue		
Original Premium	\$ 4,200,000	\$ 6,000,000
Adjustment for premium w/o loss	\$ (600,000)	
Total	\$ 3,600,000	\$ 6,000,000
Ceding Commission (40%, loss ratio < 55%)	\$ -	\$ 2,400,000
Claims Incurred		
Quota Share Percentage	\$ 3,000,000	\$ 3,000,000
Adjustment for sliding scale	\$ -	\$ -
Total	\$ 3,000,000	\$ 3,000,000
Underwriting Margin	\$ 600,000	\$ 600,000

Scenario 2 (Loss Ratio 70%)		
	IFRS 17 net approach	Existing Practice
Statement of Comprehensive Income		
Insurance Contract Revenue		
Original Premium	\$ 4,200,000	\$ 6,000,000
Adjustment for premium w/o loss	\$ (600,000)	
Total	\$ 3,600,000	\$ 6,000,000
Ceding Commission (25%, loss ratio 70%)	\$ -	\$ 1,500,000
Claims Incurred		
Quota Share Percentage	\$ 4,200,000	\$ 4,200,000
Adjustment for sliding scale	\$ (900,000)	\$ -
Total	\$ 3,300,000	\$ 4,200,000
Underwriting Margin	\$ 300,000	\$ 300,000

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Potential implementation question

For issued adverse loss covers and for claim liabilities acquired under a business combination (labeled “liability for incurred claims” in IFRS 17) it is not clear how the resulting liability for remaining coverage would be brought into revenue. The guidance in IFRS 17 paragraph B5 says that “the insured event [for these contracts] is the determination of the ultimate cost of these claims”, and paragraph 41(a) says that revenue shall reflect “the reduction in the liability for remaining coverage because of the services provided in the period”, but it is not clear how such “services” are measured in this instance. Is it:

1. When the last claim is paid and the ultimate cost is finally known?
2. Over time as claims are paid?
3. As estimates are provided for individual claims?
4. As claims are settled, such that the individual claim estimates can be replaced with known values (even if the settlement is for a future stream of payments over time)?
5. As the estimate of future cash flows is reduced (either due to payment of claims or due to changes in estimates of future payouts)?

Note that the uncertainty here is not how to estimate future cash flows, but the characterization of such estimates between liabilities for remaining coverage and liabilities for incurred claims where such coverage is for past events triggering coverage under the contracts.

We also have a related question with regard to how the volatility of these estimates should be treated.

If the liability for remaining coverage has no Contract Service Margin (CSM) but then the estimate of future cash flows drop, should a CSM be created? Or should revenue be recognized?

Paragraph of IFRS 17 *Insurance Contracts*

B5 Some insurance contracts cover events that have already occurred but the financial effect of which is still uncertain. An example is an insurance contract that provides coverage against an adverse development of an event that has already occurred. In such contracts, the insured event is the determination of the ultimate cost of those claims.

41 An entity shall recognise income and expenses for the following changes in the carrying amount of the liability for remaining coverage:

(a) insurance revenue—for the reduction in the liability for remaining coverage because of services provided in the period, measured applying paragraphs B120–B124;

B93 When an entity acquires insurance contracts issued or reinsurance contracts held in a transfer of insurance contracts that do not form a business or in a business combination, the entity shall apply paragraphs 14–24 to identify the groups of contracts acquired, as if it had entered into the contracts on the date of the transaction.

B94 An entity shall use the consideration received or paid for the contracts as a proxy for the premiums received. The consideration received or paid for the contracts excludes the consideration received or paid for any other assets and liabilities acquired in the same transaction. In a business combination, the consideration received or paid is the fair value of the contracts at that date. In determining that fair value, an entity shall not apply paragraph 47 of IFRS 13 (relating to demand features).

Analysis of the question

The analysis of the question should include a detailed description of the different ways the new Standard may be applied, resulting in possible diversity in practice

We believe that some explanation of context is needed to best understand our question, hence the illustrative scenario and discussion that follows.

SCENARIO:

Company A acquires Company B, which has \$1,000M in claim liabilities at the date of acquisition (on a nominal basis with no risk margin).

Assume the fair value of the claim liabilities is estimated to be \$900M, and fulfillment value estimated at the same value (for simplicity purposes). As a result, there is no CSM.

Rationale for assuming no CSM is as follows:

The difference between fair value and fulfillment value would potentially be (a) the risk margin and (b) the impact of “own credit standing”.

a) The risk margin for fair value is based on market risk preference, while for fulfillment value it is based on entity risk preference. Given no observable, robust market, it is expected that these two risk margins would be estimated the same way and at the same value. Hence this is not expected to be a source of difference between fair value and fulfillment value.

b) The “own credit standing” (OCS) impact would cause (under one approach for reflecting OCS) a higher discount rate for discounting future cash flows. But the requirement for an insurer to be strong in order to be a going concern in a regulated financial services industry, combined with the relatively shorter tails for non-life, would result in a relatively minor impact of OCS on the discount rate, hence a small to immaterial CSM. Note, however, that the higher discount rate under fair value vs. fulfillment value would result in the fair value to be slightly smaller than fulfillment value.

The difference in fair value vs. fulfillment value, based on the above, would be expected to be smaller than the degree of precision in the estimate of the claim liabilities, hence the simplification approach chosen. In any event, it is not anticipated that there will be any CSM.

Paragraph B94 says to use the consideration received or paid as the fair value, but in a typical non-life insurer acquisition there will be one price identified for all items included in the sale with no attribution of the components of that price. The piece of the purchase price relating to the acquired claim liabilities or any other aspect of the acquired technical provisions would not be identified in the purchase agreement. Therefore this value will have to be estimated by the acquirer.

The portfolio of claim liabilities includes many liability lines such that the payout pattern in this scenario is many years long, if not decades – i.e., it does not qualify for the Premium Allocation Approach (PAA). These liabilities also may have no maximum value nor any cutoff date for presentation of a claim or payment of a claim. Therefore there is no clear de-recognition event.

Given that these are claim liabilities (i.e., liabilities for incurred claims) that are acquired, the events triggering coverage have already occurred. Hence paragraph B5 applies, and “the insured event [for these “contracts”] is the determination of the ultimate cost of those claims.”

INITIAL MEASUREMENT

Per paragraph B93, at initial recognition (i.e., on the date of the business combination), the fulfillment value would be a liability for remaining coverage, with zero CSM in this example (and in most, if not all, business combination situations).

SUBSEQUENT MEASUREMENT

It is not clear how to reflect changes to the estimate of future cash flows, up or down, as the acquired claim liabilities run off. One of the difficulties is that these estimates can oscillate over time as the liabilities run off. Issues include:

- When is the service provided? One interpretation is that the determination of the ultimate cost of the claim is not provided until the last claim is paid. Another is that service is provided as claims are paid. A third is that service is provided as estimates are established for individual claims. A fourth is that service is provided as claims are settled, acknowledging that such settlement may result in an agreed pattern of future payments similar to an annuity. A fifth is that service is provided when the risk of future development is decreased (leading to the following question).
- What happens if the estimate of future cash flows drops but then in a later period is increased? Is there reflection of revenue during the drop (implying that “service” was provided) and then treatment as an onerous contract when it is increased? Or is the original reflection of revenue from the drop reversed when it then increases (assuming the increase does not make the original estimate at inception appear to have been deficient in retrospect). Or is a CSM created at the time the estimate drops, with reversal of the CSM when the estimate increases?

The above issues do not impact the estimate of future cash flows, but do impact the reporting of revenue, and potentially the profit and loss statement.

To better illustrate the variability of claim liabilities, the following shows the runoff of the U.S. property/casualty industry's claim liability estimate as of 31st December 2007 for the Commercial Multi-Peril line. Note that individual insurer data is more volatile than industry data, hence this display likely understates the individual company volatility in claim liability estimates. (Data in \$000.)

yr-end value	Restated yr-end 2007 outstanding	change	Cal. Yr paid	outstanding at val. date	change/ outstanding	"IBNR"
2007	24,358,481		24,358,481	13,695,729		
2008	22,997,277	(1,361,204)	6,137,375	16,859,902	-8%	9,428,472
2009	22,473,347	(523,930)	4,024,117	12,311,855	-4%	7,060,074
2010	22,001,335	(472,012)	2,794,970	9,044,873	-5%	5,242,398
2011	21,721,189	(280,146)	1,872,498	6,892,229	-4%	4,189,231
2012	21,507,956	(213,233)	1,177,746	5,501,250	-4%	3,322,427
2013	21,666,571	158,615	1,039,596	4,620,269	3%	2,751,172
2014	21,702,305	35,734	744,723	3,911,280	1%	2,279,909
2015	21,622,140	(80,165)	698,233	3,132,882	-3%	1,865,136
2016	22,008,705	386,565	534,814	2,984,633	13%	1,817,091

Commentary: We note that the treatment of acquired claim liabilities proposed by IFRS 17 under any of the above interpretations will distort the financial statements of the acquiring company, producing data inconsistent with the way management views its business. It also will necessitate tracking the runoff of the acquired claim liabilities separately from those of the pre-existing claim liabilities, despite the fact that insurance entities would commonly pool the resulting claim management and settlement operations. This pooling of operations results in different values for the runoff than would exist if the two pieces were never combined and will result in arbitrary splits of claim liability estimates between the acquired and pre-existing business. The former occurs because the situation of the insurer with regard to presented claims has changed with the acquired business. (Note that some portion of the acquired liabilities labeled "claim liabilities" internally would be required by IFRS 17 to be included in liabilities for remaining coverage while all the pre-existing business liabilities would be in liabilities for incurred claims.) Examples include situations where:

- The acquirer wrote an auto policy while the acquired company wrote a manufacturer policy that the acquirer might have subrogated against prior to the acquisition. If the acquisition had not taken place then a subrogation would have been likely, decreasing ultimate incurred claims for the acquirer and increasing them for the acquired. With the acquisition, the subrogation is unlikely.
- The acquirer wrote an umbrella policy and the acquired wrote the underlying primary policy, and a potential dispute exists as to whether the occurrence limit of the underlying policy was exhausted or not. Without the acquisition there likely would have been a coverage dispute between the two entities. With the acquisition such a dispute (and associated expenses) would not happen, impacting the claim liabilities for both entities.

The latter situation (i.e., arbitrary splits) arises due to situations such as:

- Both acquirer and acquired entities participated in a joint operation or pool with other entities, and the managing agent now sends a single bill to the combined entities with no split to the prior organizational structure. (This can be complicated by divestment of portions of the acquired entity.) The best that may be possible might be a somewhat arbitrary split of the bill to legacy entities. Such a split provides no useful information to management of the business combination.
- Claim management has to use judgment with regard to establishing the technical provision (e.g., IBNR), and focuses on the total they have to pay in the future and not on the legacy entity split. While one may try to mandate that a split be made, in practice such mandated splits tend not to be reliable where there is no business management incentive to maintain such splits.
- Systems that would have allowed such a split to be more reliably estimated are replaced with new claim management systems that do not retain the prior functionality. This is not uncommon given that claims can be reported decades after the original policy had expired for some coverages, and payment patterns can be decades long. This combined with a series of acquisitions/divestitures over the years can result in a strong incentive for management to shut down old legacy systems that have outlived their usefulness to management.

Is the question pervasive?

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This issue would affect nearly all property/casualty insurance companies involved in business combinations, especially those with claim liabilities that pay out over multiple years, i.e., after policy expiration. Therefore a majority of the premiums and claim liabilities in the global property/casualty industry are represented by companies likely to be interested or directly affected by this question.

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