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

Submission form for potential implementation question

Submission date	20/07/2018
Name	AASB representative
Title	Treatment of reinsurance held on initial recognition where they cover onerous underlying contracts and the application of IFRS 17.66(c)(ii)
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Potential implementation question

Treatment of reinsurance held on initial recognition where they cover onerous underlying contracts

IFRS 17.65(a) states that on initial recognition, an entity shall recognise any net cost **or net gain** on purchasing the group of reinsurance contracts held as a contractual service margin (CSM). A literal interpretation of IFRS 17.65(a) would mean that, where an entity issues underlying insurance contracts that are onerous for which it holds reinsurance, the benefits of the reinsurance will often be recognised in different periods from the corresponding underlying losses.

This treatment:

a) creates accounting mismatches where none exist in economic terms;
b) is inconsistent with the principles applied in other IFRS standards; and
c) misrepresents the relationship between the underlying contracts and the corresponding reinsurance/retrocession contracts, which is contrary to the principle of faithful representation that is a fundamental qualitative characteristic of useful financial information in the Conceptual Framework.

Given the significant implications of IFRS 17.65(a) please can the IASB confirm both the interpretation of this paragraph as illustrated in this paper and that they are aware of the implications for insurers?

Additional interpretation questions around the application of IFRS 17.66(c)(ii)

(1) IFRS 17.66(c)(ii) applies to changes in the fulfilment cash flows of the reinsurance contracts held that relate to “change in fulfilment cash flows allocated to a group of underlying insurance contracts that **does not adjust the contractual service margin** for the group of underlying insurance contracts”. How should IFRS 17.66(c)(ii) be applied where reinsurance contracts held that apply the general model cover underlying contracts issued applying the simplified approach (PAA) and therefore where there is no CSM?
(2) The estimated fulfilment cash flows for a group of reinsurance contracts held on initial recognition should reflect all substantive rights and obligations within the boundary of the contracts, including in relation to underlying contracts that have not yet been issued. Should IFRS 17.66(c)(ii) be applied:
   - only in respect of changes in expected fulfilment cash flows subsequent to initial recognition of the underlying contract(s); or
   - in respect of changes in expectations of fulfilment cash flows that arise subsequent to initial recognition of the reinsurance contract(s) held even if the change in expectation happens before the initial recognition of the relevant underlying contract(s)?

Paragraph of IFRS 17 *Insurance Contracts*
IFRS 17.65(a), IFRS 17.66(c)(ii), IFRS 17.BC310, IFRS 17.BC311, IFRS 17.BC315 The relevant paragraphs of IFRS 17 have been included in Appendix C of this paper.
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

1. Analysis of accounting requirements

1.1 An insurance or reinsurance contract that an entity issues is onerous when the expected present value of cash outflows exceeds the expected present value of cash inflows after risk adjustment. IFRS 17 requires a loss on those contracts to be recognised immediately in the profit or loss [IFRS 17.47]. In many cases, this would result in a corresponding net gain on the reinsurance contract held covering those underlying contracts issued. However, IFRS 17 requires a net gain on initial recognition of the reinsurance contract held to be recognised as a contractual service margin (CSM) which will be recognised in the profit or loss over the coverage period of the reinsurance contract [IFRS 17.65(a)].

1.2 IFRS 17.BC310 notes that a net gain on reinsurance contracts held is expected to be rare and describes the most likely causes of such an apparent net gain on initial recognition of a reinsurance contract as being:

(a) an overstatement of the underlying insurance contract(s). An entity would evaluate this by reviewing the measurement of the underlying insurance contract(s). [IFRS 17.BC310]

(b) favourable pricing by the reinsurer; for example, as a result of diversification benefits that are not available to the entity. [IFRS 17.BC310]

1.3 Consequently, the Board considered that "the apparent gain at initial recognition represents a reduction in the cost of purchasing reinsurance, and that it would be appropriate for an entity to recognise that reduction in cost over the coverage period as services are received" [IFRS 17.BC311].

1.4 However, IFRS 17 provides an exception when "the underlying group of insurance contracts becomes onerous [or there is an increase in previously recognised onerous losses] **after initial recognition** because of adverse changes in estimates of fulfilment cash flows relating to future service" [IFRS 17.BC315]. IFRS 17.66(c)(ii) requires that, in those cases, the corresponding changes in cash flows from the reinsurance held should not adjust the CSM but will be recognised in profit or loss when they result from changes in fulfilment cash flows on the underlying contracts that do not adjust the CSM for those underlying contracts.

2. Implementation question: Treatment of reinsurance held on initial recognition where underlying contracts are onerous

2.1 The requirement to recognise gains on reinsurance contracts held on initial recognition as a CSM where the reinsurance contract covers onerous underlying contracts will result in accounting mismatches that do not reflect the substance of the reinsurance arrangement as the benefits of the reinsurance held will often be recognised in different periods from the corresponding underlying losses they cover:

Simplified example

An entity enters into a reinsurance contract held that provides proportional cover for a portfolio of underlying property and casualty contracts on a claims-incurred basis over the contract period of 2 years. The reinsurance contract is a claims-incurred quota share and will cover 100% of each claim from the underlying insurance contracts in return for 100% of the premiums. Underlying contracts are homogenous and are issued at the start of Year 1. The expected cash flows on the underlying contracts and reinsurance contract held are as follows:

	t0	t1	t2
Underlying contracts			
Premiums received	100		
Expected claims		50	50
Reinsurance held			
Premiums paid	100		
Expected recoveries		50	50

- Claims and corresponding reinsurance recoveries are assumed to be paid when incurred.
- Premiums on the underlying contracts are received in advance at the start of Year 1.
- Risk adjustment is assumed to be 10% of claims
- Payment patterns of reinsurance premiums match the pattern of premium receipts on the underlying contracts issued

Assuming all events occur as expected and the entity does not change any assumptions related to future periods, the measurement of the underlying contracts issued and the reinsurance contract held applying the requirements of IFRS 17 is as follows:

General model: Balance sheet

	t0	t1	t2
Underlying contracts - Asset/(Liability) for remaining coverage b/f	-	(110)	(55)
Contracts initially recognised in the period			
Loss component on initial recognition	(10)	-	-
Contractual service margin (CSM)	-	-	-
Reduction in Liability for Remaining Coverage (LfRC) due to claims incurred	-	55	55
Premiums received	(100)	-	-
Underlying contracts - Asset/(Liability) for remaining coverage	**(110)**	**(55)**	**-**
Cash (paid)/received on underlying contracts	**100**	**(50)**	**(50)**
Reinsurance held - Asset/(Liability) for remaining coverage b/f	-	100	50
Contracts initially recognised in the period			
Fulfilment cash flows	10	-	-
Contractual service margin (CSM)	(10)	-	-
CSM allocation to P&L	-	5	5
Reduction in AfRC due to claims incurred	-	(55)	(55)
Ceded premiums paid	100	-	-
Reinsurance held - Asset/(Liability) for remaining coverage	**100**	**50**	**-**
Cash (paid)/received on reinsurance held	**(100)**	**50**	**50**

General model: Profit or loss

	t0	t1	t2
Insurance revenue			
Reduction in LfRC due to claims incurred	-	(50)	(50)
Insurance service expenses			
Onerous contract losses	10	-	-
Release of onerous contract losses	-	(5)	(5)
Claims incurred	-	50	50
(Profit)/Loss on the underlying contracts issued	**10**	**(5)**	**(5)**
Reinsurance (income)/expenses			
Reinsurance held: CSM allocation to P&L	-	(5)	(5)
Reduction in AfRC due to recoveries incurred	-	55	55
Reinsurance recoveries	-	(50)	(50)
(Profit)/Loss on the reinsurance contract held	**-**	**-**	**-**
Net (profit)/loss	**10**	**(5)**	**(5)**

Additional simplified examples have been included in Appendix B to illustrate the implications of applying the IFRS 17 requirements and the resulting mismatch in different scenarios.

Explanation of the issue

2.2 The asymmetrical treatment of the losses on the underlying contracts and corresponding benefits on the reinsurance held on initial recognition **does not faithfully represent[1] the economic relationship between**

[1] Paragraph QC4 of the Conceptual Framework for Financial Reporting 2010 (*emphasis added*): "If financial information is to be useful, it must be relevant and **faithfully represent what it purports to represent**".

the reinsurance contract held and the underlying contracts issued. The requirement in IFRS 17.65(a) to recognise net gains on initial recognition over the coverage period of the reinsurance contract held:

(a) does not appropriately reflect the benefits of the reinsurance contract in the cedant's financial statements as the profit or loss in each period will not reflect the fact that the underlying losses have effectively been ceded to the reinsurer; and
(b) has the effect of delaying profit recognition, which would not appropriately represent the entity's overall performance for a period.

2.3 It is also inconsistent with the principles applied in other IFRS standards. Most notably, the principles of hedge accounting in IFRS 9 exemplify the need to appropriately represent in the financial statements the effect of an entity's risk management activities using financial instruments[2] and attempts to do so by reflecting the gains or losses on a hedging instrument in the same periods (or same place in the financial statements) as gains and losses on the hedged item. Reinsurance contracts are not financial instruments in an IFRS 9 context but they can be viewed as being akin to hedging instruments for insurance risks of the underlying insurance contracts. Consequently, the same principles would reasonably be applied to reflect the fact that some (or all) of the risks on the underlying contracts have been transferred to the issuer of the reinsurance contracts held.

Applying the requirements in IFRS 17.65(a) would not faithfully represent the risk management activities undertaken by insurers when they acquire reinsurance protection for underlying onerous contracts and will result in a presentation that is unhelpful to users of financial statements as it does not clearly differentiate between:

(a) an insurer that has acquired effective economic protection for onerous losses on underlying contracts; and
(b) an insurer that has not acquired reinsurance protection for an identical group of underlying onerous contracts.

The benefits provided by the reinsurance contracts held should therefore, be recognised in the same periods as the losses on the underlying contracts they cover.

2.4 We note the desire of the Board to treat the underlying contracts issued and the reinsurance contracts held as separate contracts [IFRS 17.BC298]. However, it should be noted that reinsurance contacts would not be acquired other than to provide protection to the underlying contracts issued, a completely different situation to many hedging contracts which are equally derivatives when considered standalone. The required treatment of reinsurance gains on initial recognition in IFRS 17 ignores the interdependencies between the cash flows of the underlying contracts issued and the reinsurance contracts held. It is also in contrast with deliberate attempts in IFRS 17 at achieving alignment in other areas such as:

- recognition of proportional reinsurance contracts held at the later of when: (a) coverage begins; and (b) initial recognition of any underlying contract [IFRS 17.62(a) and BC305]. This means the recognition date for a reinsurance contract held could be delayed until the first underlying contract is written, effectively aligning the recognition dates;
- the requirement to "use consistent assumptions to measure the estimates of the present value of the future cash flows for the group of reinsurance held and for the group of underlying contracts issued" [IFRS 17.63]; and
- the subsequent measurement requirement set out in IFRS 17.66(c)(ii) which requires the gain on the reinsurance held to be recognised in profit or loss where they result from underlying contracts that become onerous (or an increase in previously recognised underlying onerous losses) after initial recognition because of adverse changes in estimates [IFRS 17.66(c)(ii)].

The treatment of the reinsurance contracts held and underlying contracts issued as separate contracts is still achieved if reinsurance benefits are recognised in the profit or loss at the same time as the losses on the underlying contracts they cover because:

- Reinsurance assets are disclosed separately from the underlying insurance liabilities on the balance sheet, and reinsurance income and expenses disclosed separately from insurance revenue and expenses in the profit or loss [IFRS 17.78];
- The risk of non-performance by the issuer of the reinsurance contract is included in the measurement of the reinsurance contract held [IFRS 17.63];

[2] IFRS 9.6.1.1: "The objective of hedge accounting is to represent, in the financial statements, the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss…"

- When measuring the reinsurance contract held, an entity is required to estimate on initial recognition all expected cash flows including in respect of underlying contracts not yet written [Agenda paper 3 of the February 2018 TRG]; and
- As noted above, symmetrical accounting of reinsurance gains and underlying contract losses is allowed under IFRS 17 where the losses arise on subsequent measurement of the reinsurance contract [IFRS 17.66(c)(ii)]. If the Board's concerns around separate treatment of reinsurance and underlying contracts do not apply in relation to IFRS 17.66(c)(ii), they should be equally irrelevant if this requirement is extended to initial recognition.

2.5 We support the subsequent measurement requirement in IFRS 17.66(c)(ii) but we consider that this requirement should be applied consistently at initial recognition and subsequent measurement with no distinction between whether an onerous underlying contract existed at initial recognition or arises on subsequent measurement of a reinsurance contract.

As illustrated in Appendix B Example B.3, applying the current IFRS 17 requirements will result in different profit profiles based on when the entity expects the underlying contracts to be onerous, whether from initial recognition of the reinsurance contract or subsequently. It would be inappropriate to reflect different outcomes for two scenarios that are identical except for the timing of the expectation of the underlying contracts becoming onerous, as the timing of the expectation does not change the nature and timing of the rights, obligations and service being provided under the reinsurance contracts.

Application of the IFRS 17 requirements in practice

2.6 We disagree with the Board's comment in IFRS 17.BC310 that a net gain on reinsurance contracts held is expected to be rare.[3] Although reinsurance contracts held would normally give rise to a net cost, as they cover profitable underlying contracts, the occurrence of a net gain on reinsurance contracts held on initial recognition is not uncommon. The IASB has devoted considerable attention to the treatment of 'onerous contracts' in IFRS 17 and a large proportion of all the paragraphs in IFRS 17 refer to 'onerous contracts'. References to 'insurance contracts' also mean 'reinsurance contracts' issued [IFRS 17.3(a)]. Accordingly, it seems incongruous for IFRS 17.BC310 to argue that net gains on reinsurance contracts held are expected to be rare. Commercial factors (and potentially information asymmetries), as well as different views of the risk, can each mean that reinsurance contracts held would give rise to gains. We have included examples in Appendix A which have been based on actual reinsurance contracts from practice to illustrate scenarios which could result in a net gain on initial recognition of the reinsurance contract held. A net gain on initial recognition of the reinsurance contracts held could arise in the following situations:

(1) Underlying contracts are onerous due to high acquisition costs incurred on new business. It is common practice in the Australian market for life reinsurance contracts to pay high upfront commissions on new contracts in anticipation of the contracts being renewed and therefore, becoming profitable in future years [Example A.1];

(2) It is not uncommon for the premiums in high catastrophe exposure areas to be less than the expected claims cost as they are expected to be subsidised by premiums from lower catastrophe risk regions. Even where premiums charged are higher than the expected claims and expenses, inclusion of the risk adjustment would commonly result in the contracts being expected to be onerous due to the low frequency and high severity of catastrophe risks[4] [Example A.2]. Consequently, the working layers of reinsurance contracts providing catastrophe cover would usually be expected to be in a net gain on initial recognition;

(3) It is common for (re)insurers to write business in a jurisdiction where the business may be in a loss position at inception after the risk adjustment is included due to the lack of diversification available to the (re)insurer. The (re)insurer would then have a reinsurance/retrocession arrangement where a portion of the risk is passed on to the reinsurer/retrocessionaire in another jurisdiction. The reinsurer/retrocessionaire has a higher level of diversification available, which would mean that from the perspective of the reinsurer/retrocessionaire, the business is expected to be profitable at inception due to the lower risk adjustment. Due to the existence of the reinsurance/retrocession arrangement it still makes commercial sense for the stand-alone (re)insurer to write new business.

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[3] The last time the IASB used rarity as a basis for not permitting a particular accounting treatment was in IFRS 3 *Business Combinations* in respect of 'true mergers' [IFRS 3.BC35, BC47, BC56 and BC79]. We note that the frequency of occurrence of net gains on reinsurance contracts held is of a far higher magnitude than for 'true mergers', and the same problematic complexities of merger accounting in the context of IFRS 3 do not apply in respect of reinsurance contracts held. By the IASB's own benchmark of 'rarity' in IFRS 3, there is simply no parallel between the case of 'true merger' transactions and reinsurance contracts held that give rise to net gains.

[4] IFRS 17.B91 (a): "risks with low frequency and high severity will result in higher risk adjustments for non-financial risks than risks with high frequency and low severity"

2.7 The apparent inconsistency in the treatment of reinsurance held at initial recognition where they cover onerous underlying contracts with other areas of IFRS 17 which actively seek to minimize accounting mismatches (such as allowing the disaggregation of insurance finance income/expenses between profit or loss and other comprehensive income, and other aspects of reinsurance accounting described in paragraph 2.4 above) is likely to lead to diversity in practice due to the different interpretations that will be applied by insurers as a result.

Alternative treatment of reinsurance held on initial recognition where they cover onerous underlying contracts

2.8 The following alternative accounting treatments are proposed:

(1) **Proposed solution 1:**
The application of the subsequent measurement requirement set out in IFRS 17.66(c)(ii) is extended to initial recognition so that, to the extent the reinsurance contract held on initial recognition covers onerous underlying contracts, the reinsurance benefit is recognised in the profit or loss instead of as a CSM on the balance sheet where they result from the losses on those underlying contracts:

65 … Hence, on initial recognition:

(a) the entity shall recognise any net cost or net gain on purchasing the group of reinsurance contracts held as a contractual service margin measured at an amount equal to the sum of the fulfilment cash flows, the amount derecognised at that date of any asset or liability previously recognised for cash flows related to the group of reinsurance contracts held, and any cash flows arising at that date; unless

(b) the net cost of purchasing reinsurance coverage relates to events that occurred before the purchase of the group of reinsurance contracts, in which case…recognise such a cost immediately in profit or loss as an expense; **and**

(c) where the group of reinsurance contracts held covers underlying insurance contracts that are onerous, the entity shall recognise a net gain on purchasing the group of reinsurance held immediately in profit or loss to the extent the gain relates to losses on the group of underlying insurance contracts that are recognised in profit or loss.

(2) **Proposed solution 2:**
Apply an accounting treatment that is similar to hedge accounting under IFRS 9.6.5.8. No change is proposed to the accounting of the reinsurance contracts held but instead the benefits of the reinsurance arrangement will be reflected in the measurement of the underlying contract. Where onerous underlying contracts are subject to reinsurance, the share of the losses that are subject to reinsurance is recognised as a negative CSM instead of as a loss in profit or loss on initial recognition. The impact of this would be to defer the losses on the underlying contracts to the extent they are subject to reinsurance so that the loss is recognised in the profit or loss at the same time as the gain on reinsurance. No Day 1 gains are reflected in the profit or loss.

47 … An entity shall:

(a) recognise a loss in profit or loss for the net outflow for the group of onerous contracts, resulting in the carrying amount of the liability for the group being equal to the fulfilment cash flows and the contractual service margin of the group being zero**, unless**

(b) the group of onerous contracts is covered by reinsurance contracts held, in which case, an entity shall recognise a contractual service margin for the share of the losses covered by the reinsurance contracts held. The contractual service margin at the end of each reporting period is measured applying paragraphs 43-46.

48 …

49 **Unless paragraph 47(b) applies,** ~~A~~an entity shall establish (or increase) a loss component…

3. Implementation question: Additional interpretation questions issues around the application of IFRS 17.66(c)(ii)

Applying IFRS 17.66(c)(ii) where underlying contracts are accounted for using the PAA

3.1 IFRS 17.66(c)(ii) applies to changes in the fulfilment cash flows of the reinsurance contracts held that result from "change[s] in fulfilment cash flows allocated to a group of underlying insurance contracts that **does not adjust the contractual service margin** for the group of underlying insurance contracts". There is a lack of clarity around how IFRS 17.66(c)(ii) would apply where reinsurance contracts held that apply the general model cover underlying contracts issued applying the simplified approach (PAA). Possible interpretations are:

(1) There is no contractual service margin on underlying contracts where they apply the PAA. Consequently, IFRS 17.66(c)(ii) would not apply where reinsurance contracts held applying the general model cover underlying contracts that apply the PAA; or
(2) IFRS 17.66(c)(ii) will apply in the same way where reinsurance contracts held cover underlying contracts that apply the PAA. Not all changes in the measurement of the PAA LfRC will result in

corresponding changes to the fulfilment cash flows of the reinsurance contracts held. Specifically, the only changes in the measurement of the PAA LfRC that will result in corresponding changes to the fulfilment cash flows of the reinsurance contracts held are changes in expectations relating to future service that would result in the group of underlying contracts becoming onerous[5] or would result in adjustment to a previously recognised onerous loss component. Consequently, applying IFRS 17.66(c)(ii) to underlying contracts that apply the PAA will mean that where a change in the fulfilment cash flows of the reinsurance contract held **results from** changes in the PAA LfRC[6], these changes shall not adjust the contractual service margin for the group of reinsurance contracts held but will be recognised in profit or loss.

Interpretation (1) would result in an inconsistent treatment of subsequent changes to fulfilment cash flows of the reinsurance contracts held depending on the measurement model being applied by the underlying contracts. Changes in the fulfilment cash flows of the reinsurance contracts held that result from underlying contracts expected to become onerous [or from an increase or decrease in previously recognised onerous losses] subsequent to initial recognition will either be recognised in profit or loss or as an adjustment to the CSM on the balance sheet depending on whether the underlying contracts apply the general model or the PAA. Interpretation (2) will result in the same outcome being achieved regardless of whether the general model or the PAA is being applied by the underlying contracts. We, therefore, consider that Interpretation (2) is more likely to reflect the intention of the IASB.

Applying IFRS 17.66(c)(ii) where underlying contracts subsequently become onerous

3.2 The estimated fulfilment cash flows for a group of reinsurance contracts held on initial recognition should reflect all substantive rights and obligations within the boundary of the contracts, including in relation to underlying contracts that have not yet been issued[7]. IFRS 17.BC315 states that "the Board considered the situation that arises when the underlying group of insurance contracts **becomes onerous after initial recognition** because of adverse changes in estimates of fulfilment cash flows relating to future service". IFRS 17.BC315 and Illustrative Example 12B in IFRS 17 appears to only include consideration of changes subsequent to initial recognition of the underlying contract(s) and there are no other explanatory paragraphs in the Standard or the Basis of Conclusions around the application of IFRS 17.66(c)(ii). It is unclear whether IFRS 17.66(c)(ii) would apply:

(1) only in respect of changes subsequent to initial recognition of the underlying contract(s), i.e. where changes in expectations relating to future service **after initial recognition of the underlying contracts** result in those underlying contracts expected to become onerous or will result in an increase/decrease to previously recognised onerous losses; or
(2) in respect of changes in expectations of fulfilment cash flows that arise **subsequent to initial recognition of the reinsurance contract(s) held** even if the change in expectation happens before the initial recognition of the relevant underlying contract(s) – for example, where underlying contracts not yet issued were expected to be profitable on initial recognition of the reinsurance contract held, but subsequent changes in expectations that arise after initial recognition of the reinsurance contract but before initial recognition of the underlying contracts result in those underlying contracts being expected to be onerous. This scenario is illustrated in Example B.3 Example 3B of this paper.

IFRS 17.66(c)(ii) applies to changes in the fulfilment cash flows of the reinsurance contract(s) held that "result from a change in fulfilment cash flows allocated to a group of underlying insurance contracts that does not adjust the contractual service margin for the group of underlying insurance contracts" [IFRS 17.66(c)(ii)]. The scenario described in Interpretation (2) would qualify as such a change even though those underlying insurance contracts have not yet been issued. We therefore, consider that Interpretation (2) reflects the intention of the Standard. We note however, that the application of Interpretation (2) could result in the recognition of a reinsurance gain in the profit or loss ahead of the recognition of the underlying losses where those underlying contracts are to be issued in future periods.

4. Conclusions

Treatment of reinsurance held on initial recognition where they cover onerous underlying contracts

[5] The PAA LfRC is not adjusted for favorable changes in expectations relating to future service unless it results in a reversal of a previously recognised loss component. IFRS 17.BC293: "The premium allocation approach measures the group of insurance contracts using estimates made at initial recognition and does not update those estimates in the measurement of the liability for remaining coverage unless the group is or becomes onerous".

[6] As noted above, this will only arise where the group of underlying contracts become onerous or changes in expectations relating to future service result in an increase or decrease to previously recognised onerous losses.

[7] It was clarified in AP03 of the February 2018 TRG meeting that the boundary of a reinsurance contract held could include cash flows from underlying contracts covered by the reinsurance contract that are expected to be issued in the future.

4.1 The requirement to defer benefits on reinsurance contracts held on initial recognition by establishing a negative CSM for net gains where the reinsurance contract covers onerous underlying contracts will result in accounting mismatches that do not faithfully represent the economic relationship between the reinsurance contract held and the underlying contracts issued.

4.2 The benefits on the reinsurance contracts held should be recognised in the same periods as the losses on the underlying contracts they cover to reflect the fact that some (or all) of the risks on the underlying contracts have been transferred to the issuer of the reinsurance contracts held.

4.3 The following alternative accounting treatments are proposed:

(1) **Proposed solution 1:**
The application of the subsequent measurement requirement set out in IFRS 17.66(c)(ii) is extended to initial recognition so that to the extent the reinsurance contract held on initial recognition covers onerous underlying contracts, the reinsurance benefit is recognised in the profit or loss instead of as a CSM on the balance sheet where they result from the losses on those underlying contracts; or

(2) **Proposed solution 2:**
Apply an accounting treatment that is similar to hedge accounting under IFRS 9.6.5.8. No change is proposed to the accounting of the reinsurance contracts held but instead the benefits of the reinsurance arrangement will be reflected in the measurement of the underlying contract. Where onerous underlying contracts are subject to reinsurance, the share of the losses that are subject to reinsurance is recognised as a negative CSM instead of a loss in profit or loss on initial recognition. The impact of this would be to defer the losses on the underlying contracts to the extent they are subject to reinsurance so that the loss is recognised in the profit or loss at the same time as the gain on reinsurance. No Day 1 gains are reflected in the profit or loss.

Simplified examples have been included in Appendix B to show the implications of applying the current IFRS 17 requirements in various scenarios and the application of the proposed solutions described above.

Additional interpretation questions around the application of IFRS 17.66(c)(ii)

4.4 This paper concludes that:

- IFRS 17.66(c)(ii) applies equally to reinsurance contracts held that cover underlying contracts applying the general model and reinsurance contracts held that cover underlying contracts applying the PAA. Where a change in the fulfilment cash flows of the reinsurance contract held results from changes in the PAA LfRC of underlying contracts, these changes shall not adjust the contractual service margin for the group of reinsurance contracts held but will be recognised in profit or loss. This will result in the same outcome being achieved regardless of whether the general model or the PAA is being applied by the underlying contracts.
- IFRS 17.66(c)(ii) would apply where subsequent changes in the fulfilment cash flows of the reinsurance contract(s) held result from changes in the expected fulfilment cash flows of the group of underlying insurance contracts that do not adjust the CSM for those underlying contracts even if the changes in expectation happen before the initial recognition of the relevant underlying contract(s).

Is the question pervasive?

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

The issue is relevant to all insurers which have reinsurance contracts held and would apply equally across general, health and life insurance. Appendix A includes examples of how the requirements impact both general insurance and life insurance products from practice.

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

Any public discussion of issues submitted will be without the identification of the submitter’s name. Although the submission forms will remain private, please do not include any confidential information in your submission.
Email the completed (including any attachments) form to: insurancecontracts@ifrs.org

Appendix A –examples based on practice

The following examples have been prepared with input from a number of companies (including reinsurers) in the Australian insurance market and is intended to provide examples based on practice of when a net gain on reinsurance contracts held can be expected to arise and the impact of applying the IFRS 17 requirements.

Discounting has been ignored in all the examples below. The examples below are based on the application of the general model but the implications of applying the IFRS 17 requirements are expected to apply equally where the PAA is applied.

Example A.1 –Proportional reinsurance contract issued and retrocession contract held covering underlying life insurance contracts which are expected to be onerous on inception

A.1.1 **Fact pattern and assumptions**

A reinsurer issues a reinsurance contract that provides proportional cover for a group of underlying life insurance contract contracts ("reinsurance arrangement"). The reinsurance contract is a risks-attaching quota share and will cover 100% of each claim from the underlying insurance contracts in return for a 100% of the premiums. At the same time the reinsurer has a proportional retrocession arrangement ("retrocession arrangement") with a retrocessionaire in another jurisdiction. Underlying contracts are written at the start of each year and can be repriced annually. Both the insurer and reinsurer enter into this transaction with an expectation of the customer renewing the policy for at least a five-year period.

- The reinsurance arrangement provides a three-year rate guarantee, which restricts the repricing ability of the reinsurer. After three years the reinsurer is fully able to reprice the risks for both covered new business and unexpired risk of in-force underlying contracts.
- The retrocession arrangement follows the reinsurance arrangement and repricing is also restricted within a three-year period.
- The reinsurer has a retrocession arrangement with a retrocessionaire in another jurisdiction where 100% of the reinsurance business written is retroceded.
- Risk adjustment is assumed to be 10% of claims
- Claims and corresponding reinsurance recoveries are assumed to be paid when incurred.
- Premiums on the underlying contracts are received in advance at the start of each annual period.
- Payment patterns of reinsurance premiums match the pattern of premium receipts on the underlying contracts issued.
- The reinsurer expects that 1 new contract will be issued in each of the three years. So that in total 3 policies will be in-force at the end of Year 3 (t3).
- The expected cash flows on the underlying contracts and reinsurance contract held are as follows:

		t0	t1	t2	t3	t+
Insurer cash flows excluding reinsurance	**Underlying contract 1 (Insurer cash flow)**					
	Commissions	(200)				
	Premiums	100	100	100	100	
	Expected claims		(50)	(50)	(50)	(50)
	Underlying contract 2 (Insurer cash flow)					
	Commissions		(200)			
	Premiums		100	100	100	
	Expected claims			(50)	(50)	(50)
	Underlying contract 3 (Insurer cash flow)					
	Commissions			(200)		
	Premiums			100	100	
	Expected claims				(50)	(50)

Reinsurer cash flows	**Reinsurance Issued (Reinsurer cash flow)**					
	Commissions	(200)	(200)	(200)		
	Premiums received	100	200	300	200	
	Expected reinsurance claims		(50)	(100)	(150)	(100)
	Retrocession held (Reinsurer cash flow)					
	Commissions	200	200	200		
	Premiums paid	(100)	(200)	(300)	(200)	
	Expected recoveries		50	100	150	100

A.1.2 **Contract coverage period**

Applying IFRS 17.34(a), the substantive obligation of the reinsurer to provide services ends at the end of Year 3 (t3) when the reinsurer has the practical ability to reassess the risks of new business as well as the unexpired risk of underlying policies being covered and set a price to reflect those risks. Consequently, the coverage period of the reinsurance contract issued is 3 years.

The pricing terms of the retrocession arrangement are the same as those of the reinsurance arrangement described above. Consequently, the coverage period of the retrocession contract held is also 3 years.

A.1.3 **Cash flows within the contract boundary**

Premiums received at t3 are premiums received in advance for the unexpired risks relating to period t4 which are outside the boundary of the existing reinsurance contract. As they are cash flows arising from the reinsurer's substantive obligation to provide services in t4+, they will be recognised within the fulfilment cash flows of the future repriced contract.

A.1.4 Assuming all events occur as expected and the reinsurer does not change any assumptions related to future periods, the measurement of the underlying contracts issued and the reinsurance contract held applying the requirements of IFRS 17 is as follows:

General model: Balance sheet (from the perspective of the reinsurer)

	t0	*t1*	*t2*	*t3*
Reinsurance contract - Asset/(Liability) for remaining coverage b/f	0	(230)	(175)	(165)
Contracts initially recognised in the period				
Loss component on initial recognition	(330)[8]	-	-	-
Reduction in LfRC due to claims incurred	-	55	110	165
Commission paid	200	200	200	0
Premiums received	(100)	(200)	(300)	0
Reinsurance contract - Asset/(Liability) for remaining coverage	**(230)**	**(175)**	**(165)**	**0**
Cash (paid)/received on reinsurance issued	**(100)**	**(50)**	**0**	**(150)**
Retrocession held – Asset/(Liability) for remaining coverage b/f	-	(100)	(100)	0
Contracts initially recognised in the period	-	-	-	-
Non loss component: Fulfilment cash flows on initial recog.	330	-	-	-
Contractual service margin (CSM)	(330)	-	-	-
CSM allocation to P&L[9]	-	55	110	165

[8] Expected claims of CU300 plus risk adjustment of CU30 calculated as 10% of CU300

[9] CSM is allocated to the P&L on the basis of coverage units (paragraph B119 of IFRS 17). The pattern of coverage units in this example has been based on the number of underlying contracts in-force in each period of the reinsurance contract coverage. (1 contract in Year 1, 2 contracts in Year 2, 3 contracts in Year 3).

Reduction in AfRC due to recoveries incurred	-	(55)	(110)	(165)
Ceded commissions received	(200)	(200)	(200)	0
Ceded premiums paid	100	200	300	0
Retrocession held – Asset/(Liability) for remaining coverage	**(100)**	**(100)**	**-**	**-**
Cash (paid)/received on retrocession held	**100**	**50**	**-**	**150**

General model: Profit or loss

	t0	t1	t2	t3
Insurance revenue				
Reduction in LfRC due to claims and expenses incurred[11]	-	(35)	(71)	(106)
Recovery of insurance acquisition cash flows[10]	-	(129)	(129)	(129)
Insurance service expenses				
Onerous contract losses	330	-	-	-
Release of onerous contract losses[11]	-	(20)	(39)	(59)
Claims incurred	-	50	100	150
Insurance acquisition costs expensed[10]	-	129	129	129
(Profit)/Loss on the underlying contracts issued	**330**	**(5)**	**(10)**	**(15)**
Reinsurance (income)/expenses				
Reinsurance held: CSM allocation to P&L	-	(55)	(110)	(165)
Reduction in AfRC due to recoveries incurred	-	55	110	165
Reinsurance recoveries	-	(50)	(100)	(150)
(Profit)/Loss on the reinsurance contract held	**-**	**(50)**	**(100)**	**(150)**
Net (profit)/loss	**330**	**(55)**	**(110)**	**(165)**

At t0, the reinsurer books a loss of CU330 immediately in the P&L, representing the present value of the future cashflows, upfront commission and upfront premium. The benefit from the 100% retrocession arrangement is not reflected in the P&L at t0 and the insurers profit and capital position does not recover until the end of the contract boundary point at the end of t3. This point is exacerbated by the CSM which defers the relief into the periods when the greatest number of policies are inforce.

A.1.5 It is common practice in the Australian market for life insurers and reinsurers to incur high acquisition costs on new business issued in anticipation of the contracts being renewed, and therefore becoming profitable in the future. Applying the requirements of IFRS 17 would result in a net profit distortion for a large portion of new business life (re)insurance contracts as losses will be reflected on initial recognition of these contracts (t0) while the benefits of the reinsurance (or retrocession) contract held in relation to those losses are reflected as profits in the later years of coverage.

[10] The amount of revenue recognised in respect of insurance acquisition cash flows is equal to the non-loss proportion (35.5% - see footnote below) of the total acquisition cash flows of CU600, allocated equally to each period of coverage, being the "portion of the premium that relates to recovering those [acquisition] cash flows" [IFRS 17.B125]. CU129 recognised in each period is calculated as CU600*35.5% / 3 years. The same amount is recognised as insurance service expenses.

[11] Applying IFRS 17.50(a), subsequent changes in fulfilment cash flows of the LfRC is allocated on a systematic basis between the loss component of the LfRC and non loss component of the LfRC. In this example, the allocation is based on the proportion of 35.5%, calculated on initial recognition as the loss component of CU330 relative to the total estimate of the present value of the future cash outflows plus risk adjustment of CU930 (CU600 + CU300 + CU30). Amounts allocated to the loss component are presented as reversals/release of onerous losses in insurance service expenses and are excluded from the determination of insurance revenue [IFRS 17.49].

Example A.2 – Non proportional reinsurance contract covering underlying property contracts that are expected to be onerous on inception

A.2.1 An entity enters into a reinsurance contract held that provides excess of loss (XOL) catastrophe cover for a portfolio of underlying property contracts on a claims incurred basis.

A.2.2 **Fact pattern and assumptions**

- The contracts incept on 1 June 20X1. The coverage period of the underlying contracts and corresponding reinsurance held is one year.
- The risk adjustment is estimated based on a confidence level of 85%.
- The reinsurance contract is the first layer of the reinsurance program and provides coverage for losses in excess of CU100 up to a limit of CU50.
- The expected cash flows on the underlying contracts and reinsurance contract held are as follows:

	CU
Underlying contracts	
Premiums received	300
Directly attributable acquisition costs	80
Expected claims	190
Directly attributable expenses	20
Risk adjustment (at confidence level of 85%)	50
Reinsurance held	
Premiums paid	60
Expected recoveries	50
Risk adjustment (at confidence level of 85%)	23

- It is assumed that premiums on the underlying contracts are received quarterly in arrears. Reinsurance premiums are paid quarterly in arrears to the reinsurer.
- Claims and expenses are expected to incur evenly over the coverage period. Claims, expenses and recoveries are assumed to be paid when incurred.

A.2.3 Assuming all events occur as expected and the insurer does not change any assumptions related to future periods, the measurement of the underlying contracts issued and the reinsurance contract held applying the requirements of IFRS 17 is as follows:

General model: Balance sheet

	1 June 20X1	31 Dec 20X1	31 May 20X2
Underlying contracts - Asset/(Liability) for remaining coverage b/f		(40)	(60)
Contracts initially recognised in the period			
Non loss component: Fulfilment cash flows on initial recog.	-	-	-
Loss component on initial recognition	(40)	-	-
Contractual service margin (CSM)	-	-	-
CSM allocation to P&L	-	-	-
Reduction in LfRC due to claims and expenses incurred		130	130
Premiums received	-	(150)	(150)
Underlying contracts - Asset/(Liability) for remaining coverage	**- 40**	**(60)**	**(80)**
Cash (paid)/received on underlying contracts	**-**	**45**	**45**
Reinsurance held - Asset/(Liability) for remaining coverage b/f		-	-
Contracts initially recognised in the period			
Fulfilment cash flows	13	-	-
Contractual service margin (CSM)	(13)	-	-
CSM allocation to P&L	-	7	7
Reduction in AfRC due to recoveries incurred	-	(37)	(37)
Ceded premiums paid	-	30	30

Reinsurance held - Asset/(Liability) for remaining coverage	**-**	**-**	**-**
Cash (paid)/received on reinsurance held	**-**	**(5)**	**(5)**

General model: profit or loss

	1 June 20X1	31 Dec 20X1	31 May 20X2
Insurance revenue			
CSM allocation to P&L	-	-	-
Reduction in LfRC due to claims and expenses incurred[12]	-	(110)	(110)
Recovery of insurance acquisition cash flows	-	(40)	(40)
Insurance service expenses			
Onerous contract losses	40	-	-
Release of onerous contract losses[12]	-	(20)	(20)
Insurance acquisition costs expensed		40	40
Claims incurred	-	105	105
(Profit)/Loss on the underlying contracts issued	**40**	**(25)**	**(25)**
Reinsurance (income)/expenses			
Recognition of changes in FCF in P&L	-	-	-
Reinsurance held: CSM allocation to P&L	-	(7)	(7)
Reduction in AfRC due to recoveries incurred	-	37	37
Reinsurance recoveries	-	(25)	(25)
(Profit)/Loss on the reinsurance contract held	**-**	**5**	**5**
Net (profit)/loss	**40**	**(20)**	**(20)**

A.2.4 The risk adjustment allocated to catastrophe exposed business is commonly high due to the low frequency, high severity as well as the high level of uncertainty associated with catastrophe risks, which could result in the contracts being expected to be onerous when considered on a gross basis. Applying the requirements of IFRS 17 would result in a net profit distortion for catastrophe exposed contracts as the corresponding benefits from the reinsurance contracts held cannot be recognised in the same period as the recognition of the underlying losses, but is instead reflected as profits in the later years of coverage.

[12] Applying IFRS 17.50(a), subsequent changes in fulfilment cash flows of the LfRC is allocated on a systematic basis between the loss component of the LfRC and non loss component of the LfRC. In this example, the allocation is based on the proportion of 15.4%, calculated on initial recognition as the loss component of CU40 relative to the total estimate of the present value of the future cash outflows plus risk adjustment of CU260 (CU190 + CU20 + CU50). Amounts allocated to the loss component are presented as reversals/release of onerous losses in insurance service expenses and are excluded from the determination of insurance revenue [IFRS 17.49].

Appendix B – simplified illustrative examples

Discounting has been ignored in all the examples below. The examples below are based on the application of the general model but the implications of applying the IFRS 17 requirements are expected to apply equally where the PAA is applied.

Example B.1 – Proportional reinsurance contract covering underlying property and casualty contracts which are expected to be onerous on inception

B.1.1 **Fact pattern and assumptions**

An entity enters into a reinsurance contract held that provides proportional cover for a portfolio of underlying property and casualty contracts on a claims incurred basis over the contract period of 3 years. The reinsurance contract is a claims incurred quota share and will cover 100% of each claim from the underlying insurance contracts in return for a proportionate share of the premiums.

- Underlying contracts incept at the start of each year and have a coverage period of 2 years. The underlying contracts are reasonably homogenous and provide relatively even cover over their two year coverage periods. It is assumed that the 2 sets of underlying contracts form 2 separate groups as defined in paragraph 16 of IFRS 17.
- The expected cash flows on the underlying contracts and reinsurance contract held are as follows:

	t0	t1	t2	t3
Underlying contracts 1				
Premiums received	100			
Expected claims		50	50	
Underlying contracts 2				
Premiums received		100		
Expected claims			50	50
Reinsurance held				
Premiums paid	100	100		
Expected recoveries		50	100	50

- Claims and corresponding reinsurance recoveries are assumed to be paid when incurred.
- Premiums on the underlying contracts are received in advance at the start of each annual period (being the start of coverage of those contracts).
- Risk adjustment is assumed to be 10% of claims
- Payment patterns of reinsurance premiums match the pattern of premium receipts on the underlying contracts issued (i.e. CU100 paid at the start of each year for 2 years)

B.1.2 Applying paragraph 23 of IFRS 17, the entity establishes a group comprising a single reinsurance contract held. The coverage period of the reinsurance contract held is the contract period of 3 years.

B.1.3 Assuming all events occur as expected and the entity does not change any assumptions related to future periods, the measurement of the underlying contracts issued and the reinsurance contract held applying the requirements of IFRS 17 is as follows:

General model: Balance sheet

	t0	t1	t2	t3
Underlying contracts - Asset/(Liability) for remaining coverage b/f	-	(110)	(165)	(55)
Contracts initially recognised in the period				
Loss component on initial recognition	(10)	(10)	-	-
Contractual service margin (CSM)	-	-	-	-
Reduction in LfRC due to claims incurred	-	55	110	55
Premiums received	(100)	(100)	-	-
Underlying contracts - Asset/(Liability) for remaining coverage	**(110)**	**(165)**	**(55)**	**-**
Cash (paid)/received on underlying contracts	**100**	**50**	**(100)**	**(50)**
Reinsurance held – Asset/(Liability) for remaining coverage b/f	-	100	150	50
Contracts initially recognised in the period				
Fulfilment cash flows	20[13]	-		
Contractual service margin (CSM)	(20)	-		
CSM allocation to P&L[14]	-	5	10	5
Reduction in AfRC due to recoveries incurred	-	(55)	(110)	(55)
Ceded premiums paid	100	100	-	-
Reinsurance held – Asset/(Liability) for remaining coverage	**100**	**150**	**50**	**-**
Cash (paid)/received on reinsurance held	**(100)**	**(50)**	**100**	**50**

General model: Profit or loss

	t0	t1	t2	t3
Insurance revenue				
Reduction in LfRC due to claims incurred[15]		(50)	(100)	(50)
Insurance service expenses				
Onerous contract losses	10	10		
Release of onerous contract losses[15]		(5)	(10)	(5)
Claims incurred		50	100	50
(Profit)/Loss on the underlying contracts issued	**10**	**5**	**(10)**	**(5)**
Reinsurance (income)/expenses				
Reinsurance held: CSM allocation to P&L	-	(5)	(10)	(5)
Reduction in AfRC due to recoveries incurred	-	55	110	55
Reinsurance recoveries	-	(50)	(100)	(50)
(Profit)/Loss on the reinsurance contract held	**-**	**-**	**-**	**-**
Net (profit)/loss	**10**	**5**	**(10)**	**(5)**

B.1.4 Applying paragraph 47 of IFRS 17, the expected net loss on the underlying contracts are recognised in the P&L on initial recognition of the group of contracts. In contrast, the net gain on purchasing the reinsurance contract is recognised as a CSM on initial recognition as required by paragraph 65 of IFRS 17. No amounts are recognised in the P&L on initial recognition in respect of the reinsurance contract held. The CSM on the reinsurance held will be allocated to the P&L over the coverage period of the reinsurance contract which is not in line with the timing of recognition of the underlying losses. The impact of this is to recognise losses on initial recognition (t0 and t1) in respect of the underlying contracts and

[13] Applying paragraph 63 of IFRS 17, the entity measures the estimates of the present value of the future cash flows for the reinsurance contract held using assumptions consistent with those used to measure the estimates of the present value of the future cash flows for the group of the underlying insurance contracts. It was clarified in the February 2018 TRG that the boundary of a reinsurance contract held could include cash flows from underlying contracts covered that are expected to be issued in the future. Accordingly, the estimated fulfilment cash flows for that reinsurance contract held on initial recognition should reflect all substantive rights and obligations within the boundary of the contract, including in relation to underlying contracts that have not yet been issued.

[14] CSM is allocated to the P&L on the basis of coverage units (paragraph B119 of IFRS 17). The pattern of coverage units in this example has been based on the number of underlying contracts in-force in each period of the reinsurance contract coverage.

[15] Applying IFRS 17.50(a), subsequent changes in fulfilment cash flows of the LfRC is allocated on a systematic basis between the loss component of the LfRC and non loss component of the LfRC. In this example, the allocation is based on the proportion of 9.1%, calculated on initial recognition as the loss component of CU10 relative to the total estimate of the present value of the future cash outflows plus risk adjustment of CU110 (CU100 + CU10). Amounts allocated to the loss component are presented as reversals/release of onerous losses in insurance service expenses and are excluded from the determination of insurance revenue [IFRS 17.49].

delay profit recognition on the reinsurance held into the later periods (t2 and t3) even though in substance, the transaction as a whole has not resulted in any gain or loss as the loss on the underlying contracts have been fully ceded out to the reinsurer. As explained in paragraph 2.2 above, this ignores the economic relationship between the underlying contracts and the reinsurance contract held.

B.1.5 Proposed solution 1

To the extent the reinsurance held provides coverage over the losses on the underlying contracts, the benefit provided by the reinsurance held should be allowed to be recognised in the P&L to offset the underlying loss so that there is no net effect on profit or loss:

General model: Balance sheet

	t0	t1	t2	t3
[Underlying contracts measurement same as above]				
Underlying contracts - Asset/(Liability) for remaining coverage	**(110)**	**(165)**	**(55)**	**-**
Cash (paid)/received on underlying contracts	**100**	**50**	**(100)**	**(50)**
Reinsurance held – Asset/(Liability) for remaining coverage b/f	-	110	165	55
Contracts initially recognised in the period				
Fulfilment cash flows	20	-	-	-
Contractual service margin (CSM)	(20)	-	-	-
Matching adjustment to reflect the reinsurance benefit in P&L[16]	10	10	-	-
CSM allocation to P&L	-	-	-	-
Reduction in AfRC due to recoveries incurred	-	(55)	(110)	(55)
Ceded premiums paid	100	100	-	-
Reinsurance held – Asset/(Liability) for remaining coverage	**110**	**165**	**55**	**-**
Cash (paid)/received on reinsurance held	**(100)**	**(50)**	**100**	**50**

General model: Profit or loss

	t0	t1	t2	t3
Insurance revenue				
Reduction in LfRC due to claims incurred		(50)	(100)	(50)
Insurance service expenses				
Onerous contract losses	10	10	-	-
Release of onerous contract losses	-	(5)	(10)	(5)
Claims incurred	-	50	100	50
(Profit)/Loss on the underlying contracts issued	**10**	**5**	**(10)**	**(5)**
Reinsurance (income)/expenses				
Matching adjustment to reflect the reinsurance benefit in P&L	(10)	(10)	-	-
Reduction in AfRC due to recoveries incurred	**-**	55	110	55
Reinsurance recoveries	-	(50)	(100)	(50)
(Profit)/Loss on the reinsurance contract held	**(10)**	**(5)**	**10**	**5**
Net (profit)/loss	**-**	**-**	**-**	**-**

[16] To the extent the losses on the underlying contracts are covered by reinsurance held, recognize the reinsurance benefit in P&L instead of CSM.

B.1.6 **Proposed solution 2**

To the extent the reinsurance held provides coverage over the losses on the underlying contracts, the loss on the underlying contracts held should be allowed to be recognised as a negative contractual service margin and released into the P&L at the same time as the reinsurance gain so that there is no net effect on profit or loss:

General model: Balance sheet

	t0	t1	t2	t3
Underlying contracts - Asset/(Liability) for remaining coverage b/f	-	(100)	(150)	(50)
Contracts initially recognised in the period				
Loss component on initial recognition	(10)	(10)	-	-
Establishment of negative contractual service margin (CSM)	10	10	-	-
CSM allocation to P&L	-	(5)	(10)	(5)
Reduction in LfRC due to claims incurred	-	55	110	55
Premiums received	(100)	(100)	-	-
Underlying contracts - Asset/(Liability) for remaining coverage	**(100)**	**(150)**	**(50)**	**0**
Cash (paid)/received on underlying contracts	**100**	**50**	**(100)**	**(50)**
Reinsurance held – Asset/(Liability) for remaining coverage b/f	-	100	150	50
Contracts initially recognised in the period				
Fulfilment cash flows	20	-	-	-
Contractual service margin (CSM)	(20)	-	-	-
CSM allocation to P&L	-	5	10	5
Reduction in AfRC due to recoveries incurred	-	(55)	(110)	(55)
Ceded premiums paid	100	100	-	-
Reinsurance held – Asset/(Liability) for remaining coverage	**100**	**150**	**50**	**0**
Cash (paid)/received on reinsurance held	**(100)**	**(50)**	**100**	**50**

General model: Profit or loss

	t0	t1	t2	t3
Insurance revenue				
Reduction in LfRC due to claims incurred		(55)	(110)	(55)
CSM allocation to P&L		5	10	5
Insurance service expenses				
Claims incurred		50	100	50
(Profit)/Loss on the underlying contracts issued	**-**	**-**	**-**	**-**
Reinsurance (income)/expenses				
Reinsurance held: CSM allocation to P&L	-	(5)	(10)	(5)
Reduction in AfRC due to recoveries incurred	-	55	110	55
Reinsurance recoveries	-	(50)	(100)	(50)
(Profit)/Loss on the reinsurance contract held	**-**	**-**	**-**	**-**
Net (profit)/loss	**-**	**-**	**-**	**-**

Example 2 Proportional reinsurance contract covering a mix of profitable and onerous underlying property and casualty contracts issued at the same time

B.2.1 **Fact pattern and assumptions**

The fact pattern in Example 1 is modified for the following:

- The underlying contracts are all issued in Year 1. The 2 sets of contracts continue to form 2 separate groups as defined in paragraph 16 of IFRS 17.
- Underlying contracts 1 are expected to be profitable on inception.
- The contract period for the reinsurance contract held is 2 years
- The expected cash flows on the underlying contracts and reinsurance contract held are as follows:

	t0	t1	t2
Underlying contracts 1			
Premiums received	200		
Expected claims		50	50
Underlying contracts 2			
Premiums received	100		
Expected claims		50	50
Reinsurance contract held			
Premiums paid	300		
Expected recoveries		100	100

B.2.2 Assuming all events occur as expected and the entity does not change any assumptions related to future periods, the measurement of the underlying contracts issued and the reinsurance contract held applying the requirements of IFRS 17 is as follows:

General model: Balance sheet

	t0	t1	t2
Underlying contracts - Asset/(Liability) for remaining coverage b/f	-	(310)	(155)
Contracts initially recognised in the period			
Non loss component: Fulfilment cash flows on initial recog.	90	-	-
Loss component on initial recognition	(10)	-	-
Contractual service margin (CSM)	(90)	-	-
CSM allocation to P&L	-	45	45
Reduction in LfRC due to claims incurred	-	110	110
Premiums received	(300)	-	-
Underlying contracts - Asset/(Liability) for remaining coverage	**(310)**	**(155)**	**-**
Cash (paid)/received on underlying contracts	**300**	**(100)**	**(100)**
Reinsurance held - Asset/(Liability) for remaining coverage b/f	-	300	150
Contracts initially recognised in the period			
Fulfilment cash flows	(80)	-	-
Contractual service margin (CSM)	80	-	-
CSM allocation to P&L	-	(40)	(40)
Reduction in AfRC due to claims incurred	-	(110)	(110)
Ceded premiums paid	300	-	-
Reinsurance held - Asset/(Liability) for remaining coverage	**300**	**150**	**-**
Cash (paid)/received on reinsurance held	**(300)**	**100**	**100**

General model: Profit or loss

	t0	t1	t2
Insurance revenue			
CSM allocation to P&L	-	(45)	(45)
Reduction in LfRC due to claims incurred[17]	**-**	(105)	(105)

[17] Applying IFRS 17.50(a), subsequent changes in fulfilment cash flows of the LfRC is allocated on a systematic basis between the loss component of the LfRC and non loss component of the LfRC. In this example, the allocation is based on the proportion of 9.1%, calculated on initial recognition as the loss component of CU10 relative to the total estimate of the present value of the future cash outflows plus risk adjustment of CU110 (CU100 + CU10). Amounts

Insurance service expenses			
Onerous contract losses	10	-	-
Release of onerous contract losses[17]	-	(5)	(5)
Claims incurred	-	100	100
(Profit)/Loss on the underlying contracts issued	**10**	**(55)**	**(55)**
Reinsurance (income)/expenses			
Reinsurance held: CSM allocation to P&L	-	40	40
Reduction in AfRC due to recoveries incurred	-	110	110
Reinsurance recoveries	-	(100)	(100)
(Profit)/Loss on the reinsurance contract held	**-**	**50**	**50**
Net (profit)/loss	**10**	**(5)**	**(5)**

B.2.3 As in Example 1 (above), there is a mismatch arising from the different timing of recognition in the P&L of the loss on the underlying contracts and the corresponding gain on the reinsurance contract held.

B.2.4 **Proposed solution 1**

To the extent the reinsurance held provides coverage over the losses on the underlying contracts, the benefit provided by the reinsurance held should be allowed to be recognised in the P&L to offset the underlying loss so that there is no net effect on profit or loss:

General model: Balance sheet

	t0	t1	t2
[Underlying contracts measurement same as above]			
Underlying contracts - Asset/(Liability) for remaining coverage	**(310)**	**(155)**	**-**
Cash (paid)/received on underlying contracts	**300**	**(100)**	**(100)**
Reinsurance held – Asset/(Liability) for remaining coverage b/f	-	310	155
Contracts initially recognised in the period	-	-	-
Fulfilment cash flows	(80)	-	-
Contractual service margin (CSM)	80	-	-
Matching adjustment to reflect the reinsurance benefit in P&L [18]	10	-	-
CSM allocation to P&L	-	(45)	(45)
Reduction in AfRC due to recoveries incurred	-	(110)	(110)
Ceded premiums paid	300	0	0
Reinsurance held – Asset/(Liability) for remaining coverage	**310**	**155**	**0**
Cash (paid)/received on reinsurance held	**(300)**	**100**	**100**

General model: Profit or loss

	t0	t1	t2
Insurance revenue			
CSM allocation to P&L	-	(45)	(45)
Reduction in LfRC due to claims incurred	-	(105)	(105)
Insurance service expenses			
Onerous contract losses	10	-	-
Release of onerous contract losses	-	(5)	(5)
Claims incurred	-	100	100
(Profit)/Loss on the underlying contracts issued	**10**	**(55)**	**(55)**
Reinsurance (income)/expenses			
Matching adjustment to reflect the reinsurance benefit in P&L	(10)	-	-
Reinsurance held: CSM allocation to P&L	-	45	45
Reduction in AfRC due to recoveries incurred	-	110	110
Reinsurance recoveries	-	(100)	(100)
(Profit)/Loss on the reinsurance contract held	**(10)**	**55**	**55**

allocated to the loss component are presented as reversals/release of onerous losses in insurance service expenses and are excluded from the determination of insurance revenue [IFRS 17.49].

[18] To the extent the losses on the underlying contracts are covered by reinsurance held, recognize the reinsurance benefit in P&L instead of CSM.

Net (profit)/loss	**0**	**0**	**0**

B.2.5 Proposed solution 2

To the extent the reinsurance held provides coverage over the losses on the underlying contracts, the loss on the underlying contracts held should be allowed to be recognised as a negative contractual service margin and released into the P&L at the same time as the reinsurance gain so that there is no net effect on profit or loss:

General model: Balance sheet

	t0	t1	t2
Underlying contracts - Asset/(Liability) for remaining coverage b/f	-	(300)	(150)
Contracts initially recognised in the period			
Non loss component: Fulfilment cash flows on initial recog.	90	0	-
Loss component on initial recognition	(10)	0	0
Contractual service margin (CSM)	(80)		
CSM allocation to P&L	-	40	40
Reduction in LfRC due to claims incurred	0	110	110
Premiums received	(300)	0	0
Underlying contracts - Asset/(Liability) for remaining coverage	**(300)**	**(150)**	**0**
Cash (paid)/received on underlying contracts	**300**	**(100)**	**(100)**
Reinsurance held - Asset/(Liability) for remaining coverage b/f	-	300	150
Contracts initially recognised in the period			
Fulfilment cash flows	(80)	-	
Contractual service margin (CSM)	80	-	
CSM allocation to P&L	-	(40)	(40)
Reduction in AfRC due to claims incurred	-	(110)	(110)
Ceded premiums paid	300	0	0
Reinsurance held - Asset/(Liability) for remaining coverage	**300**	**150**	**0**
Cash (paid)/received on reinsurance held	**(300)**	**100**	**100**

General model: Profit or loss

	t0	t1	t2
Insurance revenue			
CSM allocation to P&L	-	(40)	(40)
Reduction in LfRC due to claims incurred	**-**	(110)	(110)
Insurance service expenses			
Claims incurred	-	100	100
(Profit)/Loss on the underlying contracts issued	**0**	**(50)**	**(50)**
Reinsurance (income)/expenses			
Reinsurance held: CSM allocation to P&L	-	40	40
Reduction in AfRC due to recoveries incurred	**-**	110	110
Reinsurance recoveries	-	(100)	(100)
(Profit)/Loss on the reinsurance contract held	**0**	**50**	**50**
Net (profit)/loss	**0**	**0**	**0**

Example B.3 – Proportional reinsurance contract covering a mix of profitable and onerous underlying property and casualty contracts issued in separate periods

In this example, the facts have been modified so that one set of underlying contracts is expected to be onerous. We have illustrated two different scenarios below:

(1) Example 3A: where the underlying contracts are expected to be onerous at initial recognition of the reinsurance held;
(2) Example 3B: where the underlying contracts are expected to be profitable at initial recognition of the reinsurance held but is subsequently expected to be onerous due to unfavourable changes which result in the entity changing its estimates of fulfilment cash flows relating to future service.

The purpose of this example is to illustrate the different outcomes when applying the current IFRS 17 requirements to the two scenarios due to the subsequent measurement requirement in paragraph 66(c)(ii) of IFRS 17 to reflect in the P&L (instead of the CSM) any change in the reinsurance fulfilment cash flows subsequent to initial recognition which result from changes in the underlying fulfilment cash flows that do not adjust the CSM for the group of underlying contracts. Applying the proposed solution to Example 3A would result in the same outcomes in both scenarios.

Example 3A   On initial recognition of the reinsurance contract, some underlying contracts are expected to be onerous

B.3.1 **Fact pattern and assumptions**

The fact pattern in Example 1 is modified for the following:

- The underlying contracts issued in Year 1 are expected to be profitable on inception. The expected cash flows on the underlying contracts and reinsurance contract held are as follows:

	t0	t1	t2	t3
Underlying contracts 1				
Premiums received	200			
Expected claims		50	50	
Underlying contracts 2				
Premiums received		200		
Expected claims			100	100
Reinsurance contract held				
Premiums paid	200	200		
Expected recoveries		50	150	100

B.3.2 Assuming all events occur as expected and the entity does not change any assumptions related to future periods, the measurement of the underlying contracts issued and the reinsurance contract held applying the requirements of IFRS 17 is as follows:

General model: Balance sheet

	t0	t1	t2	t3
Underlying contracts - Asset/(Liability) for remaining coverage b/f	-	(200)	(320)	(110)
Contracts initially recognised in the period				
Non loss component: Fulfilment cash flows on initial recog.	90	-	-	-
Loss component on initial recognition	-	(20)	-	-
Contractual service margin (CSM)	(90)	-	-	-
CSM allocation to P&L	-	45	45	-
Reduction in LfRC due to claims incurred	-	55	165	110
Premiums received	(200)	(200)	-	-
Underlying contracts - Asset/(Liability) for remaining coverage	**(200)**	**(320)**	**(110)**	**-**
Cash (paid)/received on underlying contracts	**200**	**150**	**(150)**	**(100)**
Reinsurance held - Asset/(Liability) for remaining coverage b/f	-	200	328	128
Contracts initially recognised in the period				

Fulfilment cash flows	(70)	-	-	-
Contractual service margin (CSM)	70	-	-	-
CSM allocation to P&L[19]	-	(18)	(35)	(18)
Reduction in AfRC due to recoveries incurred	-	(55)	(165)	(110)
Ceded premiums paid	200	200	-	-
Reinsurance held - Asset/(Liability) for remaining coverage	**200**	**328**	**128**	**-**
Cash (paid)/received on reinsurance held	**(200)**	**(150)**	**150**	**100**

General model: Profit or loss

	t0	t1	t2	t3
Insurance revenue				
CSM allocation to P&L	-	(45)	(45)	-
Reduction in LfRC due to claims incurred[20]	-	(55)	(155)	(100)
Insurance service expenses				
Onerous contract losses	-	20	-	-
Release of onerous contract losses[20]	-	-	(10)	(10)
Claims incurred		50	150	100
(Profit)/Loss on the underlying contracts issued	**-**	**(30)**	**(60)**	**(10)**
Reinsurance (income)/expenses				
Reinsurance held: CSM allocation to P&L	-	18	35	18
Reduction in AfRC due to recoveries incurred	-	55	165	110
Reinsurance recoveries	-	(50)	(150)	(100)
(Profit)/Loss on the reinsurance contract held	**-**	**23**	**50**	**28**
Net (profit)/loss	**-**	**(8)**	**(10)**	**18**

B.3.3 In this example, the accounting mismatch in the P&L between the underlying contracts issued and the reinsurance contract held is caused by:

(1) the different timing of recognition in the P&L of the loss on the underlying contracts and the corresponding gain on the reinsurance contract held;

(2) the allocation of the CSM on reinsurance held to the P&L over the reinsurance coverage period of 3 years whilst the CSM on the profitable underlying contract is allocated to the P&L over the underlying contract coverage of 2 years.

B.3.4 **Proposed solution 1**

To the extent the reinsurance held provides coverage over the losses on the underlying contracts, the benefit provided by the reinsurance held should be allowed to be recognised in the P&L to offset the underlying loss so that there is no net effect on profit or loss:

General model: Balance sheet

	t0	t1	t2	t3
[Underlying contracts measurement same as above]				
Underlying contracts - Asset/(Liability) for remaining coverage	**(200)**	**(320)**	**(110)**	**-**
Cash (paid)/received on underlying contracts	**200**	**150**	**(150)**	**(100)**
Reinsurance held - Asset/(Liability) for remaining coverage b/f	-	200	343	133
Contracts initially recognised in the period				
Fulfilment cash flows	(70)	-	-	-

[19] CSM is allocated to the P&L on the basis of coverage units (paragraph B119 of IFRS 17). The pattern of coverage units in this example has been based on the number of underlying contracts in-force in each period of the reinsurance contract coverage.

[20] Applying IFRS 17.50(a), subsequent changes in fulfilment cash flows of the LfRC is allocated on a systematic basis between the loss component of the LfRC and non loss component of the LfRC. In this example, the allocation is based on the proportion of 9.1%, calculated on initial recognition as the loss component of CU20 relative to the total estimate of the present value of the future cash outflows plus risk adjustment of CU220 (CU200 + CU20). Amounts allocated to the loss component are presented as reversals/release of onerous losses in insurance service expenses and are excluded from the determination of insurance revenue [IFRS 17.49].

Contractual service margin (CSM)	70	-	-	-
Matching adjustment to reflect the reinsurance benefit in P&L [21]	-	20	-	-
CSM allocation to P&L	-	(23)	(45)	(23)
Reduction in AfRC due to recoveries incurred	-	(55)	(165)	(110)
Ceded premiums paid	200	200	-	-
Reinsurance held - Asset/(Liability) for remaining coverage	**200**	**343**	**133**	**-**
Cash (paid)/received on reinsurance held	**(200)**	**(150)**	**150**	**100**

General model: Profit or loss

	t0	t1	t2	t3
Insurance revenue				
CSM allocation to P&L	-	(45)	(45)	-
Reduction in LfRC due to claims incurred	-	(55)	(155)	(100)
Insurance service expenses				
Onerous contract losses	-	20	-	-
Release of onerous contract losses	-	-	(10)	(10)
Claims incurred	-	50	150	100
(Profit)/Loss on the underlying contracts issued	**-**	**(30)**	**(60)**	**(10)**
Reinsurance (income)/expenses				
Matching adjustment to reflect the reinsurance benefit in P&L	-	(20)	-	-
Reinsurance held: CSM allocation to P&L	-	23	45	23
Reduction in AfRC due to recoveries incurred	-	55	165	110
Reinsurance recoveries	-	(50)	(150)	(100)
(Profit)/Loss on the reinsurance contract held	**-**	**8**	**60**	**33**
Net (profit)/loss	**-**	**(23)**	**-**	**23**

The remaining mismatch (net effect on profit/loss) is due to the allocation of the CSM on reinsurance held to the P&L over the reinsurance coverage period of 3 years whilst the CSM on the profitable underlying contract is allocated to the P&L over the underlying contract coverage of 2 years.

B.3.5 Proposed solution 2

To the extent the reinsurance held provides coverage over the losses on the underlying contracts, the loss on the underlying contracts held should be allowed to be recognised as a negative contractual service margin and released into the P&L at the same time as the reinsurance gain so that there is no net effect on profit or loss:

General model: Balance sheet

	t0	t1	t2	t3
Underlying contracts - Asset/(Liability) for remaining coverage b/f	-	(200)	(300)	(100)
Contracts initially recognised in the period				
Non loss component: Fulfilment cash flows on initial recog.	90	-	-	-
Loss component on initial recognition	-	(20)	-	-
Contractual service margin (CSM)	(90)	20	-	-
CSM allocation to P&L	-	45	35	(10)
Reduction in LfRC due to claims incurred	-	55	165	110
Premiums received	(200)	(200)	-	-
Underlying contracts - Asset/(Liability) for remaining coverage	**(200)**	**(300)**	**(100)**	**0**
Cash (paid)/received on underlying contracts	**200**	**150**	**(150)**	**(100)**
Reinsurance held - Asset/(Liability) for remaining coverage b/f	-	200	327	127
Contracts initially recognised in the period				
Fulfilment cash flows	(70)	-	-	-
Contractual service margin (CSM)	70	-	-	-
CSM allocation to P&L	-	(18)	(35)	(18)

[21] To the extent the losses on the underlying contracts are covered by reinsurance held, recognize the reinsurance benefit in P&L instead of CSM.

Reduction in AfRC due to recoveries incurred	-	(55)	(165)	(110)
Ceded premiums paid	200	200	-	-
Reinsurance held - Asset/(Liability) for remaining coverage	**200**	**327**	**127**	**-**
Cash (paid)/received on reinsurance held	**(200)**	**(150)**	**150**	**100**

General model: Profit or loss

	t0	t1	t2	t3
Insurance revenue				
CSM allocation to P&L	-	(45)	(35)	10
Reduction in LfRC due to claims incurred	-	(55)	(165)	(110)
Insurance service expenses				
Onerous contract losses	-	-	-	-
Release of onerous contract losses	-	-	-	-
Claims incurred		50	150	100
(Profit)/Loss on the underlying contracts issued	**-**	**(50)**	**(50)**	**0**
Reinsurance (income)/expenses				
Reinsurance held: CSM allocation to P&L	-	18	35	18
Reduction in AfRC due to recoveries incurred	-	55	165	110
Reinsurance recoveries	-	(50)	(150)	(100)
(Profit)/Loss on the reinsurance contract held	**-**	**23**	**50**	**28**
Net (profit)/loss	**-**	**(28)**	**0**	**28**

Example 3B All underlying contracts are expected to be profitable on initial recognition of the reinsurance contract, but subsequent changes in expectations of future cash flows result in some underlying contracts expected to be onerous

B.3.6 **Fact pattern and assumptions**

The fact pattern in the above example is modified for the following:

- All the underlying contracts are expected to be profitable on initial recognition. The expected cash flows on the underlying contracts and reinsurance contract held at t0 are as follows:

	t0	t1	t2	t3
Underlying contracts 1				
Premiums received	200			
Expected claims		50	50	
Underlying contracts 2				
Premiums received		200		
Expected claims			50	50
Reinsurance contract held				
Premiums paid	200	200		
Expected recoveries		50	100	50

- At the end of Year 1, the entity revises its estimates of fulfilment cash flows relating to future service resulting in the following expected cash flows for Underlying contracts 2 in Years 2 and 3 (no change expected to Underlying contracts 1):

	t0	t1	t2	t3
Underlying contracts 2				
Expected claims			100	100

B.3.7 *Measurement on initial recognition*

At t0, a CSM is established for the expected net gain on Underlying contracts 1. No amounts are recognised in respect of Underlying contracts 2 at t0 as they have not yet been issued. Applying paragraph 65(a) of IFRS 17, a CSM is established for the expected net cost on the reinsurance contracts held, reflecting all expected future cash flows including in respect of underlying contracts not yet written as clarified in the February 2018 TRG. Expected fulfilment cash flows (and the corresponding CSM) under the reinsurance contract held would therefore, reflect the expected net cost in respect of Underlying contracts 2 on initial recognition of the reinsurance contract.

Subsequent measurement

At t1, Underlying contracts 2 are expected to be onerous due to unfavourable changes which result in a revision to the entity's estimates of fulfilment cash flows relating to future service in relation to those contracts. The expected loss of CU20 is recognised immediately in the P&L and a loss component of the LfRC is established in the balance sheet.

The fulfilment cash flows of the reinsurance contract held is decreased by the change in the expectation of fulfilment cash flows of Underlying contracts 2 (increase in expected recoveries of CU110). Applying paragraph 66(c)(ii), the entity does not adjust the CSM on the reinsurance held for changes in the fulfilment cash flows that result from changes in the underlying contracts that does not adjust the CSM of the underlying contracts. Consequently, CU20 is recognised as reinsurance income in the P&L to offset the loss recognised in respect of Underlying contract 2. The entity adjusts the CSM on the reinsurance held for the remaining change in fulfilment cash flows of CU90.

The measurement of the underlying contracts issued and the reinsurance contract held for all periods applying the requirements of IFRS 17 is as follows:

General model: Balance sheet

	t0	t1	t2	t3
Underlying contracts - Asset/(Liability) for remaining coverage b/f		(200)	(320)	(110)
Contracts initially recognised in the period				
Non loss component: Fulfilment cash flows on initial recog.	90	-	-	-
Loss component on initial recognition	-	(20)	-	-
Contractual service margin (CSM)	(90)	-	-	-
CSM allocation to P&L	-	45	45	-
Reduction in LfRC due to claims incurred		55	165	110
Premiums received	(200)	(200)	-	-
Underlying contracts - Asset/(Liability) for remaining coverage	**(200)**	**(320)**	**(110)**	**-**
Cash (paid)/received on underlying contracts	**(200)**	**(250)**	**(100)**	**(50)**
Reinsurance held - Asset/(Liability) for remaining coverage b/f		200	343	133
Contracts initially recognised in the period				
Fulfilment cash flows	(180)	-	-	-
Contractual service margin (CSM)	180	-	-	-
Revise estimates of fulfilment cash flows	-	110	-	-
Adjust CSM	-	(90)	-	-
CSM allocation to P&L[22]	-	(23)	(45)	(23)
Reduction in AfRC due to recoveries incurred	-	(55)	(165)	(110)
Ceded premiums paid	200	200	-	-
Reinsurance held - Asset/(Liability) for remaining coverage	**200**	**343**	**133**	**-**
Cash (paid)/received on reinsurance held	**(200)**	**(150)**	**150**	**100**

General model: Profit or loss

	t0	t1	t2	t3
Insurance revenue				
CSM allocation to P&L	-	(45)	(45)	-

[22] CSM is allocated to the P&L on the basis of coverage units (paragraph B119 of IFRS 17). The pattern of coverage units in this example has been based on the number of underlying contracts in-force in each period of the reinsurance contract coverage.

Reduction in LfRC due to claims incurred[23]	-	(55)	(155)	(100)
Insurance service expenses				
Onerous contract losses	-	20	-	-
Release of onerous contract losses[23]	-	-	(10)	(10)
Claims incurred	-	50	150	100
(Profit)/Loss on the underlying contracts issued	**-**	**(30)**	**(60)**	**(10)**
Reinsurance (income)/expenses				
Recognition of changes in FCF in P&L	-	(20)	-	-
Reinsurance held: CSM allocation to P&L	-	23	45	23
Reduction in AfRC due to recoveries incurred	-	55	165	110
Reinsurance recoveries	-	(50)	(150)	(100)
(Profit)/Loss on the reinsurance contract held	**-**	**8**	**60**	**33**
Net (profit)/loss	**-**	**(23)**	**-**	**23**

Observations on Examples 3A and 3B

B.3.8 Applying the current IFRS 17 requirements will result in different profit profiles based on when the entity expects the underlying contracts to be onerous, whether from initial recognition of the reinsurance contract or subsequently:

General model: profit or loss (extracts)

Example 3A – underlying contracts are expected to be onerous at initial recognition of the reinsurance held	**t0**	**t1**	**t2**	**t3**
(Profit)/Loss on the underlying contracts issued	-	(30)	(60)	(10)
(Profit)/Loss on the reinsurance contract held	-	23	50	28
Net (profit)/loss	**-**	**(8)**	**(10)**	**18**

Example 3B – underlying contracts are expected to be onerous subsequent to initial recognition of the reinsurance held	**t0**	**t1**	**t2**	**t3**
(Profit)/Loss on the underlying contracts issued	-	(30)	(60)	(10)
(Profit)/Loss on the reinsurance contract held	-	8	60	33
Net (profit)/loss	**-**	**(23)**	**-**	**23**

It would be inappropriate to reflect different outcomes for two scenarios that are identical except for the timing of the expectation of the underlying contracts becoming onerous, as the timing of the expectation does not change the nature and timing of the rights, obligations and service being provided under the reinsurance contracts.

[23] Applying IFRS 17.50(a), subsequent changes in fulfilment cash flows of the LfRC is allocated on a systematic basis between the loss component of the LfRC and non loss component of the LfRC. In this example, the allocation is based on the proportion of 9.1%, calculated on initial recognition as the loss component of CU20 relative to the total estimate of the present value of the future cash outflows plus risk adjustment of CU220 (CU200 + CU20). Amounts allocated to the loss component are presented as reversals/release of onerous losses in insurance service expenses and are excluded from the determination of insurance revenue [IFRS 17.49].

Appendix C – Relevant IFRS 17 requirements

IFRS 17.65 (a) the entity shall recognise any net cost or net gain on purchasing the group of reinsurance contracts held as a contractual service margin measured at an amount equal to the sum of the fulfilment cash flows, the amount derecognised at that date of any asset or liability previously recognised for cash flows related to the group of reinsurance contracts held, and any cash flows arising at that date

IFRS 17.66(c) …an entity shall measure the contractual service margin at the end of the reporting period for a group of reinsurance contracts held as the carrying amount determined at the start of the reporting period, adjusted for:

(a)-(b) …
(c) changes in the fulfilment cash flows to the extent that the change:
  (i) relates to future service; unless
  (ii) the change results from a change in fulfilment cash flows allocated to a group of underlying insurance contracts that does not adjust the contractual service margin for the group of underlying insurance contracts.

IFRS 17.BC310 …The Board considered whether the contractual service margin of the group of reinsurance contract held could be a credit if, as happens in rare cases, the amount paid by the entity is less than the expected present value of cash flows plus the risk adjustment for non-financial risk. Such a credit contractual service margin would represent a net gain on purchasing reinsurance. The most likely causes of such a net gain would be either of the following:
(a) an overstatement of the underlying insurance contract(s). An entity would evaluate this by reviewing the measurement of the underlying insurance contract(s).
(b) favourable pricing by the reinsurer; for example, as a result of diversification benefits that are not available to the entity.

IFRS 17.BC311 The Board originally proposed that entities should recognise a gain when such a negative difference arose. The Board proposed this for symmetry with the model for the underlying group of insurance contracts and for consistency with the Board's conclusion that the contractual service margin for the underlying group of insurance contracts cannot be negative. However, IFRS 17 requires entities to instead recognise the negative difference over the coverage period of the group of reinsurance contracts held. The Board was persuaded by the view that the apparent gain at initial recognition represents a reduction in the cost of purchasing reinsurance, and that it would be appropriate for an entity to recognise that reduction in cost over the coverage period as services are received.

IFRS 17.BC315 The Board considered the situation that arises when the underlying group of insurance contracts becomes onerous after initial recognition because of adverse changes in estimates of fulfilment cash flows relating to future service. In such a situation, the entity recognises a loss on the group of underlying insurance contracts. The Board concluded that corresponding changes in cash inflows from a group of reinsurance contracts held should not adjust the contractual service margin of the group of reinsurance contracts held, with the result that the entity recognises no net effect of the loss and gain in the profit or loss for the period. This means that, to the extent that the change in the fulfilment cash flows of the group of underlying contracts is matched with a change in fulfilment cash flows on the group of reinsurance contracts held, there is no net effect on profit or loss.

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