Australian Government
Australian Accounting Standards Board

AASB Transition Resource Group for AASB 17 *Insurance Contracts*

Submission form for potential implementation question

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Do you wish to present to the TRG?	Yes

Potential implementation question

Whether a cash flow settlement arrangement in an insurance contract is a relevant fact for determining the presentation of insurance revenue and insurance service expenses in the profit or loss statement?

Paragraph of IFRS 17 *Insurance Contracts*

Various, including, in particular, AASB 17 paragraphs 83, 86 and B120

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.

Please refer to Appendix A

Is the question pervasive?

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

A net settlement arrangement (i.e. when parties to an insurance or reinsurance contract exchange net payments at the end of, or during, the coverage period , as opposed to gross payments of premiums and claims) is often present for insurance and reinsurance contracts and therefore, the issue described is likely to impact many insurers. This paper was discussed at the AALC on 2 June 2021. The topic discussed was considered to be of broader interest to insurers outside of the AALC and therefore it was agreed the paper should be tabled at the AASB TRG for discussion.

Appendix A

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

Background

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

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

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

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

Consider the following example of a profit commission arrangement:

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

This reinsurance contract has the following cash flows that are settled net at the end of the Agreement Year:

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

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

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

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

Question

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

View 1 – Insurance Revenue = CU160; Insurance Service Expense = nil; (Net = CU160)

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

Where the entity expects to receive a positive amount of cash (the amount determined from the notional premiums, claims and reinsurance commission outlined above) at the end of the arrangement, that amount should be recorded as insurance revenue – in this case, CU160. As there is no outgoing payment made, claims are considered to be nil and so insurance service expense recorded is nil. Additional costs that may have been incurred to administer the arrangement are ignored for simplicity purposes.

Supporters of this view note that as a result of the net settlement terms, the reinsurer does not receive gross settlement of CU1,000 or CU800 = 1000 - 200 in cash. It only receives a payment of CU160, i.e. it is not entitled to 1,000, and the amount paid to the entity is 160. IFRS 17:83 and B120 require that insurance revenue reflect the amount of consideration to which an entity expects to be entitled (the amount of premiums paid to the entity) and so the revenue recorded must align to the amount of cash expected to be received.

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

View 2 – Insurance Revenue = CU800; Insurance Service Expense = CU640; (Net = CU160)

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

Proponents of this view consider that the mechanism by which consideration is settled should not affect the amount to record as revenue (other than because of the effect of financing, which is disregarded in this example). The amount to record as revenue should reflect the value of the service rendered by the entity in standing-ready to settle claims, in accordance with the underlying premium amount specified in the contract prior to netting of claims amounts. The value of that service is independent from the actual amount of claims ultimately incurred.

Proponents of this view consider that the wording of B120 is not intended to limit the interpretation of “consideration” and “premiums paid” to mean only amounts of cash received by the entity, but rather extends to other forms of consideration such as payments-in-kind. In this scenario, the forfeiture (as a result of net settlement) by the insured party/cedant of the amounts of cash they would have otherwise been entitled to receive had a gross-settlement mechanism been agreed upon, represents a payment-in-kind.

With regards to the impact of the profit commission term - in the context of reinsurance contracts held, IFRS 17:86 states that cash flows that are contingent on claims, should be treated as claims; amounts not contingent on claims should be treated as adjusting the premiums for the reinsurance held. September 2018 TRG AP3 concluded that the same holds true for insurance and reinsurance contracts issued.

Given the above, the amount of non-receipt of premium that varies because of the amount of claims, is in itself an amount of claims. The amount that does not vary is because it relates to service, and so is premiums, even if settled net. Provided that CU 200 is also not received on cancellation, the entity never receives CU200, so that amount does not vary with level of claims. Accordingly, applying IFRS 17:86, the amount of CU1,000 premium is adjusted by that amount to determine revenue of CU800. Of the claims of CU800, CU 200 is a policy excess and is never paid, whereas the amount of commission of CU40 is contingent on the level of claims, so adjusts the claim amount increasing it. Accordingly, claims are CU640=800-200+40. This can be expressed in this example by a formula: claims expense=amount of claims-excess of CU200+commission amount.

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

In response to the potential risks highlighted in View 1, around revenue and expenses being judgemental or open to manipulation – proponents of this view note that in an arms-length, commercially rational transaction, the insured party/cedant would not agree to inflating the underlying level of premiums (and correspondingly greater underlying amount due in the event of no claim), as this exposes them to unnecessary risk. Accordingly, the underlying premium amount not contingent on claims set in the contract would be on-market / commercially realistic amounts for the service.

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

Background

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

Consider the following example of a profit commission arrangement: at the end of each Agreement Year (e.g. 31 March of each year), the cedant calculates the balance between "premium due" and "claims payable". In the event that premiums due from the cedant exceed the claims payable to the cedant from the reinsurance contract, the reinsurer shall pay a profit commission based on a sliding scale percentage. However, if the claims payable exceed the premiums due, no profit commission is payable for that particular Agreement year.

This reinsurance contract has the following cash flows that are settled net at the end of the Agreement Year:

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

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

A. Net settlement terms: cedant settles all contractual components (notional premium, claims and reinsurance commission based on actual amounts from the underlying contracts) on a net basis at the end of each Agreement year/reporting period. In this case, the reinsurer will receive CU 160 from the cedant. This view is based on the only actual cash flows from the contract; or

B. Gross settlement terms: the reinsurer receives the premium, settles the claims payable and settles the profit commission separately at the end of each Agreement year. Note that if the reinsurer were to receive an amount of stated premium of CU1,000 before paying back claims and profit commission, CU200 of these amounts would be an non-distinct investment component (NDIC), provided such an amount would also be repayable on cancellation. This is because if the claims are nil, profit commission is CU 200 = (1,000-0)*20%. If CU 200 is also always repayable on termination, the amount is always repayable, meeting the definition of NDIC. Accordingly, it would be excluded from reinsurance service expense amount.

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

Alternative scenarios that could be expected at initial recognition							
Notional claims incurred	0	-200	-600	-800	-1000	-1200	-2000
Notional premium payable	1000	1000	1000	1000	1000	1000	1000
Notional commission receivable	-200	-160	-80	-40	0	0	0
Net cash payable/(receivable)	**800**	**640**	**320**	**160**	**0**	**-200**	**-1000**

Notional amounts are derived from the cedant's underlying reinsured contracts.

Question

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

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

IFRS 17:86(a-b) states that:
"An entity may present the income or expenses from a group of reinsurance contracts held (see paragraphs 60–70A), other than insurance finance income or expenses, as a single amount; or the entity may present separately the amounts recovered from the reinsurer and an allocation of the premiums paid that together give a net amount equal to that single amount. If an entity presents separately the amounts recovered from the reinsurer and an allocation of the premiums paid, it shall:

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

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

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

Supporters of this view argue that the cedant does not have positive claim recoveries until the level of notional claims exceeds CU1,000, and presenting imputed amounts (as in view B) is inconsistent with the economic substance of the contract. Additionally, when the notional claims incurred are lower than CU1,000, the cost of reinsurance to the cedant varies with the level of claims, and the net presentation reflects that.

View 2 – Cost of reinsurance = CU800; Reinsurance recoveries = CU640; (Net reinsurance service expense = CU160)

The cost of reinsurance is CU800, as opposed to the policy-stated notional premium of CU 1,000 because the cedant will never pay CU200 of the CU1,000 notional premium and this amount is not contingent on claims. Accordingly, applying IFRS 17:86(b) this amount is an adjustment to premium, decreasing cost of reinsurance. This is because if notional claims (claims on underlying reinsured contracts) are nil, the commission payable is 200 = 20% * (1,000-0), meaning that cedant pays CU800. If claims are a positive amount, the net amount paid to the reinsurer is even smaller, by the amount of claims e.g. if claims are 200, the profit commission is 160 = 20% * (1,000-200), so cedant pays net CU640 = (1,000-160-200).

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

With regards to the impact of the profit commission, in the context of reinsurance contracts held, IFRS 17:86(a) states that cash flows that are contingent on claims, should be treated as claims; amounts not contingent on claims should be treated as adjusting the premiums for the reinsurance held. September 2018 TRG AP3 concluded that the same holds true for insurance and reinsurance contracts issued.

Given the above, the amount of reduction in the cost of reinsurance premium that varies because of the amount of claims, is in itself an amount of claim recoveries. The amount that does not vary is because it relates to service, and so is reduction in the cost of reinsurance premiums, even if settled net. Provided that CU 200 is also not payable on cancellation, the cedant never pays CU200, so that amount does not vary with level of claims. Accordingly, applying IFRS 17:86, the amount of CU1,000 premium is adjusted by that amount to determine cost of reinsurance of CU800. When the cedant incurs actual claims of CU800 from the underlying reinsured contracts, CU 200 operates as policy excess and is never recovered, whereas the amount of profit commission of CU40 is contingent on the level of claims and it adjusts the claim recovery amount by increasing it. Given the above, claim recoveries are CU640 = (800 – 200 + 40). This can be expressed in this example by a formula: notional claims recoveries = amount of notional claims incurred - excess of CU200 + notional commission amount.

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

Alternative scenarios at the end of the coverage period (actual claim amounts on reinsured contracts)							
Notional Claims Recoveries	0	-200	-600	-800	-1000	-1200	-2000
Notional Premium Payable	1000	1000	1000	1000	1000	1000	1000
Notional Profit Commission Receivable	-200	-160	-80	-40	0	0	0
Net cash	**800**	**640**	**320**	**160**	**0**	**-200**	**-1000**
Reinsurance cost	800	800	800	800	800	800	800
Reinsurance recoveries	0	-160	-480	-640	-800	-1000	-1800
Net reinsurance cost/recovery	**800**	**640**	**320**	**160**	**0**	**-200**	**-1000**

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

In response to the potential risks highlighted in View 1, around revenue and expenses being judgemental or open to manipulation – supporters of this view note that in an arms-length transaction, the cedant would not agree to inflating the underlying level of notional premiums (and correspondingly greater amount due in the event of no claims un underlying reinsured contracts) as this exposes them to unnecessary risk. Accordingly, the notional premium amount not contingent on claims set in the contract would be a commercially realistic amount for the service.

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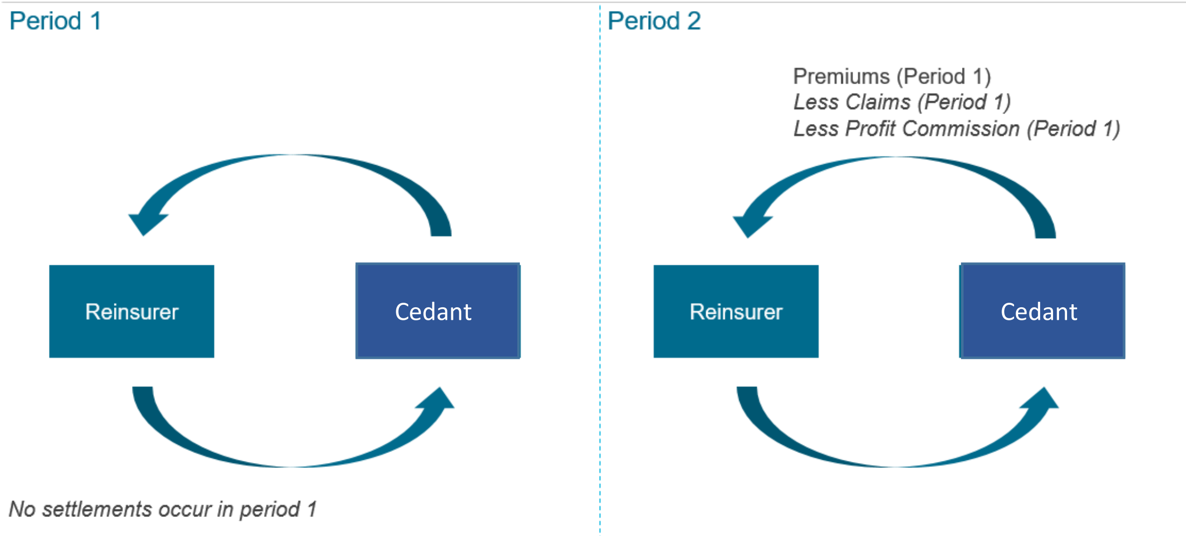
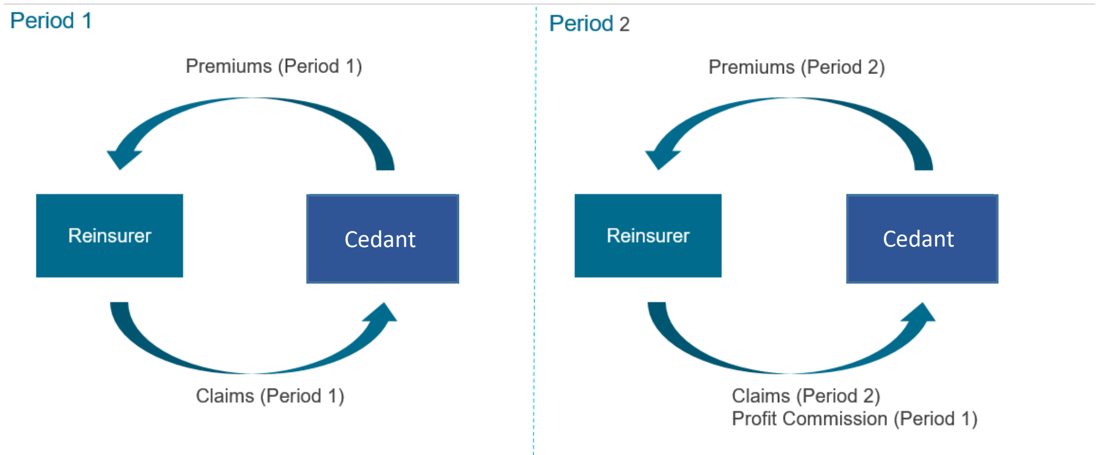
Appendix I Illustrative presentation of the settlement patterns under the two basis

A. Net Settlement basis



B. Gross settlement basis



Technical References

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

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

trg-for-ifrs17-meeting-summary.pdf

ap03.pdf

IFRS 17

IFRS 17:83
An entity shall present in profit or loss insurance revenue arising from the groups of insurance contracts issued. Insurance revenue shall depict the provision of services arising from the group of insurance contracts at an amount that reflects the consideration to which the entity expects to be entitled in exchange for those services. Paragraphs B120–B127 specify how an entity measures insurance revenue.

IFRS 17:86
An entity may present the income or expenses from a group of reinsurance contracts held (see paragraphs 60–70A), other than insurance finance income or expenses, as a single amount; or the entity may present separately the amounts recovered from the reinsurer and an allocation of the premiums paid that together give a net amount equal to that single amount. If an entity presents separately the amounts recovered from the reinsurer and an allocation of the premiums paid, it shall:

(a) treat reinsurance cash flows that are contingent on claims on the underlying contracts as part of the claims that are expected to be reimbursed under the reinsurance contract held;
(b) treat amounts from the reinsurer that it expects to receive that are not contingent on claims of the underlying contracts (for example, some types of ceding commissions) as a reduction in the premiums to be paid to the reinsurer;
(ba) treat amounts recognised relating to recovery of losses applying paragraphs 66(c)(i)–(ii) and 66A–66B as amounts recovered from the reinsurer; and
(c) not present the allocation of premiums paid as a reduction in revenue.

IFRS 17:B120
The total insurance revenue for a group of insurance contracts is the consideration for the contracts, ie the amount of premiums paid to the entity:

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