

## **Draft Educational Note**

# **IFRS 17 – Actuarial Considerations Related to P&C Reinsurance Contracts Issued and Held**

## **Committee on Property and Casualty Insurance Financial Reporting**

**April 2020**

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## MEMORANDUM

**To:** Members in the property and casualty insurance area

**From:** Steven W. Easson, Chair  
Actuarial Guidance Council  
  
Houston Cheng, Chair  
Committee on Property and Casualty Insurance Financial Reporting

**Date:** April 22, 2020

**Subject:** **Draft Educational Note: IFRS 17 – Actuarial Considerations Related to P&C Reinsurance Contracts Issued and Held**

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The Committee on Property and Casualty Insurance Financial Reporting (PCFRC) has prepared this draft educational note to summarize some of the accounting and actuarial implications affecting reinsurance contracts issued and reinsurance contracts held as a result of the upcoming implementation of the International Financial Reporting Standard 17 (IFRS 17 or the Standard) requirements.

The background on accounting treatment of reinsurance contracts outlined in this draft educational note is at a high level; additional information that provides more detail on this topic can be found in International Actuarial Association (IAA) guidance or other CIA documents. The draft educational note [Compliance with IFRS 17 Applicable Guidance](#) provides guidance to actuaries when assessing compliance with IFRS 17. It is applicable to all draft educational notes pertaining to IFRS 17 and members are encouraged to review it prior to reading any draft education note related to IFRS 17.

The purpose of this draft educational note is to provide the reader with possible interpretations of the Standard, without advocating any particular approach. Each topic presented in this document addresses the implications of the Standard for either a reinsurance contract issued, a reinsurance contract held, or both: level of aggregation, fulfilment cash flow projections, insurance revenue recognition, estimation of the Liability for remaining coverage (LRC), onerous contracts identification and recognition, and residual market mechanisms.

Various stakeholders were consulted prior to releasing this draft educational note: the CIA Committee on Life Insurance Financial Reporting (CLIFR), the CIA Committee on the Appointed/Valuation Actuary (AA), the CIA Committee on Risk Management and Capital Requirements (CRMCR), the Accounting Standards Board (AcSB), the International Insurance Accounting Committee (IIAC), the Committee on Workers Compensation (CWC), and the Group Insurance Practice Committee.

The creation of this cover letter and draft educational note has followed the Actuarial Guidance Council's (AGC's) Protocol for the adoption of educational notes. In accordance with the Institute's *Policy on Due Process for the Approval of Guidance Material other than Standards of Practice and Research Documents*, this draft educational note has been prepared by the PCFRC and has received approval for distribution from the Actuarial Guidance Council on April 14, 2020.

The actuary should be familiar with relevant educational notes. They do not constitute standards of practice and are, therefore, not binding. They are, however, intended to illustrate the application of the Standards of Practice, so there should be no conflict between them. The actuary should note however that a practice that the educational notes describe for a situation is not necessarily the only accepted practice for that situation and is not necessarily accepted actuarial practice for a different situation. Responsibility for the manner of application of standards of practice in specific circumstances remains that of the members. As standards of practice evolve, an educational note may not reference the most current version of the Standards of Practice; and as such, the actuary should cross-reference with current Standards. To assist the actuary, the CIA website contains an up-to-date reference document of impending changes to update educational notes.

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## 1. Introduction

International Financial Reporting Standard 17 Insurance Contracts (IFRS 17 or the Standard) establishes principles for the recognition, measurement, presentation, and disclosure of insurance contracts. The purpose of this draft educational note is to provide practical application guidance on Canadian-specific issues related to actuarial considerations under IFRS 17 for property and casualty (P&C) reinsurance contracts issued and reinsurance contracts held. In this draft educational note, the use of the notation IFRS 17.XX refers to specific paragraphs of IFRS 17, where XX represents the paragraph number.

The International Accounting Standards Board (Board) issued an exposure draft in June 2019 that proposed amendments to IFRS 17, including amendments specifically related to the topic of reinsurance contracts held. Furthermore, the Board has tentatively made decisions on the proposed amendments on the topic of reinsurance at its December 2019 meeting. The details of the proposed amendments are described in section 5.3.3 – Reinsurance Contracts Held – Recovery of Losses on Onerous Groups of Underlying Insurance Contracts.

As noted in IFRS 17.4, all references to insurance contracts also apply to reinsurance contracts held<sup>1</sup>, unless otherwise indicated by specific references to insurance contracts issued<sup>2</sup> or as described in IFRS 17.60 through IFRS 17.70<sup>3</sup> for reinsurance contracts held. This draft educational note addresses both reinsurance contracts issued and reinsurance contracts held.

Appendix A of IFRS 17 defines a reinsurance contract as:

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

Where an entity enters into reinsurance contracts to cede insurance risk associated with underlying insurance contracts, the reinsurance contracts held by the ceding entity are recognized and presented in the statement of financial position<sup>4</sup> and in the statement of financial performance<sup>5</sup> separately from the underlying insurance contracts (IFRS 17.78 and IFRS 17.82).

This draft educational note is structured as follows:

- Level of aggregation;
- Actuarial calculations related to fulfilment cash flows;

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<sup>1</sup> Reinsurance contracts held are often referred to as reinsurance ceded.

<sup>2</sup> Reinsurance contracts issued are often referred to as reinsurance assumed. Throughout this draft educational note, the term “insurance contracts issued” encompasses all types of insurance contracts (i.e., both primary insurance contracts issued and reinsurance contracts issued).<sup>3</sup> Under the proposed amendments, this reference will become IFRS 17.70A.

<sup>3</sup> Under the proposed amendments, this reference will become IFRS 17.70A.

<sup>4</sup> The statement of financial position is often referred to as the balance sheet.

<sup>5</sup> The statement of financial performance is often referred to as the income statement.

- Insurance revenue considerations;
- Liability for remaining coverage (LRC): premium allocation approach (PAA) and general measurement approach (GMA) considerations;
- Onerous groups identification and recognition – insurance and reinsurance contracts issued; and
- Accounting treatment of residual market mechanisms.

This draft educational note supplements the following:

- CIA Exposure Draft: [Incorporate changes required by the adoption in Canada of IFRS 17, including Principles of International Standard of Actuarial Practice 4 – Actuarial Practice in Relation to IFRS 17 Insurance Contracts, into the Canadian Standards of Practice](#) (Document 218076, May 2018); and
- Chapter 9 – Reinsurance of the CIA Draft Educational Note [Application of IFRS 17 Insurance Contracts](#) (Draft IFRS 17 Application EN), which provides general guidance about reinsurance contracts issued and reinsurance contracts held. The Draft IFRS 17 Application EN adopts without modification the *International Actuarial Note 100 Exposure Draft (IAN 100 ED)* of the IAA.

In addition, the following draft educational notes may serve as additional useful guidance to actuaries:

- CIA Draft Educational Note: [Comparison of IFRS 17 to Current CIA Standards of Practice](#) (Document 218117, September 2018);
- CIA Draft Educational Note: *Assessing Eligibility for Premium Allocation Approach Under IFRS 17 for Property & Casualty and Life & Health Insurance* (Draft PAA Eligibility EN);
- CIA Draft Educational Note: *Risk adjustment for P&C insurance companies* (Draft PCFRC Risk Adjustment EN);
- CIA Draft Educational Note: *IFRS 17 Discounting and Cash Flow Considerations for P&C Entities* (Draft PCFRC Discounting EN);
- CIA Draft Educational Note: *Liability for remaining coverage* (Draft PCFRC LRC EN).

In writing this draft educational note, the PCFRC adhered to the following guiding principles:

- Consider Canadian-specific perspectives rather than simply repeating international actuarial guidance;
- Develop application guidance that is consistent with IFRS 17 and applicable Canadian actuarial Standards of Practice and educational notes without unnecessarily narrowing the range of practice allowable under IFRS 17; and
- Consider practical implications associated with the implementation of potential approaches and methods; in particular, ensure that due consideration is given to options that do not require undue cost and effort to implement.

## 2. Level of Aggregation

Under IFRS 17, insurance contracts are aggregated into portfolios of insurance contracts (portfolios) comprising contracts subject to similar risks and managed together (IFRS 17.14). Portfolios are divided into groups of insurance contracts (groups) considering, amongst other things, the expectation regarding the net cash flow of the contracts at initial recognition (i.e., whether the contracts are expected to be onerous).

IFRS 17.47 states, in part, that:

An insurance contract is onerous at the date of initial recognition if the fulfilment cash flows allocated to the contract, any previously recognised acquisition cash flows and any cash flows arising from the contract at the date of initial recognition in total are a net outflow. (...)

### 2.1. Portfolios and Groups

Based on IFRS 17.16:

An entity shall divide a portfolio of insurance contracts issued into a minimum of:

- (a) a group of contracts that are onerous at initial recognition, if any;
- (b) a group of contracts that at initial recognition have no significant possibility of becoming onerous subsequently, if any; and
- (c) a group of the remaining contracts in the portfolio, if any.

It should be noted that there is no limit regarding the number of groups contained within a given portfolio. IFRS 17.24 states: “An entity shall establish the groups at initial recognition, and shall not reassess the composition of the groups subsequently.” At subsequent valuation, a group of insurance contracts issued that was deemed non-onerous at initial recognition may still become onerous subsequently (or vice versa) if the expectation regarding the future net cash flows of the group changes from positive to negative (or vice versa).

Based on the proposed amendments to IFRS 17 that were related to simplified balance sheet presentation issued by the Board in June 2019 and the subsequent December 2019 Board meeting discussions, insurance contract assets and insurance contract liabilities on the statement of financial position would be presented at the portfolio level rather than at the group level. In the statement of financial position, the portfolios that are in an asset position are presented separately from those that are in a liability position, assuming that the proposed amendment is adopted by the Board. For a given portfolio, the liability for incurred claims (LIC) and the LRC are reported on a combined basis in the statement of financial position.

Note that, even though the measurement of the liabilities is required at the group level, fulfilment cash flows can be estimated at a more or less granular level and then aggregated or allocated to the group level if deemed more appropriate. For example, the entity may determine that Ontario auto is a group, and the actuary may initially estimate liabilities at a coverage level and then aggregate results to the group level. See further discussion in Section 2.2 – The Insurance Contract as the Smallest Unit of Account.



The level of aggregation for reinsurance contracts held is assessed independently from the underlying insurance contracts issued. The level of aggregation requirements for insurance contracts, outlined in IFRS 17.14 through IFRS 17.24, also apply for reinsurance contracts (both issued and held). However, for reinsurance contracts held, IFRS 17.61 replaces references to onerous contracts in those paragraphs with a reference to contracts on which there is a net gain on initial recognition. For a group of reinsurance contracts held, there is no unearned profit but instead a net cost or net gain on purchasing the reinsurance. Therefore, reinsurance contracts held cannot be onerous, as indicated in IFRS 17.68.

For reinsurance contracts held, the level of aggregation (i.e., groups or portfolios) may differ from the level of aggregation of the underlying insurance contracts covered. In many cases, a single reinsurance contract held covers many underlying groups or portfolios. It may therefore be reasonable for a portfolio or a group to consist of a single reinsurance contract held, whereas a portfolio or group of a single underlying P&C insurance contract would be unusual.

## **2.2. The Insurance Contract as the Smallest Unit of Account**

Under IFRS 17, the lowest unit of account is the insurance contract. In most cases, it is not permitted to disaggregate individual insurance contracts for the purposes of assessing eligibility for the PAA, identifying groups that are onerous, or financial reporting.

Some reinsurance contracts (issued and held) cover more than one line of business under a single contract. These reinsurance contracts, often referred to as multi-line reinsurance contracts, can take various forms, such as excess-of-loss, aggregate stop-loss, and proportional reinsurance.

IFRS 17 itself does not mandate any change to the actuarial methodologies or processes currently used to estimate the obligations associated with claims that have occurred (i.e., undiscounted fulfilment cash flows associated with the LIC). Thus, the actuary's choice of segments, which are often referred to as lines of business, for the reserving analysis is not necessarily affected by IFRS 17.

Under IFRS 17, each contract would normally be assigned to a specific portfolio and group. For multi-line reinsurance contracts (issued and held), the actuary has three options for assigning those contracts including:

- Aggregating reinsurance contracts based on the predominant exposure covered;
- Creating a portfolio or group containing hybrid or multi-line contracts; or
- Separating the reinsurance contracts into sub-contracts and assigning those sub-contracts to separate groups and possibly portfolios. This option may only be acceptable if the insurer is able to prove that a single legal reinsurance contract was bound solely for the administrative convenience of the policyholder (in this case, the insurer) and the price is simply the aggregate of the standalone prices for the different reinsurance covers provided. (See [Agenda Paper 01](#) (login required) prepared by the Board staff for the February 6, 2018 TRG).

Under the first option, one acceptable methodology is to assign each multi-line reinsurance contract based on its dominant exposure as measured by expected losses, which may be

determined from a pricing analysis. For example, if the majority of the expected losses for a multi-line reinsurance contract covering both casualty and property exposures is driven by casualty exposures, then one approach is to assign such contract to a casualty portfolio and to a casualty group even though the contract also covers property exposures (albeit to a lesser extent).

### **3. Actuarial Calculations Related to Fulfilment Cash Flows**

Estimates of the fulfilment cash flows, which include discounting and risk adjustment for non-financial risk (RA), are used for:

- Determining the LIC;
- Determining the LRC when using the GMA; and
- Estimating the loss component (LC) of an onerous group (regardless of use of GMA or PAA).

The definition of the LC and the accounting for groups deemed onerous are found in Section 6.1 – Accounting for Groups Deemed Onerous.

#### **3.1. Estimation of the LIC**

The LIC consists of the fulfilment cash flows related to past services, which is often referred to as earned business. The LIC is estimated by projecting the fulfilment cash flows for earned business, which comprise:

- An unbiased current estimate of future cash flows (at the “expected value (ie the probability-weighted mean) of the full range of possible outcomes.” per IFRS 17.33(a));
- An adjustment to reflect the time value of money; and
- A RA.

#### **3.2. Discounting and Cash Flows Considerations**

A separate CIA draft educational note will address the topic of discounting under IFRS 17: Draft PCFRC Discounting EN. The discussion in this draft educational note is therefore limited to topics affecting reinsurance contracts issued and reinsurance contracts held.

For entities using the GMA, consistency of measurement for reinsurance contracts held and the underlying contracts is addressed in IFRS 17.63:

In applying the measurement requirements of paragraphs 32–36 to reinsurance contracts held, to the extent that the underlying contracts are also measured applying those paragraphs, the entity shall use consistent assumptions to measure the estimates of the present value of the future cash flows for the group of reinsurance contracts held and the estimates of the present value of the future cash flows for the group(s) of underlying insurance contracts. In addition, the entity shall include in the estimates of the present value of the future cash flows for the group of reinsurance contracts held the effect of any

risk of non-performance by the issuer of the reinsurance contract, including the effects of collateral and losses from disputes.

Assumptions selected for the estimation of the present value of the future cash flows for the LIC and the LRC (both PAA and GMA) would normally be consistent between reinsurance contracts held and the underlying insurance contracts. Reference to “consistency” and “consistent assumptions” does not necessarily imply identical assumptions.

Board staff response for TRG (#S40):

Paragraph 63 of IFRS 17 requires an entity to use consistent assumptions to measure the estimates of the present value of the future cash flows for the group of reinsurance contracts held and the estimates of the present value of the future cash flows for the group(s) of underlying insurance contracts. This consistency is required to the extent that the same assumptions apply to both the underlying contracts and the reinsurance contracts held. This requirement does not require/permit the entity to use the same assumptions used for measuring the underlying contracts when measuring the reinsurance contracts held if those assumptions are not valid for the terms of the reinsurance contracts held. If different assumptions apply for the reinsurance contract held, the entity uses those different assumptions when measuring that contract.

Consistent assumptions can produce differences between the estimates of fulfilment cash flows for insurance contracts issued and the estimates of fulfilment cash flows for reinsurance contracts held. These differences can arise from different sources, such as:

- Contract grouping;
- Contract boundaries;
- Discount rates; and
- RA.

### **3.2.1. Risk of Non-Performance by the Issuer of the Reinsurance Contracts**

As noted in the previous section, for the measurement of reinsurance contracts held, IFRS 17.63 states:

... the entity shall include in the estimates of the present value of the future cash flows for the group of reinsurance contracts held the effect of any risk of non-performance by the issuer of the reinsurance contract, including the effects of collateral and losses from disputes.

When estimating the LIC, and when estimating the LRC under the GMA, the actuary would determine a probability-weighted provision to account for the risk of non-performance of the reinsurer, including consideration for reinsurer default, coverage dispute, and other risk of non-performance. These considerations are similar to those included in the former CIA requirements for provision for adverse deviations (PfAD) for recovery from reinsurance ceded prior to the implementation of IFRS 17. The determination of the IFRS 17 provision, however, may be different. Under IFRS 17, the reinsurance counterparty risk would be included in the

measurement of the estimates of future cash flows for reinsurance contracts held (i.e., it is not calculated separately).

Thus, the risk of non-performance by the issuer of the reinsurance contracts is incorporated as a decrease to the estimates of future cash inflows for reinsurance contracts held. The actuary may choose to estimate this provision separately before combining it with the fulfilment cash flows. Separation of the expected cash flows may facilitate discussions with senior management as well as audit and peer review of the actuarial analyses.

When estimating the risk of non-performance, the actuary would consider:

- The financial strength of the reinsurers;
- The history of claims and coverage disputes with reinsurers; and
- The risk of contagion across various reinsurance arrangements.

### **3.3. Estimation of the RA**

A separate CIA draft educational note will address the topic of RA: Draft PCFRC Risk Adjustment EN. The discussion in this draft educational note is therefore limited to topics affecting reinsurance contracts issued and reinsurance contracts held.

#### **3.3.1. The RA associated with reinsurance contracts held**

The RA associated with reinsurance contracts held is described in IFRS 17.64, which states:

Instead of applying paragraph 37, an entity shall determine the risk adjustment for non-financial risk so that it represents the amount of risk being transferred by the holder of the group of reinsurance contracts to the issuer of those contracts.

Chapter 9 of the Draft [IFRS 17 Application EN](#) addresses the issue of the RA for reinsurance contracts. Question 9.9 asks: “How is the reinsurance held risk adjustment for non-financial risk determined?” The response states:

A specific definition for the determination of the risk adjustment for reinsurance contracts held is provided that replaces the general definition in paragraph 37 used for insurance and reinsurance contracts issued in the standard. Under the definition for reinsurance held, the quantum of the risk adjustment for non-financial risk represents the amount of risk being transferred by the holder of a group of reinsurance contracts to the issuer of those contracts (paragraph 64).

The risk adjustment for the reinsurance held can therefore conceptually be thought of as the difference in the risk position of the entity with (i.e., net position) and without (i.e., gross position) the reinsurance held. As a result, the appropriate risk adjustment for the reinsurance held could be determined based on the difference between these amounts.

For reinsurance held, because the risk adjustment for reinsurance held is defined based on the amount of risk transferred to the reinsurer, the risk adjustment for reinsurance held will normally create an asset. On this basis, where a reinsurance

contract held is reported as an asset the risk adjustment will have the effect of increasing the value of the asset, and will decrease the liability value where the reinsurance contract held is reported as a liability.

When estimating the present value of future cash flows and the RA, the actuary has three options:

- Estimate the gross<sup>6</sup> and the net<sup>7</sup>, and then calculate the ceded<sup>8</sup> as a difference;
- Estimate the gross and the ceded, and then calculate the net as a difference; or
- Estimate the net and the ceded, and then calculate the gross as a sum.

The RA reflects the compensation that the entity requires for bearing the uncertainty related to non-financial risks and is apportioned to insurance contracts issued and reinsurance contracts held. Ultimately, the key concepts underlying the RA are:

- The RA for the insurance contracts issued represents the compensation that the entity requires for bearing the non-financial risk associated with writing those contracts, and
- The RA for the reinsurance contracts held accounts for the non-financial risk transferred from the cedant to the reinsurer(s).

Any method that meets these concepts would generally be acceptable.

### **3.3.2. Actuarial input on the RA and the role of judgment in estimating the RA**

Questions 4.4 and 4.5 of the Draft [IFRS 17 Application EN](#) are focused on the role of actuarial input on the RA and the role of judgment in estimating the RA. In responding to these questions, the collaboration required between the actuary and the entity's management is addressed.

The response to Question 4.4 regarding the role of actuarial input on the RA states:

This actuarial input falls into four parts and can:

- assist in understanding and assessing the risk aversion of the entity ..., as it relates to the uncertainty and variability of insurance cash flows, and in understanding the extent to which the entity considers "*the degree of diversification benefit the entity includes when determining the compensation it requires for bearing that risk*" [paragraph B88(a)].
- provide quantitative measures to help evaluate the variability inherent in the insurance contracts being valued and the uncertainty which underlies such quantitative measures.
- assist in designing an approach to assess a value in terms of the compensation for bearing risk that reflects the entity's risk aversion, in the context of the

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<sup>6</sup> "Gross" in this context refers to contracts issued by an insurer or reinsurance contracts issued by a reinsurer.

<sup>7</sup> "Net" in this context refers to the difference: gross minus ceded.

<sup>8</sup> "Ceded" in this context refers to reinsurance contracts held.

relevant risks, and in the context of the diversification affecting the compensation for such risks.

- provide explanations and insights to help in communicating the understandings and judgments involved, such that the entity's board and management can have the appropriate level of direction and oversight regarding how the risk adjustment is determined.

The response to Question 4.5 concludes with:

In general, it will be important that the entity's board and management properly understand the process and the judgments used to determine the entity's risk adjustment and how their oversight and management roles and responsibilities are being satisfied.

#### **4. Insurance Revenue Considerations**

Under IFRS 17, the concept of insurance revenue for reinsurance contracts issued may differ from the concept of earned premium due to:

- Seasonality adjustments that are reflected under IFRS 17 if the expected pattern of release of risk during the coverage period differs significantly from the passage of time;
- Reinstatement premiums that are contemplated in the original reinsurance contract and collected following an insured event are generally applied against insurance service expenses under IFRS 17; and
- Some ceding commission expenses on proportional reinsurance treaties might be included as part of insurance revenue, insurance service expense, or possibly as part of the investment component.

IFRS 17.86 indicates that income or expenses from a group of reinsurance contracts held, other than insurance finance income or expenses, may be presented either:

- As a single amount (i.e., net presentation); or
- Separately as amounts recovered from the reinsurer and an allocation of premiums paid (i.e., gross presentation).

##### **4.1. Insurance Revenue Accruals – Reinsurance Contracts Issued**

IFRS 17.B126 states that when an entity applies the PAA, insurance revenue for the period is the amount of expected premium receipts allocated to the period. For proportional reinsurance contracts issued, there are many instances where the reinsurance coverage starts before premium is received by the reinsurer. For example, the first bordereau<sup>9</sup> on a proportional reinsurance contract issued having an effective date of January 1 may not be received by the reinsurer until May or June (i.e., more than four or five months after contract inception). In

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<sup>9</sup> "Bordereau" in this context refers to the invoice received by the insurer in relation to a proportional treaty.

such instances, an accrual (i.e., expected premium receipt) is used to estimate the insurance revenue reported in the statement of financial performance of the reinsurer.

#### **4.2. Insurance Revenue Recognition Pattern**

According to IFRS 17.B126, under the PAA, the allocation of insurance revenue to each period of coverage is based on either the passage of time or the expected timing of incurred insurance service expenses (i.e., based on the seasonality of losses). IFRS 17.B126 states:

When an entity applies the premium allocation approach in paragraphs 55–58, insurance revenue for the period is the amount of expected premium receipts (excluding any investment component and adjusted to reflect the time value of money and the effect of financial risk, if applicable, applying paragraph 56) allocated to the period. The entity shall allocate the expected premium receipts to each period of coverage:

- (a) on the basis of the passage of time; but
- (b) if the expected pattern of release of risk during the coverage period differs significantly from the passage of time, then on the basis of the expected timing of incurred insurance service expenses.

Examples of reinsurance arrangements where a uniform insurance revenue recognition pattern based on the passage of time may not be applicable include:

- Risk-attaching proportional treaties;
- Catastrophe treaties with material seasonality (e.g., hurricane); and
- Catastrophe treaties with low attachment points and limits for which the exposure may be heavily concentrated in specific months of the year (e.g., hail, flood, and forest fire).

If a new earning pattern is implemented along with IFRS 17, consideration would be given to applying a consistent approach for the calculation of earned premiums if that basis is used as part of the reserving analysis (e.g., Bornhuetter-Ferguson or expected loss ratio method). Consistency between the two methodologies will reduce the amount of explanations and reconciliations that the actuary would be required to perform.

#### **4.3. Income or Expenses Presentation Requirements**

Based on the economic effect of amounts exchanged between the reinsurer and the cedant, reinstatement premium and commission may have to be recorded as either insurance revenue, insurance service expense, or possibly as part of the investment component. IFRS 17.86 states:

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

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

#### **4.3.1.Reinstatement Premiums**

Following the occurrence of an insured event, the ceding company may be required to pay a reinstatement premium to be covered for additional events that may occur during the remainder of the reinsurance contract term. For the purpose of this draft educational note, two types of reinstatements are described: reinstatements contemplated in the original reinsurance contract and additional negotiated reinstatements.

##### **4.3.1.1. Reinstatements Contemplated in the Original Reinsurance Contract**

If a ceding entity makes the accounting policy choice to present separately the amounts recovered from a reinsurer and the premiums paid to the reinsurer, the cash flows related to mandatory reinstatement premiums paid are normally considered as an offset to the amounts recovered from the reinsurer. For the reinsurer, given that the amounts exchanged are contingent on claims, the reinstatement premiums collected would be accounted for as a reduction to the insurance service expense.

##### **4.3.1.2. Additional Negotiated Reinstatements**

Additional reinstatements can be negotiated as part of a separate reinsurance contract. This type of reinsurance contract is usually negotiated after the occurrence of one or more covered events to ensure that the ceding company remains covered after all contractual reinstatement limits provided in the original reinsurance contract are exhausted. An additional negotiated reinstatement to the reinsurance contract is normally considered outside of the scope of the original reinsurance contract (i.e., the terms are determined and priced independently from the original reinsurance contract and the reinsurer is not obligated to accept the reinstatement premium). As a result, the insurance revenues generated by this new reinsurance contract are considered independent from the claims incurred previously. The premium related to this reinsurance contract are therefore accounted for as reinsurance held by the ceding company and as insurance revenue for the reinsurer.

#### **4.3.2.Commissions for Reinsurance Contracts Issued**

Based on IFRS 17.86, if an entity makes the accounting policy choice to present separately the amounts recovered from the reinsurance contracts held and an allocation of the premiums paid for the reinsurance contracts held, the ceding entity shall:



... 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 general terms, the ceding commission (or portion of the ceding commission) paid by the reinsurer to the ceding company that is not contingent on the claims of the underlying contracts would be accounted for as a reduction to insurance revenue in the statement of financial performance of the reinsurer. However, the portion of the commission that is contingent on claims would be accounted for, in the statement of financial performance of the reinsurer, as either an offset to insurance service expense or as an investment component.

Amounts exchanged between the issuer of a reinsurance contract (i.e., the reinsurer) and the holder of a reinsurance contract (i.e., the cedant), such as profit-sharing or sliding scale commission adjustments, may need to be reported as investment components if they are paid after the initial premium is received, and if they are repaid to the policyholder (in this case the cedant) in all circumstances (including when an insured event does not occur and on cancellation of the contract).

The definition of investment component from the Standard may require reinsurance companies to book a portion of the ceded commissions as investment component. In June 2019, the Board issued the following revised definition of investment component<sup>10</sup>: “The amounts that an insurance contract requires the entity to repay to a policyholder in all circumstances, regardless of whether an insured event occurs.”

#### **4.3.3. Premium Adjustments Reflecting the Adjusted Exposure Base**

According to IFRS 17.B65:

Cash flows within the boundary of an insurance contract are those that relate directly to the fulfilment of the contract, including cash flows for which the entity has discretion over the amount or timing. The cash flows within the boundary include:

- (a) premiums (including premium adjustments and instalment premiums) from a policyholder and any additional cash flows that result from those premiums.

Premium adjustments related to services rendered in past periods, and reflecting any adjustments to the exposure base (e.g., gross net earned premium) are normally independent from the cedent loss experience. These premium adjustments would therefore be accounted for as insurance revenues in the financial period in which they are received. This can be the year in which services are rendered or a subsequent year.

#### **4.4. Reconciliation with Accounting Standards from Other Jurisdictions**

Some insurers and reinsurers licensed in Canada operate as part of international groups with a head office domiciled in a jurisdiction that is not required to comply with IFRS 17. The

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<sup>10</sup> Note that a similar definition was included in the original Standard: “The amounts that an insurance contract requires the entity to repay to a policyholder even if an insured event does not occur.”

consolidated financial reporting for these insurers may, in some cases, remain in their head office's jurisdiction reporting framework (e.g., US generally accepted accounting principles (GAAP)). In these circumstances, the actuary may be required to produce an estimation of liabilities under two separate bases: IFRS 17 for local Canadian regulatory reporting purposes and the financial reporting framework required in the jurisdiction of their head office. In such cases, the actuary may be required to assess the effect and explain any differences in accounting methodologies. For example, undiscounted fulfilment cash flow estimates associated with the LIC for reinsurance contracts issued and reinsurance contracts held under IFRS 17 would, in most cases, reconcile with assumed and ceded unpaid claims under US GAAP. Any differences between the two figures would need to be understood and explained.

## 5. LRC: PAA and GMA Considerations

The LRC consists of the obligation that relates to future services (i.e., the unexpired portion of the coverage period), which is often referred to as unearned business. The LRC can be estimated using the GMA or the PAA, if the option is available and the entity elects to use this approach.

### 5.1. Estimation of the LRC

Based on IFRS 17.55, under the PAA, at initial recognition, the LRC is calculated as premiums received, which are equivalent to the unearned premiums less premiums receivable, minus the insurance acquisition cash flows, unless the entity chooses to recognize insurance acquisition cash flows as expenses as they are incurred in accordance with IFRS 17.59(a).

Assuming that the entity has no financing component and no investment component, the LRC at the end of each subsequent reporting period is calculated as:

- The amount of the LRC carried at the start of the reporting period;
- Plus any premiums received in the period;
- Minus insurance acquisition cash flows, unless the entity chooses to recognize insurance acquisition cash flows as expenses as they are incurred in accordance with IFRS 17.59 (a);
- Plus any amounts related to the amortization of insurance acquisition cash flows recognized as expense in the reporting period, unless the entity chooses to recognize insurance acquisition cash flows as expenses as they are incurred in accordance with IFRS 17.59 (a);
- Minus any amounts recognized as insurance revenue for coverage provided in the period.

Any LC on onerous groups are included in the LRC.

Under the GMA, the LRC is calculated as the sum of the fulfillment cash flows related to future services and the contractual service margin (CSM). The CSM represents the projected unearned profit on a group. The CSM for reinsurance contracts held is determined in the same manner as for insurance contracts issued, but instead of reflecting the unearned profit, the CSM is the expected "net cost or net gain on purchasing the group of reinsurance contracts held" (IFRS

17.65). Thus, unlike the CSM for underlying insurance contracts, the CSM on reinsurance contracts held can be positive or negative.

More information about the CSM calculation and amortization is provided in Section 5.3.1 – Coverage Units and the CSM.

## **5.2. PAA Eligibility**

The topic of PAA eligibility is covered in detail in a separate CIA draft educational note: Draft PAA Eligibility EN. Thus, similar to the topics of discounting and RA, this draft educational note is limited to a discussion of PAA eligibility related to reinsurance contracts issued and held.

### **5.2.1.PAA Eligibility for Reinsurance Contracts Issued**

The PAA eligibility assessment for reinsurance contracts issued is similar to the assessment for primary insurance contracts. For reinsurance contracts issued, the analysis is based on IFRS 17.53, which states:

An entity may simplify the measurement of a group of insurance contracts using the premium allocation approach set out in paragraphs 55–59 if, and only if, at the inception of the group:

- (a) the entity reasonably expects that such simplification would produce a measurement of the liability for remaining coverage for the group that would not differ materially from the one that would be produced applying the requirements in paragraphs 32–52; or
- (b) the coverage period of each contract in the group (including coverage arising from all premiums within the contract boundary determined at that date applying paragraph 34) is one year or less.

In accordance with IFRS 17, the estimated LRC for a group of reinsurance contracts issued may be calculated using the PAA if all contracts within the group have a coverage period of one year or less. If any contract within the group has a coverage period greater than one year, the PAA would only be used to estimate the LRC if the PAA provides a reasonable approximation of the GMA.

### **5.2.2.PAA Eligibility for Reinsurance Contracts Held**

For reinsurance contracts held, IFRS 17.69 states similar considerations:

An entity may use the premium allocation approach ... to simplify the measurement of a group of reinsurance contracts held, if at the inception of the group:

- (a) the entity reasonably expects the resulting measurement would not differ materially from the result of applying the requirements in paragraphs 63–68; or
- (b) the coverage period of each contract in the group of reinsurance contracts held ... is one year or less.

The considerations above for reinsurance contracts held are very similar to the considerations outlined for reinsurance contracts issued.

### **5.2.3. Considerations Related to Loss-Occurring vs. Risk-Attaching Reinsurance Treaties**

For loss-occurring reinsurance contracts where the coverage period can be easily defined as one year or less based on the contract's effective date and expiry date, entities can opt to use the PAA.

For 12-month risk-attaching reinsurance treaties covering underlying insurance contracts with terms of 12 months, the reinsurance coverage would usually span two loss occurrence years, assuming that underlying contracts are underwritten throughout the year. Such risk-attaching treaties provide coverage that extends beyond a one-year coverage period.

When the coverage period of reinsurance contracts is greater than one year, entities have to determine PAA eligibility by demonstrating that the measurement of the LRC does not differ materially between the GMA and the PAA.

### **5.2.4. Determination of Coverage Period for Reinsurance Contracts Issued or Held**

Reinsurance contracts have a variety of features that the actuary would consider when determining the coverage period. Options to extend the reinsurance contract may affect the contract boundary and therefore the PAA eligibility. Alternatively, cancellation provisions may shorten the contract boundary to the extent that they are available to both parties (reinsurer and cedant). These cancellation provisions would also impact the assessment of PAA eligibility.

On the topic of coverage period and contract boundary, IFRS 17.34 states:

... A substantive obligation to provide services ends when:

- (a) the entity has the practical ability to reassess the risks of the particular policyholder and, as a result, can set a price or level of benefits that fully reflects those risks; or
- (b) both of the following criteria are satisfied:
  - (i) the entity has the practical ability to reassess the risks of the portfolio of insurance contracts that contains the contract and, as a result, can set a price or level of benefits that fully reflects the risk of that portfolio; and
  - (ii) the pricing of the premiums for coverage up to the date when the risks are reassessed does not take into account the risks that relate to periods after the reassessment date.

Contractual cancellation provisions of reinsurance contracts issued and held would be considered when assessing PAA eligibility. To the extent that cancellation provisions are available to both parties (i.e., the reinsurer and the cedant), they may have the effect of shortening the contract boundary. As a result, such cancellation provisions would generally increase the likelihood of the reinsurance contract being PAA eligible. For example, some multi-year reinsurance contracts have a cancel and re-write provision at the option of the cedant.

These types of reinsurance contracts are normally considered long-term (i.e., more than one year), and therefore PAA eligibility assessment is required.

Non-contractual cancellations (e.g., early contract termination following the sale of an entity, loss portfolio transfers, novations, and commutations) normally occur after the reinsurance contract inception date. These types of cancellations are usually unknown at inception and would not affect PAA eligibility. Non-contractual cancellations are requested by one of the parties bound by the reinsurance contract and agreed by the other(s).

In the case of an early termination and/or commutation, the accounting is fairly simple. The insured party regains ownership of all ceded assets and liabilities (i.e., the LIC and LRC). In parallel, the assets and liabilities held by the reinsurer in relation to the reinsurance contract issued are considered settled.

Depending on the circumstances, a loss portfolio transfer or novation may need to be accounted for as an acquired portfolio. The CSM for an acquired portfolio is amortized over the expected settlement period.

### **5.3. GMA Considerations**

#### **5.3.1. Coverage Units and the CSM**

For insurance contracts and reinsurance contracts issued, the CSM represents the unearned profit that the entity will recognize as it provides services in the future (IFRS 17.38).

For reinsurance contracts held, the concept of CSM is modified. According to IFRS 17.65:

The requirements of paragraph 38 that relate to determining the contractual service margin on initial recognition are modified to reflect the fact that for a group of reinsurance contracts held there is no unearned profit but instead a net cost or net gain on purchasing the reinsurance.

The CSM for reinsurance contracts held is determined in the same manner as for insurance (or reinsurance) contracts issued, but the CSM can be positive or negative. According to IFRS 17.68, “reinsurance contracts held cannot be onerous.” Therefore, the cost of reinsurance contracts held is normally recognized over the life of the reinsurance contract.

In the statement of financial position, the CSM is booked as part of the LRC. The CSM is released consistent with the quantity of benefits provided and the expected duration of the group.

According to IFRS 17.B119:

An amount of the contractual service margin for a group of insurance contracts is recognised in profit or loss in each period to reflect the services provided under the group of insurance contracts in that period ... The amount is determined by:

- (a) identifying the coverage units in the group. The number of coverage units in a group is the quantity of coverage provided by the contracts in the group, determined by considering for each contract the quantity of the benefits provided under a contract and its expected coverage duration.

- (b) allocating the contractual service margin at the end of the period (before recognizing any amounts in profit or loss to reflect the services provided in the period) equally to each coverage unit provided in the current period and expected to be provided in the future.
- (c) recognizing in profit or loss the amount allocated to coverage units remaining in the period.

The coverage units would therefore be calculated consistently with the amount of benefits provided. For a standard loss occurring reinsurance treaty, this may imply a straight line CSM release pattern. For an adverse development reinsurance contract, the coverage units may be based on the expected amounts of underlying claims<sup>11</sup>, and for a risk attaching treaty, the coverage units may be based on the underlying policies renewal pattern (i.e., the parallelogram method).

### **5.3.2. Potential Timing Mismatch: Reinsurance Contract Held Evaluated under the GMA**

In many reinsurance contracts held, neither party has the right to cancel the contract unilaterally without a valid reason (e.g., fraud or material misrepresentation). In most cases, cancellation must be mutually agreed upon.

When estimating the LRC for reinsurance contracts held valued under the GMA, the ceding company would include all projected cash flows, including those related to underlying contracts that have not yet been issued, unless the reinsurance contract includes unilateral cancellation conditions. Failure to do so would contradict the fundamental principle of IFRS 17 that all future cash flows within the boundary of each contract in the group are reflected in the measurement of an insurance contract.

The projected fulfillment cash flows for reinsurance contracts held extend to the entire exposure period (e.g., up to two years for a risk-attaching contract). The fulfillment cash flows of the subject contracts only include those underlying contracts for which insurance revenues have been recognized as per IFRS 17.25 (recognition). For example, at the end of the first quarter, assume that a primary insurer has written 25% of its policies (based on uniform writings throughout the year) and that the LRC for the underlying contracts is evaluated using the GMA. This means that 25% of the expected full year revenues would be recognized. However, the fulfillment cash flows on the risk-attaching reinsurance contract held as of January 1 would include the projected cash flows on 100% of the policies expected to be written throughout the year. Note that this issue only occurs if the entity is using the GMA to estimate the LRC for reinsurance contracts held.

The actuary and management would need to understand this potential inconsistency and be able to explain any implication on the financial statements of the organisation.

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<sup>11</sup> Additional information about coverage units and CSM amortization for adverse development reinsurance contract can be found in the IFRS 17 [TRG staff paper](#) of May 2018.

### **5.3.3. Reinsurance Contracts Held – Recovery of Losses on Onerous Groups of Underlying Insurance Contracts**

For underlying insurance contracts that are expected to be onerous at initial recognition, IFRS 17 requires a company to recognize the expected losses when the group becomes onerous.

The recovery of losses from reinsurance contracts held covering onerous groups of underlying contracts has been addressed in the proposed amendments to IFRS 17 issued by the Board in June 2019 and the subsequent tentative approval at the Board meeting on December 11–12, 2019. Based on the amendment, an entity would adjust the CSM of a group of reinsurance contracts held, and as a result recognize income, when the entity recognizes a loss on initial recognition of an onerous group of underlying insurance contracts, or on addition of new onerous contracts to that group.

The proposed calculation of the income would require an entity to determine the amount of a loss recovered from a reinsurance contract held by multiplying:

- The loss recognised on the group of underlying insurance contracts; and
- The percentage of claims on underlying insurance contracts the entity expects to recover from the reinsurance contract held.

The proposed amendment does not affect the accounting for insurance contracts issued. It only affects the timing of loss recognition (gains for the ceding company) for reinsurance contracts held.

The intent of the proposed amendment is to recognize the expected losses from onerous insurance contracts issued and the recoveries of those losses from reinsurance contracts held that cover those same underlying onerous contracts in the same financial period. However, the proposed amendment might not perfectly correct the revenue matching issue if the reinsurance held is accounted for under the GMA.

Under the GMA with no unilateral cancellation rights, the expected cash flows (and expected profit or losses) of a given contract are projected for the entire contract period. In a simple example of a 12-month loss-occurring reinsurance contract held, the contract boundary is 12 months. However, at interim valuation periods, the cedant will only have written a fraction of the subject business. The expected gain from the reinsurance contract held might therefore outweigh the expected loss on the underlying onerous contracts. This potential mismatch is described in detail in 5.3.2 – Potential Timing Mismatch: Reinsurance Contract Held Evaluated under the GMA.

## **6. Onerous Contracts Identification and Recognition – Insurance and Reinsurance Contracts Issued**

Based on IFRS 17.47, “an insurance contract is onerous at the date of initial recognition if the fulfilment cash flows allocated to the contract... are a net outflow.”

For reinsurance contracts held, the concept of onerous groups does not exist (IFRS 17.61). Under the GMA, the CSM for reinsurance contracts held is determined in the same manner as for insurance contracts issued, but the CSM can be positive or negative.

The remainder of this section applies equally to insurance contracts and reinsurance contracts issued.

### **6.1. Accounting for Groups Deemed Onerous**

The LC is defined as the expected net outflow of an onerous group. The LC is booked as part of the LRC in the statement of financial position. On the statement of financial performance, the effect of the LC is recognized as insurance service expense.

When estimating the LC under both the PAA and the GMA, the expected net outflow is projected for the entire contract period. In other words, the LC is calculated based on the projected full-term premium. Moreover, the fulfilment cash flows include the effect of discounting and RA.

The LC is reported as part of the LRC. IFRS 17.50–52 requires an entity to make a systematic allocation of the subsequent changes in fulfilment cash flows between the LC portion of the LRC and the LRC, excluding the LC.

### **6.2. Recognition of LC on Onerous Groups**

According to IFRS 17.25:

An entity shall recognise a group of insurance contracts it issues from the earliest of the following:

- (a) the beginning of the coverage period of the group of contracts;
- (b) the date when the first payment from a policyholder in the group becomes due; and
- (c) for a group of onerous contracts, when the group becomes onerous.

Initial recognition will therefore take place either at the effective date of the group or at the date when the first payment from the policyholder becomes due unless the group is onerous, in which case initial recognition will take place earlier, with the earliest possible date for initial recognition being the “issue date” (which is the date the terms of the contract are set and the parties are bound). In many cases, this means that the recognition of the LC on onerous groups may need to be made prior to the effective date of the insurance or reinsurance contract issued. For example, assume a contract issued with an effective date of January 1, 20X3 is bound during the last week of December 20X2. If the entity is aware that this contract is onerous when bound, then the entity would book a LC in the financial statements as of December 31, 20X2.

### **6.3. Onerous Contracts Assessment under the PAA**

IFRS 17.18 states that for contracts issued to which an entity applies the PAA, the entity shall assume no contracts in the portfolio are onerous at initial recognition, unless facts and circumstances indicate otherwise.

#### **6.3.1. Onerous Contracts: Initial Recognition**

Contracts measured using the PAA are presumed to be profitable at initial recognition unless management identifies facts and circumstances that indicate otherwise. Similarly, for



subsequent measurement, an onerous contract test is only required if there are facts and circumstances indicating that a group may be onerous.

IFRS 17 does not provide specific guidance about what facts and circumstances need to be considered in assessing whether a contract (or group) is onerous, and thus management's judgment is required. Facts and circumstances would generally be expected to comprise information that is readily available to senior management and the finance function as part of the regular financial reporting and planning processes. Financial planning, as used in this context, includes review of pricing insight and decisions to the extent that these influence operational planning, forecasting, and reporting to stakeholders. Information that would constitute facts and circumstances could include<sup>12</sup>:

- Forward-looking analyses of expected performance compared to historical performance (such as expected loss ratio or combined ratio measures);
- Strategic pricing objectives (such as loss leaders or diminished margins due to competitive pressures); and
- Significant changes to the expected costs of fulfilling insurance contracts (such as economic or regulatory changes that affect expected cash flows).

Testing of the fulfilment cash flows may be counter to the simplification sought by applying the PAA. Insurers could therefore define an indicator to test whether a group might potentially be onerous. A metric such as the combined ratio may be an option to identify onerous groups. The indicator may vary by line of business and account for the estimated combined effect of the discounting and RA. The actuary may assist management in establishing these indicators. A complete estimation of the fulfilment cash flows would only be needed when a certain threshold is reached for the indicator.

For some reinsurers, contract level pricing information may be available to senior management. In those instances, management may choose to consider individual reinsurance contract level pricing information to identify onerous contracts.

### **6.3.2. Onerous Contracts: Subsequent Measurement**

Based on IFRS 17.17:

If an entity has reasonable and supportable information to conclude that a set of contracts will all be in the same group applying paragraph 16, it may measure the set of contracts to determine if the contracts are onerous ... and assess the set of contracts to determine if the contracts have no significant possibility of becoming onerous subsequently...

If management identifies a group that is onerous at any point before its effective date, the group would be recognized at the date at which it is deemed onerous, and a LC would be estimated for that group.

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<sup>12</sup> Extract taken from IBC IFRS 17 Working Group Guidance Paper *Premium Allocation Approach: Onerous Contracts and "Facts and Circumstances"* (November 2019).

Applying the PAA, a group that was deemed non-onerous at initial recognition may be determined to be onerous at subsequent measurement due to changes in facts and circumstances that are unfavourable to the group. Examples of situations that may affect the expected profitability of a specific group include<sup>13</sup>:

- Judicial or legal findings (e.g., landmark court cases);
- Changes in the regulatory environment;
- Shifts in the economic environment (e.g., trends, interest rates);
- Allocation of expenses; or
- Changes in the RA in total or in the allocation of the RA<sup>14</sup>.

Similarly, a group that was deemed onerous at initial recognition may, at a later date, be determined to not be onerous due to changes in facts and circumstances that are favourable to the group.

## 7. Accounting Treatment of Residual Market Mechanisms

The Facility Association (FA) administers, on behalf of its members, several residual market mechanisms. These residual market mechanisms are:

- Facility Association Residual Market (FARM);
- Risk Sharing Pools (RSPs); and
- Uninsured Automobile Funds (UAFs).

The accounting treatment of each mechanism under IFRS 17 is the responsibility of each member company (referred to collectively as “FA membership”). It is therefore up to the membership to reach a consensus on the accounting treatment of FARM, RSPs, UAFs, and the Plan de Répartition des Risques (PRR) in Québec.

Research conducted by FA confirmed that each of the residual market mechanisms above involves insurance contracts, and therefore IFRS 17 applies.

For the FARM and UAFs, the research conducted by FA<sup>15</sup> concluded that the insurance contracts are issued by the “collective” of the FA membership. FA administers the contracts but is not the actual entity to which the insurance risk is transferred to – the insurance risk is transferred to the FA membership. On this basis, the current accounting treatment continues under IFRS 17 (i.e., members account for their share of FARM and UAF insurance contracts as direct business (i.e., insurance contracts issued).

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<sup>13</sup> Extract taken from IBC IFRS 17 Working Group Guidance Paper *Premium Allocation Approach: Onerous Contracts and “Facts and Circumstances”* (November 2019).

<sup>15</sup> Research conducted by FA can be found at the following address: <http://www.facilityassociation.com/IFRS17-research.asp>.

For the RSPs, an original insurance contract is issued by one of the FA members, who then, under a second and separate transaction, transfers some or all of the insurance risk from that contract to the “collective” of the FA membership. In this case, FA is administering the process, but it does not assume any insurance risk directly. When IFRS 4 was introduced, the previous accounting treatment was allowed to continue. This treatment was such that the transaction from the original issuing member to the collective was a novation<sup>16</sup> type transfer, so that the original issuer was able to remove the insurance from their balance sheet. The issue with this accounting treatment is that one of the parties (i.e., the policyholder) is unaware of the second transaction (i.e., the transfer of the risk from the insurer to the RSPs).

Research conducted by FA concluded that the RSPs do not truly represent a transfer of the underlying insurance contract but rather represent a transfer of some or all insurance risk that is transferred from the original policyholder to the issuing member. As such, FA believes that it would not qualify for transfer accounting but would qualify for reinsurance accounting.

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<sup>16</sup> A novation involves the transfer of contractual rights and obligations from one party to another with all three parties agreeing to the terms (i.e., the original two parties to the contract and the new party that is accepting the transfer of contractual rights).