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Comments on the IAA Exposure Draft of an Educational Monograph on Risk Adjustments for Financial Reporting of Insurance Contracts under International Financial Reporting Standards No. X

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IAA Exposure Draft of an Educational Monograph on Risk Adjustments for Financial Reporting of Insurance Contracts under IFRS No. X – Comments of the DAV

The Deutsche Aktuarvereinigung (DAV) is the German association of actuaries and in this capacity appreciates the opportunity to comment on the Exposure Draft of an Educational Monograph on "Risk Adjustments for Financial Reporting of Insurance Contracts under International Financial Reporting Standards No. X", exposed by the International Actuarial Association on November 7, 2016. The response of the DAV focuses on Section 6.

Comments on Section 6 of the Exposure Draft

1. Content

Section 6 of the IAA Monograph „Risk Adjustment under IFRS", describes the impact of passive reinsurance on the risk adjustment under the headline „Effect of Risk Mitigation Technique". The author would like to take the opportunity to comment on some aspects of reinsurance as a risk mitigation technique as described in that section. Based on the author's global experience with reinsurance accounting (and supervisory regulation) for reinsurance contracts, some statements made in the respective section may need a certain refinement, since

- some sections provide in some cases an interpretation of current IFRS rules (and the forthcoming IFRS 17, as far as that standard is known to the public yet) which are not backed by the wording of these accounting rules,
- some sections are focused to reinsurance concepts on special markets which are not common globally (in particular Continental European and Japanese reinsurance concepts are not properly reflected well)
- the monograph uses to a certain extend a notion, which is controversial to compared to international standards, in particular to the IAIS "Guidance paper on risk transfer, disclosure and analysis of finite reinsurance".

2. Comments on Sub-Section 6.1

The IAA might rethink the approach taken in this subsection to base the discussion on risk mitigation with a very particular US-product, namely the product design of variable annuities. First, the product design, is nowhere else relevant in the remaining section. Second, the product mentioned is relevant in the US, whereas such products play a niche role in most other countries of the world (with exception of Japan). For an educational monograph with a global focus a broader approach might be preferable. This is relevant in particular under the aspect that IFRS accounting has no relevance at all for the US market.

3. Comments on Sub-Section 6.2

Some technical comments to be made:

- When speaking on reinsurance contracts between affiliates the statement is made, that – different from the accounting on the group level – individual entities would

need to apply "IFRS in the same manner as reinsurance transactions between unrelated parties". One might add a comment that is holds true only, if IFRS is the respective local accounting standard in the country, the entities provides its local accounts.

- In the context of "significant risk transfer" the wording used, the text speaks about "criteria that the insurance risk transfer is sufficient". Neither IFRS 4 nor IFRS 17 (Exposure Draft) use the notion of "sufficiency" of insurance risk transfer. Introducing a new wording, different from the IFRS notion of "significant risk transfer", may give rise to misleading interpretation.

- The section on significant insurance risk is incomplete in so far as, by the terms of IFRS 17, the risk transfer test for a reinsurance contracts is "deemed to transfer significant insurance risk if it transfers to the reinsurer substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts". This additional clause in the IFRS accounting standard is of high relevance in practice and hence might be reflected in the Monograph as well.

4. Comments on Sub-Section 6.3.2

The document provides a list of typical reinsurance contract provisions. Some of them are described in a misleading way, if the focus is on IFRS accounting treatment:

- Ceding commission: Current accounting practice and the current accounting standards do not require "ceding commissions or expense reimbursements" to be "deducted from the reinsurance premium. Although IFRS 4 and IFRS 17 (Exposure Draft and more recent IASB conclusions) don't make such a statement to our knowledge. The authors of the monograph are requested to double check this statement and should explicitly refer to the corresponding IFRS rule.

- It is not clear and may be misleading to distinguish between ceding commissions and reinsurance expense allowances. In particular this is not relevant for accounting. (Also in practice, such a distinction is not made in structuring and pricing a reinsurance contract in most cases.)

- Contingent cash flows (1): The notion is highly misleading since the nature of reinsurance cash-flows is to be contingent to an insured event happening. Apparently, it is meant to describe particular profit sharing terms, which can be found in many treaties. The notion should be refined.

- Contingent cash flows (2): There are no rules under IFRS 4 and IFRS 17 (to the author's knowledge) which require to treat such cash flows as reduction of ceded premiums or reduction in losses/benefits ceded. Also, if at all, such cash-flows would mean an increase in ceded losses and not a reduction.

5. Comments on Sub-Section 6.3.3

This section is completely misleading under three aspects:

- It describes only a special form of funds withheld reinsurance, that can be found mainly in the US. I.e. it does focus on contracts, where the "investment returns …

are credited to the ultimate benefit of the reinsurer". Although funds withheld reinsurance is a global concept, this particular form can be found in e.g. in Europe and Asia only in very exceptional cases. Although in North America funds withheld contracts without transfer of the original investment return are common.

- In view of valuation, i.e. determining the notional balance sheet amount, the Monograph suggests to compute this amount based on a stochastic model. Such stochastic modelling might be a proper actuarial technique in many cases, but it is not obligatory. In particular it is highly misleading to require such a technique for a funds withheld reinsurance. If at all, such modelling should be uses universally for all form of risk mitigation techniques.
- Where market risks are concerned the use of a "full stochastic model" for valuation purpose is not backed by the requirements of IFRS 17.

6. Comments on Sub-Section 6.3.4

The text provides a statement, that, whenever a contract "provides the reinsurer the option to raise premiums" etc. this would trigger a contract boundary. Such a statement is not backed the ums which triggers a contact boundary for any insurance (and reinsurance contract). That is, premium adjustments triggered by certain external effects (and/or limited) must not automatically trigger a contract boundary, whereas options to adjust premiums to a prohibitive level do so.

7. Comments on Sub-Section 6.4.2

The balance sheet overview provided is wrong. IFRS 17 requires to measure the value of reinsurance ceded based on a building block approach with "present value of the best estimate cash-flows" plus reinsurance risk adjustment plus reinsurance contractual service margin. The latter position is missing although this a highly relevant part of the reinsurance asset.

Moreover the presentation is misleading since it indicates that insurer might be required to split insurance liabilities (and reinsurance assets) on the face of their balance sheet into the three building blocks. There may be respective disclosure requirements but the standard does not require such a split in the balance sheet.

8. Comments on Sub-Section 6.5 – General

In this section a distinction is made between so-called "basic proportional reinsurance", "financial reinsurance", "reinsurance of participating contracts" and "stop-loss reinsurance". It would be recommended to waive this distinction, since it is to a wide extend artificial. Instead it would be helpful to distinguish between proportional treaties (quota share on risk basis and coinsurance), non-proportional treaties (excess of loss, aggregate excess of loss and stop-loss treaties) which had been introduces in section 6.2. Even more beneficial would be a more comprehensive approach based on the classification of the IAIS "Guidance paper on risk transfer, disclosure and analysis of finite reinsurance".

9. Comments on Sub-Section 6.5.1

The concept of a so-called "basic proportional reinsurance" is completely unusual in the literature and in reinsurance practice. As it is defined here, such contracts will also rarely be found. However, with this new notion introduced by the Monograph the reader gets the impression that such treaties require a different accounting treatment then "normal" proportional treaties, which is misleading.

10. Comments on Sub-Section 6.5.2

This section speaks about so-called "Financial reinsurance" treaties, which are not properly defined (neither in the Monograph nor in the literature). In doing so two completely different concepts are mixed:

- "Finite Reinsurance" which is used in the context of insurance supervision stand for contracts with a ""significant but limited amount of risk transfer". Such contracts are in the particular focus of supervisors, since the recognition of risk mitigation provided by such contracts (and the related relief of supervisory capital) requires a deeper analysis.
- "Reinsurance Contracts with Market Risk mitigation", which typically focus both on the insurance risk and the transfer of timing and interest rate risk. Writing such contract is a typical risk mitigation technique used by insurers and in most cases does not give rise to particular supervisory assessment.

The no good reason to treat both forms of reinsurance under the same headline, since the respective concepts and the impact on risk mitigation are completely different. Moreover, IFRS 4 and IFRS 17 – apparently for good reasons – did neither introduces the concept of "Finite Reinsurance" nor required a special classification of contracts transferring also market risk. Hence the question may be asked, why the Monograph should introduces such a distinction.

11. Comments on Sub-Section 6.5.3

This section means to focus on "Reinsurance of Participation Contracts". However, the content is on so-called "variable annuities/variable life" contracts only. Although such contracts have a high market share in the US, their importance is mostly limited to that market (except of Japan, where between 2005 and 2010 such contracts also had a certain market share). In most other countries participating contracts are highly important as well, but the way they provide additional benefits (participation) to policyholders is very different from the "variable annuity/variable life" approach.

Taking focus to other markets would be highly appreciated of an IAA publication.