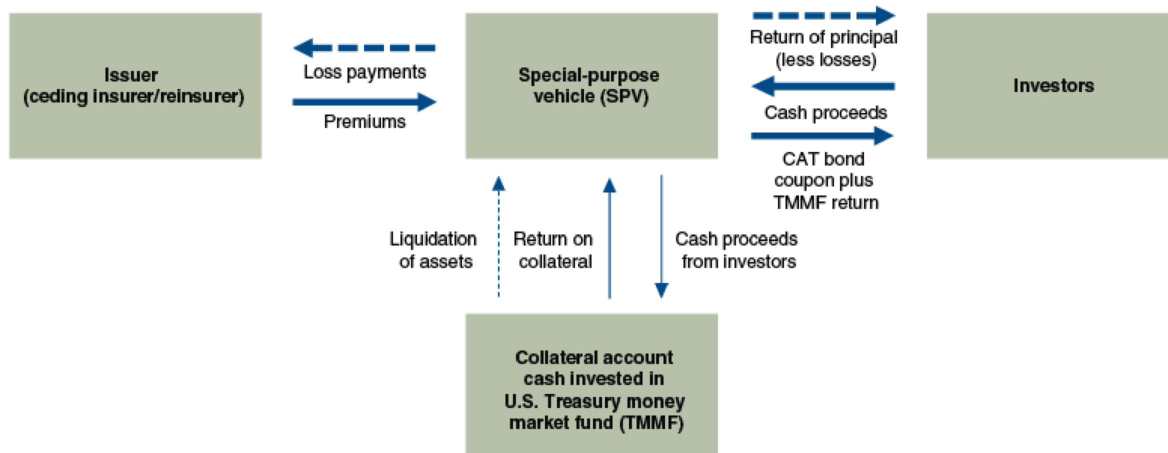
Catastrophe bonds from the investor's perspective (Deloitte)

Background

This paper considers, from the perspective of an investor (investment entity), whether a catastrophe bond with the features outlined below falls within the scope of IFRS 17 or IFRS 9.

Features of catastrophe bond addressed in this paper



Source of diagram: *Catastrophe Bonds: A Primer and Retrospective*, Federal Reserve Bank of Chicago (2018) [https://www.chicagofed.org/publications/chicago-fed-letter/2018/405]

The bond issuer is an insurer.

The SPV administers the arrangement and holds the capital contributed by investors and invests that capital in high-quality, highly liquid securities. Investors are not associated with the establishment of the SPV. Each investor has a fractional interest in the bond and none of the investors control the SPV.

The investors receive a coupon return based on premiums ceded by the issuer (insured/reinsured) and the returns on the high-quality, highly liquid securities. The investors stand to lose some or all of their capital if a specified catastrophe (such as a named storm event) affects the issuer and results in claims above a pre-determined threshold. The investors cannot lose more than the capital invested.

From the perspective of the issuer, the transfer of risk is significant, and the bonds are treated as reinsurance within the scope of IFRS 17.

IFRS 17, Appendix A defines 'insurance contract':

> A contract under which one party (the issuer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder.

IFRS 17 Application Guidance includes examples of contracts (such as catastrophe bonds) that are (and are not) insurance contracts:

> B26 The following are examples of contracts that are insurance contracts if the transfer of insurance risk is significant: …
>
> (j) catastrophe bonds that provide for reduced payments of principal, interest or both, if a specified event adversely affects the issuer of the bond (unless the specified event does not create significant insurance risk; for example, if the event is a change in an interest rate or a foreign exchange rate).[1]

1 The same wording (with different punctuation) is included in IFRS 4.B18(k) – "catastrophe bonds that provide for reduced payments of principal, interest or both if a specified event adversely affects the issuer of the bond

B27 The following are examples of items that are not insurance contracts: …

(h) contracts that provide for reduced payments of principal, interest or both, that depend on a climatic, geological or any other physical variable, the effect of which is not specific to a party to the contract (commonly referred to as catastrophe bonds).[2]

ACCOUNTING APPROACHES APPLIED BY INVESTORS

***View 1: the bonds are insurance contracts* issued by the investor and fall within the scope of IFRS 17 and they are not permitted to be scoped out of IFRS 17 by applying IFRS 17:8A.**

The catastrophe bond is as described in IFRS 17.B26(j) and, therefore, would be accounted for applying IFRS 17.

The catastrophe bond is an arrangement between the issuer and investor, with the SPV playing a largely administrative role to facilitate the transaction. The overall commercial effect is to transfer insurance risk from the issuer to the investors.[3]

The catastrophe bond addressed in this paper has the features mentioned in IFRS 17.B26(j). The investor's interest in the bond exposes them to risks akin to an excess of loss insurance contract.

IFRS 17.B13 does not exclude the bond from IFRS 17 because the trigger for losing capital (effectively paying a claim) is an event that has an adverse effect on the issuer/policyholder, which is a party to the contract.

B13 Some contracts require a payment if a specified uncertain future event occurs, but do not require an adverse effect on the policyholder as a precondition for the payment. This type of contract is not an insurance contract even if the holder uses it to mitigate an underlying risk exposure. For example, if the holder uses a derivative to hedge an underlying financial or non-financial variable correlated with the cash flows from an asset of the entity, the derivative is not an insurance contract because the payment is not conditional on whether the holder is adversely affected by a reduction in the cash flows from the asset. The definition of an insurance contract refers to an uncertain future event for which an adverse effect on the policyholder is a contractual precondition for payment. A contractual precondition does not require the entity to investigate whether the event actually caused an adverse effect, but it does permit the entity to deny the payment if it is not satisfied that the event did cause an adverse effect.

Proponents of View 1 believe IFRS 17:8A (reproduced in View 2 below) does not apply as the amendment to IFRS 17 to introduce this paragraph was in response to loans with death waiver features whereby the contractual amount owed under the loan when the borrower dies is reduced if the

(unless the specified event does not create significant insurance risk, for example if the event is a change in an interest rate or foreign exchange rate)".

2 Similar wording is included in IFRS 4.B19(h) – "catastrophe bonds that provide for reduced payments of principal, interest or both, based on a climatic, geological or other physical variable that is not specific to a party to the contract".

3 The discussion at the IFRS 17 Transition Resource Group (TRG) May 2018 meeting of Agenda paper 1 *Combination of insurance contracts* may be relevant here. Paragraph 15 of that paper says: "When developing IFRS 17, the Board considered consistency with the principle set out in the 2015 Exposure Draft of the *Conceptual Framework for Financial Reporting* that contracts should be combined as necessary to report their substance. The Conceptual Framework was published in March 2018 and this principle has remained the same".

property is lower than the nominal amount under the loan. Catastrophe bonds are not the same as the types of loans the IASB had in mind when it introduced the new scope exception in paragraph 8A.

***View 2: the bonds are insurance contracts* issued by the investor and fall within the scope of IFRS 17 however they are permitted to be scoped out of IFRS 17, into IFRS 9, by applying IFRS 17:8A.**

By analogy with mortgages with death waivers, equity release/reverse mortgages, and student loan contracts whose repayment is income contingent, which are the subject of IFRS 17.8A, an irrevocable accounting policy choice on a portfolio basis is available to apply either IFRS 9 or IFRS 17.

> 8A Some contracts meet the definition of an insurance contract but limit the compensation for insured events to the amount otherwise required to settle the policyholder's obligation created by the contract (for example, loans with death waivers). An entity shall choose to apply either AASB 17 or AASB 9 to such contracts that it issues unless such contracts are excluded from the scope of AASB 17 by paragraph 7. The entity shall make that choice for each portfolio of insurance contracts, and the choice for each portfolio is irrevocable.

The catastrophe bonds are another example of the contracts addressed in IFRS 17.8A because the maximum amount that would be needed to settle the obligation to the issuer of the bonds is the amount held in the SPV. The issuer of the bond (the policyholder) has an obligation to pay the fixed nominal amount of the bond in the absence of claim under the insurance event, but if the insurance event occurs and there is a claim the amount payable to the investor of the bond (writer of the insurance contract) is reduced by this amount. Applying paragraph 8A, in this case the compensation for the insured event (being the amount of the claim) is limited to the amount otherwise required to settle the policyholder’s obligation created by the contract (the nominal owed under the bond).

The IFRS 17 Basis for Conclusions notes:

> BC94E The Board noted that an entity would provide useful information about such contracts whether it applied IFRS 17 or IFRS 9. Hence the Board concluded that requiring an entity to apply IFRS 17 to those contracts when the entity has previously been applying an accounting policy consistent with IFRS 9 or IAS 39 could impose costs and disruption for no significant benefit.

Note that scope exclusions and limitations in IFRS are typically specific and not subject to extension by analogy. For example, the scope exclusions listed in IFRS 17.7 are specific.

However, IFRS 17.8A provides an entity specific election for each portfolio based on meeting stated criteria and identifies examples of transactions expected to meet those criteria. Accordingly, IFRS 17.8A is suitable to be applied to catastrophe bonds addressed in this paper and they are an example of the transactions described in the paragraph.

Treating the catastrophe bonds addressed in this paper as falling within the criteria in IFRS 17.8A, could be seen as being in direct contradiction of the specific example of a catastrophe bond that is an insurance contract in IFRS 17.B26(j). However, applying IFRS 17.8A would not imply that the catastrophe bonds addressed in this paper are not insurance contracts. On the contrary, IFRS 17.8A acknowledges that they are insurance contracts but permits a choice to treat some types of insurance contracts within the scope of IFRS 9.