IASB /FASB Meeting
10 February 2010

IASB agenda reference	**1A**
FASB memo reference	**38A**

Project	**Insurance Contracts**
Topic	**Reinsurance**

Purpose of this paper

1. An insurance contract involves purchase by a policyholder (the insured) of protection against a potential insurable loss from an insurer. A reinsurance contract is an insurance contract purchased by an insurer (the ceding entity or cedant) from the reinsurer (the assuming entity) that indemnifies the insurer against contractually specified losses on the direct contracts it has written. This paper addresses accounting for reinsurance contracts by both the reinsurer (principally its obligations) and the cedant (its reinsurance assets—recoverables on business written).

Summary of recommendations

2. The staff recommends:

    (a) that reinsurers use the same recognition measurement principles for the reinsurance contracts they issue as all other insurers use for the insurance contracts they have issued.

    (b) the cedant should recognize and measure its reinsurance asset (reinsurance recoverable) using the same measurement and recognition methods it uses to measure and recognize the reinsured portion of the underlying insurance contracts it has issued. This includes the following:

This paper has been prepared by the technical staff of the FAF and the IASCF for discussion at a public meeting of the FASB or the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the FASB or the IASB.

Comments made in relation to the application of U.S. GAAP or IFRSs do not purport to be acceptable or unacceptable application of U.S. GAAP or IFRSs.

The tentative decisions made by the FASB or the IASB at public meetings are reported in FASB *Action Alert* or in IASB *Update*. Official pronouncements of the FASB or the IASB are published only after each board has completed its full due process, including appropriate public consultation and formal voting procedures.

(i) The expected present value of the cash flows required to fulfil the reinsured portion of the insurer's obligations.

(ii) The addition of the risk margin (but not the residual margin) included in the measurement of the reinsured portion of the contract liability.

(iii) The addition of the residual margin arising from the reinsurance contract.

(iv) A reduction for the impact of possible impairment and coverage disputes, measured using the building block approach, in other words on an expected value basis, rather than an incurred loss basis.

(c) The reinsurance asset should not be offset against the cedant's insurance contract liabilities.

(d) Reinsurance of insurance contract liabilities does not result in derecognition of those liabilities, because the insurer remains primarily responsible for those obligations. Only in the rare case where assumption (novation) reinsurance is used would the liabilities be transferred to the reinsurer and hence derecognized by the insurer.

(e) The cedant and the reinsurer should account for ceding commissions in the same manner as the related acquisition costs. Thus, since the boards have tentatively decided that acquisition costs should be expensed as incurred, the cedant and reinsurer should include the ceding commissions in current income.

(f) Thinking about how to account for reinsurance contracts provides little input in determining the accounting by policyholders.

Structure of the paper

3. The rest of this paper is divided into the following sections:

(a) Background (paragraphs 5 through 8)

(b) Measurement and recognition of reinsurance contract by reinsurer (paragraph 9)

(c) Measurement and recognition of reinsurance asset by cedant (paragraphs 10 through 16)

(d) Offsetting (paragraph 17)

(e) Derecognition (paragraphs 18 through 19)

(f) Ceding commission (paragraphs 20 through 22)

(g) Symmetry (paragraphs 23 through 29)

(h) Appendix A includes a brief description of basic types of reinsurance contracts.

4. This paper does not address:

(a) The level of aggregation used by reinsurers to measure their liabilities (which depends on the type of reinsurance written). The staff plans to ask the boards to discuss the level of aggregation for both insurance contracts (including reinsurance contracts) at a future meeting.

(b) The boundary for the reinsurance contract, which will often be the same as the boundary for the underlying insurance contract, is an issue that is still being debated by the boards. However reinsurance may be written on an annual basis for long-duration insurance contracts. The staff plans to ask the boards to discuss contract boundaries at a future meeting.

(c) The transfer of significant insurance risk from the insured to the insurer must be included in the contract for it to qualify for insurance or reinsurance accounting. The boards will address the meaning of significant insurance risk later in their discussion of the definition of insurance contracts (including reinsurance).

(d) The use of unbundling (bifurcation) and deposit accounting to account for contracts or portions of contracts that do not transfer significant insurance risk. These subjects are being addressed in another paper for the boards' consideration at a future meeting.

Background

Financial reinsurance

5. Several years ago (early to mid 2000s) reinsurance became a headline issue when it was determined that several companies had improperly accounted for some contracts as if they were insurance or reinsurance transactions, even though the contracts did not transfer significant insurance risk from the policyholder to the insured or from the insurer to the reinsurer and, therefore, failed to qualify for insurance accounting. Insurance accounting provided the insured with an insurance recovery benefit in their income statement (usually to offset an "insured" loss). Instead, courts and regulators decided in several cases that these transactions should have been accounted for as deposits, which would have provided no significant income statement benefit. Although the financial reporting periods covered by these transactions have long passed, some of the law suits related to those reporting periods continue. In any case the notoriety produced by, and outcomes of, these cases likely has served to heighten the awareness of preparers and auditors to the risk transfer requirements necessary for insurance and reinsurance accounting.

6. Both IFRS 4 and U.S. GAAP require the transfer of significant insurance risk to qualify a contract for insurance or reinsurance accounting—both also require judgment in making the determination of significance. As noted in paragraph 4(c), the guidance concerning the determination of significant insurance risk will be addressed in later Board discussions.

Other

7. Some have asserted that other abusive accounting results have also resulted from the misuse of reinsurance contracts. For example, the use of retroactive reinsurance (reinsurance of events that have already occurred) can create a mismatch because of mixed attributes. For example, in many jurisdictions, nonlife insurance contracts measure claim liabilities in nominal currency—i.e., discounting (and the use of risk adjustments) is not required in measuring many claims liabilities . The subsequent purchase of reinsurance (after such liabilities

are recognized) can result in a gain for the cedant, because the cost of the reinsurance typically reflects the time value of money (i.e., it is determined on a discounted basis). The US has developed GAAP to address these situations by deferring such gains over the settlement period. However, the measurement model being developed by the boards would require discounting of claims (and other insurance) liabilities and there should no longer be any attribute mismatch. The FASB has yet to discuss the applicability of discounting to short duration contract claims liabilities.

8. Including investment or deposit components of insurance contracts (i.e., contract components with no or little transfer of insurance risk) in the measurement of revenue and benefit or claims payments can obfuscate an insurer's operating results. This is principally an issue for life insurance contracts with significant investment components and the potential to overstate premium volume (although the issue can be resolved through performance presentations that exclude the investment and deposit components). For nonlife contracts including these nonrisk transfer components in the income statement as premium receipts and claims payments could distort current common measures of operating results (especially for nonlife contract metrics such as loss and combined ratios which are based on earned premiums, incurred claims, and expenses).

Measurement and recognition of reinsurance contract by reinsurer

9. As noted above, the staff sees no reason not to measure and recognize reinsurance contracts using the same measurement and recognition methods used to measure insurance contracts. This is a natural result of the notion that reinsurance contracts are insurance contracts written by the reinsurer to protect the cedant (reinsured) against specified insured losses on the insurance contracts the cedant has written. The same indemnification principles that work in insurance contracts also are at work in reinsurance contracts and the same uncertainties regarding amount and timing of claims payment by the reinsurer exist as they do for insurers.

Staff recommendation and question 1 for the boards
The staff recommends that reinsurers use the same recognition measurement principles for the reinsurance contracts they issue as all other insurers use for the insurance contracts they have issued. Do the boards agree with the staff recommendation?

Measurement and recognition of reinsurance asset by cedant

10. The staff also sees no reason for the cedant to measure and recognize its reinsurance asset (reinsurance recoverable) differently from its contract obligations.

    (a) Proportional (pro rata or quota share) reinsurance: first three building blocks should lead to same result for cedant's reinsurance asset as for its underlying direct insurance liabilities. For example, a 30% proportional reinsurance agreement means the reinsurance asset equals 30% of liability (before considering residual margin but including risk margin).

    (b) The same principle applies for non-proportional reinsurance: the amount included in the ceded part of the direct liability should also be included in reinsurance asset.

11. Three notes concerning this measurement are needed:

    (a) The risk margin included in the measurement of the contract obligation should be included in the asset measurement (but not the residual margin). Although a risk margin for an asset would normally be thought of as a reduction in the asset measurement value, the risk margin in this case relates to the uncertainty in the portion of the cedant's obligation that has been reinsured. Accordingly, this risk margin increases the measurement of the

asset (as discussed in agenda paper 1B / FASB memo 38B). This same margin could be considered the reinsurer's profit.

(b) The residual margin in the underlying liability is the cedant's profit margin and therefore not a component of the reinsurance asset. However, the measurement of the cedant's reinsurance asset (and the measurement of the reinsurer's liability) will include the residual margin that is implicit in the pricing of the reinsurance contract.

(c) On the other hand, the reinsurance asset should be reduced for items which could affect the amount of the recoverable, namely the reinsurance asset should be reduced for the expected present value of any credit losses (impairment) or coverage losses on the reinsurance contract.

12. This recommended approach is consistent with paragraph 20 of FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, which states:

> Reinsurance receivables [the reinsurance recoverable or reinsurance asset] shall be recognized in a manner consistent with the liabilities (including estimated amounts for claims incurred but not reported and future policy benefits) relating to the underlying reinsured contracts. Assumptions used in estimating reinsurance receivables shall be consistent with those used in estimating the related liabilities.

13. The principal concerns regarding the collectability of the reinsurance asset include any expected credit or coverage losses (impairments) with respect to the reinsurer or the reinsurance contract, respectively. The first component of the adjustment relates to normal credit impairment resulting from the insurer's assessment of the creditworthiness of the reinsurer.

14. The credit risk of credit default is covered by both US GAAP and IFRS 4, *Insurance Contracts*:

(a) US GAAP would apply a FASB Statement No. 5, *Contingencies*, "probable loss" model, which is also an incurred loss model.

(b) IFRS 4 also uses an incurred loss model, consistent with IAS 39, *Financial Instruments: Recognition and Measurement.*

(c) For phase 2:

(i) An expected loss model would be consistent with the building block approach.[1] It would also be consistent with the recent IASB exposure draft (ED), *Financial Instruments: Amortised Cost and Impairment*. Some respondents to the discussion paper (DP) supported this approach.

(ii) Other respondents to the DP supported retaining the incurred loss model, perhaps, in part, because many insurers use a relatively small number of reinsurers. The fact that most insurers use only a few reinsurers would mean that the law of large numbers does not apply and so some question whether sufficiently robust inputs are available to apply an expected loss approach .

15. Coverage issues result when the parties to the reinsurance contract (cedant and reinsurer) disagree on whether a particular loss by the cedant is covered by the reinsurance contract. A significant recent dispute involved the twin towers of the World Trade Center and whether that disaster was considered one or two events. The courts eventually determined that the answer depended on which contract the individual reinsurers had committed to—for some insurers/reinsurers it was determined to be a single event and for others two events. The issue has also arisen when a hurricane makes more than one landfall (a single versus multiple event(s)). Hurricanes have also recently resulted in disputes concerning the cause of the damage to properties—wind (hurricane) versus flooding (excluded from hurricane coverage by being covered separately by available flood insurance)

[1] Arguably, expected losses at inception are inherent in the pricing of the reinsurance contract and therefore in the initial measurement of the residual margin. Thus, to avoid double counting, an expected loss model would consider only changes in the expected losses since inception.

16. As the examples point out, a number of factors can enter into coverage disputes, which leads the staff to conclude that an expected value approach is an appropriate measurement approach to capture the various possibilities. Also, expected value is more consistent with the building block approach proposed for other insurance contract related measurements. Moreover, it is worth remembering that some of the objections sometimes made to applying the expected loss model to loan losses arise from the interaction of expected losses with amortised cost; that interaction does not arise in the proposed model for insurance contracts.

Staff recommendation and question 2 for the boards

The staff recommends that the cedant should recognize and measure its reinsurance asset (reinsurance recoverable) using the same measurement and recognition methods it uses to measure and recognize the reinsured portion of the underlying insurance contracts it has issued. This includes the following:

(a) The expected present value of the cash flows required to fulfil the reinsured portion of the insurer's obligations.

(b) The addition of the risk margin (but not the residual margin) included in the measurement of the reinsured portion of the contract liability.

(c) The addition of the residual margin arising from the reinsurance contract.

(d) the impact on the reinsurance asset of possible impairment and coverage disputes, measured using the building block approach, in other words on an expected value basis, rather than an incurred loss basis.

Do the boards agree with the staff recommendation?

Offsetting

17. Reinsurance recoverables (assets) cannot normally be offset against insurance liabilities because they generally do not satisfy the requirements for offsetting under either IFRS or U.S. GAAP:

(a) Paragraph 14(d) of IFRS 4 states:

> (d) [an insurer]shall not offset:
>
> > (i) reinsurance assets against the related insurance liabilities; or
> >
> > (ii) income or expense from reinsurance contracts against the expense or income from the related insurance contracts.

(b) Paragraph BC 106 of The Basis for Conclusions of IFRS 4 states:

> A cedant (ie the insurer that is the policyholder under a reinsurance contract) does not normally have a right to offset amounts due from a reinsurer against amounts due to the underlying policyholder. Normal offsetting criteria prohibit offsetting when no such right exists. When these criteria are not met, a gross presentation gives a clearer picture of the cedant's rights and obligations, and related income and expense (see paragraph 14(d) of the IFRS).

(c) Paragraphs 15 and 16 of FASB Statement 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, state:

> Amounts receivable and payable between the ceding enterprise and an individual reinsurer shall be offset only when a right of setoff exists, as defined in Interpretation 39.
>
> The amounts of earned premiums ceded and recoveries recognized under reinsurance contracts either shall be reported in the statement of earnings, as separate line items or parenthetically, or those amounts shall be disclosed in the footnotes to the financial statements.

(d) Paragraph 5 of FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*, states:

> Opinion 10, paragraph 7, states that "it is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except where a right of setoff exists." A right of setoff is a debtor's legal right, by contract or otherwise, to discharge all or a portion of the debt owed to another party by applying against the debt an amount that the other party owes to the debtor. A right of setoff exists when all of the following conditions are met:
>
> a. Each of two parties owes the other determinable amounts.

> b. The reporting party has the right to set off the amount owed with the amount owed by the other party.
>
> c. The reporting party intends to set off.
>
> d. The right of setoff is enforceable at law.
>
> A debtor having a valid right of setoff may offset the related asset and liability and report the net amount. [Footnotes omitted.]

Staff recommendation and question 3 for the boards
The staff recommends that reinsurance balances not be offset against related direct reinsurance balances (balance sheet and income statement) unless legal requirements for offsetting are met. The staff believes a gross presentation gives a clearer picture of the cedant's rights and obligations, and related income and expense. Do the boards agree with the staff recommendation?

Derecognition

18. In November, the boards tentatively decided that insurance liabilities would be derecognized when they were extinguished. Applying that conclusion, reinsurance will not generally qualify for derecognition of the cedant's reinsured direct insurance liability. Most reinsurance contracts provide indemnification only (known as indemnification reinsurance), in other words the cedant retains its obligation towards the policyholder and has a separate right to be indemnified by the reinsurer. However, if the reinsurer legally assumes the insurance liability via assumption reinsurance (generally through a legal novation or transfer), the cedant no longer has an obligation to the policyholder and so would derecognize the liability). Assumption reinsurance (novations) are rare and usually require the approval of the insured (policyholder or cedant) and/or the regulator.

19. Furthermore, reinsurance generally does not satisfy the requirements for derecognition under either IFRS or U.S. GAAP:

    (a) Paragraph 14(c) of IFRS 4 confirms this position:

> [an insurer] shall remove an insurance liability (or a part of an insurance liability) from its balance sheet when, and only when, it is extinguished—ie when the obligation specified in the contract is discharged or cancelled or expires.

(b) Paragraph BC 105 of The Basis for Conclusions of IFRS 4 states:

> The Board identified no reasons why derecognition requirements for insurance liabilities and insurance assets should differ from those for financial liabilities and financial assets. Therefore, the derecognition requirements for insurance liabilities are the same as for financial liabilities (see paragraph 14(c) of the IFRS). However, because derecognition of financial assets is a controversial topic, the IFRS does not address derecognition of insurance assets.

(c) Paragraph 14 of FAS 113 states:

> Reinsurance contracts that are legal replacements of one insurer by another (often referred to as assumption and novation) extinguish the ceding enterprise's liability to the policyholder and result in removal of related assets and liabilities from the financial statements of the ceding enterprise. Reinsurance contracts in which a ceding enterprise is not relieved of the legal liability to its policyholder do not result in removal of the related assets and liabilities from the ceding enterprise's financial statements. Ceding enterprises shall report estimated t reinsurance receivables arising from those contracts separately as assets. Amounts paid to the reinsurer relating to the unexpired portion of reinsured contracts (prepaid reinsurance premiums) also shall be reported separately as assets.

Staff recommendation and question 4 for the boards
The staff recommends that reinsurance does not result in derecognition of the related direct insurance liabilities unless the obligation specified in the insurance contract is [legally] discharged or cancelled or expires. Do the boards agree with the staff recommendation?

Ceding commission

20. In a proportional reinsurance contract the reinsurer shares a percent (fixed by the contract, e.g., 30 percent) of the reinsured contracts premiums and losses. Typically the reinsurer also will pay the cedant a ceding commission,

principally to reimburse the cedant for its (i.e., the cedent's) acquisition costs. These "ceding commissions" traditionally have been paid only on proportional reinsurance (otherwise known as pro-rata or quota-share reinsurance). However, ceding commissions are generally a negotiated amount and can include a profit for the insurer.

21. Under many current accounting standards where deferred acquisition costs (DAC) are carried as an asset on the balance sheet, the ceding commission is accounted for by the reinsurer as DAC and as a reduction in DAC by the cedant.

22. In the staff's view:

    (a) The reinsurer should treat ceding commissions in the same way as acquisition costs. Applying the boards' tentative decision to expense acquisition costs as incurred, this would mean that the reinsurer would expense ceding commissions as incurred.

    (b) The cedant should recognise ceding commissions as income at the same time as it recognises its own acquisition costs as an expense. Applying the boards' tentative decision to expense acquisition costs as incurred, this would mean that the cedant would recognise ceding commissions as income when it expenses the related acquisition costs.

Staff recommendation and question 5 for the boards
The staff recommends that ceding commissions be credited/charged to the income statement by both the cedant and reinsurer in the same manner as acquisition costs. Do the boards agree with the staff recommendation?

Symmetry

23. The following paragraphs consider issues of symmetry between:

    (a) the cedant's reinsurance asset and its underlying insurance liability

    (b) the cedant's reinsurance asset and the reinsurer's liability

    (c) insurers and policyholders

Cedent's reinsurance asset and underlying direct insurance liabilities

24. The staff concludes that symmetry exists between a cedant's reinsurance asset and its underlying direct insurance liabilities:

    (a) There seems to be no reason for the cedant to use a different measurement model for its reinsurance asset than for its underlying direct contracts.

    (b) Note that the coverage period for a proportional reinsurance contract is often based on an underwriting year, which will include all direct contracts written during that 12 month period. Therefore, the reinsured direct contracts' coverage period will extend to 24 months (for example, for a calendar year reinsurance contract some direct contracts covered by the reinsurance will incept on December 31st and run for 12 months). This also would extend the reinsurance contract's coverage period to 24 months and would suggest an amortization of the reinsurer's residual margin over at least that period. However, this would not affect the symmetry between the cedant's reinsurance asset and its direct contract liability.

Between cedent's reinsurance asset and reinsurer's liability

25. There is also symmetry between a cedant and the reinsurer (and policyholder and insurer). However due to information asymmetry and considering the

different markets the products are being sold in, differences in results can be expected. However, the methodologies should be applicable at all levels.

(a) In principle, the same model is used for both parties

(b) A difference may arise where:

(i) a cedant has more detailed and timely information about its own portfolio than the reinsurer does.

(ii) a reinsurer has information gained from other cedants.

(iii) the level of aggregation will be different if the measurement is at portfolio level (i.e., the cedant's portfolio corresponds to the reinsurance asset, the reinsurer's liability is effectively a portfolio of reinsurance assets).

(iv) The cedant and reinsurer may make different assessments of the risk adjustment. As noted in agenda paper 1B / FASB memo 38B, this is because the cedant will attach more value than the reinsurer would to the cash flow that will occur if the insured event happens.

(v) The measurement of the cedant's reinsurance asset will reflect the risk of non-performance by the reinsurer, but the measurement of the reinsurer's liability will not reflect this.

26. Reinsurance arrangements can become more complex. Some nonproportional contracts are written on an incurred loss basis—that is, the reinsurance covers only losses occurring during the contract term. In this case the reinsurance contract's coverage period also defines the reinsurance coverage period for the cedant's direct contract claims. Note that proportional reinsurance arrangements can also be written to cover a 12 month period, but these contracts require a transfer of unearned premium from one treaty year to the next. The reinsurance arrangement can be tailored to include only current year earned premium and claims payments. For this to be done requires the transfer in of the unearned premium and outstanding claims from the prior year, earning and paying current year premiums and claims and transferring out year end

unearned premium and the outstanding claims liability to the next treaty year (clean cut treaties—not common in the US but the staff understands they are used in other parts of the world).

27. As the reinsurance arrangements become more complex, symmetry (although ideal) will be harder to achieve in practice. Not only will the available information be different between the cedant and reinsurer but the units of account are also likely to be different (the reinsurer's unit of account will be portfolios of cedant's assets). Symmetry at this level would be hard to achieve.

Symmetry between the insurer and the policyholder

28. Given the difficulties presented above concerning symmetry between the reinsurer and the cedant (insurer), it is hard to imagine achieving symmetry in **outcomes** between the insurer and policyholder. However, the staff believes that symmetry can and should be achieved in the **methodologies**.

29. Accounting for reinsurance provides little insight into accounting by other policyholders. The insurer (as cedant) does not function as a useful model for other policyholders.

Staff recommendation and question 6 for the boards

The staff recommends symmetry of measurement methods:

(a) between the the cedant's reinsurance asset and its underlying insurance liabilities.

(b) between the cedant's asset and the reinsurer's liability (the insurer's reinsurance asset and the reinsurer's liability), except in relation to the credit risk of the reinsurer. However, because different information is available to the insurer and because the units of account and views on risk adjustments may differ, the application of the same methodologies may result in different amounts.

Do the boards have any questions or observations concerning symmetry?

Appendix A

Reinsurance—types and description:

30. The following are some of the more common types of reinsurance written.

31. Reinsurance contracts are generally divided into two broad categories—treaty and facultative.

    (a) Reinsurance treaties typically cover all insurance contracts of a particular type or class specified in the contract written by the reinsured or cedant during the period specified in the contract. For example, if the treaty specifies all annual homeowners contracts written by the insurer during the year 201X, the reinsurance will cover all claims under those contracts during their terms. Although the amount of covered premium is not known at the inception of the reinsurance contract, an estimate of that premium will be made in the treaty. Because the last homeowner's contract covered by the reinsurance contract could be written on December 31, 201X, claims covered under that contract can extend to the end of the following year. Another reinsurance contract could, for example, cover only accidents occurring during the year 201X, irrespective of when the insurance contract was written. The reinsurer receives information from the insurer—typically quarterly, setting forth the insurance contracts covered, the premium written for that quarter on those contracts as well as the claims reported to the insurer and sometimes an estimated incurred but not reported reserve (IBNR). Information for reinsurance written on international insurance business will often be submitted less frequently and with a longer delay.

    (b) Facultative reinsurance contracts (often called certificates), on the other hand are written to cover a single insurance contract.

Facultative contracts are typically written on larger or more complex insurance contracts.

32. Reinsurance contracts may be short or long duration contracts. Short duration reinsurance contracts can be used to reinsure a period (e.g., a year) of a long duration insurance contract but may be renewable annually.

33. Reinsurance contracts are generally written on a proportional (prorata) or nonproportional (excess) basis:

    (a) In a prorata reinsurance contract the reinsurer shares a percentage (fixed by the contract, e.g., 30 percent) of the reinsured contract's premiums and losses. Typically the reinsurer also will pay the ceding insurer a ceding commission, principally to reimburse the insurer for its acquisition costs. However, these ceding commissions are generally a negotiated amount and can include a profit margin for the insurer. For more on the accounting for these commissions see paragraphs 20 to 22 of this paper.

    (b) In an excess reinsurance contract, the reinsurer specifies what portion of the cedant's covered incurred claims during the contract's term it will reinsure. These reinsurance contracts can be written in terms of all claims from of a certain line of business incurred in excess of a specified amount (e.g., a stop-loss treaty) or a portion (percentage) of those incurred claims. More often the reinsurer will reinsure all or a portion of a layer (usually a monetary range) of claims from a certain line of business incurred, such as CU X of claims on Y type business incurred during the contract period in excess of CU Y of claims incurred on that type of business. The range can be based per insurance contract or on the total claims incurred for the line for the period. The ceding premiums paid by the insurer for these covers are based on the volume of insurance premium covered and are negotiated based on the insurer's and reinsurer's views of the

potential losses. Traditionally there is no ceding commission on excess business.

34. There are many other variations of insurance and reinsurance. For example:

    (a) Incurred claim vs. claims made—focuses on whether the insured event is the underlying event (incurred claim) or reporting of that underlying event to the insurer (claims made) that triggers a valid reinsurance claim.

    (b) Prospective vs. retroactive reinsurance—does the insurance or reinsurance cover future losses or losses that have occurred prior to the cover being written.

35. There are also other contractual terms can be used to categorize types of insurance contracts. For example, the insurer may hold the premiums due to the reinsurer as protection against potential credit defaults by the reinsurer. The earnings on the funds held by the insurer are determined by the terms of the contract. Ultimately any residual funds held by the insurer (including earnings on those funds) are paid to the reinsurer. For obvious reasons these contracts are known as funds held contracts by the cedant.

36. Finite reinsurance refers to reinsurance that transfers limited insurance risk, requiring judgment to separate those contracts that transfer significant insurance risk from those contracts that are basically deposits. See paragraphs 5 to 6 for more information on these contracts.