Project **Insurance Contracts**

Topic **Reinsurance – Follow up issues**

Purpose of this paper

1. This paper addresses the following reinsurance accounting questions raised by the boards at their joint board meeting on 10 February:

   (a) Can residual and composite margins for reinsurance assets be negative?

   (b) How should ceding commissions be recognised by a cedant?

   (c) What is the interaction between the impairment of an insurer's reinsurance recoverable asset and the building block approach?

   (d) How would the proposed accounting for reinsurance contracts by a cedant apply to a non-proportional reinsurance contract?

Staff recommendations

2. In this paper the staff recommend that:

   (a) A cedant shall not recognise any negative residual or composite margins when measuring a reinsurance asset. Instead, if the consideration paid by the cedant for the reinsurance contract is less than the measurement of the reinsurance asset under the building block approach:

      (i) the cedant shall recognise that difference as a gain in profit or loss at inception of the reinsurance contract; however

      (ii) before recognising a gain, the cedant shall reassess whether it has correctly measured the underlying insurance asset (and thus the reinsurance asset, including an assessment of the risk of non-

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performance by the reinsurer) or whether the negative difference arises as the result of a measurement inaccuracy and, if so, it shall correct it.

(b) A cedant shall recognise any ceding commissions arising from reinsurance contracts:

(i) [IASB] as a reduction in the premium paid to the reinsurer.

(ii) [FASB] as a gain in profit or loss, to the extent that these ceding commissions refer to the reinsurer's share of the cedant's incremental acquisition costs. The cedant shall recognise that gain at the earlier of the day on which it recognised the reinsurance contract and the day on which it incurred the incremental acquisition costs. The cedant shall treat the remaining share of ceding commissions as a reduction of the premium ceded to the reinsurer.

3. This paper also presents information to answer the questions in paragraphs 1 (c) and 1(d), but does not contain recommendations on these points.

Background

4. At their joint meeting on 10 February, the boards discussed the accounting for reinsurance contracts by both the reinsurer (principally its obligations) and the cedant (principally its reinsurance assets, ie the recoverables on its direct insurance liabilities).

5. The boards tentatively decided that:

(a) A reinsurer should use the same recognition and measurement approach for the reinsurance contracts it issues as all other insurers use for the insurance contracts they have issued.

(b) A cedant should recognize and measure its reinsurance asset (reinsurance recoverable) using the same recognition and measurement approach it uses for the reinsured portion of the underlying insurance contracts it has issued (subject to further staff research described below). This measurement approach includes:

(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 implied by the pricing of the reinsurance contract.

(c) The cedant and the reinsurer, respectively, should credit and charge to the income statement ceding commissions for proportional reinsurance contracts in a manner consistent with the treatment of acquisition costs.

6. Also, at that same meeting, the boards asked the staff to research the following issues:

(i) Can the residual margin implied by the pricing of the reinsurance contract be negative? (paragraphs 8-17)

(ii) What are the operational consequences of a treatment of ceding commissions consistent with the proposed accounting for acquisition costs? How to distinguish ceding commissions from other contractual cash flows? (paragraphs 18-25)

(iii) How do the building blocks of the proposed measurement approach interact with the impairment test of the reinsurance asset? (paragraphs 26-28)

(iv) How does the proposed measurement approach apply to non-proportional reinsurance contracts? (paragraphs 29-32)

7. In this paper, staff will focus only on the cedant's perspective and, in particular, on the measurement of reinsurance assets and on the related issues summarised in paragraph 6.

Treatment of negative differences arising from the measurement of reinsurance assets

8. The proposed measurement approach for reinsurance assets requires a cedant to determine, on the date of inception of the reinsurance contract, either:

(a) a residual margin as the difference between (i) the estimate of the present value of expected cash flows plus a risk adjustment and (ii) the consideration paid to the reinsurer by the cedant; or

(b) a composite margin as the difference between (i) the estimate of the present value of expected cash flows and (ii) the consideration paid to the reinsurer by the cedant.

9. The estimate of present value of future cash flows takes into account the risk of reinsurer's non-performance (reinsurer's credit risk) both at inception and subsequently.

10. For both the residual margin approach and the composite margin approach, a positive difference arises if the consideration paid by the reinsurer is higher than the estimated amounts (ie present value of cash flows plus, only for a residual margin approach, a risk adjustment). In this case, an amount corresponding to this positive difference is recorded as a residual or composite margin as shown in Table 1 below (as explained in agenda paper 1A for the 10 February joint meeting / FASB memo 38A, the risk adjustment component increases, rather than decreases, the measurement of the reinsurance asset because it refers to the share of risk that has been reinsured).

Table 1 Positive difference on measurement of reinsurance asset

Input description	Amounts (CU)	
Approach	Residual margin	Composite margin
Consideration paid (premium ceded to the reinsurer, lump sum paid upfront)	100	100
Expected present value of reinsurance recoverable cash outflows	80	80
Risk adjustment (portion related to recoverable cash flows ceded)	15	-
Expected present value of cash flows plus risk adjustment (if any)	(95)	(80)
Residual margin/Composite margin	5	20

11. However, a negative difference would arise if the consideration paid to the reinsurer is less than the estimated amounts of reinsurance recoverable under the building block approach. The question that needs to be answered then is whether, in those cases, a residual or composite margin should be permitted to be negative. Table 2 illustrates this case for the residual margin approach (the analysis for a composite margin is similar,

although because there is no separate risk adjustment, a negative composite margin is less likely to arise).

Table 2 Negative difference on measurement of reinsurance asset

Input description	Amounts (CU)
Consideration paid (ceded premium, lump sum paid upfront)	93
Expected present value of cash flows	80
Risk adjustment	15
Expected present value of cash flows plus risk adjustment (if any)	(95)
Residual margin?	(2)

12. The proposed measurement approach for insurance contracts is basically a direct liability measurement that includes an allocation component (the residual or composite margins) to eliminate any gains at inception of the contract.

13. The consideration can differ from the amount determined for the insurance liability under the building block approach, for at least two reasons:

    (a) measurement inaccuracies in the application of the building block approach to the insurance liability; and

    (b) different measurement perspectives adopted (market participant’s view as opposed to an insurer’s specific view).

14. These two factors can help explain any divergence between the amount paid as consideration for the reinsurance contract and the measurement under the building block approach of the reinsurance asset. Particularly, in the case under examination, a negative difference could arise if the pricing considers diversification benefits between portfolios, but the measurement by the cedant excludes diversification benefits.

15. Let us focus first on negative differences arising from the determination of a residual margin. The same considerations would then apply to the calculation of a composite margin. In the example shown in Table 2 above, if the cedant thinks cash flows plus risk adjustment are CU95, but the reinsurer was willing to accept CU93, what caused that negative difference of CU2? As mentioned in paragraph 13, possible explanations are:

(a) The cedant overstated the liability. If so, the remedy is to re-measure the underlying insurance liability and thus the related reinsurance asset.

(b) The reinsurer underpriced the reinsurance contract. If so, the underlying liability is correctly stated at CU95 and the cedant has made an economic gain, which could be either recognised immediately or deferred.

(c) The reinsurer is actually able to fulfil the contract more cheaply than the cedant, perhaps because of economies of scale or diversification benefits.

16. Staff believe that any negative differences between the consideration paid and the measurement of the reinsurance asset could be attributed to any of the three factors identified in paragraph 15 (a), (b) and (c). Also staff believe that a negative amount for a residual or composite margin would be inconsistent with the boards' decisions not to allow residual or composite margins to be negative for direct insurance contracts (ie insurance contracts other than reinsurance contracts).

17. Therefore staff recommend that a cedant shall not include any negative residual or composite margins when measuring a reinsurance asset. Instead, if a negative amount arises a cedant:

(a) shall recognise that difference as a gain in profit or loss on the date of inception of the reinsurance contract; however

(b) before recognising a gain, the cedant shall reassess whether it has correctly measured the underlying insurance asset (and thus the reinsurance asset, including an assessment of the risk of non-performance by the reinsurer) or whether the negative difference arises as the result of a measurement inaccuracy and, if so, it shall correct it.

Question 1 for the boards
Do the boards agree with the staff recommendation?

Treatment of ceding commissions

18. As noted during the joint board meeting on 10 February, ceding commissions are paid principally on proportional reinsurance arrangements for reimbursement of a proportional share of the acquisition costs paid by the cedant. This section discusses

whether the cedant should recognise ceding commission in profit and loss at the same time as it incurs acquisition costs, or whether it should treat them as a reduction in the premium paid by the cedant to the reinsurer.

19. The boards decided tentatively that acquisition costs shall be expensed as incurred. The IASB decided tentatively to exclude from the initial measurement of the residual margin an amount equal to the incremental acquisition costs. However, the FASB decided tentatively not to recognise any corresponding amount of the premium as revenue (or income) at inception. Therefore, under the IASB tentative decision, incremental acquisition costs are a *neutral* item in the income statement (ie offset by an equal amount of income) while under FASB's proposal they represent an expense without any balancing (offsetting) amounts.

20. At its April 2009 meeting the IASB discussed acquisition costs and defined incremental acquisition costs as:

    > those costs that the insurer would not have incurred if it had not issued those contracts.

    Although FASB has not specifically discussed this definition of incremental acquisition costs, it may also apply in the context of US GAAP.

21. The example below shows how the ceding commissions from a reinsurance contract could be accounted for under both boards' decisions regarding insurance acquisition costs.

    (a) Underlying contract:

Table 3 Residual/composite margin – underlying contract

Description of inputs	IASB (CU)	FASB (CU)
A) Single premium	1,000	1,000
B) Expected Present Value of cash outflows	(800)	(800)
C) Risk margin	(80)	N/A
D) Incremental acquisition costs	(40)	(40)
E) Non-incremental acquisition costs	(20)	(20)
F) Residual/composite margin at inception (1,000-800-80-40)/(1,000-800)	80	200

Table 4 Initial measurement – underlying contract

Description of inputs	IASB (CU)	FASB (CU)
A) Single premium	1,000	1,000
D) Incremental acquisition costs	(40)	N/A
G) Initial measurement (1,000-40)/(1,000)	960	1,000

Table 5 Initial measurement – underlying contract (alternative analysis)

Description of inputs	IASB (CU)	FASB (CU)
B) Expected Present Value of cash outflows	800	800
C) Risk margin	80	N/A
F) Residual/composite margin at inception	80	200
G) Initial measurement	960	1,000

(b) Reinsurance contract 50% quota share of the above:

Table 6 Residual / composite margin – reinsurance asset

Description of inputs	IASB (CU)	FASB (CU)
A) Single premium	500	500
B) Expected Present Value of cash outflows	(400)	(400)
C) Risk margin	(40)	N/A
D) Ceding commission (paid by reinsurer to cedant to cover 50% of incremental and non-incremental acquisition costs)	(30)	(30)
E) Residual/ composite margin at inception (500-400-40-30)/(500-400)	30	100

Table 7 Initial measurement –reinsurance asset

Description of inputs	IASB (CU)	FASB (CU)
A) Single premium	500	500
D) Ceding commission (paid by reinsurer to cedant to cover 50% of incremental and non-incremental acquisition costs)	(30)	N/A
F) Initial measurement of reinsurance asset (500 - 30)/(500)	470	500

Table 8 Initial measurement –reinsurance asset (alternative analysis)

Description of inputs	IASB (CU)	FASB (CU)
B) Expected Present Value of cash outflows	400	400
C) Risk margin	40	N/A
E) Residual/composite margin at inception	30	100
F) Initial measurement	470	500

(c) Income and expense at inception:

Table 9 – Profit or Loss of the Cedant

Description of inputs	IASB (CU)	FASB (CU)
Income equal to incremental acquisition costs	40	-
Ceding commission (representing the recovered share of acquisition costs)	-	30
Incremental acquisition costs	(40)	(40)
Non-incremental acquisition costs	(20)	(20)
Net loss	**(20)**	**(30)**

22. Remark: for simplicity the example assumes that the ceding commissions exactly cover the reinsurer's share of acquisition costs. In practice, the extent to which the cedant recovers acquisition costs through the ceding commissions paid by the reinsurer would depend on the terms of the contract.

23. Under the IASB's view, for the underlying insurance contract, all acquisition costs are expensed and an amount is recognised in profit or loss to reflect the incremental component of those acquisition costs. As a result, the profit or loss will reflect a loss equal to the amount of non-incremental acquisition costs. For the reinsurance contract, the ceding commission is not included in the cedant's profit or loss because it has already made an adjustment to the underlying insurance liability and because identifying the split in the ceding commission between the portions relating to incremental and non-incremental acquisition costs may be burdensome and arbitrary, therefore the ceding commissions will be simply treated as a reduction of the premium ceded to the reinsurer.

24. On the other hand, under FASB's tentative decision to expense all acquisition costs as incurred without recognising any recovery of the incremental component of those costs, it would seem consistent for a cedant to recognize the entire amount of ceding commissions (CU30) in profit or loss as a gain. However, in order to avoid any concerns

about possible manipulation, staff believe that only the share of ceding commissions that is attributable to incremental acquisition costs shall be recognised as a gain in profit or loss (CU20 in the example). The remaining part of ceding commissions (CU10) would decrease the amount of the premium ceded to the reinsurer by the cedant.

25. Therefore staff recommend that a cedant shall recognise any amounts attributable to ceding commissions arising from reinsurance contracts:

    (a) [IASB] as a reduction in the premium paid to the reinsurer.

    (b) [FASB] as a gain in profit or loss to the extent that they refer to the reinsurer's share of the cedant's incremental acquisition costs. The cedant shall recognise that gain on the earlier of the day on which it recognised the reinsurance contract and the day on which it recognised the incremental acquisition costs. The cedant shall treat the remaining share of ceding commissions as a reduction of the premium ceded to the reinsurer.

Question 2 for the boards
Do the boards agree with the staff recommendation?

Impairment testing for reinsurance assets

26. As mentioned in paragraph 5, at their joint meeting on 10 February, the boards tentatively decided to use the building blocks approach for the impairment testing of reinsurance assets by applying an expected value basis rather than an incurred loss basis. During that meeting a specific question arose whether there would be any conflict in using the building blocks both to measure the reinsurance asset and to measure any impairment of that same asset.

27. Particularly, the reason for this question was that, if the initial measurement of reinsurance assets includes the effect of the risk of non performance by the reinsurer only implicitly in the residual or composite margin, then the subsequent measurement, in order to avoid double counting, should pick up only changes in the expected losses, excluding any losses that were already implicit in the residual or composite margin determined at inception.

28. However, because an expected loss model is used in the proposed measurement for the reinsurance asset at inception and subsequently, that measurement include the risk of the reinsurer's non-performance in the estimate of expected future cash flows, rather than implicitly in the margins. Therefore, there is no double counting.

The proposed accounting for reinsurance contracts and non-proportional reinsurance contracts: an example

29. The example in Table 10 and Table 11 below shows how a cedant would measure the asset related to a non-proportional reinsurance contract. It is based on a stop-loss contract covering losses exceeding CU1,000. Assume the following measurement of the underlying contract at a point in time after inception:

Table 10 Measurement of underlying contract

Input Description	On losses <CU1,000	On losses > CU1,000	Total
Expected Present Value of cash flows	CU500	**CU200**	CU700
Risk adjustment	CU50	**CU 30**	CU80
Sub-total	CU550	**CU 230**	CU780
Remaining Residual margin			CU100
Total			CU880

30. The total amount of insurance liability measured by the cedant is CU880, but the cedant only reinsures losses exceeding CU1,000 (the related relevant amounts are emphasised in the Table 10 above). Also, we assume at this measurement point that the remaining residual margin for the reinsurance asset is CU25 and that the credit risk is negligible. (This residual margin is an amount given by the fact pattern and cannot be derived from other information presented for this example). The measurement of the reinsurance asset would then be:

Table 11 Measurement of reinsurance asset residual margin

Input Description	On losses > CU1,000
Expected Present Value of cash flows	200
Risk adjustment	30
Sub-total	230

Residual margin	25
Total	255

31. Table 12 below shows the measurement of the reinsurance asset in a composite margin approach:

Table 12 Measurement of reinsurance asset composite margin

Input Description	On losses > CU1,000
Expected Present Value of cash flows[1]	200
Composite margin	55
Total	255

32. Conclusion: as in a proportional reinsurance arrangement, also for a non-proportional contract, the measurement of the reinsurance asset mirrors the measurement of the underlying direct contract.

[1] That includes the risk of non-performance by the reinsurer.