IASB/FASB Meeting
Week beginning 16 May 2011

IASB Agenda reference **3J**

FASB Agenda reference **68J**

Staff Paper

Project	**Insurance contracts**
Topic	**Reinsurance**

Purpose of this paper

1. This paper discusses the accounting for reinsurance and asks the boards to decide whether to:

    a. Clarify when significant risk transfer occurs for some reinsurance contracts in the guidance on definition of an insurance contract;

    b. Clarify the guidance on considering interdependent contracts when evaluating whether significant risk transfer occurred;

    c. Recognize reinsurance contracts applying the recognition criteria for the underlying contracts;

    d. Measure the ceded risk adjustment/composite margin or derive the ceded risk adjustment/composite margin based on a with and without reinsurance approach;

    e. Treat reinsurance as part of the expected cash flows of the underlying insurance contract or as a separate contract when measuring the gain or loss on reinsurance;

    f. Estimate the present value of the fulfilment cash flow for the reinsurance contract without consideration to the residual/composite margin on the underlying contracts;

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g. Treat ceding commissions as part of the expected cash flows or as a reduction in ceded premiums; and,

h. Evaluate the reinsurance recoverable using an expected loss or incurred loss model.

2. This paper does not discuss:

a. Presentation of reinsurance in the statement of financial position and the statement of comprehensive income

b. Amendments to reinsurance contracts, including commutations

c. Participating features such as reinstatement premiums

d. Amortisation of residual/composite margin

e. Assumption reinsurance arrangements

f. Accounting model (building block or modified approach) used by the reinsurer

These items will be discussed in future meetings.

3. The rest of the paper is set out as follows:

a. Staff recommendation summary

b. Relevant questions from the DP/ED

c. Summary of feedback received

d. Staff analysis

i) Significant risk transfer

(1) Guidance for reinsurance contracts

(2) Interdependent contracts

ii) Recognition

iii) Ceding entity symmetry with underlying insurance contracts

(1) Risk adjustment

(2) Gain and loss recognition

(3) Residual margin

(4) Ceding commission

(5) Credit risk measurement

Staff recommendation summary

4. The staff recommends that:

   a. If substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts has been assumed by the reinsurer, the reinsurance contract is deemed to transfer significant insurance risk.

   b. An insurer shall assess the significance of insurance risk contract by contract. Contracts entered into simultaneously with a single counterparty for the same risk, or contracts that are otherwise interdependent shall be considered a single contract.

   c. When the amount recoverable from the reinsurer for a loss on an underlying insurance contract is independent of the recoverable for losses on other underlying insurance contracts, the cedant should recognize a reinsurance asset when the underlying contract is recognized, otherwise the cedant should recognize a reinsurance asset when the reinsurance coverage period begins. An onerous contract liability would be recognized if management becomes aware of an onerous contract in the pre-coverage period.

   d. If the present value of the fulfillment cash flows for the reinsurance contract is:

      i. less than zero (ie the expected present value of future cash inflows (plus the risk adjustment under the IASB's ED) is less than the expected present value of future cash outflows), the cedant shall establish that amount as part of the reinsurance recoverable, representing a prepaid reinsurance premium and should recognize the cost over the coverage period of the underlying insurance

contracts. If the reinsurance protection is for past events, the loss should be immediately recognized.

ii. greater than zero (ie the expected present value of future cash inflows plus the risk adjustment exceed the expected present value of future cash outflows), the cedant shall recognize a reinsurance residual/composite margin.

e. When considering the treatment of ceding commissions:

   i. The cedant shall treat ceding commissions it receives as a part of the contract cash flows to the extent those costs are included in the expected cash flows

   ii. The cedant shall treat expense allowances as a part of the contract cash flows to the extent those costs are included in the expected cash flows

   iii. Any ceding commissions and expense allowances in excess of those direct costs included in the contract cash flows should be recorded as reduction of the premium ceded to the reinsurer

f. The cedant shall consider the risk of non-performance by the reinsurer when estimating the present value of the fulfilment cash flows on an:

   i. incurred loss basis, or

   ii. expected loss basis

g. The determination of risk of non-performance by the reinsurer shall consider all facts and circumstances, including collateral.

h. Losses from disputes should be reflected in the measurement of the recoverable when there is an indication that there is a dispute.

Background

5. The following terms used in this paper are specific to reinsurance:

   a. Reinsurance - a contract by which an insurer transfers all or part of its risk under an insurance contract to another insurer.

   b. Cedant - the entity (i.e., the reinsured) that receives the right to reimbursement from the assuming company (i.e., the reinsurer) under the terms of a reinsurance contract and pays a reinsurance premium for that right.

   c. Assuming company-the entity (i.e., the reinsurer) that accepts an obligation to reimburse a ceding company (i.e., the reinsured) under the terms of a reinsurance contract and receives a reinsurance premium for the assumption of that obligation.

   d. Cession - the process of transferring the risk from the ceding company to the reinsurer.

   e. Retrocession – the process of an assuming company, in turn, transferring a portion of its risk.

6. Insurers enter into reinsurance contracts primarily to:

   a. Spread the risk of their insurance contracts

   b. Reduce exposure on particular risks or classes of risks

   c. Provide the financial capacity to accept risks and contracts with larger face amounts than those that could otherwise be accepted

   d. Help stabilize operating costs

   e. Improve their statutory surplus position; transfer from the ceding company to the reinsurer the part of the surplus strain that results from writing new contracts.

   f. Protect against accumulations of losses arising out of catastrophes

g. Limit liabilities of captive insurers

h. Assist in financial and tax planning strategies

i. Obtain underwriting assistance with respect to risk classification, or broaden the ability to market products with which the cedant has little experience

j. Exit a line of business

k. Test new coverages or new classes

7. There are various types of reinsurance (proportional, excess, etc.) that cover blocks of business or individual/specific contracts for either future losses or past losses. Appendix A describes these various types of reinsurance for both life and non-life insurance as well as the form of reinsurance.

Relevant questions in the exposure draft/discussion paper

8. Question 26 of the DP asked respondents the following:

> The scope of the proposed guidance includes reinsurance contracts that an insurer issues or acquires. However, insurance contracts held directly by other policyholders would be excluded from the scope of the proposed guidance. Do you agree with this exclusion? Why or why not?

9. Question 27 of the DP asked respondents the following:

> Should there be symmetry between the recognition and measurement of reinsurance contracts and the underlying contract ceded?

10. Question 16 of the ED asked respondents the following:

> (a) Do you support an expected loss model for reinsurance assets? Why or why not? If not, what do you recommend and why?
>
> (b) Do you have any other comments on the reinsurance proposals?

Summary of feedback received

General feedback

11. Respondents generally agreed with the proposal to exclude policyholder accounting from the guidance. Most respondents also agreed that the recognition and measurement approach applied to direct insurance contracts should also be applied to reinsurance contracts.

12. Many respondents mentioned reinsurance in their response to general questions regarding:
    a. Recognition (timing and interaction with underlying contracts)
    b. Definition (determing significant risk transfer)

c. modified approach eligibility (applicability to risk-attaching contracts and interaction with underlying contracts)

13. Most respondents cited lack of detail as a primary concern with reinsurance proposals in the DP/ED.

14. Symmetry between reinsurance and direct insurance was interpreted differently between respondents. Some respondents questioned whether:

a. Reinsurers should "mirror" the measurement assumptions reflected in the cedant's reinsurance asset

b. Cedants should "look through" to the underlying liability when determining risk transfer and measurement approach eligibility

c. Cedants and reinsurers would need to estimate all cash flows from the reinsurance contract at the initial coverage date even for contracts that cover unwritten underlying policies

15. Specific topics where clarification or redeliberation was frequently requested include:

a. Evaluation of significant risk transfer

b. Calculation of risk adjustments and margins

c. Recognition of day one gains

d. Consideration of reinsurer credit by the cedant

e. Product-specific guidance

Significant risk transfer

16. Some respondents were concerned the proposed definition and supporting guidance is difficult to apply to certain types of reinsurance contracts. Particularly, it was unclear if the discussion of significant insurance risk in Paragraphs B23-B27 was operational for all reinsurance contracts. This includes:

a. An insurer should consider the time value of money in assessing whether the additional benefits payable in any scenario are significant.

b. A contract does not transfer significant insurance risk if there is no scenario that has commercial substance in which the insurer can suffer a loss, with loss defined as an excess of the present value of the cash outflows over the present value of the premiums.

17. Several respondents also requested clarification of Paragraph B28 in the IASB ED. The guidance proposes for the purpose of assessing the significance of insurance risk, contracts entered into simultaneously with a single counterparty, or contracts that are otherwise interdependent, form a single contract. Respondents were concerned that fronting arrangements, reinsurance programs, and retrocession agreements may experience unintended consequences. Some noted diversity in practice currently exists for these arrangements and clarification in the standard is important.

Risk adjustments and margins

18. Most respondents to the reinsurance questions in the DP/ED asked for additional guidance on the proposed calculation of risk adjustments and composite/residual margins.

19. Many respondents who addressed this concern interpreted the DP/ED as applying a "gross less ceded equals net" approach. This implies measuring the risk adjustment and residual margin on the ceded portion proportionately with the gross amount. However, many reinsurance arrangements are non-proportional (i.e., excess of loss contracts) and therefore the net liability retained is not proportionate to the gross. Most respondents suggested that the amount of risk adjustment ceded should reflect the relief from risk of the underlying insurance liability. Most variations of this approach involved calculating the direct insurance liability before and after the effects of the reinsurance agreement. The difference in the risk adjustment would represent the relief from risk and therefore be included in the reinsurance recoverable. Some referred to this as the "Gross less net equals ceded" approach.

20. Determining the ceded residual margin based on a calibration to the reinsurance premium was frequently mentioned as a potential measurement weakness. Differences often exist in the amount the cedant charged direct policyholders for the amount of risk and the amount the reinsurer charges to reinsure that risk. This results from circumstances unique to the insurer and their estimates of risk.

21. Many respondents believe investors would not understand the true reinsurance protection provided if the residual margin on the asset was higher or lower simply because of differences between premiums for the direct contracts and the corresponding portion of a reinsurance contract. They felt the ceded margin should reflect the proportion of reinsurance provided on the underlying contracts.

22. The tentative proposal to lock-in the residual or composite margin compounded this issue when reinsurance was written for in-force blocks of business. The residual/composite margin will partially be based on the discount rate used for the fulfilment cash flows which presumably will be different if reinsurance is entered into after the insurance contract effective date.

Day-one gains

23. Respondents were divided on the proposal to recognize day-one gains.

    a. Some respondents found it appropriate to recognize gains to offset losses that the entity had recognized on the underlying contracts. Likewise, they thought it appropriate to recognize losses to offset gains (residual/composite margin) recognized on the underlying contracts.

    b. Some respondents believe that when the reinsurance contract is signed the cedant transfers risk to the reinsurer and an economic gain is realized.

    c. Others believe that no gain should be recognized since the cedant is not relieved of the underlying risk.

    d. Some respondents worried that the potential for "window dressing" and "accounting arbitrage" presented too great a risk to justify the proposals. A

proposed solution to manipulation concerns required disclosure of management's justification for any gains recognized on these contracts.

Reinsurer credit risk

24. Some respondents agreed that recognizing credit risk using an expected loss model on the reinsurance asset was appropriate. Some support was contingent on the outcome of the ongoing impairment discussions in the boards' work on financial instruments. However, others believed an incurred loss model was more appropriate.

25. Some respondents were concerned the measurement proposed in the ED/DP created unnecessary complexities in financial statements by hindering comparability with the underlying liability. Several respondents thought determining credit risk on an expected value basis was an exit value concept and was inconsistent with a fulfilment value notion since insurers do not enter into contracts they expect to default.

26. Many respondents requested additional guidance on implementing the measurement if the proposed expected loss model is included in a final standard. Several characteristics unique to insurance contracts led respondents to question if the complexities of calculating the credit risk were justified.

27. Reinsurance contracts are typically net settled. A charge based on the gross recoverable and the credit rating may not appropriately reflect the risk of default in these cash flows. Some reinsurance contracts rely on collateral to offset the credit risk in a contract. Examples of collateral include "funds withheld", letters of credit, and reinsurance trusts. Respondents requested clarification on including these factors in the measurement.

28. Some respondents mentioned the proposed measurement model would result in any credit risk, which reduces the recoverable, would be reflected in the composite or residual margin. The release of the margin would not necessarily reflect the release of the default risk included, distorting comparability.

Additional feedback

29. Several respondents did not believe that reducing reinsurance premiums by ceding commissions would provide useful information to the users of the financial statements. This would also result in the need to explain changes in performance metrics commonly understood by users.

30. Many respondents noted that there should be more guidance on particular reinsurance arrangements, specifically,

    a. Loss portfolio transfers

    b. Commutations

    c. Funds withheld arrangements

    d. Catastrophe bonds

Staff analysis

Significant risk transfer

31. At the 18 March joint board meeting, the boards tentatively decided that an *insurance contract* is "a contract under which one party accepts significant insurance risk from another party by agreeing to compensate the policyholder if a specified uncertain future event adversely affects the policyholder." The boards also tentatively decided that:

    a. An insurer should consider the time value of money in assessing whether the additional benefits payable in any scenario are significant.

    b. A contract does not transfer significant insurance risk if there is no scenario that has commercial substance in which the insurer can suffer a loss, with *loss* defined as an excess of the present value of the cash outflows over the present value of the premiums.

32. Paragraph 28 of the IASB's basis for conclusions on the ED states that an insurer shall assess the significance of insurance risk contract by contract. Many

respondents found the requirement that there must be a scenario in which the insurer can suffer a loss problematic when considering reinsurance. This is because many times the underlying insurance portfolio being reinsured is expected to be profitable, although at the individual insurance contract level, the direct insurer is exposed to risk.

33. Some refer to this as "stepping in the shoes of" the ceding company and is typical in "straightforward" quota share reinsurance contracts (i.e., contracts without adjustable features), historically profitable reinsurance contracts in which substantially all of the reinsured insurance risk has been assumed by the reinsurer, and facultative certificates.

34. The requirement to have a scenario in which there must be a loss is also problematic for certain catastrophe reinsurance cover which is sometimes referred to as "sleep insurance". This type of insurance typically has high severity of loss if the event occurs, however, there typically is a low frequency of the event occurring.

35. The staff believe if the economic benefit to the reinsurer for its respective portion of the underlying policies is virtually the same as the ceding company's economic benefit, then the reinsurer has assumed substantially all the insurance risk related to the reinsured policies. This would be the case if substantially all the insurance risk relating to the reinsured portions of the underlying insurance contracts has been assumed by the reinsurer, leaving the ceding entity with no more than trivial insurance risk on the reinsured portions of the underlying insurance contracts.

    a. For those contracts mentioned above, the economic benefit to both the ceding and assuming company is substantially the same (for the portion reinsured) when there are no adjustable features and the assuming company has stepped into the shoes of the direct insurer.

    b. For catastrophe reinsurance, the economic benefit to both the ceding and assuming company is substantially the same (for the portion reinsured) when there is "fixed premium for fixed coverage".

Staff recommendation

36. The staff recommend that the board clarify the definition of insurance by adding the following provision from FASB Statement No. 113 to the application guidance:

    a. If substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts has been assumed by the reinsurer, the reinsurance contract is deemed to transfer significant insurance risk.

Question 1 – Definition of significant risk transfer
Do the Boards agree with the staff recommendation to add to the application guidance: a) If substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts has been assumed by the reinsurer, the reinsurance contract is deemed to transfer significant insurance risk.

Interdependent contracts

37. Paragraph B28 requires the evaluation of significant risk transfer contract by contract but clarifies that contracts that are entered into simultaneously with a single counterparty or contracts that are otherwise interdependent, form a single contract. In this situation the group of contracts is evaluated together for determination of risk transfer.

38. Many respondents felt this may lead to unintended consequences for certain reinsurance contracts.

39. ASC 944-20-55-58 states: “Determining whether a reinsurance contract indemnifies the ceding enterprise against loss or liability relating to insurance risk requires a complete understanding of all contracts or agreements with related reinsurers. Although an individual contract may appear to indemnify the ceding enterprise, the risk assumed by the reinsurer through one reinsurance contract may

have been offset by other contracts or agreements. A contract does not meet the conditions for reinsurance accounting if features of the reinsurance contract or other contracts or agreements directly or indirectly compensate the reinsurer or related reinsurers for losses. That compensation may take many forms, and an understanding of the substance of the contracts or agreements is required to determine whether the ceding enterprise has been indemnified against loss or liability relating to insurance risk."

40. The staff believe that the requirement to consider that multiple contracts may form a single contract does not mean that all contracts with one reinsurer are evaluated on a collective basis but rather when evaluating multiple contracts with one reinsurer, a ceding company should evaluate each contract individually while remaining alert to the provisions that may tie the results under one contract to an adjustable feature of another contract.

41. Some respondents were concerned that considering multiple contracts that are interdependent as a single contract would impact the accounting for captive and fronting arrangements as well as retrocession agreements.

    a. Fronting arrangements are sometimes used in jurisdictions where the reinsurer is not licensed to write insurance. The fronting insurer will issue contracts and reinsure all or substantially all of the risks on the insurance for a fee or portion of the profits. In these situations the fronting insurer retains the same risks associated with any other type of reinsurance contract and is not relieved of its obligation to the policyholders. As such, fronting arrangements should not be impacted by considering multiple contracts.

    b. Corporations often establish captive insurance companies to improve risk management programs. In a simple captive transaction, a parent company will establish a wholly-owned, or captive, subsidiary to issue insurance policies to the parent. The subsidiary will receive premium payments from the parent and payout claims. These structures allow the parent to improve controls and transparency over risks they are forced or choose to retain when compared to establishing loss reserves. On a consolidated basis the parent

entity would apply the consolidation guidance and eliminate the intercompany transaction.

c. Retrocession arrangements where an operating entity within a consolidated group transfers risk through insurance to an independent insurer and this insurer passes the risk back to a captive insurer in the same consolidated group as the operating entity. Companies should consider these arrangements together to determine whether there is significant risk transfer.

42. While the issues in the interpretation of interdependent contracts were raised by several constituents in the context of reinsurance, the staff believe the clarification should apply to all insurance/reinsurance contracts.

Staff recommendation

43. The staff recommends that the guidance be clarified such that an insurer shall assess the significance of insurance risk contract by contract. Contracts entered into simultaneously with a single counterparty for the same risk, or contracts that are otherwise interdependent shall be considered a single contract.

Question 2 – Interdependent contracts
Do the Boards agree with the staff recommendation that: b) An insurer shall assess the significance of insurance risk contract by contract. Contracts entered into with a single counterparty **for the same risk**, or contracts that are otherwise interdependent shall be considered a single contract.

Recognition

44. The boards tentatively decided that insurance contract assets and liabilities should initially be recognized when the coverage period begins and that onerous contract liability would be recognized if management becomes aware of an onerous contract in the pre-coverage period.

45. However, the staff believe there needs to be clarity for reinsurance arrangements where the reinsurance coverage may be for a specific time period but is based on the underlying contracts being written. Many property and casualty reinsurance

agreements are designed to cover policies written during a twelve-month period (known as risk attaching contracts). Typically, the reinsured policies in the portfolio are written throughout the year. The reinsurance would provide coverage for each individual policy's coverage period thus extending the reinsurance coverage from twelve months to twenty-four months.

46. For example, a reinsurance contract may cover a portion of all losses for contracts written from 1 January 2011 through 31 December 2011. The insurance coverage on the direct contracts within the reinsurance contract may be written throughout the year and therefore the insurer will not have recognised the direct contract. In the case of automatic reinsurance, the reinsurer is bound to accept all amounts written by the insurance company up to a predetermined maximum (the binding authority).

47. Where the reinsurance recoverable is based on the loss of an individual underlying insurance contract and is independent of the reinsurance recoverable on losses for other underlying insurance contracts, the staff believe that the recognition of the reinsurance asset or liability should be based on the coverage effective date of the underlying contract(s) because:

    a. Reinsurance contracts do not transfer risk if the underlying insurance contract is not written and has not yet been recognized by the insurer. Exposure to risk will arise only if the underlying insurance contract is written and at the start of the underlying insurance contract coverage period.

    b. Adjustments would need to be made to reflect the actual contracts written which will inevitably differ from those expected at initial recognition; and

    c. Recognizing such contracts before the underlying insurance contract is recognized would be misleading and is unlikely to provide any useful additional information to users of financial statements.

48. There are other reinsurance contracts where the protection to the cedants is based on aggregate losses rather than providing indemnification for an individual underlying contract. Typically the ceded premium is a fixed amount or based on

premiums written for which there is a minimum, maximum, and estimated amounts. In these contracts the reinsurer is exposed to risk at the effective date of the reinsurance agreement and therefore the staff believe the reinsurance asset or liability should be recognized at that date.

Staff recommendation

49. Based on the above factors, the staff recommend that when the amount recoverable from the reinsurer for a loss on an underlying insurance contract is independent of the recoverable for losses on other underlying insurance contracts, the cedant should recognize a reinsurance asset when the underlying contract is recognized, otherwise the cedant should recognize a reinsurance asset when the reinsurance coverage begins.

Question 3 – Recognition of reinsurance contract
Do the Boards agree with the staff recommendation that a. When the amount recoverable on an underlying insurance contract is independent of the losses and recoverable on other underlying insurance contracts, the cedant should recognize a reinsurance asset when the underlying contract is recognized, otherwise the cedant should recognize a reinsurance asset when the reinsurance coverage period begins.

Ceding entity symmetry with underlying insurance contracts

50. Paragraph 44 of the IASB's ED states that "The cedant shall estimate the present value of the fulfilment cash flow for the reinsurance contract in the same manner as the corresponding part of the present value of the fulfilment cash flows for the underlying insurance contract or contracts, after remeasuring the underlying insurance contracts on initial recognition of the reinsurance contract."

51. Paragraph 110 of the IASB's ED states: "The cedant would estimate the present value of the net cash flows in the same manner as the corresponding part for the present value of the future net cash flows for the underlying insurance contract."

52. Paragraph B36 of the IASB's ED requires a cedant to measure a reinsurance contract initially at the present value of the fulfilment cash flows plus a residual margin.

53. The following examples are from the IASB's ED paragraph B 36 and assume:

Expected present value of premiums	1,000
Expected present value of acquisition costs	30
Expected present value of losses	870
Risk adjustment	60
Residual margin	40

EXAMPLE A

DIRECT COMPANY			30% QUOTA SHARE CEDED REINSURANCE CONTRACT			REINSURER		
DAY 1			DAY 1			DAY 1		
EPV inflow	1,000		EPV inflow	261		EPV inflow	275	
EPV outflow loss		870	EPV outflow		275	EPV outflow		261
EPV outflow commission		30						
Risk adjustment		60	Risk adjustment	18		Risk adjustment		18
PV fulfillment cash flow		40	PV fulfillment cash flow		4	PV fulfillment cash flow		(4)
Residual margin		40	Residual margin		-	Residual margin		-
P/L impact day 1		-	P/L impact* day 1		4	P/L impact day 1		(4)

EXAMPLE B

DIRECT COMPANY			30% CEDED REINSURANCE CONTRACT			REINSURER		
DAY 1			DAY 1			DAY 1		
EPV inflow	1,000		EPV inflow	261		EPV inflow	285	
EPV outflow loss		870	EPV outflow		285	EPV outflow		261
EPV outflow commission		30						
Risk adjustment		60	Risk adjustment	18		Risk adjustment		18
PV fulfillment cash flow		40	PV fulfillment cash flow		(6)	PV fulfillment cash flow		6
Residual margin		40	Residual margin		6	Residual margin		(6)
P/L impact day 1		-	P/L impact day 1		-	P/L impact day 1		-

Risk adjustment ceded

54. The example above is based on proportional reinsurance however there is also non-proportional reinsurance. Non-proportional arrangements provide for financial protection to the cedant for aggregate losses rather than providing indemnification for individual policies covered by the reinsurance contract. This type of reinsurance is typically written on an annual basis to protect the ceding insurer from excessive aggregate losses and is sometimes referred to as excess of loss or catastrophe reinsurance.

55. Typically, the reinsurance arrangement covers losses that exceed either a predetermined dollar amount or a percentage of the direct writer's subject premiums for the specific period, subject to a specified limit. For example a ceding company may have a CU 10 million exposure and want to cede all losses in excess of CU 1 million.

    a. In some instances the arrangement is one layer, for example, CU 9 million of coverage in excess of CU 1 million of losses.

    b. In other instances these contracts are written in layers to allow for differences in pricing for different layers of risk. For example:

Layer	Amount of Coverage	Aggregate Loss Trigger for Reinsurance	Aggregate Losses
1	CU 2 million	CU 1 million	CU 3 million
2	CU 3 million	CU 3 million	CU 6 million
3	CU 4 million	CU 6 million	CU 10 million
Total	CU 9 million	CU 10 million	

(i) Layer 1 = CU 2 million of coverage in excess of CU 1 million of losses;

(ii) Layer 2 = CU 3 million of coverage in excess of CU 3 million of losses;

(iii) Layer 3 = CU 4 million of coverage in excess of CU 6 million of losses. Typically the layers are priced differently.

56. As previously noted, the ED and the DP proposed that the cedant estimate the present value of the fulfilment cash flow for the reinsurance contract in the same manner as the corresponding part of the present value of the fulfilment cash flows (including a risk adjustment under the IASB's ED) for the underlying insurance contract or contracts. The boards tentatively decided that should they determine the insurance liability should include an explicit risk adjustment, the risk adjustment shall be the compensation the insurer requires to bear the risk that the ultimate cash flows could exceed those expected.

57. Cedants often focus their reinsurance coverage on the tails of the distribution. These are usually the most difficult parts of the underlying distribution to estimate. However, the ceded risk adjustment in these cases should be very large compared to the gross risk adjustment. This occurs, not only because the reinsurance coverage is for the tail or excess portions but also because the ceding company typically can't diversify the volatility due to the insignificant volume of specific catastrophe contracts compared to the volume of contracts for specific catastrophe that the reinsurer accepts which is included in the reinsurance pricing.

58. Because various layers are typically priced differently for the different risks being ceded to the reinsurer, the calculation of the ceded risk adjustment based on the gross risk adjustment can theorectically be done. However, many respondents believe it would be more appropriate to determine the risk adjustment on the remaining net liability to determine the amount of the risk adjustment ceded.

59. Sometimes, the most practical approach in such circumstances is to estimate the expected present value of cash flows and the risk adjustment for these contracts net of reinsurance cover and then gross up the net estimate for the effect of reinsurance. This is because ceding companies significantly reduce the volatility of their business when viewed on a net of reinsurance basis with the purchase of excess of loss reinsurance.

60. The advantage of this approach is that the measurement of the net position has a direct effect on profit or loss. Conversely, although information about magnitude of the reinsured portion of the gross position gives users an insight into the extent

of the credit risk borne by the cedant, it has no direct effect in profit or loss. It has only an indirect effect through any subsequent adjustment for changes in the risk of default or dispute by the reinsurer which may not receive as much scrutiny if the focus is on net balance.

61. Some respondents have argued that the ceded risk adjustment could be different if based off of the gross risk adjustment or the net risk adjustment. Theoretically, the calculation of the ceded risk adjustment should be the same regardless of whether it is determined based on the gross risk adjustment or the net risk adjustment. One situation where the ceded risk adjustment could potentially be different is when underlying insurance contracts within different portfolios are reinsured together.

Staff recommendation

62. By entering into a non-proportional reinsurance arrangement, the insurer is limiting the uncertainty inherent in fulfilling the insurance contract. Theoretically an insurer should arrive at the same answer whether it calculates the ceded risk adjustment based on the gross risk adjustment or determines the ceded risk adjustment based on performing a with and without reinsurance calculation of the risk adjustment. The staff do not believe that it is appropriate to specify the method in which the cedant determines the amount of risk adjustment ceded. Instead the staff believe that the guidance should be clarified by stating that the ceded portion of the risk adjustment should represent the risk being removed from the use of reinsurance.

Question 4– Ceded risk adjustment
Do the Boards agree with the staff recommendation that: (a) The ceded portion of the risk adjustment should represent the risk being removed from the use of reinsurance.

Recognition of gains and losses from reinsurance

63. Paragraph 45 of the IASB's ED states if the present value of the fulfillment cash flows for the reinsurance contract is:

    a. less than zero (ie the expected present value of future cash inflows plus the risk adjustment is less than the expected present value of future cash outflows), the cedant shall establish that amount as the residual margin at initial measurement.

    b. greater than zero (ie the expected present value of future cash inflows plus the risk adjustment exceed the expected present value of future cash outflows); the cedant shall recognize that amount as a gain at initial recognition of the reinsurance contract.

64. Paragraph 110 of the FASB's DP states that: If the future cash inflows exceed the future cash outflows, a gain would be recognized in earnings. However, if the future cash inflows are less than the future cash outflows, the difference would be recognized in the composite margin (for the IASB, the residual margin).

65. Paragraph BC236 in the IASB's ED indicates that the Board noted the most likely cause of a negative residual margin on a reinsurance contract would be:

    a. an overstatement of the underlying direct insurance contract(s). A cedant would deal with this by reviewing the measurement of the direct contract(s).

    b. favourable pricing by the reinsurer, for example as a result of diversification benefits. The Board concluded that the recognition of a gain would be appropriate in such cases. This is because doing so is consistent with the Board's conclusion that the residual margin for the underlying contract should not be negative (although for the underlying contract the consequence is the immediate recognition of a loss, rather than the immediate recognition of a gain).

66. The guidance in the IASB's ED and the FASB's DP for reinsurance treated reinsurance as an extension of the initial contract:

a. When the consideration paid for reinsurance exceeds the insurance liability reinsured under the contract (present value of the expected cash flows), the ceding company would in essence recognize a loss, however, under the proposal would record a composite/residual margin which would offset the composite/residual margin on the underlying insurance.

b. When the insurance liability reinsured under the contract (present value of the expected cash flows), exceeds the consideration paid for reinsurance, the ceding company would in recognize a gain which in theory offsets a loss that the insurer recognized on the underlying contracts.

67. Many respondents noted that determining the ceded residual/composite margin based on a calibration to the reinsurance premium is a measurement weakness. While the proposal in the ED/DP produces reasonable results in simple scenarios, some would argue that it does not produce reasonable results in more complex scenarios such as:

a. The direct insurance produces a gain and the reinsurance produces a gain or a loss that is greater than the direct insurance gain

b. The direct insurance produces a loss and the reinsurance produces a loss or a gain greater than the direct insurance loss

c. Reinsurance of in-force blocks of insurance

d. Non-proportional reinsurance

68. The difference between the amount paid to the reinsurer and the liabilities related to the reinsured contracts may result from underwriting, investment, service, sales, or financing activities. In addition, the reinsurer may have different estimates of the loss expectations than the cedant. In addition, reinsurers typically write large portfolios of specific risks and thereby including them within a larger portfolio allow them to diversify much of the variability and reflect that in the pricing of the reinsurance contract.

69. Most respondents did not object to the treatment of the loss as a residual/composite margin. However, allowing the residual/composite margin on

reinsurance to be greater than the residual/composite margin on the underlying insurance contracts would result in a net negative residual/composite margin which would represent a loss on the overall contract and if recorded as a residual/composite margin would result in deferring a loss. This is inconsistent with the boards' tentative decisions that an insurer should recognise any loss on day one immediately when it occurs, in profit or loss (net income).

70. Many respondents were opposed to recognizing a gain on the initiation of a reinsurance arrangement because the insurer is not extinguished from its obligation. Recognising a gain on reinsurance would be inconsistent with the boards' tentative decision that any gain at inception of an insurance contract should not be recognised but rather increase the insurance liability (as a residual or composite margin).

71. In addition, recognising a gain could cause accounting arbitrage. For example, in order to increase its profits for the year, an insurer may enter into a reinsurance arrangement, only to commute[1] (cancel) it subsequent to the reporting period. Commutations are very common and frequently result in gains or losses to both the insurer and reinsurer.

72. The staff considered whether reinsurance should be treated as part of the underlying contract or as a separate contract.

Treat as part of underlying contract

73. If the reinsurance contract is treated as part of the underlying contract then the determination of whether a residual/composite margin or a loss is recorded should be based on the results after reinsurance.

    a. A residual/composite margin would be recorded on a reinsurance contract up to the residual/composite margin on the underlying contract(s). Any amount greater than the residual/composite margin on the underlying contract should be recorded to the income statement.

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[1] Commutation is a settlement agreement (a buy back) reached between a reinsured and a reinsurer by which the reinsurance obligation is terminated by an agreement by the reinsurer to pay funds at present value that are not yet due under the reinsurance agreement.

b. A gain would be recorded on a reinsurance contract up to the amount of loss recorded on the underlying insurance contract. Any amounts in excess of the loss would be recorded as a residual/composite margin on reinsurance. This would defer a gain that is related to the combined underlying insurance contract(s) and the reinsurance contract.

74. This approach has the same results of determining the present value of the expected cash flows without reinsurance and with reinsurance.

75. A disadvantage of this approach is the operational complexities. If the reinsurance contract is entered into at the same time as the underlying insurance contract, insurers will be able to perform the calculations. However, when reinsuring an in-force block of insurance, the calculation becomes more complicated due to the following:

a. The residual/composite margin will likely be managed and measured at a higher level than the contract(s) reinsured. However, in prior meetings, the staff has indicated that the residual margin cannot be re-measured at each reporting period. Therefore it will be difficult to match the remaining residual/composite margin with the contract(s) being reinsured.

b. The residual/composite margin on the underlying insurance contracts and the reinsurance contract is impacted by the discount rate at the inception of the respective contracts. Should the discount rate differ from when the residual margin was determined on the underlying insurance contracts and when it is determined on the reinsurance contract, the results will not be comparable.

c. The gain on reinsurance would be recognised in a period subsequent to the initial loss, distorting the financial results.

Treat as a separate contract

76. If the reinsurance contract is treated as a separate contract then the determination of whether a residual/composite margin or a loss is recorded should be based on entering into the separate contract.

77. The boards tentatively decided that an insurer should not recognise any gain at inception of an insurance contract. Some argue that insurance company as the cedant, is a consumer, and therefore if the price for reinsurance is less than the value they are receiving, a gain should be recognized. However, the staff believe that because the cedant has not been relieved of its obligation to the policyholder and therefore the gain is not certain, as well as the fact that the cedant can commute the reinsurance contract, the cedant should not recognize a gain at inception of a reinsurance contract and should instead establish a reinsurance residual/composite margin. The staff believe that the reinsurance residual/composite margin should be recognized consistent with the principles for recognizing the residual/composite margin on the underlying insurance contracts covered by the reinsurance contract.

78. A cedant may have a loss on a reinsurance contract, after updating the expected cash flows (plus a risk adjustment under the IASB's ED). While not typical, there are situations when a cedant will pay premiums in excess of the updated expected cash flows for risk management purposes, such as to exit a line of business.

79. One view is that all losses should be expensed when incurred. This would be consistent with the boards tentative decision that an insurer should recognise any loss on day one immediately when it occurs, in profit or loss (net income). However, the staff believe that the reason the boards decided that a loss should be recognized immediately on an underlying contract is because it would be considered an onerous contract. A loss on the reinsurance contract is not because it is an onerous contract but rather represents the cost to purchase reinsurance for risk management purposes.

80. Another view is that the ceded premium represents an expense of purchasing reinsurance and therefore the cost should be recognized over the period of benefit. If the insurer is recognizing the income over the underlying insurance contract period, as has been tentatively decided by the boards for the modified approach, then the purchaser of the insurance protection, the policyholder, should be expensing the cost of buying the protection over the same period. This would

mean that once the period that covered events could occur has been reached then the insurer would have recognized its revenue, net of expected losses that will be settled in the future and the policyholder would have expensed the net cost. As such, the cedant as the purchaser of reinsurance should expense the costs of reinsurance, which represents the insurers protection of loss on the underlying insurance contracts, over the same period, that being the coverage period of the underlying contracts.

81. Reinsurance contracts are also written to cover past events. Because the coverage period of the underlying insurance contracts is past, some staff believe that costs for retroactive reinsurance should be expensed as incurred.

82. These staff believe that there is no accounting basis to require one customer to have expensed the entire cost once the coverage period has ended if they decided to buy the insurance protection before the event happens and another customer who decided to wait until the event period has ended and buy insurance to cover the variability in the ultimate settlement to recognize the cost over the payout period.

83. Conversely, if the board believes that for those that buy coverage after the event occurs can recognize the cost over the payout period then the customer that has purchased the coverage in advance should not expense that cost over the coverage period but should expense it over the payout period as well. If the customer would be expensing the cost over the payout period then it is only logical to also have the insurer recognize its revenue over the pre-claim and post claim periods.

Staff recommendation

84. The staff believe that the reinsurance contract should be deemed a separate contract and that:

   a. Gains from purchasing reinsurance should be recognised as a residual/composite margin on reinsurance.

b. Losses from purchasing reinsurance should be treated as a cost of buying insurance protection and recognized over the underlying insurance contracts coverage period.

Question 5– Treatment of gain or loss on reinsurance
Do the Boards agree with the staff recommendation that if the present value of the fulfillment cash flows for the reinsurance contract is: a. less than zero (ie the expected present value of future cash inflows (plus the risk adjustment under the IASB's ED) is less than the expected present value of future cash outflows), the cedant shall establish that amount as part of the reinsurance recoverable, representing a prepaid reinsurance premium and should recognize the cost over the coverage period of the underlying insurance contracts. If the reinsurance protection is for past events, the loss should be immediately recognized. b. greater than zero (ie the expected present value of future cash inflows plus the risk adjustment exceed the expected present value of future cash outflows) the cedant shall recognize a reinsurance residual/composite margin.

Residual/ Composite Margin

85. Several respondents questioned why the same percentage (in a proportional reinsurance arrangement) or a portion (for a non-proportional reinsurance arrangement) of the residual/composite margin on the underlying insurance contracts (or CU 12 in the example above) is also not released.

86. The boards tentatively decided that the residual/composite margin is established to eliminate a gain at initiation of a contract. Because a reinsurance contract is not a legal replacement of one insurer by another, unless it is a novation, and thereby does not extinguish the ceding enterprise's liability to the policyholder, the staff do not believe it is appropriate to recognize a proportion of the residual/composite margin on the underlying insurance contracts as a gain when entering into a reinsurance agreement.

Question 6 – Cession of residual/composite margin on underlying insurance contracts
Do the Boards agree with the staff that:

> a. The cedant shall estimate the present value of the fulfilment cash flow for the reinsurance contract, **including the ceded premium and without reference to the residual/composite margin on the underlying contracts**, in the same manner as the corresponding part of the present value of the fulfilment cash flows for the underlying insurance contract or contracts, after remeasuring the underlying insurance contracts on initial recognition of the reinsurance contract.

Ceding commissions

87. Several respondents questioned the presentation of ceding commissions in the financial statements as proposed by the IASB's ED.

88. Reinsurance agreements generally provide for a ceding commission, which is intended to reimburse the ceding entity for the costs it incurred selling and underwriting contracts.

89. In addition, reinsurance agreements may contain an expense allowance to reimburse the cedant for costs to administer the contract which are included in the insurer's expected cash flows.

90. Reinsurance agreements may also provide for contingent commissions, which are intended to allow the ceding entity to share in the profits realized by the assuming entity on the business subject to the reinsurance agreements. Contingent commissions may be in the form of volume commissions, sliding scale commissions, or commission adjustments or other adjustments that allow increasing commissions as losses decrease and vice versa, subject to maximum and minimum limits. The accounting for contingent commissions is not addressed in this memo.

91. Current practice in most jurisdictions is to reduce the deferred acquisition costs for the ceding commission.

92. Paragraph 46 of the IASB's ED states: "The cedant shall treat ceding commissions it receives as a reduction of the premium ceded to the reinsurer".

93. At the February 1, 2011 meeting, the boards tentatively decided that the contract cash flows should include those acquisition costs that relate to a portfolio of insurance contracts.

94. Several respondents questioned why ceding commissions would not parallel the treatment for acquisitions costs for the insurer and therefore be included in the cedant's estimate of expected cash flow. In addition, there may be instances where the ceding commission is higher than the reinsurance premium thus distorting performance indicators and not being useful to users of the financial statements. Specifically, underwriting component metrics including loss ratios, expense ratios, and underwriting profit ratios between direct and net business may be inappropriately altered under the proposals.

95. The boards have tentatively decided that in measuring the insurance liability the expected cash flows would include all costs that an insurer will incur directly in fulfilling a portfolio of insurance contracts. In addition, acquisition costs that relate to a portfolio of insurance contracts should be included in the expected cash flows to the extent that they relate directly to the acquisition of the portfolio. The FASB limited the acquisition costs to those costs related to successful acquisition efforts and direct costs that are related to the acquisition of a portfolio of contracts.

96. A concern of the staff is that the ceding commissions and expense allowances included in the reinsurance contract may not "match" the acquisition costs and the costs to fulfil the insurance contracts that the cedant has included in the expected cash flows of the underlying insurance contracts. Including ceding commission and expense allowances (ie., reimbursements) in excess of the direct costs could be misleading to users of the financial statements.

97. Another concern of the staff is that the ceding commission may include a profit factor which the staff do not believe should be included in the expected cash flows.

98. While ceding commissions and allowances are an integral component of the economic obligations of the parties under a reinsurance agreement it is not always clear how the percentage or stated amounts for the ceding commissions and

expense allowances match the costs of the cedant and therefore the amounts included in the expected cash flows.

Staff recommendation

99. As such, the staff believe that the ceding commissions and expense allowances should be included in the expected cash flows of the measurement of the liability to the extent that the cedant has included their direct costs in the expected cash flows. Any excess amount should be recorded as a reduction in the ceded premium. While this may be cumbersome to prove, the staff believe that including the entire amount as a reduction in premium would misrepresent the portion of premium ceded and including a potential profit factor in the expected cash flows would not be appropriate.

Question 7 – Treatment of ceding commissions
Do the Boards agree with the staff recommendation that: a. The cedant shall treat ceding commissions it receives as a part of the contract cash flows to the extent those costs are included in the expected cash flows b. The cedant shall treat expense allowances as a part of the contract cash flows to the extent those costs are included in the expected cash flows. c. Any ceding commissions and expense allowances in excess of those included in the contract cash flows should be recorded as reduction of the premium ceded to the reinsurer.

Credit risk on reinsurance recoverables

100. Paragraph 44 of the IASB's ED states that the cedant shall consider the risk of non-performance by the reinsurer on an expected value basis when estimating the present value of the fulfilment cash flows.

101. Paragraph BC 240 of the IASB's ED indicates that a reduction for the expected present value of losses from default or disputes in the reinsurance recoverable

would be consistent with a measurement model that starts with the expected present value of cash flows.

102. In the IASB and FASB's project on financial instruments, the boards tentatively decided that an entity should use the best available and supportable information at the date of estimation (historical, current, and forecasted) to estimate expected losses. At the March 22 joint board meeting, the boards tentatively decided that expected losses should be estimated with the objective of an expected value. They tentatively decided that the final standard will explain that an expected value identifies possible outcomes (or a representative sample of the possible outcomes), estimates the likelihood of each outcome, and calculates a probability-weighted average. However, the final standard will acknowledge that other appropriate methods could be used as a reasonable way to achieve the objective of an expected value. An example of a suitable method would be a loss rate method and the use of probabilities of default, loss given default, and exposure at default data. In performing this calculation, an entity must not ignore observations and possibilities that are known.

103. Several respondents believed that the expected loss model for a recoverable is more akin to an exit value notion and is inconsistent with the fulfilment measurement model for the insurance liabilities.

104. Many respondents did not object to the expected loss model however many asked for clarification on whether collateral would be considered. Reinsurance arrangements are structured in various forms:

    a. Net settlement: the reinsurance payable for premiums is settled net of the reinsurance recoverable of losses ceded to the reinsurer. Therefore, some believe the reinsurance payable acts as collateral for the reinsurance recoverable to the extent that it does not exceed the reinsurance recoverable.

    b. Many reinsurance agreements include provisions that require collateral for the reinsurance recoverable. Collateral arrangements take many forms but some common ones include: trust funds, letters of credit, and funds withheld.

Expected Loss Model

105. Including the expected present value of losses from default in the measurement of the reinsurance recoverable is consistent with the measurement of the underlying insurance being ceded. However, some view a credit risk provision as an exit value characteristic that should not be reflected in an asset that is not typically transferred. A cedant expects fulfilment of the asset at the amounts measured without the credit risk provision. The Boards decided to not include own-credit in the measurement of the insurance liability because it was not appropriate to reflect changes in the credit risk of the insurer. Similarly, it may not be appropriate for a cedant to measure deterioration or changes in the reinsurer's credit.

106. The Proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities,* paragraph 65 states: "For a financial asset evaluated for impairment on an individual basis, where there are no past events or existing conditions indicating that the financial asset is impaired, an entity shall not automatically conclude that no credit impairment exists. The entity shall determine whether assessing the financial asset together with other financial assets that have similar characteristics indicates that a credit impairment exists. If the entity determines that a credit impairment exists in that circumstance, the entity shall recognize a credit impairment in net income. The amount of the credit impairment shall be measured by applying to that financial asset the historical loss rate (adjusted for existing economic factors and conditions) applicable to the group of similar financial assets referenced by the entity in its assessment."

107. Some believe that the reinsurers should not be grouped as the risks are different. If the "grouping" of risks do not include a significant number of reinsurers than the determination of expected losses would be performed at the individual reinsurer level. These respondents believe the expected loss model is more appropriate when many instruments are bought or sold by an entity and the law of large numbers is applicable. Insurers enter into reinsurance arrangements with select reinsurers; while there may be a significant number of reinsurers, it is far

less than the various investees in an investment portfolio for which the expected loss model is being considered for the financial instruments project.

108. However, others believe that regardless of the volume of reinsurers an expected loss model is appropriate to determine credit risk of reinsurers. For example, if a cedant has an expectation that there will be a 1% loss on reinsurance recoverables, regardless of whether events or circumstances currently exist that would indicate an identifiable loss, a provision should be recorded. In addition, some believe that the pricing of reinsurance, similar to any other financial instrument, includes an expectation that there could be a loss.

109. The boards' discussions for financial instrument credit risk highlights the challenges required in measuring the amount on an expected loss basis. Applying the expected loss model to reinsurance assets may represent a considerable challenge to preparers. The unique characteristics of reinsurance assets need to be considered when deciding if the model provides more useful information than an incurred loss model.

110. First, the observable inputs to determine the expected loss on the reinsurance recoverable are limited:

    a. The most observable input for estimating expected credit losses on reinsurance is the credit default swap rate of the reinsurer or other reinsurers with the same credit rating. However, the spreads on an entity's credit default swap rate can be extremely volatile and would lead to significant fluctuations in the recoverable amount that is not reflective of the expected losses of these instruments.

    b. Credit rating of the reinsurer is typically an observable input, however, often used to determine a probability of default. This amount can be applied to the cash flows of the asset to determine a provision for credit risk. Many believe that the use of the credit rating of the reinsurer does not consider that reinsurance recoverables typically have a higher priority in bankruptcy than general liabilities and are closer to policyholder obligations. In some jurisdictions outside the US, reinsurer default is managed under regulated

receivership laws that reduce the relative risk of default on reinsurance recoverables. Defaulted claims may be restructured to pay out over time or the receiver may use another construct to eventually pay claims to the cedant.

111. Second, many believe that because an insurer does not have a significant volume of reinsurers that they conduct business with, insurers would be performing the review for impairment by each reinsurer or small groups of reinsurers. The question is whether, after performing a review of the individual reinsurers and determining there is no indication that the current information and events suggest the cedant will be unable to collect all amounts due according to the contractual terms of the reinsurance contract, an allowance should be recorded.

Incurred Loss Model

112. Some believe that requiring a cedant to record the reinsurance recoverable considering expected losses is inconsistent with the boards' tentative decision that the cedant shall account for the reinsurance contract in the same manner as the underlying insurance contract(s) which would result in a recoverable equivalent to the ceded portion of the insurance liability on the underlying insurance contracts. In addition, incorporating the credit risk of reinsurance assets in the measurement of the reinsurance recoverable is inconsistent with the boards' tentative decision that the discount rate used to measure the insurance liabilities does not allow the effects of the cedant's credit risk.

113. Several respondents suggested determining the reinsurance recoverable on an incurred loss basis, which is consistent with the practice in many jurisdictions today. While incurred loss models are often criticized for providing information "too little too late", recently, expected loss models received criticism for providing credit loss information prematurely.

114. IAS 39 paragraph BC110 states that "...for a loss to be incurred, an event that provides objective evidence of impairment must have occurred after the initial recognition of the financial asset...Possible or expected future trends that may lead to a loss in the future do not provide objective evidence of impairment. In

addition, the loss event must have a reliably measureable effect on the present value of estimated future cash flows and be supported by current observable data.”

Consideration of collateral

115. Because reinsurance arrangements often times include collateral for the reinsurance recoverable, which mitigates the risk of default by the reinsurer, many believe the loss model, regardless of whether it is an incurred or expected model, should be applied to the net recoverable amount after considering the collateral. Examples include:

   a. Reinsurance payable in excess of the reinsurance recoverable whereby the reinsurance contract provides a right of offset.

   b. Funds withheld arrangements where the cedant retains ownership of the assets (and invests the funds either in the general accour or in a segregated account) that otherwise would be paid to the reinsurer as ceded premiums and credits the funds withheld assets for losses recoverable from the reinsurer. In addition, the cedant credits the funds withheld due to the reinsurer a specified percentage or actual performance of the assets.

   c. Letter of credit that is for the benefit of the cedant and contains no restrictions on the cedants ability to draw down on the letter of credit.

   d. Trust fund that is maintained by a third party and for the benefit of the cedant and contains assets in excess of the reinsurance recoverable.

116. The staff believe that when cedants have unilateral access to funds that can be used to settle outstanding amounts owed by the reinsurer the cedant should consider those funds in its evaluation of the amount of funds due the cedant that may not be collected. This collateral represents a reduction in credit risk, and should be considered in the determination of the reinsurance recoverable.

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117. In addition to reducing the reinsurance recoverable for losses from default, Paragraph BC 240 of the IASB's ED indicates that a reduction for the expected present value of losses from disputes should be included.

118. Occasionally a reinsurer will question whether an individual claim is covered under a reinsurance agreement or may even attempt to nullify an entire agreement. However, an insurer does not enter into reinsurance arrangements with an expectation that there will be disputes. In addition, disputes are fact specific and therefore the staff do not believe that a dispute by a reinsurer for a recoverable on a specific loss or losses should be reflected in the expectation that there will be additional disputes on the remaining recoverable from that reinsurer or other reinsurers, unless there is an indication that there will be additional disputes, such as additional recoverables for similar risks or an issue with the wording in the reinsurance contract that has been used on other reinsurance contracts, etc.

119. As such, the staff believe that losses from disputes should be reflected in the measurement of the recoverable when there is an indication that there is a dispute.

Staff recommendation

Question 8 – Credit risk of reinsurer
Do the Boards agree with the staff recommendation that a. the cedant shall consider the risk of non-performance by the reinsurer when estimating the present value of the fulfilment cash flows on an: i. incurred loss basis, or ii. expected loss basis b. The determination of risk of non-performance by the reinsurer shall consider all facts and circumstances, including collateral. c. Losses from disputes should be reflected in the measurement of the recoverable when there is an indication that there is a dispute.

Appendix A – Types and Forms of Reinsurance

1. Property casualty reinsurance

    a. Treaty Reinsurance Contracts—Pro Rata:

        i. Quota Share Reinsurance—The ceding entity is indemnified against a fixed percentage of loss on each risk covered in the agreement;

        ii. Surplus Share Reinsurance—The ceding entity establishes a retention or "line" on the risks to be covered and cedes a fraction or a multiple of that line on each policy subject to a specified maximum cession;

    b. Treaty Reinsurance Contracts—Excess of Loss:

        i. Excess Per Risk Reinsurance—The ceding entity is indemnified, subject to a specified limit, against the amount of loss in excess of a specified retention with respect to each risk covered by a treaty;

        ii. Aggregate Excess of Loss Reinsurance—The ceding entity is indemnified against the amount by which the ceding entity's net retained losses incurred during a specific period exceed either a predetermined dollar amount or a percentage of the entity's subject premiums for the specific period subject to a specified limit;

    c. Treaty Reinsurance Contracts—Catastrophe: The ceding entity is indemnified, subject to a specified limit, against the amount of loss in excess of a specified retention with respect to an accumulation of losses resulting from a catastrophic event or series of events;

    d. Facultative Reinsurance Contracts—Pro Rata: The ceding entity is indemnified for a specified percentage of losses and loss expenses

arising under a specific insurance policy in exchange for that percentage of the policy's premium;

e. Facultative Reinsurance Contracts—Excess of Loss: The ceding entity is indemnified, subject to a specified limit, for losses in excess of its retention with respect to a particular risk.

2. Life Reinsurance

   a. Yearly Renewable Term (YRT):

      i. The ceding insurer transfers the net amount at risk (mortality or morbidity risks, but not the permanent plan reserves) on the portion reinsured to the reinsurer and pays a one-year term premium that varies each year with the amount at risk and the ages of the insureds. Neither party is committed to future years, although YRT contracts are typically renewed for future years.

      ii. The "net amount at risk"—as defined in the contract—is usually the amount of insurance provided by the policy in excess of the ceding insurer's reserve on it.

   b. Coinsurance:

      i. The risks are reinsured on the same plan as that of the original policy. The direct writer and the reinsurer share in the risk in the same manner.

      ii. The ceding company pays the reinsurer a proportional part of the premiums collected from the insured. In return, the reinsurer reimburses the ceding company for the proportional part of the death or accident and health claim payments and other benefits provided by the policy, including nonforfeiture values, policy dividends, experience rating refunds, commissions, premium taxes, and other direct expenses agreed to in the contract.

iii. The reinsurer must also establish the required reserves for the portion of the policy it has assumed. In coinsurance of participating policies, the reinsurer may reimburse the ceding company for its portion of the dividends paid to the policyholder.

iv. Coinsurance of all or a portion of a block of business also is used in situations where a severe strain is placed on the direct writing company's surplus in the first policy year. For example, the premium received by the direct writer during the first policy year usually is insufficient to pay the high first-year commissions and other costs of issue and to establish the initial reserve. In such an example, coinsurance relieves some of the surplus strain of adding large amounts of new insurance.

c. Modified Coinsurance: A variation of coinsurance.

i. The ceding insurer has transferred all or a portion of the net policy liabilities on the reinsured policies to the reinsurer, and the reinsurer is required to indemnify the ceding insurer for the same amount.

ii. The assets necessary to support the reserves for the original policies are maintained by the ceding company instead of the reinsurer. This is accomplished by designating in the contract the transfer of the net policy liabilities to the assuming company and an immediate transfer back to the extent of the modco deposit.

iii. Under modified coinsurance, the assuming company shall transfer to the ceding company the increase in the reserve on the reinsured portion. This transaction reflects the reinsurer's risk with respect to the reinsured business and its obligation to maintain the reserves supporting such obligation.

d. Non-proportional Reinsurance:

    i. These arrangements provide for financial protection to the ceding insurer for aggregate losses rather than providing indemnification for an individual policy basis.

    ii. Catastrophic and stop-loss reinsurance are written on an annual basis to protect the ceding insurer from excessive aggregate losses.

    iii. Usually, the coverage does not extend over the life of the underlying policy nor is there any requirement on the ceding insurer to renew the arrangement.

3. Forms of reinsurance

    a. Prospective reinsurance - reinsurance in which a reinsurer agrees to reimburse a ceding entity for losses that may be incurred as a result of future insured events covered under contracts subject to the reinsurance

    b. Retroactive reinsurance - reinsurance in which a reinsurer agrees to reimburse a ceding entity for liabilities incurred as a result of past insured events covered under contracts subject to the reinsurance

    c. Occurrence-based insurance - insurance of insured events occurring during the coverage period of the insurance policy

    d. Claims-made insurance - insurance of insured events that are reported to the insurer during the period specified by the policy

    e. Fronting arrangements - the ceding enterprise reinsures all or substantially all of the insurance risk with the assuming enterprise

    f. Facultative reinsurance

        i. Each risk is handled separately at the time it is written. When the direct writing company receives an application for a policy and it wishes to reinsure some or all of the risk, it negotiates

with another company for a transfer of all or a portion of that risk.

ii. For purely facultative cessions, the assuming company is not obligated to assume any of the risk until its offer to reinsure is accepted.

iii. For facultative obligatory reinsurance, the assuming company is obligated to reinsure the risk subject to its having sufficient available capacity.

g. Automatic reinsurance

i. The ceding company agrees to reinsure with the reinsurance company all cases which meet certain defined conditions for amounts as defined in the reinsurance agreement.

ii. The reinsurance company is bound to accept all such amounts, up to a predetermined maximum. When the amount lies within the automatic maximum limit, called the binding authority, the ceding company issues its policy upon completion of its underwriting procedures and without securing the prior approval of the reinsurance company.

iii. Notification of automatic reinsurance is sent to the reinsurer within a specified period after the ceding company issues its policy.