STAFF PAPER

Insurance working group

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Insurance contracts	**Considering the different approaches for accounting for reinsurance assets**		
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Purpose of paper

1. The purpose of this paper is to seek feedback from the working group on the Boards' proposed approach to the measurement of reinsurance contracts including the recognition of gains and losses arising from reinsurance.

2. This paper does not discuss:

   (a) Timing of recognition

   (b) Presentation

   (c) Disclosures

3. Reinsurance was discussed at the joint Board meeting during the week commencing the 31st May (Agenda paper 3A/FASB memo #69A). Tentative decisions reached at that meeting are summarised in appendix A.

4. The first section of this paper describes three possible approaches to the measurement of insurance contract assets. The final section compares these three approaches.

Description of the approaches

5. Each of the three approaches described below:

   (a) uses a building blocks approach to measure the reinsurance asset;

(b) bases the measurement of that asset on the expected present value of the net cash flows and risk adjustment associated with the underlying direct insurance contracts.

6. Consequently, the measurement of the present value of the cash flows and risk adjustment associated with the reinsurance asset is the same under each of the three approaches. The differences between the three approaches arise in the measurement of the residual margin and the treatment of any resulting gains and losses. These differences are summarised in the following table[1]:

	Approach A	**Approach B**	**Approach C**
Expected PV of net cash flows	Based on cash flows of underlying insurance contracts	Based on cash flows of underlying insurance contracts	Based on cash flows of underlying insurance contracts
Risk adjustment	Based on risk adjustment of underlying insurance contracts	Based on risk adjustment of underlying insurance contracts	Based on risk adjustment of underlying insurance contracts
Residual Margin	Measured by reference to reinsurance premium paid	Measured by reference to reinsurance premium paid	Measured by reference to premium paid on underlying insurance contracts
Treatment of apparent gains for cedant	Recognised in profit or loss	Recognised as a reinsurance residual margin	Recognised in profit or loss
Treatment of apparent losses for cedant	Included in the measurement of the reinsurance asset	Included in the measurement of the reinsurance asset[2]	Recognised in profit or loss

7. Approach A was proposed in the exposure draft. Approach B is the approach the boards tentatively decided on at the May 2011 joint board meeting. Approach C

[1] The colours in this table are used to visualise similarities and differences between the three approaches.
[2] If the coverage provided by the reinsurance is for future events; if the coverage is for past events the loss is recognised in profit or loss.

was proposed by a number of respondents to the ED (including a number of reinsurance companies).

8. To illustrate the three approaches we have used a simple example that assumes the following basic fact pattern:

Assumptions

A cedant enters into a 30 per cent proportional reinsurance contract. At initial recognition of the reinsurance contract, the cedant measures the corresponding underlying insurance contract, which is issued at the same moment, as follows:

	CU
Single premium	(1,000)
Expected present value (EPV) of claims	870
Acquisition costs	30
Risk adjustment	60
Present value of fulfilment cash flows	**(40)**
Residual margin	**40**
Liability at initial recognition	**0**

From the characteristics of the underlying insurance contract, the cedant estimates the following:

- EPV of cash inflows CU261 (recovery of 30 per cent of the EPV of the CU870 claims on the underlying insurance contract)
- Risk adjustment of CU18 (30 per cent of the risk adjustment of CU60 of the underlying insurance contracts)
- EPV of cash outflows (the premium paid to the reinsurer) of:
    - In example (i), CU295
    - In example (ii), CU275

The risk of non-performance by the reinsurer is assumed to be negligible.

Approach A

9. Under approach A, the residual margin on the reinsurance asset is measured by reference to the reinsurance premium paid:

(a) If the premium for reinsurance is more than the expected present value of cash inflows adjusted for risk (ie there is an apparent loss), the cedant will include the difference in the measurement of the reinsurance asset. This difference represents prepaid insurance premiums and is recognised as an expense over the coverage period.

(b) If, however, the premium for reinsurance is less than the expected present value of cash inflows adjusted for risk, the cedant recognises a gain.

10. This was the approach proposed in the exposure draft. Under this approach initial measurement of the reinsurance asset would be:

	Example A(i)	Example A(ii)
	CU	**CU**
EPV of cash inflows (recoveries)	261	261
Risk adjustment	18	18
EPV of cash outflows (premium ceded)	(295)	(275)
Present value of the fulfilment cash flows	(16)	4
Residual margin	16	0
Asset at initial recognition	**0**	**4**
The effect on profit or loss will be the following:		
(Loss)/gain at initial recognition	**0**	**4**

11. Subsequently, the cedant would:

(a) Remeasure the fulfilment cash flows. Changes in the fulfilment cash flows would be recognised in profit or loss.

(b) Recognise the residual margin determined at initial recognition as an expense in profit or loss over the coverage period.

Approach B

12. Under approach B, the residual margin on the reinsurance asset is measured by reference to the reinsurance premium paid (as under approach A):

(a) if the premium for reinsurance is more than the expected present value of cash inflows adjusted for risk (ie there is an apparent loss), the cedant will recognise:

(i) an asset if the coverage provided by the reinsurance asset is for future events. This asset represents prepaid insurance premiums and is recognised as an expense over the coverage period;

(ii) A loss if the coverage is for past events.

(b) If, however, the premium for reinsurance is less than the expected present value of cash inflows adjusted for risk (ie there is an apparent gain), the cedant recognises a reinsurance residual or single margin.

13. This was the approach proposed at the May 2011 joint board meeting. Under this approach initial measurement of the reinsurance asset would be:

	Example B(i)	**Example B(ii)**
	CU	**CU**
EPV of cash inflows (recoveries)	261	261
Risk adjustment	18	18
EPV of cash outflows (premium ceded)	(295)	(275)
Present value of the fulfilment cash flows	(16)	4
Residual margin	16	(4)
Asset at initial recognition	**0**	**0**
The effect on profit or loss will be the following:		
(Loss)/gain at initial recognition	**0**	**0**

14. Subsequently, the cedant would:

(a) Remeasure the fulfilment cash flows. Changes in the fulfilment cash flows would be recognised in profit or loss.

(b) Recognise the residual margin determined at initial recognition in profit or loss over the coverage period.

Approach C

15. Under approach C, the residual margin included in the measurement of the reinsurance asset at initial recognition is set equal to the corresponding portion

of the residual margin on the underlying contracts. Any difference between the amount recognised as an asset and the reinsurance premium is recognised in profit or loss. The residual margin is recognised as an expense in profit or loss over the coverage period.

16. Under this approach, initial measurement of the reinsurance asset would be:

The corresponding portion of the residual margin on the underlying contracts is 12 (40 x 30%).

	Example C(i)	Example C(ii)
	CU	**CU**
EPV of cash inflows (recoveries)	261	261
Risk adjustment	18	18
EPV of cash outflows (premium ceded)	(295)	(275)
Present value of the fulfilment cash flows	(16)	4
Residual margin	12	12
(Liability)/asset at initial recognition	**(4)**	**16**
The effect on profit or loss will be the following:		
(Loss)/gain at initial recognition	**(4)**	**16**

17. Subsequently, the cedant would:

   (a) Remeasure the fulfilment cash flows. Changes in the fulfilment cash flows would be recognised in profit or loss.

   (b) Recognise the residual margin determined at initial recognition as an expense in profit or loss over the coverage period.

Comparison of the approaches

18. Approach C measures the residual margin on the reinsurance asset by reference to the residual margin on the underlying insurance contracts. Supporters of this approach argue that it better reflects the economics of reinsurance. They state that on signing a reinsurance contract a cedant transfers the risks associated with the underlying contracts to the reinsurer. Consequently, they argue that the net

position of the insurer should reflect only those risks retained by the cedant. In their view, approach C achieves this because as the net insurance liability of the cedant (ie the net of the reinsurance asset and the insurance liability) is equal to the carrying amount of the insurance liability retained by the cedant (the measurement of the insurance contract liability and the reinsurance contract asset is aligned for all building blocks). Gains and losses arising on reinsurance are recognised immediately under this approach as the cedant is considered to be no longer at risk for the part of the risks that are reinsured (although the cedant is exposed to the credit risk of the reinsurer).

19. Approaches A and B measure the residual margin on the reinsurance asset by reference to the reinsurance premium paid. Those who support these approaches argue that the residual margin on the underlying contracts is not relevant to the measurement of the reinsurance asset. The reinsurance asset arises from a separate transaction to the underlying contracts. Consequently, the premium charged on the underlying contracts should not affect the measurement of the reinsurance asset.

20. Under approach A apparent losses on reinsurance contracts are treated as a cost of acquiring reinsurance. Consequently, the apparent loss is recognised as an asset (representing pre-paid reinsurance services) that is recognised in profit or loss over the coverage period. To be consistent with the proposals for insurance contracts the residual margin of the reinsurance asset is not permitted to be negative. Consequently, any apparent gains on reinsurance are recognised immediately in profit or loss.

21. Approach A is the approach proposed in the exposure draft. Some respondents to the ED objected to the proposal to recognise day-one gains under this approach. They stated that:

    (a) No gain should be recognised since the insurer is not relieved of the underlying risk

    (b) The proposals provide opportunities for insurers to manipulate their results by entering into reinsurance contracts.

22. Approach B is consistent with the view that a reinsurance contract provides a service over the contract term and that the cedant is not relieved from risk

associated with the underlying contracts. As a result, any apparent gains or losses are recognised over the coverage period.

23. In addition, approach B makes a distinction between reinsurance contracts that provide coverage for past events and those that provide coverage for future events. If the coverage is for past events any apparent loss is recognised immediately. Those who support this approach note that it ensures that the costs associated with past coverage are not deferred. However, others believe that this distinction is difficult to apply and is inconsistent with the proposed definition of insurance which does not draw a distinction between coverage for future events and coverage for past events.

Questions for the working group

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1. Do working group members think that the residual margin on the reinsurance contract should be measured by reference to: (a) the reinsurance premium paid; or (b) the premiums on the underlying contracts? 2. Do working group members think that apparent gains or losses arising on reinsurance should be recognised in profit or loss or recorded as a residual margin? 3. Do working group members think that the treatment of any losses arising on reinsurance should depend upon whether the coverage is for past or for future events?

Appendix A – Summary of tentative decisions on reinsurance

At their meeting on 31 May 2011, the boards tentatively decided the following:

1. If a reinsurance contract does not transfer significant insurance risk because the assuming company is not exposed to a loss, the reinsurance contract is nevertheless deemed to transfer significant insurance risk if substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts is assumed by the reinsurer. A loss is defined as an excess of the present value of the cash outflows over the present value of the premiums.
2. An insurer should assess the significance of insurance risk at the individual contract level. Contracts entered into simultaneously with a single counterparty for the same risk, or contracts that are otherwise interdependent that are entered into with the same or a related party, should be considered a single contract for the purpose of determining risk transfer.
3. A cedant should not recognise a reinsurance asset until the underlying contract is recognised, unless the amount paid under the reinsurance contract reflects aggregate losses of the portfolio of underlying contracts covered by the reinsurance contract. If the reinsurance coverage is based on aggregate losses, the cedant should recognize a reinsurance asset when the reinsurance contract coverage period begins. An onerous contract liability should be recognized if management becomes aware in the pre-coverage period that the reinsurance contract has become onerous.
4. The ceded portion of the risk adjustment should represent the risk being removed through the use of reinsurance.
5. If the present value of the fulfilment cash flows (including the risk adjustment under the IASB's tentative decisions) for the reinsurance contract is:

    (a) Less than zero and the coverage provided by the reinsurance contract is for future events, the cedant should establish that amount as part of the reinsurance recoverable, representing a prepaid reinsurance premium and should recognise the cost over the coverage period of the underlying insurance contracts.

    (b) Less than zero and the coverage provided by the reinsurance contract is for past events, the cedant should recognise the loss immediately.

(c) Greater than zero, the cedant should recognise a reinsurance residual or composite margin.

6. The cedant should estimate the present value of the fulfilment cash flows 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.

7. When considering non-performance by the reinsurer:

   a) The cedant would apply the impairment model for financial instruments when determining the recoverability of the reinsurance asset.

   b) The assessment of risk of non-performance by the reinsurer should 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 on the basis of current information and events, the cedant may be unable to collect amounts due according to the contractual terms of the reinsurance contract.
   All members of the IASB and the FASB supported these decisions.