STAFF PAPER

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Project	Insurance Contracts		
Paper topic	Additional Topics on Reinsurance Contracts Accounting		

CONTACT(S)	Christopher Irwin	cgirwin@fasb.org	+1 (203) 956-3468
	Jennifer Weiner	jmweiner@fasb.org	+1 (203) 956-5305
	Matthias Zeitler	mzeitler@ifrs.org	+44 20 7246-6453
	Akwasi Ampofo	aaampofo@fasb.org	+1 (203) 956-3421

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What is the purpose of this paper?

1. As a follow up to the May 2011 agenda paper 3J (IASB) or 68J (FASB), *Reinsurance*, this paper discusses additional issues on accounting for reinsurance[1] by the cedant and reinsurer and asks the boards to decide on the:

   (a) Period over which the FASB single margin and IASB residual margin on profitable *retroactive* reinsurance contracts is released (**Issue 1**);

   (b) Measurement and recognition of loss sensitive features and other contingent terms of reinsurance contracts (**Issues 2a, 2b** and **2c**); and

   (c) The accounting model (that is building block approach (BBA) or premium allocation approach (PAA)) used by the:

      (i) Reinsurer (**Issue 3b**)

      (ii) Cedant under FASB model (**Issue 3a**)

      (iii) Cedant under IASB model (**Issue 3c**)

[1] Some of these topics (e.g., loss sensitive features) have broader applicability to other (non-reinsurance) insurance contracts, although the related issues tend to be more prevalent for reinsurance transactions. To the extent the topic has broader applicability, this paper discusses the topic in the context of all insurance contracts.

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2. This paper does not address disclosures about reinsurance contracts which will be brought to the boards as part of the overall disclosures on insurance contracts.

Summary of Staff Recommendations

3. The staff recommends that:

   (a) For retroactive[2] reinsurance contracts, the residual or single margin included in the cedant's reinsurance recoverable and the reinsurer's insurance contract liability should be amortized over the remaining settlement period in the same manner as the release of the single/residual margin, i.e. based on:

      (i) (for the FASB) release from risk; and

      (ii) (for the IASB) the pattern of services under the contract. (**Issue 1**).

   (b) For contracts with loss-sensitive features**:**

      (i) **Issue 2a**: Cash flows resulting from loss sensitive features that are not accounted for as investment components should be treated as part of the claims and benefits cash flows (rather than part of the premiums).

      (ii) **Issue 2b:** Insurers should treat the effects of loss sensitive features in the same way as other changes in estimates of claims and benefits cash flows arising from the contract. Accordingly, under the premium allocation approach, cedants and reinsurers should recognize an asset or liability to the extent that any cash (or consideration) would be receivable or payable under the contract based on experience to date (in other words based on incurred losses).

   (c) **Issue 2c**: Insurers should treat the effects of non-loss sensitive premium adjustments in the same way as other changes in estimates of premiums

[2]For prospective insurance contracts, the boards have already decided that the residual/single margin should be recognised over the contract term.

arising from the contract. Any premium adjustments pursuant to contractual features providing cedants a unilateral right (but not an obligation) to reinstate a reinsurance contract should not be considered to be a loss sensitive feature for purposes of applying this guidance.

(d) The **reinsurer** should evaluate whether the reinsurance contract should be accounted for under the building block approach or premium allocation approach in the same manner in which an insurer should evaluate a direct insurance contract. (**Issue 3b**).

4. Additionally, for the FASB, the staff recommend:

(e) The **cedant** should account for a reinsurance contract using the same approach (building block approach or premium allocation approach) that the cedant uses to account for the underlying direct insurance contracts. Reinsurance contracts that reinsure both insurance contracts measured using the building block approach and insurance contracts measured using the premium allocation approach, should be separated based on the underlying contract measurement model and each component accounted for using the same approach used to account for the underlying direct insurance contracts. (**Issue 3a**).

5. For the IASB, the staff recommend that the cedant should evaluate whether to account for the reinsurance contract using the building block approach or premium allocation approach in the same manner in which an insurer should evaluate a direct insurance contract. (**Issue 3c**).

Background

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

(a) Reinsurance contract – An insurance contract issued by one insurer (the reinsurer) to compensate another insurer (the cedant) for losses on one or more contracts issued by the cedant.

(b) Cede – The action of a cedant of reinsuring insurance contract liabilities by purchasing a reinsurance contract.

(c) Prospective reinsurance – Reinsurance in which the reinsurer agrees to reimburse a cedant for losses that may be incurred as a result of future events.

(d) Retroactive reinsurance – Reinsurance in which a reinsurer agrees to reimburse a cedant for liabilities incurred as a result of past events.

Proposals in the exposure draft and discussion paper

7. In the IASB exposure draft *Insurance Contracts* (the "ED") and the FASB discussion paper *Preliminary Views on Insurance Contracts* (the "DP"), the boards proposed that:

> Reinsurance assets would be measured using the same basis as the underlying insurance liability, which would include the following:
>
> (a) The present value of the probability-weighted estimate of net cash inflows from the reinsurer less the present value of the cedant's expected payments to the reinsurer (for the IASB, the expected present value of the fulfilment cash flows[3])
>
> (b) A single margin (for the IASB, a residual margin) to eliminate any loss at initial recognition of the reinsurance contract.

8. Feedback on the reinsurance aspects of the ED/DP was included in paragraphs 11 through 30 of Agenda Paper 3A (IASB) / 69A (FASB) which was discussed at the May 2011 meeting. Specific feedback regarding the topics discussed in this paper is:

[3] Defined as "the expected present value of the future cash outflows less future cash inflows that will arise as the insurer fulfils the insurance contract, adjusted for the effects of uncertainty about the amount and timing of those future cash flows."

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

(b) Symmetry between reinsurance and direct insurance was interpreted differently between respondents. Some respondents questioned whether cedants should look through to the underlying liability when determining measurement approach (i.e., PAA or BBA) eligibility.

(c) Specific topics where clarification or redeliberation was frequently requested included calculation of margins.

(d) Many respondents noted that there should be more guidance on particular reinsurance arrangements, specifically,

(i) Retroactive reinsurance contracts including loss portfolio transfers

(ii) Commutations

Previous Board Discussions

9. At the May 2011 meeting, the boards discussed the various forms of reinsurance in agenda paper 3A or 69A which are not repeated in this paper. The boards made the following tentative decisions on reinsurance contracts at that meeting:

(a) If a reinsurance contract does not transfer significant insurance risk because the reinsurer is not exposed to a loss (with loss defined as an excess of the present value of the cash outflows over the present value of the premiums), the reinsurance contract is 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. Substantially all of the insurance risk relating to the reinsurance portions of the underlying insurance contracts is not transferred unless the economic benefit transferred to the reinsurer for its respective portion of the underlying contracts is virtually the same as the economic benefit previously held by the cedant.

(b) 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.

(c) A cedant should not recognize a reinsurance asset until the underlying contract is recognized 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.

(d) The ceded portion of the risk adjustment should represent the risk being removed through the use of reinsurance.

(e) If the present value of the fulfilment cash flows (including the risk adjustment under the IASB's tentative decisions) for the reinsurance contract is:

(i) 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 recognize the cost over the coverage period of the underlying insurance contracts.

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

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

(f) 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.

(g) When considering non-performance by the reinsurer:

(i) The cedant should apply the impairment model for financial instruments when determining the recoverability of the reinsurance asset.

(ii) The cedant should consider all facts and circumstances, including collateral, when assessing the risk of non-performance by the reinsurer.

(iii) The losses from disputes should be reflected in the measurement of the recoverable when there is an indication that current information and events suggest the cedant may be unable to collect amounts due according to the contractual terms of the reinsurance contract.

Staff Analysis

Period margin is released over for profitable retroactive reinsurance contracts

10. At the May 2011 joint board meeting, the boards made tentative decisions on the recognition of margins, summarised (paraphrased) as follows:

(a) If there is an apparent loss for the cedant and the coverage provided by the reinsurance contract is for future events (i.e., prospective reinsurance), the cedant should 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.

(b) If there is an apparent loss for the cedant and the coverage provided by the reinsurance contract is for past events (i.e, retroactive reinsurance), the cedant should recognize the reinsurance loss[4] immediately.

(c) For all reinsurance contracts (i.e., retroactive or prospective) for which there is an apparent gain for the cedant, the cedant should recognize a reinsurance residual or single margin.

11. The following example reflects the initial measurement for a reinsurance contract where there is an apparent gain for the cedant (i.e., application of paragraph 1(c)).

[4] From the perspective of the cedant, a reinsurance loss arises when the present value of the cash inflows is less than the present value of the cash outflows on reinsurance contract (adjusted for the risk adjustment, as applicable).

Example 1 – PV of fulfilment CF greater than zero

A cedant enters into a reinsurance contract in which it cedes 30% of its remaining obligations related to previously incurred claims to a reinsurer, in exchange for CU 295. At initial recognition of the reinsurance contract, the cedant measures the corresponding underlying insurance contracts as follows:

	(IASB)	**(FASB)**
	CU	**CU**
Expected present value (EPV) of claims	1000	1000
Risk adjustment	50	NA

The cedant estimates the following for the reinsurance contract:

- The EPV of cash inflows is CU 300 (recovery of 30 percent of the EPV of the CU 1000 claims on the underlying insurance contract)
- Risk adjustment of CU15 (i.e., the amount of risk removed from the uncertainty inherent in the cash flows of the underlying portfolio)

The risk of non-performance by the reinsurer and the time between claim payment and reinsurance recovery are assumed to be negligible.

The initial measurement of the reinsurance asset would be as follows:

	(IASB)	**(FASB)**
	CU	**CU**
EPV of cash inflows (recoveries)	300	300
Risk adjustment	15	NA
EPV of cash outflows (premium ceded)	(295)	(295)
Present value of the fulfilment cash flows	20	5
Residual / single margin	(20)	(5)
Asset at initial recognition	0	0
The effect on profit or loss will be the following:		
Gain at initial recognition	0	0

12. As it relates to profitable retroactive reinsurance contracts (i.e., those reinsuring past events such as in Example 1), the prior decisions did not address the period the reinsurance residual or single margin (and the implicit residual or single margin for contracts measured under the premium allocation approach) should be amortized over.
13. Based on tentative decisions reached by the IASB, the residual margin for insurance contracts (in general) should be released over the coverage period on a systematic basis that is consistent with the pattern of transfer of services provided under the

contract. Similarly, the FASB has tentatively decided that, for contracts measured under the premium allocation approach, there should be no single margin included in the measurement of the liability for incurred claims (and therefore any implicit single margin, or gain, is released over the coverage period).[5]

14. The ED defines coverage period as, "the period during which the insurer provides coverage for insured events." Under a wholly retroactive reinsurance contract, the coverage period is considered by many to end on or prior to the date the cedant and reinsurer enter into the contract (i.e., the cedant is only reimbursed for losses that have occurred up through this date under the underlying insurance contracts) because the covered events have already occurred by the date the cedant and reinsurer enter into the contract (but are not yet known). Many contracts will include a *retroactive date* which defines the date (in the past) from which the reinsurer is covering events. For these contracts, one might consider the coverage period to commence on the retroactive date and terminate on the contractually specified date (i.e., terminating on or prior to the date the retroactive contract is entered into). Such an interpretation would result in the recognition of a gain for retroactive reinsurance at the inception of the reinsurance contracts, which would be inconsistent with the boards' tentative decisions to not recognize a gain at the inception of an insurance contract and to not recognize a gain at the inception of a reinsurance contract.
15. However, IFRS 4 defines insured event as, "an uncertain *future* event that is covered by an insurance contract and creates insurance risk [*emphasis added*]". Paragraph B5 of the ED discusses insurance contracts that cover events that have already occurred (e.g., a retroactive reinsurance contract) and identifies the insured event for these contracts as the discovery of the ultimate cost of the reinsured claims. Viewed in this manner, the coverage period for retroactive reinsurance contracts would be the period of discovery of the ultimate cost of the contract's claims, which will often be similar to the settlement period (i.e., assuming continued variability in future cash

[5] For contracts measured under the building block approach, the FASB has tentatively decided that, an insurer should recognize the single margin in profit as it is released from risk, which is based on reduced uncertainty in the variability of cash flows.

flows), the period over which deferred gains are realized currently under US GAAP[6]. Under this interpretation:

(a) the single margin included in the cedant's reinsurance recoverable and/or the reinsurer's insurance contract liability for retroactive reinsurance contracts should be released over the period of discovery of the ultimate cost of the contract's claims based on release from risk.

(b) the residual margin included in the cedant's reinsurance recoverable and/or the reinsurer's insurance contract liability for retroactive reinsurance contracts should be released over this same period of discovery in a systematic way that is consistent with the pattern of services under the contract.

16. The period of release of the single/residual margin described in paragraph 15 would reflect the economic reality of profitable retroactive reinsurance contracts because it aligns the allocation of gains on retroactive reinsurance contracts with risk exposure during the settlement period (and avoids the recognition of a day 1 gain, consistent with the tentative decisions of the boards). It is important to note that this amortization period is directionally consistent with current practice under U.S. GAAP for retroactive reinsurance (i.e., gains amortized over the settlement period) and is analogous to the FASB's tentative decisions to recognize direct insurance single margins over the risk release period under the BBA.

17. One potentially negative consequence of the ED interpretation of retroactive reinsurance contracts' coverage period (noted above in paragraph 15) relates to potential inconsistency between the margin release for retroactive contracts (i.e., through the end of the settlement period) versus other insurance contracts. By the *beginning* of the settlement period, margins (or implicit margins / gains included within the liability for remaining coverage) are released for all prospective insurance contracts accounted for pursuant to tentative decisions of the IASB and for

[6] Existing US GAAP uses the term contract period, for example, in reference to the period over which premiums should be recognized for short duration contracts and the period over which prepaid *prospective* reinsurance premiums should be amortized. Alternatively, the period over which deferred gains are realized for *retroactive* reinsurance is referred to as the *settlement period* rather than the contract period.

prospective contracts measured under the premium allocation approach pursuant to tentative decisions of the FASB. The following example illustrates this point.

Example 2

On 1 January 2011, a cedant enters into a prospective reinsurance contract reinsuring 50% of the losses incurred during 2011 on a portfolio of contracts. The premiums paid under this contract are CU1200 (i.e. 50% of the premiums on the underlying portfolio of contracts). The cedant's mean estimate of discounted claims to be recovered under this contract is CU1320 (i.e., 50% of the estimated 2011 losses on the portfolio of reinsured direct contracts). After one year no losses have been reported but the estimate of recoveries remains at CU1320 (i.e., all underlying losses are represented by incurred but not reported claims), which the cedant expects to collect over the following five year period during the discovery of the ultimate cost of the reinsured claims. At December 31, 2011, the cedant will have recorded a liability for incurred claims of CU2640, recognized a loss of CU240 on its underlying portfolio of contracts, recorded a reinsurance recoverable asset of CU1320 (for purposes of this example, assume there is no risk adjustment), and have recognized CU120 in profit on the reinsurance contract[7].

On January 1, 2012, the cedant enters into a retroactive reinsurance agreement for the remaining 50% of the portfolios losses incurred during 2011. Assume the premiums paid are also CU1200. Because the cedant's contractual rights to reinsurance recoveries are equivalent to its remaining rights under its first reinsurance contract, the cedant's mean estimate of claims to be recovered under this contract is also CU1320. If the coverage period is considered to have ended on the date the retroactive contract is entered into (i.e., paragraph 14 interpretation), then a day one gain of CU 120 will have been recognized (on the reinsurance contract), which would be inconsistent with the boards' tentative decision regarding day one gains. If the coverage period is considered to be *the period of discovery of the ultimate cost of the contract's claims*, then the cedant will record a reinsurance recoverable of CU1320 with an offsetting CU120 margin.

As can be observed in this example, there is no remaining unamortized profit (i.e., implicit margin) on the first reinsurance contract (i.e., it was all recognized

[7] Assume for purposes of this example that this prospective reinsurance contract is not accounted for under the FASB's building block approach model.

during the one year coverage period) whereas there is on the second (to be recognized over a five year period) despite the estimated profitability and cedant's benefits under the two contracts being economically equivalent as of January 1, 2012.[8]

18. Notwithstanding the inconsistency identified in the previous paragraph's example, the Staff do not think that the solution to addressing this inconsistency is to require the cedant and/or reinsurer to recognize a day one gain for retroactive reinsurance contracts. Such a treatment would be inconsistent with the boards' tentative decisions to not recognize any day one gain on insurance or reinsurance contracts. Additionally, the Staff think that ignoring the remaining claims exposures and recognizing day one gains in current income might inappropriately suggest to financial statement users that the reinsurer isn't providing any service or benefit to the insured in the period subsequent to initial recognition of the contract. A cedant's motivation to enter into a retroactive contract is often to protect itself from the risks of past insurable events and the pricing differs from prospective contracts. Nonetheless, retroactive coverage (similar to prospective coverage) exists because it serves the purpose of allowing the cedant to transfer risks that manifest themselves in the uncertainty of future cash flows.

Staff recommendation

19. The staff recommends that, for retroactive reinsurance contracts, the residual or single margin included in the cedant's reinsurance recoverable and the reinsurer's insurance contract liability should be released over the remaining settlement period based on the release from risk (FASB) or the pattern of services under the reinsurance contract (IASB).
20. In the staff's view, applying this recommendation would mean:

[8] The insured risk that existed at the inception of the prospective reinsurance contract in this example included the risk of whether and when an insured event would occur, but the remaining risks under the contract as of January 1, 2012 are limited to how much compensation the cedant will receive from the reinsurer for these insured events. This risk is virtually the same as exists under the retroactive reinsurance contract despite the substantive differences between the contracts at their dates of inception.

(a) The single and residual margin release periods are not expected to be different because as the reinsurer fulfils the obligation to provide reinsurance coverage continuously over the coverage period, the reinsurer would be released from risk and the related part of the premium would be considered earned (that is, pattern of services).

(b) Releasing the single or residual margin in this way would best reflect the economics of the transactions on profitable reinsurance contracts because it would allocate gains over the period the reinsurer remains at risk and provides service to the insurer. As a result, it would take into account the remaining future risks exposures (e.g., the fulfilment cash flows for incurred but not reported losses could increase or decrease) over this period of continued insurance risk and contractual obligation. Thus, releasing the single or residual margin in this way would be:

  (i) consistent with the profit motive of retroactive reinsurance contracts, which is dependent on future loss experience from the reinsurance contracts.

  (ii) generally consistent with existing U.S. GAAP for retroactive reinsurance, the ED identification of the insured event for retroactive reinsurance as the discovery of the ultimate cost of the reinsured claims, and the FASB's tentative decisions for (profitable) contracts measured under the BBA.[9]

[9] For prospective contracts, the IASB has decided that the residual margin should be released over the coverage period. Although the staff recommendation for retrospective contracts is that the residual margin should be released over the settlement period, the staff notes that this achieves the same result as recognising the margin over the coverage period, if the the insured event for these contracts as the discovery of the ultimate cost of the reinsured claims and the coverage period for these contracts would be regarded as the period up to discovery of the ultimate cost of the claims as proposed in the ED.

Question 1 – Amortization period for margins on profitable retroactive reinsurance contracts
Do the boards agree that, for retroactive reinsurance contracts, the residual or single margin included in the cedant's reinsurance recoverable and the reinsurer's insurance contract liability should be amortized over the remaining settlement period in the same manner as the release of the single/residual margin, ie based on: (i) (for the FASB) release from risk; and (ii) (for the IASB) the pattern of services under the contract?

Accounting for Loss Sensitive Features

Are loss-sensitive features adjustments to premiums or adjustments to claims? [Issue 2a]

21. Reinsurance contracts[10] often include contingent provisions (collectively called "loss sensitive features[11]") that affect the amount of premiums or ceding commissions upon the occurrence of a triggering event(s). Generally, the triggering event is the claims (loss) experience on the underlying contracts. Examples of loss sensitive features include, but are not limited to, reinstatement premium provisions, retrospective premium adjustments, profit commissions and sliding scale commissions all of which limit the risk for the reinsurer and reward the cedant based on favourable loss experience and / or penalize the cedant for unfavourable loss experience. Reinstatement premiums might be either obligatory, in which case the cedant is obligated to pay additional premium amounts, or non-obligatory, in which

[10] Because loss sensitive features are most frequently encountered in reinsurance transactions, this paper discusses them in that context. However, albeit less common, loss sensitive features are also included in certain direct insurance contracts and the staff analysis and recommendations included herein are equally applicable for direct insurance contract loss sensitive features.

[11] Casualty Actuarial Society defines loss sensitive term or feature as "a provision within a reinsurance contract that causes the ceded premium, ceded loss, or commission to vary based on the loss experience of that contract."

case the cedant has the option to pay the additional premium (at rates established at the inception of the original contract) in order to continue coverage under the contract or to let the contract lapse.

22. In this issue the staff are asking the boards to clarify whether insurers should account for the effect of loss-sensitive features as an adjustment to premium and / or ceding commissions (Alternative 1) or as an adjustment to the line item in the statement of comprehensive income where the reinsurance claims experience is recognized (e.g., claims or benefits line item for the reinsurer and reinsurance recoveries for the cedant) (Alternative 2). The form of the loss sensitive features is often expressed as an adjustment to the contractual premium or ceding commissions for any changes in claims or benefits experience. Accordingly, current practice under US GAAP is to account for the effect of the loss-sensitive features as an adjustment to premiums or commissions, as applicable. However, the staff considered whether financial statement users would be provided with more useful information under Alternative 2 because the presentation of the effect of loss sensitive features affects insurer’s key performance metrics such as the loss ratio and combined ratio.
23. Proponents of Alternative 2 believe that such a presentation better reflects the economics of loss sensitive features as being more of an adjustment of the claims benefit under the reinsurance contract and that this approach would account for contracts with these features consistently with economically equivalent contracts that do not contain a loss sensitive feature. Consider the following example:

Example 3

In some reinsurance contracts, the premium increases or decreases if the contract's losses are different than the losses that correspond to the provisional premium, usually subject to a maximum and minimum. Table 1 below illustrates such a retrospective premium adjustment. This particular retrospective premium adjustment increases or decreases premium by CU1 for every CU2 increase or decrease in losses.

Table 1: Example of Retrospective Premium Adjustment

Premium Provision		Losses	Premiums	Reinsurer's Profit
Maximum		800,000	850,000	50,000
Provisional		700,000	800,000	100,000
Minimum		600,000	750,000	150,000

Assume that on January 1st 2012, a cedant reinsured a portfolio of contracts under a one year reinsurance contract for ceded premiums based on the formula included in the table included above (and no ceding commission). Further assume that at the end of the contract (i.e., after all claims are settled), the estimated actual loss experience was that CU 800,000 of losses were ceded to the reinsurer).

Alternative 1 – If the effects of the loss-sensitive features are treated as an adjustment to premium, the total ceded premium and claims recognized in the statement of comprehensive income would be CU 850,000 and CU 800,000, respectively.

Alternative 2 – If the effects of the loss-sensitive features are instead treated as an adjustment to claims, the total ceded premium and claims recognized in the statement of comprehensive income would show ceded premium of CU 750,000 (i.e., CU 850,000 of contractual premium less CU 100,000 of loss sensitive premium) and claims of CU 700,000 (i.e., CU 800,000 less the CU 100,000 adjustment resulting from the loss sensitive feature).

An economically equivalent contract to the one described above in this example would be one that charged a fixed CU 750,000 of premium and provided a claims benefit of 100% of losses up to CU 600,000, 50% of the next CU 200,000 of losses, and 100% of losses thereafter.

With the same experience as assumed above in this example, the presentation would be consistent with that described in Alternative 2 (i.e., CU 750,000 in

ceded premium and CU 700,000 in claims). Similarly, any other loss experience under these two economically equivalent contracts would result in consistent presentation under Alternative 2.

24. During the March 2012 joint board meeting, the boards tentatively decided that an investment component in an insurance contract is an amount that the insurer is obligated to pay the policyholder or a beneficiary regardless of whether an insured event occurs. If the cedant had paid ceded premiums in excess of CU750,000 (e.g., if the initial cash flow was based on the provisional premium) in Example 3, these amounts would need to be assessed to determine whether they constituted an investment component. The staff think that Alternative 2 is consistent with the March tentative decisions of the boards.
25. As noted above, reinstatement premium (i.e., a prorated reinsurance premium charged for the reinstatement of the amount of a reinsurance coverage limit that has been reduced or exhausted by loss payments under such coverages) might be either obligatory or non-obligatory. If it is non-obligatory, the cedant (policyholder) has the option to pay the additional premium (identified at the inception of the original contract) in order to continue coverage under the contract (with reinstated coverage to replace the coverage otherwise exhausted) or to let the contract lapse. This distinction is an important one for an insurer to consider in accounting for a contract with a reinstatement premium feature. The staff think that a mandatory reinstatement premium is most comparable to each of the other various loss sensitive features discussed in this section of the paper (i.e., the experience under the contract determines the effect of the features on the cash flows of the reinsurance contract and the amount of the coverage is “fixed” at contract inception). Accordingly, the staff believe it should be accounted for in the same manner.
26. However, the staff do not consider non-obligatory reinstatement premium clauses to be loss sensitive features due to the unilateral right of the cedant to avoid payment of these premiums (i.e., by opting not to replace the otherwise exhausted coverage). This is discussed further in paragraph 33.

When should adjustments arising from loss-sensitive features be recognized? [Issue 2b]

27. The staff asks the boards to clarify when loss sensitive features of the reinsurance contracts should be measured and recognized.

28. There is some diversity in practice for reinsurers. However, for cedants, current practice is to recognise loss sensitive features within short duration contracts when the actual loss sensitive event occurs, rather than when the event becomes probable of occurring and the amount can be reasonably estimated, or by reflecting the event based on a probability weighted estimate of scenarios from the beginning of the contract. Based on our recommendation to Issue 2a, the cedants' current practice equates to treatment of the effects of loss sensitive features in the same way as other changes in estimates of claims and benefits cash flows arising from the contract. Accordingly, loss sensitive features are recognised at the same time other estimates of claims and benefits cash flows are recognized (i.e., when incurred under the PAA and as estimates change under the BBA). Furthermore, they should be based on assumptions consistent with the claims and benefits cash flows used in measuring insurance contract liabilities and onerous contracts. This has the following advantages:

    (a) It matches the recognition of the adjustments arising from the loss sensitive features with the recognition of the corresponding loss experience (i.e., symmetry). This concept of the contemporaneous consideration of the loss sensitive feature cash flows and the cash flows for incurred losses is consistent with the boards' tentative decisions regarding the contemporaneous consideration of all cash flows considered in recognizing and measuring onerous contracts.

    (b) It avoids the costs and complexity associated with re-estimation during the pre-claims period of any fulfilment cash flows for these loss sensitive features that might be required under other alternatives.

    (c) It essentially eliminates smoothing of premium earned that is attributable to the occurrence of insured events (i.e., as would occur if the effects of the loss sensitive premium were treated as earned consistently with the non-loss sensitive premium). The staff think that eliminating this smoothing is appropriate because these loss sensitive "premiums" differ

from non-loss sensitive premium that a reinsurer receives as consideration for bearing risk over the remainder of the life of the contract (and which are earned over the coverage period).

Example 4

Assume each of the same facts as included in Example 3 except that only one year has passed since the inception of the reinsurance contract and the premium paid at inception was CU 800,000.

On December 31st 2012 (after one year), the losses incurred based on actual experience are estimated to be CU 800,000.

On January 1st 2012, the cedant recognizes a reinsurance recoverable of CU 800,000. This includes an asset of CU 50,000, representing the amount of premium paid to the reinsurer that the cedant is currently entitled to based on CU 0 of incurred losses (i.e., CU 800,000 of premium paid less CU 750,000 of minimum premium if losses ceded under the contract are less than CU 600,000). The remaining CU 750,000 of the reinsurance recoverable represents a prepaid reinsurance premium.On December 31st 2012, the cedant would have amortized the full CU 750,000 of prepaid reinsurance premium and recognized reinsurance recoveries equal to CU 800,000. Based on the incurred losses experience, the cedant's contractual premiums are CU 850,000. Because CU 800,000 of ceded premium was originally paid, the cedant has a payable to the reinsurer of CU 50,000.

29. Other alternatives considered by the staff include those that would require the cedant and reinsurer to:

    (a) recognize an asset or liability when it is probable there would be favourable or unfavourable future loss experience (in an amount that would trigger a loss sensitive feature) and the amount of the loss experience can be reliably estimated; or

    (b) recognize a loss sensitive feature adjustment, during the period before a claim is incurred, to be estimated based on a probability-weighted mean expectation of future cash flows.

30. Under these alternatives, the measurement of the loss sensitive features (but not necessarily the triggering losses) would be directionally consistent with the expected

cash flows notion under the building block approach. However, because each of these alternatives would necessitate the re-estimation of cash flows that was purposely removed from the premium allocation approach measurement of the liability for remaining coverage, the staff do not think these are viable options. Furthermore, these alternatives would be inconsistent with the conclusion in issue 2a that loss sensitive features should be treated as part of the claims and benefits rather than as part of the premiums.

When to recognize changes to premiums for future coverage [Issue 2c]

31. Under the premium allocation approach, some changes in premium and acquisition cost cash flows would be reflected in an updated measurement of the liability for remaining coverage. Specifically, this issue refers to any changes in the premiums and acquisition costs arising from changes in the amount of coverage expected to be provided.
32. For example, the premium for workers compensation insurance is generally based on contractual rates multiplied by the "premium base", which for workers' compensation is often the payroll dollars or hours worked by employee category or other indicator of risk. To the extent these contractual premium base adjustments are reasonably estimable, the staff understand that the estimated ultimate premium shall be recognized as revenue over the period of the contract and revised to reflect current coverage levels (i.e., to ensure that the liability for remaining coverage is reduced over the coverage period on the basis of the expected timing of incurred claims and benefits if that pattern differs significantly from the passage of time).
33. As stated above, a non-obligatory reinstatement premium feature, because of the influence of policyholder behaviour in determining the amount of coverage under the reinsurance contract, is considered by the staff to be equivalent to other premium based adjustment features (i.e., it represents the premium for future coverage). Accordingly, that additional premium shall be recognized as revenue over the period of the related future coverage and be reduced on the basis of the expected timing of incurred claims and benefits.
34. For example, a contract provided CU 100,000 of loss protection, which could be reinstated for an additional pre-determined amount of premium that is payable in the

event that the loss limit is exhausted. The staff think that the liability for remaining coverage should be initially measured at the amount of obligatory premium, which would be released over the period up through the occurrence of CU 100,000 of losses. Upon such an occurrence, the cedant should immediately expense any remaining balance of prepaid reinsurance premium, and the reinsurer should earn any remaining balance of the liability for remaining coverage.

35. At that point, if the cedant exercises his option to reinstate, the prepaid reinsurance premium would be adjusted to reflect the additional reinstatement premium payable, which would then be expensed over the remaining coverage period. Similarly, the reinsurer should adjust the liability for remaining coverage to reflect the additional reinstatement premium receivable.

Staff recommendation

36. On issue 2a, the staff recommend cash flows resulting from loss sensitive features that are not accounted for as investment components (i.e., pursuant to the tentative decisions of the boards during the March 2012 joint board meeting) should be treated as part of the claims and benefits cash flows (rather than part of the premiums).
37. On issue 2b, the staff recommend that insurers treat the effects of loss sensitive features in the same way as other changes in estimates of cash flows arising from the contract. Accordingly, under the premium allocation approach, cedants and reinsurers should recognize an asset or liability to the extent that any cash (or consideration) would be receivable or payable under the contract based on experience to date (e.g., incurred losses). The staff recommendations in issue 2a and b would be a faithful representation of the interdependency of the loss sensitive features and the underlying loss experience (i.e., the clear cause-and-effect relationship between incurred losses and the loss sensitive feature cash flows) and it would, therefore, provide relevant information that would be more comparable for analytical purposes by financial statement users. Additionally, these recommendations should ensure contracts with loss sensitive features are accounted for consistently with economically equivalent contracts that do not contain a loss sensitive feature.

38. On issue 2c, the staff recommend that insurers treat the effects of non-loss sensitive premium adjustments in the same way as other changes in estimates of premiums arising from the contract. Any premium adjustments pursuant to contractual features providing cedants a unilateral right (but not an obligation) to reinstate a reinsurance contract should not be considered to be a loss sensitive feature for purposes of applying these staff recommendations. The staff considers such payments to be more of a function of a policyholder election to purchase future insurance coverage rather than a reduction in the contractual benefits for previously incurred insured events.

Question 2 – Accounting for loss sensitive included in reinsurance contracts

Do the boards agree that:

Issue 2a: Cash flows resulting from loss sensitive features that are not accounted for as investment components should be treated as part of the claims and benefits cash flows (rather than part of the premiums)?

Issue 2b: Insurers should treat the effects of loss sensitive features in the same way as other changes in estimates of claims and benefits cash flows arising from the contract. Accordingly, under the premium allocation approach, cedants and reinsurers should recognize an asset or liability to the extent that any cash (or consideration) would be receivable or payable under the contract based on experience to date (e.g., incurred losses).

Issue 2c: Insurers should treat the effects of non-loss sensitive premium adjustments in the same way as other changes in estimates of premiums arising from the contract. Any premium adjustments pursuant to contractual features providing cedants a unilateral right (but not an obligation) to reinstate a reinsurance contract should not be considered to be a loss sensitive feature for purposes of applying this guidance.

Application of the Building Block Approach or Premium Allocation Approach to Reinsurance Contracts (Issue 3)

39. The question of whether to apply the BBA or the PAA in accounting for reinsurance contracts is related to the decisions on the eligibility criteria for the premium allocation approach for insurance contracts in general that the boards had different views on. Because the FASB and the IASB have reached different conclusions as to which circumstances govern when each of the two measurement models should be applied to the insurance contract liability, the staff considers this issue separately in applying the FASB tentative decisions (paragraphs 40-51) and the IASB tentative decisions (paragraphs 52-57).

Applying FASB tentative decisions

40. At the February 2012 joint board meetings, the FASB tentatively decided that:
    - (a) Insurers should apply the building-block approach rather than the premium allocation approach if, at the contract inception date, either of the following conditions is met:
        - (i) It is likely that, during the period before a claim is incurred, there will be a significant change in the expectations of net cash flows required to fulfill the contract; or
        - (ii) Significant judgment is required to allocate the premium to the insurer's obligation to each reporting period. This may be the case if, for example, significant uncertainty exists about:
            - (i) The premium that would reflect the exposure and risk that the insurer has for each reporting period; or
            - (ii) The length of the coverage period.
    - (b) A contract should fall within the scope of the premium allocation approach without further evaluation if the coverage period is one year or less.
    - (c) The premium allocation approach should be required for contracts that qualify for that approach.

41. This paper doesn’t revisit the previous paragraph’s criteria but rather addresses whether the approach (PAA or BBA) that applies to the reinsured contracts (i.e., the

underlying insurance contracts) should influence the determination of which approach should be applied to the reinsurance contract by the cedant (Issue 4a) or reinsurer (Issue 4b). The staff considered two alternatives for resolving Issues 4a and 4b as follows:

(a) Alternative 1 would require accounting for the reinsurance contracts using the same approach (the BBA or PAA) that the cedant uses to account for the underlying direct insurance contracts. Thus, if the cedant is currently using the building block approach for the reinsured direct insurance contracts, the cedant and/or the reinsurer should correspondingly use the building block approach for the reinsurance contracts. Reinsurance contracts that reinsure both insurance contracts measured using the building block approach and insurance contracts measured using the premium allocation approach, should be separated based on the measurement model used for the underlying contracts[12] and each component accounted for using the same approach that the cedant uses to account for the underlying direct insurance contracts.

(b) Alternative 2 would require evaluating whether the reinsurance contract should be accounted for under the building block approach or premium allocation approach in the same manner in which an insurer should evaluate a direct insurance contract.

Cedant Measurement Approach (Issue 4a)

42. For the cedant, one advantage of Alternative 1 is that it would minimize accounting mismatches that might, otherwise, result if the cedant accounted for its reinsured direct contracts under a different approach than it applied to the accounting for the reinsurance contract. Existing differences between the BBA and PAA include remeasurement of the liability for remaining coverage, whether the insurance contract liability is discounted, (for the FASB) whether there is a single margin for

[12] It is rare today that for a reinsurance contract to reinsure both life and non-life insurance contracts. Depending on the eligibility criteria for application of the premium allocation approach, these circumstances might continue to be rare.

the liability for incurred claims, and the presentation on the statements of financial position and comprehensive income. These differences between the PAA and BBA may lead to different measurement of the insurance contracts and / or timing of recognition of contract profitability. Therefore, Alternative 1 would enhance the economic relevance of reported information by minimizing accounting mismatches that might, otherwise, result from different measurement basis for the risks accepted from the policyholders and the same risks ceded to reinsurers. Also, it would likely be operationally less intrusive, less costly and less time-consuming to account for reinsurance contracts under the same model as the related direct insurance contracts.

43. A notable consequence of a circumstance wherein the reinsured direct contracts are accounted for under the PAA but the reinsurance of these risks is accounted for under the BBA would be that the cedant would, essentially, need to determine current estimates of the direct contracts' cash flows associated with the liability for remaining coverage (i.e., as a first step in re-estimating the cash flows for the reinsurance contract). Such an exercise would largely eliminate any of the intended simplicity and cost savings associated with applying the premium allocation approach to the eligible direct contracts.

44. Alternative 1, however, is not without demerits. The risks insured under a reinsurance contract are *not* always substantially the same as the risks insured by the cedant under the direct insurance contracts. For example, consider a multiple year reinsurance contract that reinsures aggregate annual workers compensation losses in excess of a high deductible expressed as a currency unit amount threshold[13]. An insurer might reasonably conclude that updated information affecting expectations of net cash flows for the underlying direct contracts might be limited to information received on incurred claims. However, the experience on the cedant's incurred losses that are within the reinsurance contract's deductible layer might provide, during the period before a *reinsurance* claim is incurred, updated information that effects expectations regarding the *reinsurance* contract cash flows. Under circumstances

[13] For *reinsurance* contracts an aggregate deductible threshold is established as either a *loss ratio* or a currency unit amount in current practice. For reinsurance contracts with *loss ratio* aggregate deductibles, the timing of when reinsurance claims and benefits are incurred would *not* be expected to differ significantly from the timing of the incurred losses on the underlying contracts.

such as exist in this example the different risks inherent in the reinsurance contract would not have been considered in determining which of the BBA or PAA should be applied to the contract in the way they would have been considered if the contract determination was not linked to the reinsured contracts.

Example 5

A cedant issues 100 one year insurance contracts, each written on January 1st for CU100 each and with an expected loss ratio of 70% (based on a range of scenarios from 50% to 90%). The cedant concludes that these insurance contracts are to be accounted for under the premium allocation approach. The cedant also enters into a reinsurance contract on the same date that covers aggregate losses in excess of CU 7000.

On June 30th, there is a large loss incurred in the amount of CU 1500, which does not trigger recognition of an onerous contract liability. Experience to date has otherwise been consistent with the 70% loss ratio expectation (i.e., total incurred losses at June 30th are CU 5000, or 70% of the CU 5000 of earned premium + the CU 1500 large loss). The cedant has not changed its expectations of the loss ratio for the remaining coverage. Accordingly, the cedant's expectation is to incur CU 8500 of losses under the direct contracts, CU 1500 of which would be reimbursed by the reinsurer.

The cedant would need to recognize on June 30th the CU 1500 for the large loss in its liability for incurred losses (i.e., for its direct contracts). If the reinsurance contract is also accounted for under the premium allocation approach, the CU 1500 reinsurance recovery wouldn't be recorded until the 2nd half of the year[14] (whereas under the building block approach, the CU 1500 recovery would be recorded on June 30th, the same date as the direct policy large loss is recognized on).

[14] There is some diversity in practice regarding when cedants (and reinsurers) recognize reinsurance recoveries under reinsurance contracts with aggregate deductible thresholds established as a currency unit amount. Under this example, the staff are deeming the insured event recoverable under the reinsurance contract to be the aggregation of underlying losses in an amount that exceeds CU 7000. In practice, others deem an insured event under insurance contracts with aggregate deductible thresholds established as a currency unit amount to be the adverse development in excess of the portion of the pro-rata deductible corresponding to the insurance coverage provided to date (i.e., in this example the CU 1500 in excess of CU 3500 corresponding to the first half of the contract). This paper does not address this diversity in practice.

45. Alternative 2 provides the cedant with the opportunity to take a fresh look at the terms of the reinsurance agreement to determine the appropriateness and relevance of using the BBA or PAA to account for the reinsurance contract. The resulting conclusion as to which of the BBA or PAA to apply to reinsurance contract will often be consistent with the conclusions reached for the underlying direct insurance contracts given that the assessment is based on the characteristics of the contracts. However, the outcome of the re-evaluation under alternative 2 could lead to a different outcome of the model than what is being applied to the reinsured direct insurance contracts especially if the reinsurance risks combines insurance risks in different underlying contracts (e.g., in aggregate excess of loss contracts).

Reinsurer Measurement Approach (Issue 4b)

46. Should the reinsurer similarly utilize Alternative 1, this would also lead to accounting symmetry for the same transaction between the cedant and reinsurer to enhance understandability and foster further analysis by financial statement users. Proponents of the reinsurer following this alternative argue that the reinsurer is subject to (a portion of) the same risks that the cedant accepted from its policyholders and, accordingly, the same accounting model should be applied.
47. However, for the reinsurer, Alternative 1 would require it to consider how to account for underlying contracts if it only has limited visibility into those contracts, instead of utilizing the information it has available from the underwriting process regarding the reinsurance contract it sold (because an entity's financial statements should reflect its own management's judgements and estimates, it would likely be deemed inappropriate for the reinsurer to rely on the cedant's determination as to which accounting model is appropriate).
48. From the reinsurer's perspective the issuance of a reinsurance contract is comparable to an insurance company's issuance of a policy to its policyholder (i.e., the cedant is the reinsurer's policyholder) and, accordingly, a reinsurer's application of alternative 2 is no different than the process (direct) insurance companies need to go through to classify their contracts.

Staff recommendation applying the FASB tentative decisions

49. On balance, the staff recommends alternative 1 for the cedant and alternative 2 for the reinsurer.
50. Alternative 1 would require the cedant to account for the reinsurance contracts using the same approach (BBA or PAA) that the cedant uses to account for the underlying direct insurance contracts.
51. Alternative 2 would require the reinsurer to evaluate whether the reinsurance contracts should be accounted for under the BBA or PAA in the same manner in which an insurer should evaluate a direct insurance contract. Importantly, although the staff think that it would be beneficial to users to encourage symmetry between the cedant's and reinsurer's accounting for the same transactions, the benefits are not considered as significant as achieving the internal symmetry for the cedant. Also, because the reinsurer will have less transparency into the cedant's contracts than the cedant, the costs and complexity of trying to mirror the eligibility criteria that would apply to the ceded risks is much higher for the cedant. Additionally, requiring the reinsurer to apply the same eligibility criteria as insurers apply for all direct contracts helps ensure better comparability amongst insurers and also bases the eligibility determination on the substance rather than the form (i.e., reinsurance vs. direct insurance) of the insured risk.

FASB Question 3 – building block approach or premium allocation approach for reinsurance contracts

Does the FASB agree with the staff recommendations that:

For issue 3a: The cedant should account for the reinsurance contracts using the same approach (building block approach or premium allocation approach) that the cedant uses to account for the underlying direct insurance contracts (alternative 1). Reinsurance contracts that reinsure both insurance contracts measured using the building block approach and insurance contracts measured using the premium allocation approach, should be separated based on the underlying contract measurement model and each component accounted for using the same approach used to account for the underlying direct insurance contracts.

For issue 3b: The reinsurer should evaluate whether the reinsurance contracts should be accounted for under the building block approach or premium allocation approach in the same manner in which an insurer should evaluate a direct insurance contract (alternative 2)?

Applying IASB tentative decisions (Issue 3c)

52. During the joint board meeting on 27 February, the IASB reached the following tentative decisions regarding the premium allocation approach:

    (a) Contracts should be eligible for the premium allocation approach if that approach would produce measurements that are a reasonable approximation to those that would be produced by the building block approach.

    (b) A contract should be deemed to meet the condition in (a) without further work if the coverage period is one year or less.

    (c) The IASB also decided to provide application guidance that contracts would not produce measurements that are a reasonable approximation to

those that would be produced by the building block approach if, at the contract inception date:

(i) it is likely that, during the period before a claim is incurred, there will be a significant change in the expectations of net cash flows required to fulfil the contract; or

(ii) significant judgement is required to allocate the premium to the insurer's performance obligations for each reporting period. This may be the case if, for example, significant uncertainty exists about the premium that would reflect the exposure and risk that the insurer has for each reporting period; or the length of the coverage period.

(d) An insurer should be permitted but not required to apply the premium allocation approach to contracts that are eligible for that approach.

53. The IASB views the PAA as an approximation of the BBA and has tentatively decided that insurers could apply the PAA if that approach would produce measurements that are a reasonable approximation to those that are produced by the BBA. A reinsurance contract is an insurance contract, and the boards have previously decided that the reinsurance asset and the underlying insurance contract liability should be measured using consistent assumptions, with the margin calibrated to the reinsurance premium paid. This means that the reinsurance asset is measured the same way as all insurance contracts. Applying the eligibility principle for the PAA, the insurer would be permitted to measure the reinsurance asset using the PAA if that approach would produce measurements that are a reasonable approximation to those that are produced by the BBA.

54. The staff did not find a compelling reason to identify a different principle to determine whether an insurer should use the PAA or the BBA for reinsurance contracts, compared to the principle the IASB decided to use for insurance contracts.

Do some reinsurance agreements require special consideration?

55. Even though the staff does not see the need to amend the overall principle to cope with the accounting for the reinsurance asset, we have analysed some features that were highlighted to us during the comment letter period and the outreach since the

ED/DP to determine whether any additional application guidance should be provided:

(a) Some one year reinsurance contracts cover underlying direct business that either begins or ends in coverage during the year reinsured (so called 'risk-attached-to' reinsurance). Because of this feature, effectively the coverage period of these reinsurance contracts is two years. Some questioned whether these contracts would be eligible for the PAA because the ED included the approximately 12 month criterion and feared counterintuitive results.

(b) Some questioned the accounting model that should be applied if the reinsurance contract might cover both direct contracts that are accounted for applying the PAA and direct contracts that are accounted for applying the BBA.

56. In both cases, some feared that the accounting for reinsurance contracts could be inconsistent and counterintuitive, if that accounting would apply a different accounting approach from the underlying business. However, the staff thinks that the principle developed for the eligibility for the PAA can also be applied in the same way and that the difference in approaches would not matter if the PAA would produce measurements that are a reasonable proxy to those that are produced by the BBA. In the staff's view, there is no need for additional application guidance.

Staff recommendation

57. Consequently the staff recommends that the IASB should use the same principle as used for insurance contracts in general to determine whether the premium allocation approach can be used for reinsurance contracts.

IASB Question 3 – BBA or PAA for reinsurance contracts
(For issues 3b and 3c) Does the IASB agree that the cedant and the reinsurer should evaluate whether to account for the reinsurance contract using the building block approach or premium allocation approach in the same manner in which an insurer should evaluate a direct insurance contract?

Appendix A – *Current Guidance under U.S. GAAP*

A1. Existing U.S. GAAP provide the following guidance that is pertinent to the issues discussed in this paper. IFRS 4 does not address these items.

Retroactive Reinsurance

A2. Accounting Standards Codification (ASC) subtopic 944-605, *Reinsurance of Short Duration Contracts* provides that:

a. The amounts paid for retroactive reinsurance of short-duration contracts shall be reported as reinsurance receivables to the extent those amounts do not exceed the recorded liabilities relating to the underlying reinsured contracts. If the recorded liabilities exceed the amounts paid, reinsurance receivables shall be increased to reflect the difference and the resulting *gain deferred*. If the amounts paid for retroactive reinsurance for short-duration contracts exceed the recorded liabilities relating to the underlying reinsured short-duration contracts, the ceding entity shall increase the related liabilities or reduce the reinsurance receivable or both at the time the reinsurance contract is entered into, so that the excess is *charged to earnings*. (paragraphs 25-22 and 25-23)

b. The cedant shall defer and amortize gains on retroactive reinsurance contracts over the estimated *remaining settlement period*. If the amounts and timing of the reinsurance recoveries can be reasonably estimated, the deferred gain shall be amortized using the *effective interest rate* inherent in the amount paid to the reinsurer and the estimated timing and amounts of recoveries from the reinsurer; that is, the interest method. Otherwise, the proportion of actual recoveries to total estimated recoveries (*the recovery method*) shall determine the amount of amortization. (paragraphs 35-9 and 35-10)

A3. Prepaid reinsurance premiums on prospective reinsurance shall be amortized over the *remaining contract period* in proportion to the amount of insurance protection provided.

Loss Sensitive Features

A4. Subtopic 944-605-25-2 provides that if premiums are subject to adjustment (for example, retrospectively rated or other experience-rated insurance contracts for which the premium is determined after the period of the contract based on claim experience or reporting-form contracts for which the premium is adjusted after the period of the contract based on the value of insured property), premium revenue shall be recognized as follows:

a. If the ultimate premium is reasonably estimable, the estimated ultimate premium shall be recognized as revenue over the period of the contract. The estimated ultimate premium shall be revised to reflect current experience.
b. If the ultimate premium cannot be reasonably estimated, the cost recovery method or the deposit method may be used until the ultimate premium becomes reasonably estimable.

A5. Subtopic 944-20-25-4, Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises (formerly EITF 93-6), requires that:

a. The ceding enterprise should recognize an asset and the assuming enterprise should recognize a liability to the extent that any cash (or other consideration) would be payable from the assuming enterprise to the ceding enterprise based on experience to date under the contract.
b. The ceding enterprise and the assuming enterprise should account for changes in coverage in the same manner as changes in other contract costs.

A6. With regards to the measurement of the liability on retrospectively rated contracts, subtopic 944-20-35-19, With-and-Without Method, requires that if a decision to terminate a contract has been made, the liability shall be measured based on the assumption of *termination* and experience to date. Otherwise, the measurement of the liability shall be based on the lesser of the following:

a. The total incremental cost that would be paid based on the with-and-without method assuming experience to date and assuming termination, or

b. The total incremental cost that would be paid based on the with-and-without method assuming experience to date and assuming no termination.

A7. The effects of future losses and future premiums that would have been paid regardless of experience to date shall be excluded from both calculations. Costs associated with the decision not to terminate shall be recognized in the period in which the future coverage is provided because those costs are associated with that future coverage.