STAFF PAPER

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REG IASB Meeting

Project	Insurance Contracts		
Paper topic	Impairment of reinsurance contracts held by insurer		
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Introduction

1. During its meeting held 31 May – 2 June 2011, the IASB tentatively decided that a cedant should apply the impairment model being proposed for IFRS 9 *Financial Instruments* (Impairment project) to the reinsurance asset[1]. At that time the IASB had issued proposals (an Exposure Draft (ED) and Supplementary document(SD)) to recognise impairment on financial assets on an expected loss basis. Given the feedback received on the SD, in its May /June 2011meeting the IASB tentatively decided to develop a new variation of the expected loss impairment model[2], taking into account the feedback from the boards' original EDs and the SD.

2. Appendix B provides an overview of the current impairment model based on the tentative decisions reached.

Staff recommendation

3. The staff recommends that a cedant account for the risk of non-performance associated with changes in expected credit losses in the same way as other changes in the expected fulfilment cash flows. Accordingly, a cedant would not

[1] The staff notes that in general, the scope of IFRS 9 excludes insurance contracts as defined in IFRS 4.

[2] This decision was taken jointly with the FASB. In August 2012 the FASB decided to separately develop new proposals for the impairment of financial assets. .

apply the proposals of the Impairment project being developed by the IASB to reinsurance contracts.

Common terms used in paper

4. This paper uses the following terms:

   (a) *Cedant*: The policyholder under the reinsurance contract.

   (b) *Reinsurance asset*: A cedant's net contractual rights under a reinsurance contract.

   (c) *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.

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

Background

5. In short, reinsurance is insurance for insurers. By entering into a reinsurance contract, an insurer (cedant) is able to transfer all or a part of its risk under an insurance contract to another insurer. The insurer (cedant) recognises a reinsurance asset for its net contractual rights. Appendix A includes a description of reasons why insurers may enter into reinsurance contracts.

6. The IASB's proposal for the accounting treatment for reinsurance contracts are based on the following principles:

   (a) A cedant should use assumptions for measuring the reinsurance contract that are consistent with the equivalent assumptions made for the underlying direct insurance contracts; and

   (b) The reinsurance contract is separate from the underlying direct insurance contracts. Accordingly, a cedant:

      (i) Would not derecognise the underlying direct insurance liabilities unless the underlying contracts are extinguished;

(ii) Does not offset the reinsurance asset against related insurance liabilities or offset the reinsurance income and expense against related insurance expense and income.

7. Applying the principles for determining the insurance liability to the reinsurance contract, the Exposure Draft (ED) proposed that a cedant should, in accounting for the reinsurance contract:

(a) Estimate the present value of the fulfilment cash flows in the same manner as the corresponding part of the fulfilment cash flows of the direct underlying insurance contract, being the present value of fulfilment cash flows. However, while the ED proposed that an insurer should *not* reflect the risk of its own non-performance in the present value of the fulfilment cash flows for insurance contracts that it *issues*, either at initial recognition or subsequently, the ED did propose that a cedant *should* include the risk of non-performance of the reinsurer on an expected value basis when estimating the present value of the fulfilment cash flows of the reinsurance contract. Subsequently, the cedant would update the measurement of the present fulfilment cash flows of a reinsurance contract for changes in the risk of non-performance by the reinsurer.

(b) Calibrate the residual margin to the premium paid for the reinsurance contract. The ED proposed that:

(i) If a day-one gain arises, the cedant should recognise the gain immediately.

(ii) If the premium paid by the cedant exceeds the present value of expected inflows and is for future coverage, the excess is recognised as a negative residual margin and the cedant releases the margin to profit or loss over the coverage period.

Respondents' feedback to the proposals of the ED

8. Overall respondents stated that there should be more guidance for reinsurance contracts than had been proposed in the ED. Since the ED, the IASB has discussed how a cedant that holds a reinsurance contract would apply the

proposals of the model and the staff intends to explain more specifically the requirements for reinsurance contracts in the exposure draft.

9. Respondents also supported:

   (a) including expectations of the risk of non-performance in the model, ie an expected loss model. Some also suggested that the expected loss model for reinsurance be co-ordinated with the project on impairment of financial assets.

   (b) the proposal to recognise as a residual margin the excess of the expected present value of future cash outflows over the expected present value of future cash inflows (ie apparent day-one loss). Some argued that the day-one loss represented the cost to purchase the reinsurance contract as part of risk management. Others viewed that the ceded premium represents an expense of purchasing reinsurance and therefore the cost (ie day-one loss) should be recognised over the period of the benefit, ie over the same period as premiums for underlying insurance contracts.

10. However, some respondents (mostly users and regulators) disagreed with the recognition of a day-one gain when the expected present value of future cash inflows plus the risk adjustment exceeds the expected present value of future cash outflows. These respondents argued that the cedant should release the profits over the coverage period, because it represents the benefit that would be received by the cedant over the coverage period of the reinsurance contract.

Tentative decisions subsequent to ED

11. During redeliberations, the IASB confirmed the proposals in the ED that an insurer should estimate cash flows considering all current facts and circumstances, including the risk of non-performance due to expected losses arising from credit risk or from disputes. In addition, the IASB tentatively decided that a cedant should apply the requirements of the Impairment project in assessing the recoverability of the reinsurance asset.

12. The IASB was persuaded by arguments to propose changes to the proposals in the ED for the recognition of the residual margin in reinsurance contracts. In

particular, the IASB was persuaded that the apparent gain or loss that arises when insurer purchases reinsurance represents the cost or gain from the service the reinsurer provides in providing reinsurance coverage. Thus, for reinsurance contracts, the IASB decision means that a cedant should recognise a residual margin for a day one gain or a negative residual margin for a day one loss.

Interaction with residual margin decisions

13. Because the measurement of a reinsurance contract that a cedant holds includes a residual margin, the IASB's tentative decisions on the residual margin are also relevant. The ED proposed that the residual margin would be locked-in at inception and all changes in estimates would be recognised in profit or loss. During redeliberations, the IASB tentatively decided that an insurer or cedant should offset against (unlock) the residual margin favourable and unfavourable changes in cash flow estimates and tentatively decided that it would not limit the increase in the residual margin arising from such changes. The following arguments supported the IASB's view:

    (a) The residual margin represents the unearned profit in the contract. As estimates of future cash flows change during the life of the contract, the amount of unearned profit the insurer expects for providing services under the contract changes. Consequently a change in the estimate of the future cash flows should be viewed as a transfer between the components of the total liability, ie offset against the residual margin.

    (b) It would avoid outcomes that some people regard as counterintuitive. To recognise immediately adverse changes in estimates can make contracts that are profitable overall appear to be loss-making in some years. It can also make contracts that actually become loss-making overall appear to be profitable in later years.

    (c) An approach that offsets changes in estimates against the residual margin could help prevent manipulation of profits. Applying the ED proposals, an insurer might over-estimate the fulfilment cash flows on 'day 1' of the contract. On 'day 2' it could revise the estimates down and recognise the difference as an immediate gain. In contrast, when changes in estimates are offset in the residual margin, the insurer would

recognise the difference as an adjustment to the residual margin. The outcome would be the same as if the insurer had correctly estimated the fulfilment cash flows on day 1. The insurer would not recognise an immediate gain.

The issue

14. In this paper the staff considers how the tentative decisions on the Impairment project of the IASB will apply in accounting for a reinsurance asset. Because the impairment model is concerned with the effects of changes in credit risk, and not with other changes in the asset, this paper will consider only risk of non-performance associated with expected losses arising from credit risk of the reinsurance asset (ie expected credit losses). This paper does not reconsider the proposal to update the measurement of reinsurance contracts arising from other aspects of non-performance such as disputes.

15. The staff notes that the IASB's tentative decision to apply the impairment model for financial instruments to the reinsurance asset was taken when:

    (a) the IASB had not yet concluded on whether to offset any changes in estimate in the residual margin; and

    (b) the IASB had issued an Exposure Draft and a Supplementary Document (SD) in its Impairment project to apply an expected loss model. ED/2009/12 *Financial Instruments: Amortised costs* recognised the initial expected credit losses (priced in to the asset) through adjusting the effective interest rate and all changes in expected credit losses subsequent to initial recognition (ie those not priced in) when they occurred. The Supplementary Document to the ED required an entity to recognise the higher of the time proportional amount and the expected losses over the foreseeable future for assets within the 'good book' and lifetime expected losses for the 'bad book'

    Applying the proposals in the original ED, a similar result would have been achieved regardless of whether the cedant applied the insurance contract model (which would have recognised all changes in estimates in profit or loss

immediately) or the impairment model per the ED/2009/12 (which would have also recognised impairment gains and losses in profit or loss).

16. However, the staff believes there is currently a conflict between the IASB's most recent proposals on impairment of the reinsurance assets and the IASB's decision on the unlocking of the residual margin. The conflict relates to how the cedant would treat the initial and subsequent changes in expected credit losses of the reinsurance asset. The conflict is illustrated as two alternatives:

    (a) Alternative 1 – The cedant should account for the initial estimate and subsequent changes in estimates of expected credit losses in accordance with the insurance contracts decisions. The cedant would adjust the residual margin for changes in cash flows because of changes in expected credit losses. As a result, the cedant would not recognise a portion of the initial estimate (ie 12-month expected loss) and changes in expected credit losses in profit or loss as would be required by the impairment proposals (paragraph 18 - 22);

    (b) Alternative 2 – The cedant should account for a portion of the initial estimate and subsequent changes in estimates of the expected credit losses in accordance with the impairment project decisions. The cedant would recognise on initial recognition of the reinsurance contract a portion of the initial estimate (ie 12-month expected loss). Subsequently, the cedant should recognise in profit or loss changes in estimates of cash flows because of changes in expected credit losses as required by the impairment proposals. As a result, the cedant would not offset those changes in the residual margin (paragraphs 23– 28).

17. In addition, the paper:

    (a) Illustrates in a numerical example the application of the alternatives 1 and 2 (paragraphs 29 - 43);

    (b) Analyses the merits of each approach (paragraphs 44 -49); and

    (c) Discusses the additional considerations that the IASB would need to consider if it selects Alternative 2 (paragraphs 50 -54).

Alternative 1 – Adjust residual margin for changes in expected credit losses

18. This alternative considers how the cedant would account for changes in the expected credit losses by applying the tentative decisions the IASB has made for unlocking the residual margin, ie the cedant would offset all changes in expected cash flows against the residual margin. The reasons for that decision are described in paragraph 13.

The mechanics

19. On initial recognition, the cedant implicitly includes its expectation of expected loss in determining the residual margin by including its expectation of expected credit losses in the fulfilment cash flows.

20. Subsequent to initial recognition, the cedant would account for any favourable or unfavourable changes in the expected cash flows by adjusting the residual margin (which may be positive or negative). The cedant would not distinguish between those changes in cash flows caused by changes in expected credit losses and other changes in estimated fulfilment cash flows.

21. By adjusting the residual margin for changes in estimates of fulfilment cash flows, the cedant would not recognise any amounts in profit or loss because of changes in expected credit losses in the period of the change. As a consequence, in the period that a change in expected losses occurs, the carrying amount of the reinsurance asset will not change. However, in subsequent periods, the total profit or loss will be lower than if the entity had not unlocked the margin, as the cedant recognises the residual margin in profit or loss when it receives the services over the coverage period.

22. The numerical examples illustrate how an entity would account for changes in expected credit losses using this alternative and also illustrates how the results would differ when we compare it with alternative 2.

Alternative 2 – Apply the requirements of the Impairment project

23. This alternative considers how a cedant would apply the proposals in the Impairment project as an overlay to the proposals of accounting for reinsurance

contracts as proposed by the May 2011 tentative decisions. Applying those proposals, a cedant would distinguish between:

(a) a portion of initial expected credit losses(ie 12month expected loss); and

(b) changes in cash flows because of changes in expected credit losses and other changes in estimated fulfilment cash flows.

The cedant would recognise immediately both a and b in profit or loss.

24. Applying the proposals in the Impairment project, the cedant would account for the expected credit losses as follows:

(a) A 12-month expected loss, where the cedant would estimate the present value of the expected loss associated with a probability that the reinsurer would default in the 12 months after the reporting date. This would result in the cedant recognising a loss upon initial recognition of the reinsurance contract.

(b) A lifetime expected loss, where the cedant would recognise the expected lifetime losses when there is a significant deterioration in credit quality of the reinsurance asset (taking into consideration the term of the asset and the original credit quality)[3].

The initial 12-month expected loss and changes in the expected credit loss would be recognised immediately in profit or loss.

25. Consequently, the cedant would account for expected credit losses similar to a holder of an interest bearing financial asset.

The mechanics

26. Essentially, the alternative creates a combined approach:

(a) Firstly, a cedant will apply the requirements applicable to insurance contracts. The cedant would exclude, after initial recognition, the

[3] For higher quality assets, lifetime expected losses shall be recognised if the asset deteriorates below investment grade. (See Appendix A for a description of the lifetime loss criteria).

effects of changes in expected credit losses, on its estimate of cash flows;

(b) Secondly, the cedant would consider the credit quality the reinsurer and account for estimates of and changes in expected credit losses consistently with the Impairment project, ie in profit or loss. The Impairment project proposes that an entity recognises immediately in profit or loss the initial estimate and subsequent changes in the 12-month expected loss, or an expected lifetime loss when there is a significant deterioration in credit quality of the financial asset (taking into consideration the term of the asset and the original credit quality).

27. For any changes in the expected credit losses, the cedant would reduce the carrying amount of the reinsurance asset immediately and recognises an amount in profit or loss.

28. The numerical examples illustrate how an entity would account for expected credit losses using this alternative and compare it with alternative 1.

Numerical illustration of Alternative 1 and Alternative 2

29. The following numerical examples[4] illustrate how a cedant would apply alternatives 1 and 2 to the same set of facts, and describe how a cedant would present its results under alternative 1 and 2 in the Statement of Financial Position and Statement of Comprehensive Income.

(a) Example 1 illustrates the scenario where the present value of cash inflows exceeds the outflows, ie the cedant makes an apparent gain;

(b) Example 2 illustrates the scenario where the present value of cash inflows is less than the outflows, ie the cedant makes an apparent loss.

[4] In calculations, small differences arise because of rounding

Example 1: Cedant makes an apparent gain

Example 1

This example illustrates a cedant entering into a reinsurance contract where it expects the present value of expected cash *inflows* to exceed the present value of expected cash *outflows*.

The table below summarises the expected cash flow pattern and present value on initial recognition.

	Y0	Y1	Y2	Y3	Present value
	CU	CU	CU	CU	CU
Claim recoveries (inflows)		330	330	340	1 000
Reinsurance premiums (outflows)	(800)				(800)
Subtotal					**200**
Residual margin					(200)
Total reinsurance asset					**0**

Assume:

The cedant expects to receive services under the contract evenly over the contract period of 3 years, ie the cedant releases the residual margin on a straight-line basis.

The cedant estimates that on initial recognition the 12 month expected credit loss is CU20. That amount is part of the initial estimated cash flows .

For simplification:

- Ignore any risk margin
- Ignore time value of money
- Assume changes in estimates of cash flows are because of credit deterioration

At the end of year 1, the cedant updates its expectations of the fulfilment cash flows. The updated cash flows indicate that the future expected inflows have decreased only because of expected credit losses . The cedant now expects only CU300 in year 3 (ie a change of CU40 in the 12 month expected loss). The deterioration in credit quality since initial recognition is not considered significant (ie no lifetime loss should be recognised).

30. At the end of year 1, the cedant would have paid the premium of CU800 and received inflows on claims of CU330. Thus, the expected cash flows at the end of year 1 are CU330+CU340=CU670. The cedant would also have released one third of the residual margin, leaving a remaining negative residual margin of CU133. Before adjusting for changes in expected credit losses, the carrying amount of the reinsurance asset is CU537 (alternative 1) or CU517[5] (alternative 2 after recognition of the initial 12-month expected loss of CU20).

Alternative 1

31. When the cedant updates the expected cash flows for changes in expected credit losses, the net expected cash inflows are CU630[6], a decrease of CU40[7]. The decrease in expected cash flows is offset against the residual margin, resulting in a new carrying amount of CU93[8]. The carrying amount of the reinsurance contract asset will remain CU537. This is illustrated as follows:

[5] CU517 = 670 – 133 - 20

[6] CU630 = 330 + 300

[7] CU40 = 670 – 630

[8] CU93 = 133 – 40

	As originally estimated	Change in estimate	Revised estimate
	CU	CU	CU
Expected cash flows	670	(40)	630
Residual margin	(133)	40	(93)
Reinsurance asset	537		537

32. The reduced residual margin of CU93 releases over the remaining coverage period, being CU46 and CU47 respectively each year.

Alternative 2

33. On initial recognition, the cedant would recognise a 12 month expected loss of CU20 in profit or loss (debit) with a corresponding adjustment to the reinsurance contract (credit).

34. When the cedant updates the expected cash flows for changes in expected credit losses, the net expected cash inflows are CU630. The difference of CU40 is immediately recognised in profit or loss, because the change was a result of changes in expected credit losses. The residual margin remains unchanged at CU133. The carrying amount of the reinsurance asset decreases to CU477. This is illustrated as follows:

	As originally estimated	Change in estimate	Revised estimate
	CU	CU	CU
Expected cash flows	670		670
12-month expected loss	(20)	(40)	(60)
Residual margin	(133)		(133)
Reinsurance asset	517		477

35. The increase in the estimate of 12-month expected loss of CU40 is recognised in profit or loss in the year. The unchanged residual margin of CU133 releases over the remainder of the coverage period, being CU66 and CU67 respectively each year.

36. The following table summarises the amounts the cedant would present using the two alternatives.

Alternative 1 – Unlock residual margin for all changes in expected cash flows	
Debit / (Credit)	Y1 CU
Amount recognised in SoFP	
Reinsurance Asset	537
Amount recognised in SCI	
• Residual Margin released (Profit or loss)	(67)
Alternative 2 – Overlay impairment model	
Debit / (Credit)	Y1 CU
Amount recognised in SoFP	
Reinsurance Asset	477
Amounts recognised SCI	
• Day 1 recognition of 12 month expected loss	20
• Residual Margin released	(67)
• Subsequent change in expected credit losses	40
Total recognised in profit or loss	(7)

Example 2: Cedant makes an apparent loss

Example 2

This example illustrates a cedant entering into a reinsurance contract where it expects the present value of expected cash *outflows* to exceed the present value of expected cash *inflows*.

The table below summarises the expected cash flow pattern and present value:

	Y0	Y1	Y2	Y3	Present value
	CU	CU	CU	CU	CU
Claim recoveries (inflows)		250	250	250	750
Reinsurance premiums (outflows)	800				(800)
Subtotal					**(50)**
Residual margin					50
Total reinsurance asset					**0**

Assume:

The cedant expects to receive services under the contract evenly over the contract period of 3 years, ie the cedant releases the residual margin on a straight-line basis.

The cedant estimates that on initial recognition the 12 month expected loss is CU10. That amount is part of the initial estimated cash flows.

For simplification:

- Ignore any risk margin
- Ignore time value of money
- Assume changes in estimates of cash flows are because of credit deterioration

At the end of year 1, the cedant updates its expectations of the fulfilment cash flows. The updated cash flows indicate that the future expected inflows have decreased only because of expected credit losses . The cedant now expects

only CU220 in year 3 (ie a change of CU30 in the 12 month expected loss). The deterioration in credit quality since initial recognition is not considered significant (ie no lifetime losses shall be recognised).

37. At the end of year 1, the cedant would have paid the premium of CU800 and received inflows on claims of CU250. Thus, the expected cash flows at the end of year 1 are CU250+CU250=CU500. The cedant would also have released one third of the residual margin, leaving a remaining negative residual margin of CU33. Before adjusting for changes in expected credit losses, the carrying amount of the reinsurance asset is CU533[9] or CU523 (alternative 2 after recognition of the initial12 month expected of CU10)

Alternative 1

38. When the cedant updates the expected cash flows for changes in expected credit losses, the net expected cash inflows are CU470[10], a decrease of CU30[11]. The decrease in expected cash flows is offset against the residual margin, resulting in a new carrying amount of CU63[12]. The carrying amount of the reinsurance contract asset will remain CU533. This is illustrated as follows:

	As originally estimated	Change in estimate	Revised estimate
	CU	CU	CU
Expected cash flows	500	(30)	470
Residual margin	33	30	63
Reinsurance asset	533		533

39. The increased (negative) residual margin of CU63 releases over the remaining coverage period, being CU32 and CU31 respectively each year.

[9] CU533 = 500 + 33

[10] CU470 = 250 + 220

[11] CU 30 = 500 – 470

[12] CU63 = 33 + 30

Alternative 2

40. On initial recognition, the cedant would recognise a 12 month expected loss of CU10 in profit or loss (debit) with a corresponding adjustment to the reinsurance contract (credit).

41. When the cedant updates the expected cash flows for changes in expected credit losses, the net expected cash inflows are CU470. The difference of CU30 is immediately recognised in profit or loss, because the change was a result of changes in expected credit losses. The residual margin remains unchanged at CU33. The carrying amount of the reinsurance asset decreases to CU493. This is illustrated as follows:

	As originally estimated	Change in estimate	Revised estimate
	CU	CU	CU
Expected cash flows	500		500
12 month expected loss	(10)	(30)	(40)
Residual margin	33		33
Reinsurance asset	523		493

42. The increase in the estimate of 12 month expected loss of CU30 is recognised in profit or loss in the year. The unchanged residual margin of CU33 releases over the remainder of the coverage period, being CU17 and CU16 respectively each year.

43. The following table summarises the amounts the cedant would present using the two alternatives.

Alternative 1 – Unlock residual margin for all changes in expected cash flows	
Debit / (Credit)	Y1
Amount recognised in SoFP	
Reinsurance Asset	CU533
Amount recognised in SCI	
• Residual Margin released (Profit or loss)	17

Alternative 2 – Overlay impairment model	
Debit / (Credit)	Y1
Amount recognised in SoFP	
Reinsurance Asset	CU493
Amounts recognised SCI	
• Day 1 recognition of 12 month expected loss	10
• Residual Margin released	17
• Subsequent change in expected credit losses	30
Total recognised in profit or loss	57

Staff analysis

44. Alternatives 1 and 2 would treat estimates of and changes in estimates of expected credit losses in different ways:

    (a) In Alternative 1, the change in expected credit losses is offset in the residual margin, depicting that the unearned profit in the contract has changed as a result of the change in expectations of expected credit losses. Thus, the cedant will earn a different profit or loss in each future period as it receives the service under the reinsurance contract.

    (b) In alternative 2, the change in expected credit losses is recognised in profit or loss, depicting that the insurer is better or worse off as a result of the change. The amount that the insurer recognises as the cost of reinsurance in each future period remains the same. In addition, upon

initial recognition of the reinsurance contract, a cedant would recognise a 12-month expected loss. This results in recognising the initial expected credit loss twice. .

45. In support of alternative 2 it could be argued that changes in value that arise from changes in expected credit losses are different from other changes in the future cash flows used to estimate the insurance contract asset. A change in the estimates of the *other* future cash flows does not affect the service received by the cedant—the cedant remains as well protected against the insured risk as it was when the contract was incepted. All that has changed are the estimates of the reinsurer's costs of providing that service (and hence of its unearned profit).

46. However, changes in the expected credit losses of the reinsurer *would* affect the amount of service a cedant expects to receive from the reinsurer, because an increase in expected credit losses would mean that the reinsurer is less likely to provide the coverage or services originally promised in the contract. Accordingly, it may be appropriate to reflect that change in the amount of service in profit or loss. This would result in consistent accounting for impairment losses between reinsurance contracts and other financial assets.

47. However, to counter that view, the staff observe:

    (a) A key objective in offsetting changes in estimates of cash flows against the residual margin is that the unearned profit in the contract would be measured consistently at inception and subsequently. Reflecting the changes in expected credit losses is consistent with the rationale that the residual margin should reflect the difference between the premium in the contract and an updated measure of the present value of fulfilment cash flows both at inception and subsequently.

    (b) A core principle in the insurance contracts proposals is that an insurance contract (and equally a reinsurance contract) should be measured on the basis of all the cash flows expected to arise as the contract is fulfilled, regardless of the reasons that specific cash flows arise. Accordingly, requiring different treatments for initial estimates and subsequent changes in cash flows associated with expected credit

losses and those that arise for other reasons is not consistent with that principle.

(c) The impairment model would apply only to the initial estimate and subsequent changes in expected credit losses, and not to cash flows that arise from other causes of non-performance, such as disputes. Such cash flows would also affect the amount (rather than only the price) of service the cedant expects to receive. It would be inconsistent to apply different accounting to the different causes of non-performance. On the other hand it would also be inconsistent, and result in reduced comparability and understanding by users, to extend the impairment approach to cash flows that arise from changes in the risk of non-performance other than credit deterioration.

(d) The objective of the Impairment project is to ensure that initial estimates and changes in expectations about future credit losses are faithfully represented in the value of financial assets at amortised cost or FVOCI. However, the proposals in the insurance contracts project would measure reinsurance contracts on a current, expected value basis that incorporates changes in the risk of non-performance (which includes expected credit losses). Thus, arguably, the reinsurance contract would already be measured in a way that fully reflects expectations about future credit losses.

48. Furthermore that staff notes that the IASB's tentative decisions would not apply to other assets within the scope of the Insurance Contracts Standard (such as insurance contract assets that arise when the insurer has cash outflows before receiving cash inflows). The effect of any changes in expected credit losses for such assets would be offset against the residual margin. Therefore applying the impairment model to reinsurance contracts would result in inconsistent accounting for assets within the scope of the Insurance Contacts Standard.

49. Accordingly, the staff supports alternative 1, ie that the cedant would adjust the residual margin for changes in cash flows because of changes in expected credit losses.

Question 1
Does the IASB agree that cedant should account for the risk of non-performance associated with expected credit losses in the same way as other changes in the expected fulfilment cash flows; accordingly, a cedant would not apply to reinsurance contracts the proposals for impairment being developed by the IASB?

Additional considerations if Alternative 2 is selected

50. The Impairment model applies a three bucket approach to recognise impairment. The approach would require an entity to track credit deterioration, which some believe may be onerous for non-financial institutions to apply. As a result, the IASB decided to provide simplifications for trade receivables (that result from revenue transactions within the scope of the Revenue Project) and lease-receivables (as recognised in the Leases Project) in applying the Impairment model.[13]

51. If the IASB were to choose to apply the impairment model as an overlay (ie alternative 2) the IASB could consider whether to provide a similar simplification for insurance contracts.

52. The reasons for the IASB's decision to provide a simplification for these receivables are as follows:

    (a) Despite the disadvantage of reduced comparability due to different accounting for trade and lease receivables as compared to other financial assets, the IASB concluded that the advantages for the proposed simplified approach were significant enough to allow different requirements for these assets. Advantages identified included that:

        (i) operational relief would be provided to non-financial institutions, due to the difficulty in calculating 12-month expected losses for assets with a longer maturity; and

[13] Currently the scope of IFRS 9 excludes *Leases*. However, the IASB decided that entities shall apply IFRS 9 to the impairment of the lease receivable.

(ii) entities would not be required to track credit migration on these instruments.

(b) applying the simplified approach to trade receivables without a significant financing component was consistent with the Revenue ED's practical expedient of allowing entities to recognise revenue based on the undiscounted invoice amount.

53. Accordingly:

(a) For trade receivables *without* a significant financing component, an entity shall recognise lifetime expected losses on initial recognition and throughout the life of the asset;

(b) For trade receivables with a significant financing component and lease receivables an entity may select an accounting policy to either:

(i) fully apply the impairment model (ie 3 bucket approach); or

(ii) account for the lifetime expected loss at initial recognition and throughout the life of the contract.

54. The staff thinks that a simplification should not be permitted for entities' accounting for insurance contracts. Insurers issuing insurance are often large financial institutions and have complex accounting and management systems. Accordingly, the motivation to provide the simplification would not justify the simplification for insurance contracts.

55. The staff also notes that entities that issue insurance contracts would also hold financial assets that would not be able to apply the relief given to trade and lease receivables. As a result such entities would need to have in place methods to measure the 12 month expected loss and determine and track significant deterioration in credit quality for these financial assets.

Question 2
Does the IASB agree not to include a simplification in applying the Impairment model to reinsurance contracts?

Appendix A – Reasons for Entering into reinsurance contracts

A1. Paragraph 5 indicate that insurers can transfer their risk by entering into a reinsurance contract. Insurers enter into reinsurance contracts for various reasons, including:

(a) Spread the risk of their insurance contracts;

(a) Reduce exposure to particular risks;

(b) Provide insurers with financial capacity to accept risks and contracts with larger face amounts than those it would otherwise be able to accept;

(c) Improve an insurer's statutory surplus position. The cedant transfers to the reinsurer the surplus strain resulting from writing new contracts;

(d) Protect insurers against losses arising from catastrophes;

(e) Limit liabilities of captive insurers (a form of self-insurance set up by a non-insurance entity);

(f) Assist in financial and tax planning strategies;

(g) Obtain underwriting assistance (assistance to issue a contract) with risk classifications, or broaden ability to market products with which the cedant has little experience;

(h) Exit a line of business;

(i) Test new coverage.

Appendix B – Impairment Project – Three Bucket model

A1. The IASB has developed an Impairment model to recognise

A2. The impairment allowance and associated gain or loss for:

a. financial assets measured at amortised cost under IFRS 9 *Financial Instruments*;

b. financial assets measured at fair value through other comprehensive income under draft Amendments to IFRS 9 *Financial Instruments (2010)*;

c. loan commitments, except for loan commitments that are accounted for at fair value through profit or loss under IFRS 9 *Financial Instruments*;

d. financial guarantee contracts to which IFRS 9 *Financial Instruments* is applied and that are not accounted for at fair value through profit or loss; and

e. lease receivables within the scope of IAS 17 *Leases*, or for the right to receive lease payments under the proposals of the Leases Project.

A3. The model is an 'expected loss model', as it would require a holder of the financial asset to account for expected rather than incurred losses. This is a change from the current 'incurred loss model' of IAS 39, where a holder would only account for impairment if there is objective evidence that a loss event had incurred. The result of this change is that the recognition of lifetime losses will accelerate from the treatment we have today.

A4. An entity shall recognise an impairment allowance for 12-month expected losses when a non-credit impaired asset is first recognised and subsequently until the lifetime loss criterion are met.

A5. An entity should recognise an impairment allowance for lifetime expected losses for those assets if there has been deterioration in credit quality since initial recognition that is significant (taking into consideration the term of the asset and the original credit quality).

A6. To alleviate the complexity and cost of performing an assessment of credit risk deterioration for higher credit quality assets, the IASB also tentatively decided that the recognition of lifetime expected losses for a higher credit quality asset is when it deteriorates below 'investment grade'.

A7. Changes in the allowance for the impairment would be recognised in profit or loss in the period of the change.

A8. In measuring the amortised cost of the financial asset, an entity would apply the contractual effective interest rate, ie not adjusted for credit.

A9. The holder of the financial asset would recognise interest income on the gross carrying amount of the financial asset, unless there is objective evidence of impairment due to an event(s), in which instance the holder would recognise the interest on the net carrying amount.

A10. The IASB tentatively decided to provide a simplified approach for trade receivables (that result from revenue transactions within the scope of the Revenue Project) and lease-receivables (as recognised in Leases Project) to provide operational relief to non-financial institutions, due to the difficulty in calculating 12-month expected losses for assets with a longer maturity; and to alleviate the need to track credit migration on these instruments.

A11. While for trade receivables *without* a significant financing component, an entity shall recognise lifetime expected losses on initial recognition and throughout the life an entity may select an accounting policy for trade receivables with a significant financing component and lease receivables to either:

(a) fully apply the impairment model (ie 3 bucket approach); or

(b) account for the lifetime expected loss at initial recognition and throughout the life of the contract.

A12. The scope and the treatment of purchased credit impaired assets remains unchanged from IAS 39. For these assets lifetime expected losses are included in the estimated cash flows when computing the effective interest rate on initial recognition, and subsequent changes in lifetime losses are recognised in profit and loss.