STAFF PAPER

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Project	Insurance contracts		
Paper topic	Reinsurance contracts and the scope of the variable fee approach		
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Purpose of this paper

1. This paper asks the Board to amend the scope of the variable fee approach to exclude reinsurance contracts that an entity issues or an entity holds.

Staff recommendation

2. The staff recommends that an entity should not apply the variable fee approach to reinsurance contracts issued or reinsurance contracts held.

Background

Reinsurance contracts within the scope of the new Standard

3. A reinsurance contract is defined as "An insurance contract issued by one entity (the 'reinsurer') to compensate another entity (the 'cedant') for claims arising from one or more insurance contracts that are issued by the cedant" (taken from the 2013 Exposure Draft *Insurance Contracts).*

4. The forthcoming Standard will apply to insurance contracts, including reinsurance contracts, it issues. The Standard does not distinguish insurance contracts issued and reinsurance contracts issued.

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5. The forthcoming Standard will also apply to reinsurance contracts that an entity holds. The Standard will not apply to other insurance contracts that an entity holds.

Scope of variable fee approach

6. The variable fee approach is intended to apply to insurance contracts that create an obligation to pay to the policyholder an amount equal to the value of underlying items, less a variable fee for service. Thus, the variable fee approach applies for insurance contracts that meet the following criteria at initial recognition:

> (a) the contractual terms specify that the policyholder participates in a share of a clearly identified pool of underlying items;
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> (b) the entity expects to pay to the policyholder an amount equal to a substantial share of the returns from the underlying items; and
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> (c) a substantial proportion of the cash flows that the entity expects to pay to the policyholder should be expected to vary with the cash flows from the underlying items.

7. The staff's working draft also provides application guidance that states:

> B96 A share referred to in paragraph [x] exists only when the contract specifies the share that the entity may retain and the share that the policyholder must receive. A share does not preclude the existence of the entity's discretion to vary the amount that the entity retains in a way that results in the policyholder receiving a different share of returns than specified in the contract.
>
> B97 The pool of underlying items referred to in paragraph [x] can comprise any items, for example a reference portfolio of assets, the net assets of the entity, or a specified subset of the net assets of the entity as long as they are clearly identified by the terms of the contract. An entity does not need to hold the identified pool of

underlying items. However, a clearly identifiable pool of underlying items does not exist when:

(a) an entity can retroactively change the underlying items that determine the amount of the entity's obligation; or

(b) there are no underlying items identified, even if the policyholder could be provided with a return that generally reflects the entity's overall performance and expectations, or the performance and expectations of a subset of assets that the entity holds. An example of such a return is a crediting rate or dividend payment set at the end of the period to which it relates. In this case, the obligation to the policyholder reflects the crediting rate or dividend amounts the entity has set, and not an identified underlying item. "

Staff analysis

8. Some types of reinsurance contracts issued might meet the criteria as currently drafted. In particular, a reinsurance contract always specifies a clearly identified pool of underlying items, namely the direct insurance contracts that are reinsured. Thus, the entity would be required to apply the variable fee approach to reinsurance contracts if the conditions in paragraph 6 are met. This may be the case if:

    (a) The cedant participates in a share of the reinsured direct insurance contracts;

    (b) the reinsurer expects that the cedant will retain a substantial share of the returns from the reinsured direct insurance contracts; and

    (c) a substantial proportion of the cash flows that the reinsurer expects the cedant to retain are expected to vary with the cash flows from reinsured direct insurance contracts.

9. The staff observes that the variable fee approach was developed to address situations in which the policyholder pays a premium and expects to receive both

insurance coverage and investment returns in excess of the premium paid. In contrast, in a reinsurance contract:

(a) the cedant pays a premium but does not generally expect to receive reimbursements greater than the premium paid. The reinsurer does not provide a cedant with a return on underlying items and keep a proportion for itself as a fee.

(b) The profit the reinsurer earns is not a fee for providing investment management services, it is earned from providing reinsurance coverage.

10. The staff thinks that the Board did not intend for reinsurance contracts issued to be within the scope of the variable fee approach, and propose that the eligibility criteria for the variable fee approach should be modified to exclude reinsurance contracts issued.

Reinsurance contracts held

11. The staff observes that the rationale for the variable fee approach, that an entity and policyholder share in the returns of underlying items, does not apply for reinsurance contracts that an entity holds. When an entity holds reinsurance contracts, it does so to obtain insurance coverage over the amounts needed to settle insurance contracts it issues, and not to receive a share in investment returns. Accordingly, the staff recommend that the Board clarify that the variable fee approach does not apply to reinsurance contracts held.

12. Some interested parties state that the treatment of the contractual service margin for reinsurance contract held should be consistent with the treatment of the contractual service margin for the underlying insurance contracts issued. This is to avoid mismatches when the pattern of recognition of the CSM for reinsurance contracts differs from the pattern of recognition of the CSM for the underlying insurance contracts. This would mean that the variable fee approach would apply to reinsurance contracts that reinsure contracts within the scope of the variable fee approach, and the general model would apply to reinsurance contracts that reinsure reinsurance contracts within the scope of the general model.

13. However, such an approach would be inconsistent with the Board's reasoning that a reinsurance contract held should be accounted for separately from the underlying direct contracts it relates to (BCA126 of the 2013 ED). Any differences in the recognition pattern of the CSM between the reinsurance contract and the underlying insurance contracts reflects the different economic depictions of the two types of contract, and reflects that the expense of purchasing the reinsurance contract may be incurred in a different period from the period in which the profit from the underlying insurance contract is earned. Accordingly, the staff does not propose modifying the accounting for reinsurance contracts held to make it consistent with the accounting for the underlying insurance contracts issued.

Question for Board members
Does the Board agree that an entity should not apply the variable fee approach to reinsurance contracts issued or reinsurance contracts held?