

Chapter 8

Reinsurance

Definitions of Reinsurance Contract, Reinsurer and Cedant

Principle 8.1

- 8.1** *A reinsurance contract should be defined as an insurance contract issued by one insurer (the reinsurer) to indemnify another insurer (the cedant) against losses on an insurance contract issued by the cedant.*

Accounting by Reinsurers and Cedants

Principle 8.2

- 8.2** *Reinsurers and cedants should apply all the recognition, derecognition and measurement requirements in principles 2.1-7.6 to all reinsurance contracts.*

- 8.3** Reinsurance contracts may pose additional measurement difficulties because:

- (a) there are sometimes long delays before the reinsurer receives information about claims and certain adjustments to premiums.¹ Also, when the information does arrive, it is often less detailed than the information available to the direct insurer;
- (b) because reinsurance contracts are sometimes customised to meet specific requirements, a book of reinsurance contracts may be less homogeneous than a book of direct insurance contracts;
- (c) reinsurance contracts sometimes contain complex features that are less common in direct insurance contracts, such as stop loss clauses, high deductibles and retrospective adjustments to premiums. Such features may mean that the measurement of the liability responds in a highly non-linear way to key variables. As a result, the measurement may be extremely sensitive to assumptions about those key variables;
- (d) a book of reinsurance liabilities may be less homogeneous than a book of typical direct insurance liabilities. This may make it more difficult to determine the unit of account for reinsurance (see principle 5.5);

¹ Principle 3.4. states the view that deferred and fund methods are now unnecessary, given modern advances in communications.

- (e) the amount of reinsurance capacity in the market tends to change more rapidly than the amount of direct insurance capacity. As a result, reinsurance premium rates may fluctuate more than premium rates for direct insurance;
 - (f) some consider that established reinsurers set premium rates in the expectation of a continuing relationship with the policyholder over a number of contract periods, rather than on the basis of a desire to set an appropriate premium for each period taken in isolation; and
 - (g) a reinsurance contract exposes the cedant to credit risk.
- 8.4 Nevertheless, this DSOP identifies no reason to set different accounting requirements for reinsurance contracts. In particular, this DSOP contains no specific measurement guidance for reinsurance contracts, on the basis that all important aspects of the measurement of reinsurance assets and liabilities are already covered by the discussion in other parts of this DSOP.
- 8.5 Principle 5.5 may sometimes lead to a unit of account in reinsurance that differs from the unit of account in direct insurance.
- 8.6 For proportional reinsurance, it would generally be sufficient to account for the proportionate share of the assets, liabilities, income and expense arising from the direct insurance contract. For example, if proportional reinsurance covers 30% of all future claims, premiums and other cash flows from a book of insurance contracts:
- (a) the cedant recognises a reinsurance asset equal to 30% of the amount recognised as an insurance liability (subject to any adjustments required for the credit risk borne by the cedant and for claim handling costs or other expenses that will not be borne by the reinsurer); and
 - (b) the reinsurer recognises a reinsurance liability equal to 30% of the liability recognised by the cedant (assuming the cedant's methods for determining this amount are consistent with the reinsurer's methods for applying the Standard and subject to any adjustments required for claim handling costs or other expenses that will not be borne by the reinsurer). As explained above, the reinsurer may have less information than the cedant. Also, the reinsurer may conclude that its unit of account is larger than the unit of account for the cedant. For example, if the cedant reinsures an entire book of motor insurance contracts against aggregate claims exceeding a certain amount, the cedant's unit of account may be that book, whereas the reinsurer's unit of account is likely to include similar reinsurance policies issued to other cedants. For these reasons, the liability recognised by the reinsurer in practice may differ from the asset recognised by the cedant.
- 8.7 For non-proportional reinsurance, more detailed analysis will normally be required of the amount, timing and uncertainty of cash flows. In estimating those cash flows, the cedant would need to use assumptions that are consistent with the assumptions that the cedant uses in estimating the cash flows under the corresponding direct insurance contract(s).

- 8.8 The cedant's reinsurance asset includes the reinsurer's share of the market value margin relating to the direct insurance liability. For example, in the example in paragraph 8.6, the reinsurance asset includes 30% of the market value margin included in the direct insurance liability. In effect, the reinsurance contract eliminates 30% of the cedant's risk exposure under the direct insurance contract (subject to credit risk).
- 8.9 A reinsurance contract may cover a longer period than the underlying direct insurance contract. For example, a reinsurance contract may cover all claims arising under direct insurance contracts that cover risk up to 30 June 2003; the cedant may have issued direct insurance contracts covering claims up to 30 June 2002. If the cedant issues further contracts covering claims arising from 1 July 2002 to 30 June 2003, the reinsurance contract would indemnify the cedant against those claims. Both the cedant and the reinsurer use principle 4.2 to determine whether the cash flows arising under the reinsurance contract from those further contracts enter into the measurement of the cedant's reinsurance asset and the reinsurer's reinsurance liability. The implications of principle 4.2 are discussed below.
- (a) The cedant already has reinsurance cover for those further contracts. That cover represents a contractual right of the cedant and a contractual obligation of the reinsurer. In measuring its reinsurance liability, the reinsurer includes the present value of those additional net cash flows if, and only if, either:
 - (i) their inclusion would increase the measurement of the reinsurer's liability; or
 - (ii) the cedant's existing contractual right to call on the reinsurance cover for those further contracts is potentially valuable (as described in principle 4.2).
 - (b) The cedant has not yet recognised any asset or liability for its future contractual rights and obligations under the further direct insurance contracts. Therefore, the cedant does not recognise a reinsurance asset for estimated future reinsurance recoveries of the, as yet unrecognised, future claims under those potential further direct insurance contracts.
 - (c) The cedant's existing contractual right to call on the reinsurance cover for those further contracts is an option. Conceptually, the cedant should recognise that option as an asset and use an option pricing model to measure it. In practice, it may often be reasonable to assume that the entity-specific value or fair value of that option is immaterial.

Cedant's Gains or Losses on Reinsurance

- 8.10 The amount paid to a reinsurer may differ from the carrying amount of related insurance liabilities. If the amount paid exceeds the amount previously recognised as liability for that portion of the exposure, it is clear that the cedant should recognise a loss. However, in some cases, the amount paid is less than the amount previously recognised. Some argue that immediate recognition of the resulting gain would allow

insurers to manipulate reported net profit by entering into reinsurance contracts. Therefore, they suggest that the cedant should defer the gain and amortise it over time on some rational basis.

8.11 This DSOP proposes that any such gain should be recognised immediately, for the following reasons:

- (a) any deferred gain does not meet the definition of a liability under the Framework. If the insurance liability and the reinsurance asset are both measured on a basis that is consistent with current market pricing, any gain arising on buying reinsurance is a real economic event and should be recognised when it occurs; and
- (b) in countries where general insurance liabilities are not discounted, it may be necessary to prevent immediate recognition of a gain on some financial reinsurance transactions that would otherwise allow the insurer to recognise the economic impact of discounting. However, because this DSOP proposes that all insurance liabilities and insurance assets should be discounted, no such restriction is needed.

8.12 Entering into a reinsurance transaction does not affect the measurement of the original liability directly. Nevertheless, reinsurance prices may sometimes give the cedant more information to help predict the timing and amount of claims. However, the cedant would need to consider carefully the following factors:

- (a) some argue that prices in the reinsurance market are often influenced by other factors, such as the business cycle, a desire to buy market share or a wish to maintain long-term relationships with cedants; and
- (b) reinsurers may be able to price more competitively than a direct insurer for the same risk if they may have a more diversified portfolio of contracts or if their distribution costs are lower.

Credit risk

8.13 In measuring assets arising under reinsurance contracts, the cedant would need to consider the probability that:

- (a) the reinsurance contract may not cover claims under the direct insurance contract in full in the manner anticipated; or
- (b) the reinsurer may fail to satisfy its obligation under the reinsurance contract in full in a timely manner (credit risk).

8.14 In some cases, for example where the reinsurer is in a very strong financial position, and there is no doubt about the extent of coverage under the reinsurance contract, the cedant may be able to conclude that these probabilities are negligible. However, it is important for the cedant to carry out and update this assessment.

- 8.15 If these probabilities are not negligible, the cedant will need to consider the impact on both the expected cash flows and the market value margin.

Gross Presentation for Reinsurance

Principle 8.3

8.16 *If a reinsurance transaction does not qualify for derecognition of the related direct insurance liability under principle 2.3, a cedant should present:*

- (a) *an insurance asset arising under reinsurance contracts as an asset, rather than as a deduction in measuring the related direct insurance liability; and***
- (b) *reinsurance premiums as an expense and the reinsurer's share of claims expense as income.***

Balance Sheet

- 8.17 Some argue that a cedant should present an insurance asset arising under reinsurance contracts as a deduction in measuring the related direct insurance liability, rather than as an asset. They consider that the reinsurance effectively settles part or all of the insurer's original liability by reimbursing part or all of the claims. They also suggest that a net presentation gives users a clearer picture of a cedant's net risk exposures.
- 8.18 This DSOP proposes that the cedant should present the insurance asset as a separate asset, because:
- (a) the reinsurance contract does not "fix" the amount that must be paid to policyholders. It simply provides a related promise from the reinsurer. If the reinsurer defaults or refuses to pay, the cedant must still make payments to policyholders for valid claims. The gross presentation gives a clearer picture of credit risk; and
 - (b) a net presentation would be inconsistent with the offsetting requirements in IAS 1, *Presentation of Financial Statements*, IAS 32, *Financial Instruments: Disclosure and Presentation*, and IAS 37, *Provisions, Contingent Liabilities and Contingent Assets* (except in the rare cases when the reinsurance transaction satisfies the derecognition proposals in principle 2.3).

Income Statement

- 8.19 Some favour a net presentation for reinsurance on the face of the income statement - a cedant should deduct reinsurance premium expenses in determining premium revenue and should also deduct the reinsurer's portion of claim expense in determining claims expense. They consider that gross disclosure in the notes is necessary and also sufficient. They argue that net presentation on the face of the income statement:
- (a) avoids unnecessary detail on the face of the income statement; and

- (b) is consistent with a treatment already permitted by IAS 37 for reimbursements of provisions.

8.20 This DSOP proposes a gross presentation - the cedant should report reinsurance premiums as an expense and the reinsurer's share of claims expense as income, because:

- (a) this gives a clearer picture of the scale of the insurer's activities. A reinsurance programme and the underlying direct insurance activity may be driven by different factors;
- (b) this is consistent with similar requirements in IAS 1, *Presentation of Financial Statements*, and IAS 32, *Financial Instruments: Disclosure and Presentation*; and
- (c) while IAS 37's option of a net presentation in the income statement may be acceptable for unusual items, such as insurance reimbursements of expenditure required to settle a provision, it is not appropriate where reimbursements are a recurring feature of an enterprise's daily operations – as in the case of reinsurance transactions of a cedant.