

## Insurance Accounting Alert

# Boards discuss reinsurance topics

### What you need to know

At a joint meeting of the Boards on 31 May to discuss a number of reinsurance topics they agreed on the following:

- ▶ Certain reinsurance contracts would meet the definition of insurance even if there is no expected loss to the reinsurer
- ▶ Non-recognition of reinsurance assets when related to underlying coverage is not yet in force
- ▶ The ceded portion of the risk adjustment should represent the risk being reinsured
- ▶ To disregard the residual (or composite) margin of the underlying insurance contracts when measuring a reinsurance asset
- ▶ There should be no gain or loss at inception of a reinsurance contract unless the loss relates to a portfolio transfer of incurred claims
- ▶ To recognise impairments due to credit risk consistently with general guidance on impairment, and recognise impairments due to disputes incurred based on facts and circumstances

At a joint meeting on 31 May, the Financial Accounting Standards Board and the International Accounting Standards Board (the FASB and the IASB respectively, or collectively, the Boards) discussed several reinsurance topics. The Boards are committed to approaches to measurement and presentation for reinsurance that are broadly consistent with their decisions related to direct insurance. However, articulating the guidance applied to reinsurance contracts is proving difficult. The Exposure Draft/Discussion Paper (ED/DP) provided somewhat limited guidance on the accounting for reinsurance contracts, which has resulted in many requests for expanded guidance and new issues being raised. Due to these concerns and the additional feedback received through the outreach programme, the Boards discussed the following topics at this meeting:

- ▶ Can a reinsurance contract transfer risk if there is no expected loss to the reinsurer?
- ▶ When are reinsurance assets recognised?
- ▶ Should the ceding risk adjustment be measured using a gross or net of reinsurance method (IASB-only issue)?
- ▶ Is the residual/composite margin in the underlying contracts reinsured relevant to the measurement of the reinsurance asset?
- ▶ Can a cedant have a gain or loss when entering into a reinsurance contract?
- ▶ When is a reinsurance asset impaired?

### Risk transfer

The Boards debated whether a reinsurance contract that did not meet the definition of insurance, because there is no expectation of a loss, could still be considered insurance. Specifically, is risk transferred when a portfolio of individual direct policies that might all independently be exposed to a loss, but are grouped together, does not result in a scenario where a loss is expected. Hence, it is difficult for the insurer (or the reinsurer) to demonstrate there is a scenario where significant insurance risk has been transferred, which is one of the requirements to qualify for insurance accounting. The Boards agreed that if the reinsurer 'steps into the shoes' of the direct writer, the contract should be deemed insurance, regardless of whether an expected loss can be demonstrated. However, the Boards stated clearly that arrangements that are, in substance, financing, and where a loss was not expected, should not be accounted for under the insurance contract standard.

The Boards agreed with the staff that a modification to the definition of insurance is necessary to address reinsurance contracts where no expected loss is present. They also agreed in principle with the staffs' recommendation. However, the Boards asked the staffs to find alternative wording that expresses the intent to permit insurance accounting only when the reinsurer is in virtually the same benefit position as the direct writer relative to the reinsured risks.



The Boards further agreed that, when assessing whether an insurer or reinsurer has assumed significant insurance risk, contracts entered into simultaneously with a single counterparty (including all members of a group) for the same risk(s) have to be combined and evaluated as one contract.

#### **Recognition of reinsurance assets**

The Boards agreed with the staffs' recommendation that reinsurance assets are recognised when the underlying insurance contracts are recognised. The recognition date may be later than the effective date of the reinsurance agreement if the direct insurance contract is not yet in force; for example, when the reinsurance is for coverage that attaches to individual policies that are written over a 12-month period.

#### **Measurement of margins in the reinsurance contract asset**

The Boards also agreed with the staffs' recommendations regarding margins, specifically:

- ▶ The ceded portion of the risk adjustment should represent the risk being removed through the use of reinsurance. The Boards indicated that using this definition for determining the measurement will allow companies greater flexibility, including a net approach that is referred to as 'gross less net equals ceded.
- ▶ The residual or composite margin in the direct liability plays no role in the measurement of the related reinsurance asset.

#### **Ceding commission**

The Boards discussed whether commission or expense allowances should be reflected in the cash flows of the reinsurance contract – to the extent that they are a reimbursement for direct costs of the direct writer that are included in the building block component of the

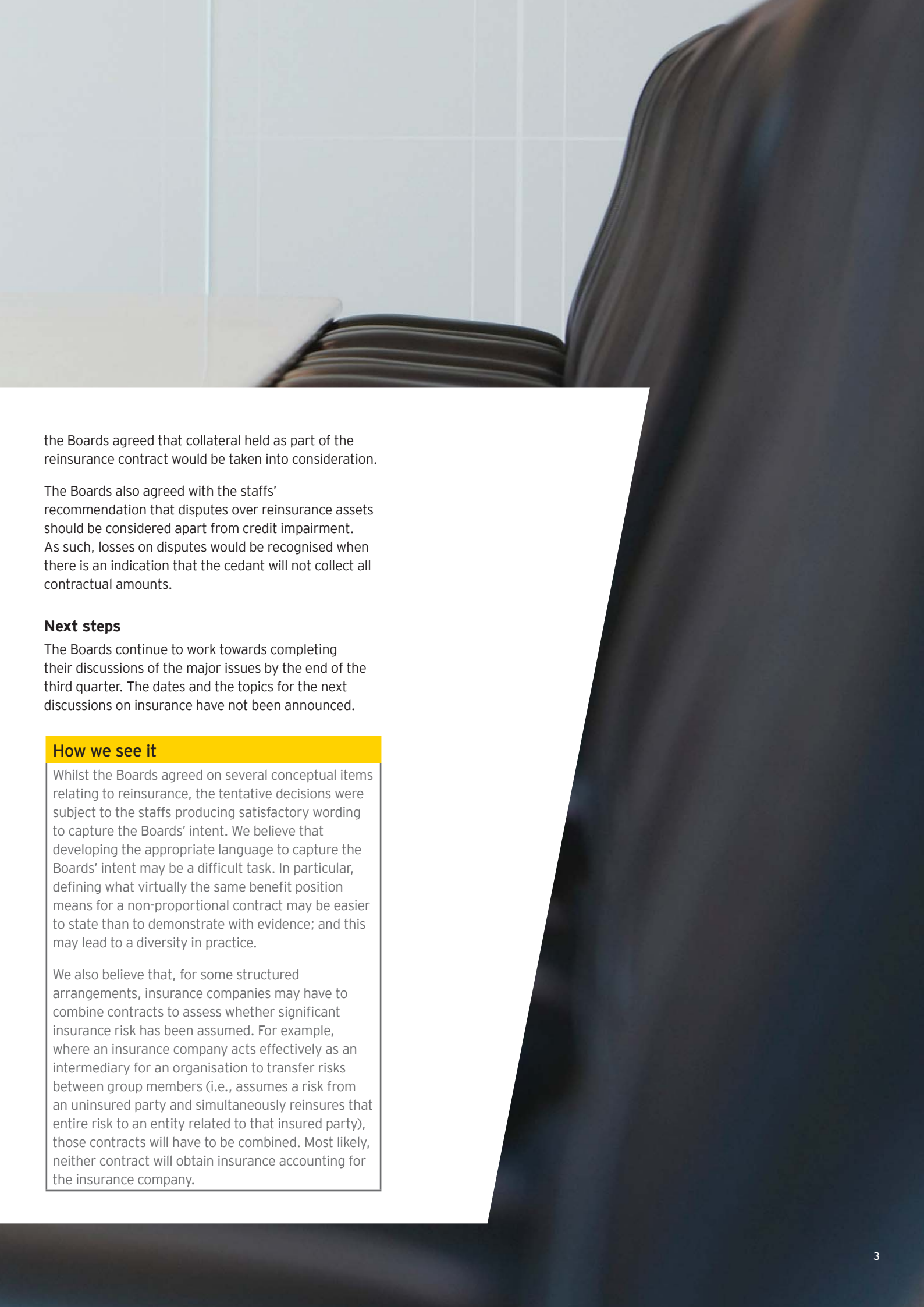
insurance liability. The discussions also showed that the Boards were unable to decide whether this issue was only a matter of presentation or it affected the measurement of the reinsurance asset. No decision was made and further discussions were postponed to a later date.

#### **Initial recognition of ceded reinsurance contract**

The Boards discussed whether to immediately recognise amounts when the present value of the fulfilment cash flows does not equal zero. When that amount is greater than zero, it is referred to as a gain, whilst an amount below zero has been labelled a loss. Some insurers argue that if a loss on the direct insurance contract has to be recognised, then a corresponding gain on a related reinsurance contract could be recognised. The Boards took the position recommended by the staffs that any calculated amount above zero should be deferred as part of the residual or composite margin. They also felt that amounts below zero on ceded reinsurance should be treated similarly to a prepaid cost when the reinsurance coverage is for future events. Although the IASB voted not to recognise the amount when it is below zero, seven members of the IASB voted against not immediately recognising the amount below zero. The Boards came to a different decision if the contract related to reinsurance for a past event (e.g., claims have already been incurred) and stated that those amounts should be recognised immediately.

#### **Impairment of reinsurance assets**

The Boards agreed to use the same model used for financial instrument impairment for reinsurance asset impairment. They are hopeful that the general financial instrument guidance on impairments can be completed before insurers must implement the new insurance standard. When determining the impairment amount,



the Boards agreed that collateral held as part of the reinsurance contract would be taken into consideration.

The Boards also agreed with the staffs' recommendation that disputes over reinsurance assets should be considered apart from credit impairment. As such, losses on disputes would be recognised when there is an indication that the cedant will not collect all contractual amounts.

### **Next steps**

The Boards continue to work towards completing their discussions of the major issues by the end of the third quarter. The dates and the topics for the next discussions on insurance have not been announced.

### **How we see it**

Whilst the Boards agreed on several conceptual items relating to reinsurance, the tentative decisions were subject to the staffs producing satisfactory wording to capture the Boards' intent. We believe that developing the appropriate language to capture the Boards' intent may be a difficult task. In particular, defining what virtually the same benefit position means for a non-proportional contract may be easier to state than to demonstrate with evidence; and this may lead to a diversity in practice.

We also believe that, for some structured arrangements, insurance companies may have to combine contracts to assess whether significant insurance risk has been assumed. For example, where an insurance company acts effectively as an intermediary for an organisation to transfer risks between group members (i.e., assumes a risk from an uninsured party and simultaneously reinsures that entire risk to an entity related to that insured party), those contracts will have to be combined. Most likely, neither contract will obtain insurance accounting for the insurance company.

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