
Insurance alert

ISAB/FASB Board Meeting

Insurance Contracts

PwC Summary of Meetings

31 May 2011

Since a variety of viewpoints are discussed at FASB and IASB meetings, and it is often difficult to characterise the FASB and IASB's tentative conclusions, these minutes may differ in some respects from the actions published in the FASB's Action Alert and IASB Observer notes. In addition, tentative conclusions may be changed or modified at future FASB and IASB meetings. Decisions of the FASB and IASB become final only after completion of a formal ballot to issue a final standard.

Highlights

The IASB and FASB held a joint Board meeting on 31 May, 2011 where they discussed 8 of the 14 issues identified to date relating to reinsurance. With many topics to cover in a relatively short period of time, the Boards addressed the issues at a very high level, with few examples or the chance to reflect on potential unintended consequences. Interpreting the implications of the Boards' decisions for various reinsurance structures and applying some of the Boards' conclusions to actual reinsurance transactions may prove challenging.

The Boards tentatively agreed to clarify that if the economic benefit to the reinsurer for its respective portion of the underlying policies is virtually the same as the ceding company's economic benefit, the reinsurer has assumed substantially all the insurance risk related to the reinsured policies. Therefore, the reinsurance contract is deemed to transfer significant insurance risk.

The Boards also tentatively agreed that the assessment of significance of insurance risk should be done contract by contract, and that contracts entered into with a single counterparty (or related counterparties) for the same risk or that are otherwise interdependent should be considered a single contract.

The Boards agreed that revised wording was needed to the staff proposal on recognising ceded reinsurance. Conceptually, for many contracts (such as risk attaching quota share), the cedant should recognise a reinsurance asset when the underlying direct contract liability is recognised rather than at the beginning of the reinsurance coverage period. This would avoid recording a reinsurance asset prior to recording an underlying direct liability. However, for other types of coverage, (such as aggregate excess of loss coverage) recognition would be at the beginning of the reinsurance coverage period.

The Boards agreed with the staff proposal to clarify that in calculating a risk adjustment on ceded reinsurance, the ceded portion of the risk adjustment should represent the risk being removed from the direct insurer by the use of reinsurance. The Boards also agreed with the staff proposal that the guidance should not specify whether the risk adjustment should be calculated on a gross basis or arrived at by performing a "with and without" reinsurance calculation of the net exposure.

The staff proposal, that the Boards tentatively agreed to at the 31 May meeting, differs from the ED and DP proposal to record day 1 gains immediately but defer "losses" upon initial recognition of a ceded reinsurance contract. The FASB and a large majority of the IASB supported the staff proposal to recognise losses immediately relating to reinsurance of past events. The FASB also agreed with the staff proposal to defer amounts paid or payable for prospective reinsurance coverage in excess of fulfilment cash inflows, as did a slight majority of the IASB. The FASB and a large majority of the IASB also supported the staff's proposal to defer any day 1 gains.

The FASB and all but one IASB member agreed with the staff proposal that the cedant's estimate of the present value of the fulfilment cash flows for the reinsurance contract should be done excluding the residual/composite margin on the underlying direct contracts.

The Boards discussed but did not conclude on whether the ED proposal to treat ceding commissions received as a reduction of the premium ceded to the reinsurer should be retained. The Boards decided that this was a presentation issue and therefore should be discussed when presentation and the modified approach are re-deliberated.

The Boards also seemed to be leaning toward an approach whereby guidance on recording an impairment allowance for the risk of non-performance by the reinsurer would be aligned with the Boards' ultimate conclusions on impairment in the financial instrument project, rather than developing guidance specific to insurance.

Risk transfer for reinsurance contracts

The staff noted that some respondents were concerned that the proposed criteria for risk transfer, (which requires that there must be at least one scenario where the insurer suffers a loss), would be problematic for certain types of reinsurance coverage. The staff gave examples of two types: historically profitable quota share reinsurance and catastrophe reinsurance that covers high severity but low frequency claims. However, given that the IFRS 4 risk transfer criteria are met even if an insured event is extremely unlikely, it would appear

that most quota share reinsurance contracts and catastrophe covers should pass the risk transfer test unless they lack commercial substance. There may be isolated situations where the direct contracts are so highly profitable that reinsurance of those contracts is not expected to generate any net losses to the reinsurer.

Nevertheless, to eliminate concerns raised by constituents as noted above, the staff proposed that the definition be clarified to add wording similar to the "stepping into the shoes of the cedant" wording in existing US GAAP literature. This provision notes that if substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts has been assumed by the reinsurer, the reinsurance contract is deemed to transfer significant insurance risk. The provision is necessary in US GAAP give the higher threshold for assessing risk transfer (that is, there must be a reasonable possibility of significant loss to the reinsurer).

Several FASB members seemed uncomfortable with the staff wording as currently proposed as it seemed rather broad, with one Board member noting that because it referred to having substantially the same risks but not substantially the same premium, a reinsurer could charge a different premium (for example, higher) and therefore actually have less risk. Another FASB member proposed that perhaps the guidance should provide for looking through to the underlying direct contracts and whether each of those contracts transferred risk. This idea was ultimately rejected on the basis that it would be too difficult to do for non-proportional reinsurance coverage and would require allocations of the reinsurance premium to individual underlying contracts, which would be operationally challenging.

An IASB member noted that if existing IFRS 4 risk transfer guidance were retained, (there is no requirement that there be at least one scenario where the insurer suffers a loss), this new "stepping into the shoes" provision would not be required, but reluctantly agreed that the guidance was now needed. Another IASB member suggested that the guidance should say that if the economic benefit to the reinsurer for its respective portion of the underlying policies is virtually the same as the ceding company's economic benefit, then the reinsurer has assumed substantially all the insurance risk related to the reinsured policies and thus the reinsurance contract is deemed to transfer significant insurance risk. Both Boards seemed to agree with this approach, subject to going back to insurers applying IFRS to determine if this notion was current practice. The FASB chair remarked that it was already an existing US GAAP provision.

Interdependent contracts

The staff presented its proposal that contracts entered into with a single counterparty (or related counterparties) for the same risk or that are otherwise interdependent should be considered a single contract for insurance and reinsurance risk transfer analysis.

Several Board members asked that the guidance be clarified to emphasise that the combination of contracts would only be applied where contracts are with the same party or a related party, but that contracts executed with unrelated parties would not be combined. For example, if a fronting company accepted risk from one company, and then retroceded that risk on a 100% basis to a totally unrelated party, each of those two contracts would be evaluated separately for risk transfer. On the other hand, an operating entity may transfer risk to an independent insurer which then passes the risk back to a captive insurer in the same consolidated group as the operating entity. The entities should consider these arrangements together to determine risk transfer.

The discussion did not specifically cover other issues raised by constituents outside of reinsurance relating to interdependent contracts. For example, it is not clear whether this guidance would also apply to situations where a bank issues a loan for which its insurance subsidiary contemporaneously issues a policy to the borrower that would waive the loan on death and therefore require the bank to combine the loan and the insurance policy into one contract for accounting purposes in its consolidated accounts.

Recognition of reinsurance contracts

The staff reminded the Boards of their previous decision that direct insurance contracts should be recognised at the start of the coverage period (unless onerous). A ceded reinsurance contract may start on 1 January, and provide coverage for all direct contracts expected to be written in the upcoming year (referred to as a risk attaching contract). The issue with such contracts is whether they should be recognised and measured at the start of the reinsurance coverage period (1 January), even though this may be prior to recognising the underlying direct contracts, which are not yet in existence.

The staff and Boards seemed to agree with the goal of avoiding the recording of a reinsurance asset prior to recording an underlying direct liability. The Boards therefore agreed with the general staff direction of recognising a reinsurance asset when the underlying direct contract liability is recognised rather than at the beginning of the reinsurance coverage period. However, for other types of coverage (such as aggregate excess of loss coverage) recognition would be at the beginning of the coverage period.

It was unclear from the limited discussion how ceded residual/composite margin on the reinsurance contract would be calculated if recognition occurs as each underlying contract is written rather than at a single point in time. In addition, while the approach seems as if it may be more straightforward to apply for the IASB's modified approach, the application to the modified approach was not discussed.

Ceded risk adjustment

The staff noted that some constituents interpreted the ED as requiring a "gross less ceded equals net" approach to determining the risk adjustment associated with ceded reinsurance, whereas many suggested a "gross less net equals ceded" approach. The staff noted that they do not intend to be prescriptive in the approach, and would allow the use of either method. The Boards agreed with the staff proposal.

The staff noted that theoretically, the calculation should be the same in either approach if both calculations are done at the same portfolio level. However, respondents indicated that the "gross less net equals ceded" approach was operationally easier to apply, especially in situations involving aggregate excess of loss contracts.

Treatment of gain or loss on reinsurance

The ED and DP proposal would have recorded day 1 gains immediately and deferred "losses" upon initial recognition of a ceded reinsurance contract. However, the revised staff proposal agreed to by the FASB and narrowly by the IASB is to recognise losses immediately relating to reinsurance of past events and to defer amounts paid or payable for prospective reinsurance coverage in excess of fulfilment cash inflows. Under the revised staff proposal, any day 1 gains would be deferred.

The staff revised its view based on comments from many respondents (both cedants and assuming companies) to the ED and DP and outreach efforts. The amounts deferred relating to prospective coverage would be equivalent to prepaid insurance premiums. The staff and most Board members believe that while amounts should be deferred relating to prospective coverage, such amounts paid for adverse development coverage of past events should not be deferred.

There was no discussion during the meeting as to why this US GAAP distinction between "prospective" and "retroactive" coverage with different deferral treatment to each was being applied. This seems inconsistent with the IFRS 4 definition of insurance which explicitly acknowledges that some insurance contracts cover events that have already occurred, but whose financial effect is still uncertain.

The FASB and a large majority of IASB members also agreed that there should be no immediate gain upon entering into a reinsurance contract, consistent with the notion of no immediate gain when entering into an insurance contract. However, several IASB members disagreed, noting that the accounting should be aligned between the accounting for the direct contract liability and the reinsurance contract asset.

An IASB member countered that he supported the staff position, commenting that an exchange price is different from how one would recognise the liability. Another IASB member agreed with the staff proposal to defer the gain, but questioned whether it would be appropriate to defer a loss on prospective coverage if the cedant paid more for the reinsurance coverage than he received as premium on the direct business. The staff commented that it would be rare to have a loss on day 1 on a prospective cover, but it could be more common for reinsurance purchased on in-force business.

It was noted that taking an immediate gain would be inappropriate for several reasons, one being that entering into a reinsurance contract does not extinguish the underlying liability, (unlike a novation), and therefore the earnings process is not complete and there is uncertainty in the measurement.

Cession of residual/composite margin on underlying insurance contracts

The FASB and all but one IASB member agreed with the staff proposal that the cedant's estimate of the present value of the fulfilment cash flows for the reinsurance contract should be done excluding the residual/composite margin on the underlying direct contracts. The dissenting IASB member noted her concern with the odd results that could occur if the residual margin in the direct contracts is ignored in quota share cessions.

Treatment of ceding commissions

The Boards discussed but did not conclude on whether the ED proposal to treat ceding commissions received as a reduction of the premium ceded to the reinsurer should be retained.

The staff noted that some constituents had requested that the Boards reconsider this issue, believing that the gross presentation of premiums, ceding commission, and expense allowances is important to enable the determination of key metrics such as loss ratios and expense ratios and underwriting profit ratios between direct and net business. The staff realises that ceding commission and expense allowance amounts included in a reinsurance contract may not "match" the actual acquisition costs and costs to fulfil the insurance contract that the cedant has included in the expected cash flows of the underlying insurance contracts. For this reason, the staff recommended that any excess amounts above those included in the direct contract cash flows should be recorded as a reduction of the premium ceded to the reinsurer.

After some debate and requests for clarification of the staff's proposal, the Boards decided that this was an income statement presentation issue and not a measurement of timing of income recognition issue and therefore should be discussed when presentation and the modified approach are re-deliberated. It was also clarified that the staff was not proposing offsetting reinsurance ceding commission or expense allowance cash flows against direct liability cash flows (that is, there would be no balance sheet offsetting between the reinsurance contract and underlying direct contracts).

Credit risk of reinsurer

There was some discussion of how an impairment model might work in the context of the reinsurance market, where impairment would tend to be analysed on an individual reinsurer basis, and how the application of an incurred versus an expected loss model might work. The FASB chair noted that it was her understanding that the staff was merely asking for confirmation that the impairment model should not be comingled with the insurance expected loss estimate rather than asking for a separate impairment model for insurance.

The Boards seemed to be leaning toward an approach whereby guidance on recording an impairment allowance for the risk of non-performance by the reinsurer should be aligned with the Boards' ultimate conclusions on impairment in the financial instrument project rather than developing guidance specific to insurance.

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