STAFF PAPER

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REG IASB Meeting

Project	**Insurance Contracts**
Paper topic	Non-targeted issues: Asymmetrical treatment of gains from reinsurance contracts

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Purpose of paper

1. This paper considers whether there should be an exception to the proposal in the 2013 Exposure Draft *Insurance Contracts* (the 2013 ED) that a favourable change in cash flows of a reinsurance contract held by an entity should be recognised in profit or loss over the coverage period, if those cash flows reimburse the entity for losses that arise from an underlying insurance contract that is onerous.

Why does the IASB need to address this issue?

2. Some comment letters on the 2013 ED indicated that asymmetrical treatment between the contractual service margin of a reinsurance contract and a reinsured portion of an underlying insurance contract would not depict appropriately the economic relationship between the reinsurance contract and the underlying insurance contract.

3. In April 2014, the IASB asked the staff to consider whether the IASB should mitigate a possible accounting mismatch that arises when changes in cash flows of a reinsurance contract are recognised in profit or loss on a different basis from changes in cash flows from the underlying direct insurance contract. The IASB did not propose to reconsider the measurement of a contractual service margin for a reinsurance contract on initial recognition.

Staff recommendation

4. The staff recommend that an entity should recognise in profit or loss any changes in estimates of cash flows for a reinsurance contract that arise as a result of changes in estimates of cash flows for an underlying direct insurance contract that are recognised immediately in profit or loss.

Overview of the paper

5. Paragraphs 10-12 describe background on the proposals in the 2013 ED.

6. Paragraphs 13-24 provide staff analysis and recommendations for the issue about the asymmetrical accounting treatment of the contractual service margin when there is a loss on an underlying direct insurance contract.

7. Paragraphs 25-29 describe the staff's reasons for rejecting an approach proposed by some comment letters.

8. Paragraphs 30-33 consider implications of the staff recommendation for the premium allocation approach.

9. Appendix A includes relevant paragraphs from the 2013 ED.

Background

10. The treatment of the contractual service margin for reinsurance contracts was not one of the five targeted areas in the 2013 ED. However, a number of respondents were concerned that the proposed requirements could cause an accounting mismatch.

11. Those respondents commented that the proposals in the 2013 ED could result in an entity recognising expected losses on an underlying insurance contract immediately in profit or loss (because the contract is onerous), while recognising the corresponding reimbursement from an reinsurance contract in the contractual service margin for the reinsurance contract. The contractual service margin will be recognised in profit or loss when the margin is allocated in future periods. The respondents believed that outcome would not depict faithfully the economic

relationship that the reinsurance contract transfers insurance risk to a reinsurer. This issue is described in more detail in paragraphs 13-20.

12. A few respondents suggest that there should be an exception for some types of reinsurance contracts held (in particular for 'individual loss basis reinsurance contracts'[1]) so that the entity could recognise a gain in profit or loss from these reinsurance contracts at the same times as it would recognise any loss from the underlying direct insurance contracts. However, as described in paragraphs 25-29, the basis for this distinction was not clear.

Staff analysis

13. For a direct *insurance* contract that an entity issues, the measurement of the contract includes a contractual service margin that is determined as the excess of the expected present value of cash inflows (premiums) over the expected present value cash outflows (claims), after adjustment for risk. When the expected present value of cash outflows exceeds the expected present value of cash inflows after adjustment for risk, the contract is onerous and a loss is recognised immediately in the profit or loss.

14. For a *reinsurance* contract that an entity holds:

    (a) the cash outflows are the expected premiums paid to the reinsurer. The reinsurer would usually charge premiums based on the pricing of the direct insurance contracts; and

    (b) the cash inflows are the expected reimbursements that an entity receives from a reinsurer. Those amounts relate to the expected cash outflows under the direct insurance contract, and thus the entity would measure the expected cash outflows under the direct insurance contract and the expected reimbursement cash flows from the reinsurance contract on a consistent basis (paragraph 41(b) of the 2013 ED).

15. Consequently, when an entity purchases a reinsurance contract:

[1] Individual loss basis reinsurance contracts are described and discussed in more detail in paragraph 25 of this paper.

(a) An apparent net loss arises when the premiums paid to the reinsurer exceed the expected cash inflows (reimbursements) from the reinsurer. Paragraph BCA139 of the Basis for Conclusions to the 2013 ED noted that this would typically be the case, and that the apparent net loss represents the expense of purchasing reinsurance (that is part of the premium paid to the reinsurer for the services). Accordingly, the 2013 ED proposed that this cost would be recognised as a contractual service margin, which means it would be recognised as an expense over the period in which the service is received.

(b) An apparent net gain arises when the expected cash inflows (reimbursements) from the reinsurer exceed the premiums paid by the entity. Such a situation is not expected to occur often and, when it does, it would be likely to arise from favourable pricing at inception or subsequent changes in cash flows (see paragraphs 17-18). As described in paragraph BCA140 of the Basis for Conclusions to the 2013 ED, the IASB proposed that this apparent gain should be recognised over the coverage period of the reinsurance contract held.

16. In some cases, an entity might recognise a loss on an underlying insurance contract and, at the same time, recognise a reinsurance asset with an apparent net gain as demonstrated in the following example:

Reinsurance contract	**CU[2]**	**Underlying insurance contract**	CU
- Premiums paid to reinsurer	(90)	+ Premiums receivable	100
+ Expected reimbursements	(120)	- Expected claims	(120)
= CSM	(30)	= Loss	20

17. Paragraph BCA139 of the Basis of Conclusions to the 2013 ED describes the most likely causes of such an apparent net gain at initial recognition of a reinsurance contract as being:

[2] In this Staff Paper, currency amounts are denominated in 'currency units' (CU).

(a) an overstatement of the underlying direct insurance contract, which an entity would normally evaluate by reviewing the measurement of the direct contract; or

(b) favourable pricing by the reinsurer, for example, because of diversification benefits for a reinsurer that are not available to the insurer or because the reinsurer wants to enter a new market.

18. After initial recognition, estimates of cash inflows (reimbursements) from the reinsurance contract might be higher than expected because of higher than expected future cash outflows (claims) for a direct insurance contract. According to the IASB's tentative decisions to date, the change in estimates of cash flows for the reinsurance contract would adjust the amount of the contractual service margin, and be recognised in profit or loss over the coverage period of the reinsurance contract.

19. For the underlying insurance contract, in normal circumstances, the change in estimates of cash flows would also adjust the amount of the contractual service margin and be recognised in profit or loss over the coverage period of the underlying insurance contract. However, in some cases, the unfavourable changes in estimates of cash outflows on the underlying insurance contract can be so severe that the underlying insurance contract becomes onerous. Because the contractual service margin on the underlying insurance contract cannot be negative, an entity would recognise an immediate loss in profit or loss as a result of such unfavourable changes in estimates of cash flows.

20. Some respondents believe that it would be misleading for an entity to adjust the contractual service margin for changes in cash flows for the reinsurance contract when the changes in cash flows for the direct insurance contract that give rise to those changes would be recognised immediately in profit or loss. Accordingly, proponents of this view believe that such favourable changes in estimates of cash flows for reinsurance contract should be recognised in profit or loss in the same period as the related unfavourable changes in cash flow estimates of the underlying direct insurance contract.

21. Respondents to the 2013 ED did not draw a distinction between whether an onerous insurance contract existed at initial recognition or on subsequent

measurement of a reinsurance contract. Nevertheless, the staff believe that there is merit in such a distinction, as explained below.

22. As agreed at the April 2014 discussion of the project plan for non-targeted issues, the staff propose not to revisit the IASB's previously conclusion that a gain on a reinsurance contract at inception should be recognised over the coverage period of the reinsurance contract. This applies even in the rare instance when an underlying insurance contract is onerous at the inception of a reinsurance contract *and* the premium for reinsurance contract is lower than the expected reimbursement cash flows from the reinsurance contract. That approach is consistent with the Board's general conclusion that the underlying direct insurance contract and the reinsurance contract are separate contracts, and that an entity should not recognise a gain at inception of a contract.

23. However, the staff believe that different considerations apply after the contract is priced at initial recognition. In particular, the staff support the view that changes in estimates of cash outflows on underlying direct insurance contracts that have corresponding changes in cash inflows from a reinsurance contract should have no net effect in profit or loss for the period. This would generally be the case because both types of the described changes in estimates of cash flows would generally adjust the contractual service margin. However, when the underlying insurance contracts are onerous, changes in estimates of cash flows are recognised in profit or loss. Consequently, the staff believe that changes in estimates of cash flows for the reinsurance contract related to those changes in estimates of cash flows should also be recognised in profit or loss so that they are treated in a consistent way.

Staff recommendations

24. The staff recommend that an entity should recognise in profit or loss any changes in estimates of cash flows for reinsurance contracts that arise as a result of changes in estimates of cash flows for an underlying insurance contracts that are recognised immediately in profit or loss (ie because the contract is onerous). In the staff's view, the exception to the general treatment of changes in estimates for reinsurance contracts would be justified because the symmetrical accounting

treatment of gains would reflect the economic relationship of the insurance and reinsurance contracts in a more faithful way.

Question for board members
Does the IASB agree to address this issue? If yes: Does the IASB agree that an entity should recognise in profit or loss any changes in estimates of cash flows for a reinsurance contract that arise as a result of changes in estimates of cash flows for an underlying direct insurance contract that are recognised immediately in profit or loss?

Whether there should be an exception for some types of reinsurance contracts

25. As noted in paragraph 12, a few constituents suggested that there should be an exception to the recognition of a contractual service margin when there is an apparent gain on a reinsurance contract. Those constituents noted that the 2013 ED distinguishes reinsurance contracts that provide coverage on an individual loss basis and on an aggregate loss basis, described as follows:

    (a) individual loss basis—where the reinsurance contract reimburses the losses of underlying insurance contracts on a proportional basis and the changes of cash flows for the reinsurance contract could therefore be assigned directly to the underlying insurance contracts; and

    (b) aggregate loss basis—where the reinsurance contract reimburses losses *in excess* of a specified amount and the changes of cash flows for the reinsurance contract may not always be assigned directly to the underlying insurance contracts.

26. The 2013 ED introduced this distinction between types of reinsurance contracts for the practical purpose of determining when a reinsurance contract should be recognised. The intention was to ensure that reimbursements from reinsurance contracts held are recognised at the same time as the underlying insurance contracts to which they relate. Therefore:

(a) when the reinsurance contract held provides reimbursements on an individual loss basis, that contract would be recognised when the underlying insurance contract is recognised, ie when coverage period of the underlying contract begins; and

(b) when the reinsurance contract held provides reimbursements on an aggregate (ie in excess of) loss basis, that contract would be recognised when the coverage period of the reinsurance contract begins because it is not possible to determine any individual underlying contract that leads to reimbursements under the reinsurance contract (paragraph 41(a)).

27. A few respondents believed that this distinction should also be applied for the treatment of the contractual service margin of a reinsurance contract; they proposed that a requirement for an immediate recognition of a net gain on a reinsurance contract would be necessary only when onerous insurance contracts are reinsured on an 'individual loss basis'.

28. However, as stated above, the distinction between the 'individual loss basis' and 'aggregate loss basis' reinsurance contracts was introduced in the 2013 ED for practical purposes; conceptually these reinsurance contracts are not treated differently:

(a) insurance and reinsurance contracts are treated separately irrespective of the type of reinsurance contract;

(b) cash flows of a reinsurance asset and of an insurance liability are measured using consistent assumptions about the cash flows. The estimates of cash flows need to be made regardless of whether the contract is on an individual loss basis or an aggregate loss basis. For example:

(i) an individual loss reinsurance contract might reimburse an entity with 50 per cent of the amount of claims for each underlying direct contract. The cash flows for the reinsurance contract are therefore based on the estimates of a reimbursement of 50 per cent of the expected claim;

(ii) an aggregate loss reinsurance contract might reimburse an entity with an amount in excess of an aggregate amount of claims. In this case the cash flows for the reinsurance contract are based on the estimate of the total amount of expected claims less the aggregate amount specified in the contract;

(c) the service provided by both types of contract is the provision of reinsurance coverage, and the contractual service margin is released to profit or loss on the basis of this service irrespective of the type of reinsurance contract.

29. On this basis, the staff believe that there is no conceptual difference between reinsurance contracts on an 'individual loss basis' and an 'aggregate loss basis', and that therefore there should be no difference in the treatment of the contractual service margin for the two types of reinsurance contract.

Implications of the staff recommendation to the premium allocation approach

30. In practice, the staff expect that many reinsurance contracts will be accounted for using the premium allocation approach, a simplification of the general model in the 2013 ED. The following paragraphs consider the implications of the staff recommendation for the premium allocation approach.

31. The issue in this paper about the accounting mismatch between immediate losses on an onerous underlying insurance contracts and favourable changes in estimates of cash flows on a reinsurance contract arises equally when an entity applies the premium allocation approach to a reinsurance contract, instead of applying the general measurement model in the 2013 ED. This is because the premium allocation approach does not remeasure the cash flows arising from the reinsurance contract. As a result, applying the premium allocation approach to the reinsurance contract would mean that measurement of the reinsurance contract would not reflect the expected increase in reimbursements that might arise if an entity expects unfavourable changes in cash flows because of increased expected claims for the direct insurance contract.

32. Because the IASB intended that the premium allocation approach should be applied only if doing so produces measurement that is a reasonable approximation of the measurement under the general measurement approach, the staff propose that the staff recommendation should apply equally when the premium allocation approach is applied to reinsurance contracts that an entity holds. This is equivalent to (and symmetrical with) the proposed requirement in paragraph 36 of the 2013 ED that an entity applying the premium allocation approach to an insurance contract should recognise an additional liability if the contract is onerous.

33. This example demonstrates the staff proposal for remeasuring a reinsurance asset under the premium allocation approach, in combination with an underlying direct insurance contract:

Initial recognition

Dr Cash	Cr Liability	CU100 - for insurance premiums received
Dr Asset	Cr Cash	CU75 - for reinsurance premiums paid

Subsequent measurement—cash outflows of insurance contract are estimated to be 120.

Dr Loss	Cr Liability	CU20 - for loss on onerous insurance contract
Dr Asset	Cr Gain	CU20 - for gain on reinsurance contract

Appendix A: Relevant paragraphs from the 2013 ED

15 An entity needs to assess whether a contract is onerous when facts and circumstances indicate that the portfolio of contracts that will contain the contract is onerous. A portfolio of insurance contracts is onerous if, after the entity is bound by the terms of the contract, the sum of the *fulfilment cash flows* and any pre-coverage cash flows is greater than zero. Any excess of this sum over zero shall be recognised in profit or loss as an expense.

Reinsurance contracts held

41 An entity that holds a reinsurance contract pays a premium and receives reimbursement if it pays valid claims arising from underlying contracts, instead of receiving premiums and paying valid claims to the policyholder. Consequently, some of the requirements in this [draft] Standard are modified to reflect that fact, as follows:

(a) the recognition requirements of paragraph 12 are modified so that an entity shall recognise a reinsurance contract held:

(i) from the beginning of the coverage period of the reinsurance contract, if the reinsurance contract provides coverage for the aggregate losses of a portfolio of underlying contracts; and

(ii) when the underlying contracts are recognised, in all other cases.

(b) in applying the measurement requirements of paragraphs 19–27 to estimate the fulfilment cash flows for a reinsurance contract held, the entity shall use assumptions that are consistent with those that are used to measure the corresponding part of the fulfilment cash flows for the underlying insurance contract(s). In addition, the entity shall, on an expected present value basis:

(i) treat cash flows, including ceding commissions, that are contingent on the occurrence of claims of the underlying contracts as part of the claims that are expected to be reimbursed under the reinsurance contract;

(ii) treat ceding commissions that it expects to receive that are not contingent on the occurrence of claims of the underlying contracts as a reduction of the premiums to be paid to the reinsurer;

(iii) apply the requirements of paragraph 21 so that the fulfilment cash flows reflect the risk of non-performance by the issuer of the reinsurance contract, including the effects of collateral and losses from disputes; and

(iv) determine the risk adjustment required by paragraph 27 so that it represents the risk being transferred by the holder of the reinsurance contract.

(c) the requirements of paragraph 28 that relate to determining the contractual service margin on initial recognition are modified so that, at initial recognition:

(i) the entity shall recognise any net cost or net gain on purchasing the reinsurance contract as a contractual service margin measured at an amount that is equal to the sum of the amount of the fulfilment cash flows and pre-coverage cash flows for the reinsurance contracts; unless

(ii) the net cost of purchasing reinsurance coverage relates to events that occurred before the purchase of the reinsurance contract, in which case the entity shall recognise such a cost immediately in profit or loss as an expense.

(d) the requirements of paragraphs 30–31 that relate to the subsequent measurement of the contractual service margin are modified so that the entity shall measure the remaining amount of the contractual service margin at the end of the reporting period at the carrying amount that was determined at the start of the reporting period:

(i) plus the interest accreted on the carrying amount of the contractual service margin to reflect the time value of money (the interest accreted is calculated using the discount rates specified in paragraph 25 that applied when the contract was initially recognised);

(ii) minus the amount recognised relating to services that were received in the period; and

(iii) plus (or minus) a favourable (or unfavourable) change in the future cash flows if that change arises from a difference between the current and previous estimates of the future cash flows that relate to future coverage and other future services. Changes in the expected present value of cash flows that result from changes in the expected credit losses of the reinsurer do not relate to future coverage or other future services and shall be recognised immediately in profit or loss.

Gains and losses on buying reinsurance (paragraph 41(c))

BCA139 The amount paid by the cedant would typically exceed the expected present value of cash flows generated by the reinsurance contracts held, plus the risk adjustment. Thus, a positive contractual service margin, which represents a net expense of purchasing reinsurance, would typically be recognised at the initial recognition of a reinsurance contract held. The IASB considered whether the contractual service margin in the reinsurance contract held could be negative if, as happens in rare cases, the amount paid by the cedant is less than the expected present value of cash flows plus the risk adjustment. Such a negative gain would represent a net gain in purchasing reinsurance. The most likely causes of such a negative difference would be either of the following:

(a) an overstatement of the underlying direct insurance contract(s). A cedant would evaluate this by reviewing the measurement of the direct contract(s).

(b) favourable pricing by the reinsurer, for example, as a result of diversification benefits that are not available to the cedant.

BCA140 In the 2010 Exposure Draft, the IASB proposed that entities should recognise a gain when such a negative difference arose. The IASB proposed this for symmetry with the underlying model and to be consistent with the IASB's conclusion that the contractual service margin for the underlying contract should not be negative. However, this Exposure Draft proposes that entities should instead recognise the negative difference over the coverage period of the reinsurance contract held. The IASB was persuaded by the view that the apparent gain at contract inception represented a reduction in the cost of purchasing reinsurance, and that it would be appropriate to recognise that reduction in cost over the coverage period as services are received.

BCA141 The IASB also believes that the net expense of purchasing reinsurance should be recognised over the coverage period as services are received unless the reinsurance coverage is for events that have already occurred. For reinsurance contracts held that provide coverage for events that have already occurred, the IASB concluded that entities should recognise the whole of the apparent loss at contract inception because the coverage period of the underlying contracts has expired.

BCA142 The IASB considered the view that the amount of the contractual service margin included in the measurement of the reinsurance contract held should be proportional to the margin on the underlying contract instead of being measured separately by reference to the reinsurance premium. Under this approach, any difference between the amount recognised for the underlying insurance contract and the reinsurance premium would be recognised in profit or loss when the contract is initially recognised. That approach would depict a gain or loss that is equal to the shortfall or excess of the reinsurance premium that the entity pays to the reinsurer over and above the premium that the entity receives from the policyholder. The unearned profit from the underlying contract would be offset by an equal and opposite expense for the reinsurance premium. However, in the IASB's view, measuring the reinsurance contract held on the basis of the premium that the entity received for the underlying contract when that premium does not directly affect the cash flows arising from the reinsurance contract held would be contrary to viewing the reinsurance contract held and the underlying contract as separate contracts. It also does not reflect the economics of the reinsurance contract the entity holds: that the expense of purchasing the reinsurance contract is equal to the whole of the consideration paid for the reinsurance contract.

BCA143 For the measurement of insurance contracts that the entity issues, this Exposure Draft proposes that the contractual service margin can never be negative, but can be rebuilt. That would mean that entities would recognise losses when the contractual service margin has been eliminated, depicting that the entity no longer expects profit from the contract and would depict any increase in expected profit by an increase in the contractual service margin. This Exposure Draft does not include a limit on the amount by which the contractual service margin of a reinsurance contract held could be adjusted as a result of changes in estimates of cash flows. In the IASB's view, the contractual service margin for a reinsurance contract held is different from that for an insurance contract issued: it reports the expense that the entity incurs when purchasing reinsurance coverage rather than the profit it will make by selling the insurance contract. Accordingly, there is no limit on the amount of adjustment to the contractual service margin for reinsurance contracts held, subject to the amount of premium paid to the reinsurer.