AMERICAN ACADEMY *of* ACTUARIES

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November 20, 2014

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom
Via email apryde@ifrs.org and jyeoh@ifrs.org

RE: IASB Reinsurance and Ceding Commissions Proposal

Dear Members of the International Accounting Standards Board's Insurance Contracts Project:

On behalf of the American Academy of Actuaries'[1] Reinsurance Committee, we are pleased to provide comments to the International Accounting Standards Board (IASB) on its reinsurance and ceding commissions proposal within the Insurance Contracts Project, in particular the presentation of such amounts in the income statement.

It is our understanding that the current IASB position on the display of ceding commissions in the income statement is to have the ceding company use the commissions to offset ceded premiums. It is unclear, however, whether a reinsurer would include the assuming commissions in the income statement as an acquisition expense, similar to a direct writer paying its field force, or netted against premiums. The committee believes that the assuming and ceding companies should both account for reinsurance commissions as described below.

In the property and casualty (P&C) or the general insurance sector, reinsurance is fundamental to the business model. Most industry metrics—including net loss ratio, which is a measure of a company's ability to underwrite its policies, and net earned premium, a common measure of both revenue and the amount of risk a company retains after reinsurance—are calculated and compared on an after reinsurance basis. The committee is concerned that, for both the assuming and ceding companies, netting ceding commissions against contract premium for proportional reinsurance contracts could negatively impact the usefulness of commonly used metrics, such as those mentioned above. Including the reinsurance commission with premium would impact the comparability of companies' net loss ratios and net earned premiums depending on whether and/or the extent to which proportional reinsurance is used, either on an assumed or ceded basis.

[1] The American Academy of Actuaries is an 18,000+ member professional association whose mission is to serve the public and the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

For example, consider two companies that have substantially the same business and economics—one company is the direct writer and the other company assumes a 50 percent quota share of that same business. If ceding commissions were netted against premium, the net of reinsurance loss and expense ratios for these companies would be different depending on the size of the commission. The direct writer would have a low net loss ratio and high net expense ratio, while the assuming company would have the opposite. Thus, a presentation netting ceding commission against ceded premium would impair comparability between these two companies. Comparability would still be impaired for one of these companies if the direct company changed from assuming business fronted[2] by another company to writing it directly.

Exhibit I to this letter provides a numerical illustrative example on this topic. As shown, the netting of ceding commission treatment under the 50 percent quota share example shows different revenue and loss ratio amounts for the ceding and assuming companies, despite these companies having the same insurance risk retained net of reinsurance.

Also shown on Exhibit 1 is an example of a 100 percent or fronting agreement. In such a case, the netting of ceding commissions results in significant revenue on a net of reinsurance basis to the ceding company although it retains no insurance risk after reinsurance.

In the life insurance business, ceding commissions are meant to offset the expenses incurred by the cedant. The National Association of Insurance Commissioners' Life and Health Reinsurance Agreements Model Regulation requires reinsurers to reimburse expenses:

> "No insurer subject to this regulation shall, for reinsurance ceded, reduce any liability or establish any asset in any financial statement filed with the Department if, by the terms of the reinsurance agreement, in substance or effect, any of the following conditions exist:
>
>> (1) Renewal expense allowances provided or to be provided to the ceding insurer by the reinsurer in any accounting period, are not sufficient to cover anticipated allocable renewal expenses of the ceding insurer on the portion of the business reinsured, unless a liability is established for the present value of the shortfall (using assumptions equal to the applicable statutory reserve basis on the business reinsured). Those expenses include commissions, premium taxes and direct expenses including, but not limited to, billing, valuation, claims and maintenance expected by the company at the time the business is reinsured."[3]

Ceding commissions, therefore, are not primarily paid to reduce the premiums received by the reinsurer, but rather to reimburse the reinsurer's share of expenses associated with managing the business being ceded. It is important to show this relationship in IASB standards in addition to U.S. statutory statements.

[2] "Fronted" or "Fronting" refers to the company ceding 100 percent of whatever it sells to an assuming company; typically, the assuming company or its affiliates have the business relationship that generates the business, but requires a licensed company or a highly rated company to write the policies on a direct basis.
[3] This is also included in Appendix A-791 of the NAIC's Accounting Practices and Procedures Manual.

As such, the committee suggests the IASB consider the following alternatives:

- Allow for ceding commissions on proportional reinsurance contracts to reduce the ceding company's acquisition expenses confirm the treatment as acquisition expenses for the assuming company;
- Add two additional rows on the statement of comprehensive income that show gross premiums before reinsurance and ceding commissions on proportional reinsurance contracts explicitly; or
- Include a footnote to the premium line that shows the gross premium and ceding commission components that went into the calculation of that number.

While the first option is consistent with common practices—including U.S. generally accepted accounting principles (GAAP), U.S. statutory accounting, and U.K. GAAP—the second or third options would still allow for the net of reinsurance ratios to be calculated in a meaningful manner.

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Thank you for this opportunity to provide our views on on IASB's reinsurance and ceding commissions proposal. If you have any questions or would like to discuss these issues in more detail, please contact Lauren Sarper, the Academy's senior policy analyst for Risk Management and Financial Reporting, at 202.223.8196 or sarper@actuary.org.

Sincerely,

Jeremy Starr, MAAA, FSA
Chairperson, Reinsurance Committee
Risk Management and Financial Reporting Council
American Academy of Actuaries

Exhibit I-Illustrative Examples[4]

50% Quota Share

Basic Information Gross and Ceded	Direct Writer		Reinsurer		Assumptions
Direct/Assumed Premium	100,000		50,000		50% Quota Share (and thus 32,500 expected loss for reinsurer)
Ceded Premium	(50,000)				Reinsurer has $2,000 allocated expenses to the transaction
Direct/Assumed Incurred Losses (65% Expected L/R)	(65,000)		(32,500)		Reinsurer needs $38,500 to meet its pricing goals
Ceded Incurred Losses	32,500				This yields a 23% ceding commission
Direct/Assumed U/W Expenses (ex-Ceding Commission)	(25,000)		(2,000)		
Ceding Commission	11,500		(11,500)		
Net Underwriting Income/(Loss)	4,000		4,000		

Metrics Net of Ceded Reinsurance	Direct Writer		Reinsurer	
Net Premium based on Exposure Draft	61,500		38,500	
Net Losses	32,500	52.8%	32,500	84.4%
Net Expenses based on Exposure Draft	25,000	40.7%	2,000	5.2%
Net Underwriting Income/(Loss)	4,000		4,000	
Net Combined Ratio based on Exposure Draft		93.5%		89.6%
Net Premium - Alternate Presentation	50,000		50,000	
Net Losses	32,500	65.0%	32,500	65.0%
Net Expenses - Alternative Presentation	13,500	27.0%	13,500	27.0%
Net Underwriting Income/(Loss)	4,000		4,000	
Net Combined Ratio - Alternative Presentation		92.0%		92.0%

Fronting Arrangement

Basic Information Gross and Ceded	Direct Writer		Reinsurer		Assumptions
Direct/Assumed Premium	100,000		100,000		100% Fronting (and thus 65,000 expected loss for reinsurer)
Ceded Premium	(100,000)				Reinsurer has $4,000 allocated expenses to the transaction
Direct/Assumed Incurred Losses (65% Expected L/R)	(65,000)		(65,000)		Reinsurer needs $74,000 to meet its pricing goals
Ceded Incurred Losses	65,000				This yields a 26% ceding commission
Direct/Assumed U/W Expenses (ex-Ceding Commission)	(25,000)		(4,000)		
Ceding Commission	26,000		(26,000)		
Net Underwriting Income/(Loss)	1,000		5,000		

Metrics Net of Ceded Reinsurance	Direct Writer		Reinsurer	
Net Premium based on Exposure Draft	26,000		74,000	
Net Losses	-	0.0%	65,000	87.8%
Net Expenses based on Exposure Draft	25,000	96.2%	4,000	5.4%
Net Underwriting Income/(Loss)	1,000		5,000	
Net Combined Ratio based on Exposure Draft		96.2%		93.2%
Net Premium - Alternate Presentation	-		100,000	
Net Losses	-		65,000	65.0%
Net Expenses - Alternative Presentation	(1,000)		30,000	30.0%
Net Underwriting Income/(Loss)	1,000		5,000	
Net Combined Ratio - Alternative Presentation				95.0%

[4] These examples were developed for illustrative purposes only by the American Academy of Actuaries' Reinsurance Committee.