



AMERICAN ACADEMY of ACTUARIES

April 11, 2011

International Accounting Standards Board (IASB)
30 Cannon Street
London, EC4M 6XH
United Kingdom

Re: Recognition of gains and losses on reinsurance ceded

The American Academy of Actuaries¹ (Academy) Risk Management and Financial Reporting Council's Reinsurance Subcommittee offers the following comments on the IASB *Insurance Contracts Exposure Draft* (ED).

The purpose of this letter is to extend comments already submitted by the Academy to include an additional reinsurance issue. We believe the calculation and amortization of residual margins on reinsurance ceded for long duration contracts does not work well as proposed in the ED. Other options produce a result that is more consistent with the actual financial results of the transactions and provide financial statement users with better information.

The underlying reason for our comments, related to the impact on the calculation of the residual margins by reinsurance, is that insurers price and manage their business based on expected results net of reinsurance. This is especially true for life insurance, but we also believe it applies to all long duration contracts. The combination of the direct policy liability and the reinsurance asset for such a product should reflect the simultaneous nature of the insurance policy issue and the accompanying new business reinsurance transaction, since the product development process includes factoring in the impact of reinsurance prior to completing the final product design, policy premium determination, and risk profile of the insurance product. To account for the simultaneity of these events would require that the calculation of net results should be based on the present value of fulfillment values after factoring in the impact of reinsurance (hereinafter called the theoretical benefit method or "TB method").

We found that although the ED produces expected results that match the TB method (as defined in the third to last paragraph of this letter) results in a common scenario, there are scenarios where the guidance produces bottom-line results different from the answer that would be expected. For example, assume that reinsurance starts at the same time as the direct policy. At this common scenario's inception the direct insurance policy, after accounting for risk margins, shows a present value gain, since the insurer has priced the product to produce a profit. If the insurer purchases quota share reinsurance on the policy, its expectation at inception is that it will pass to the reinsurer, the approximate quota share portion of the profits. Thus, the present value

¹ The American Academy of Actuaries is a 17,000-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.

of the reinsurance cash flows, after factoring in insurance and reinsurer credit risk, will produce a loss to the insurer. Under the TB method, at inception, the result of the combined direct policy liability and the reinsurance asset will be approximately equal to the retained quota share of the policy's inception fulfillment value, adjusted for residual margins to defer the net gain. The ED does produce this result, as the following simple Example 1 illustrates.

Illustrative Example 1

Assumes a direct policy with a present value gain of 100 at inception, with simultaneous 50% quota share ceded reinsurance on identical terms. The ceding company therefore has a present value profit expectation of 50, after contracting to provide the reinsurer with 50% of the future profitability.

Ceding Company at Inception

Direct PV	(100)	(a negative liability = a profit)
Margin	<u>100</u>	(to defer the direct gain, as required by the ED)
Liability	0	
Reinsurance PV	(50)	(a negative asset = a loss; half the profits will be due the reinsurer)
Margin	<u>50</u>	(to defer the reinsurance loss, as required by the ED)
Asset	0	
Bottom Line	0	(the net profit of 50 is deferred, and amortized by release of margin)

However, in Example 2, assume that the direct product produces a gain and the reinsurance also produces an additional gain for the direct insurer. This could happen if the reinsurer uses more favorable experience assumptions (e.g. lower mortality assumption) when pricing the reinsurance, which would lead to lower net reinsurance cost to the direct writer. The reinsurance produces a gain under the direct insurer's assumptions. When applying the ED approach, the after reinsurance result is a gain. This occurs because the direct present value is amortized, but the reinsurance gain drops straight to the bottom line. This is contrary to the principle of not having gains at the inception of a policy.

Illustrative Example 2

Assumes a direct policy with a present value gain of 100 at inception, with simultaneous 50% quota share ceded reinsurance with competitive terms (e.g., reinsurance premium is 40% of direct premium, not 50% as would be implied by the quota share). This example assumes that the ceding company has a present value profit expectation of 20 on the reinsurance, producing a total profit expectation after reinsurance equal to 120.

Ceding Company at Inception

Direct PV	(100)	(a negative liability = a profit)
Margin	<u>100</u>	(to defer the direct gain, as required by the ED)
Liability	0	
Reinsurance PV	20	(a positive asset = an expected gain on the reinsurance)
Margin	<u>0</u>	(to recognize the reinsurance gain, as required by the ED)
Asset	20	
Bottom Line	20	(the direct profit is deferred, but reinsurance profit is recognized)

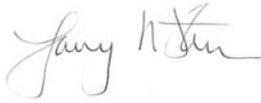
Another example where the ED procedure produces contrary results is when both the direct fulfillment present value and the reinsurance fulfillment present value produce losses to the direct insurer. This could happen when the direct insurer develops a product as a loss leader. The ED guidance in this scenario results in an immediate recognition of loss on the direct insurance but defers recognition of loss on the reinsurance. The ED methodology thus understates the total loss that was expected.

Under the TB method a combined gain would be deferred, and a combined loss would be recognized. The reinsurance asset would be reported as the difference between the fulfillment value with and without reinsurance. Unfortunately, there are situations where this solution would present practical issues. For example, if reinsurance is purchased at a time other than at the inception of the direct policy, how would the combined margin be calculated?

Another option to consider is a method where the reinsurance gain or loss would be recognized based on whether the associated direct business has a gain or loss (“the Net Benefit method or “the NB Method”). If the direct business has a gain at inception, and therefore a margin is established to defer the gain, then the reinsurance fulfillment PV would be deferred whether the reinsurance produces a gain or loss. Similarly, if the direct business produces a loss at inception which is immediately recognized, then the reinsurance results would also be immediately recognized. Should the result of this calculation be a gain at inception, then that gain shall be amortized. Using the NB approach the net gain or loss at inception in both the problem areas listed above and other scenarios reviewed by the Subcommittee, match the TB method.

We would be happy to participate in further discussions on this issue. If you have any questions, please contact Tina Getachew, Senior Policy Analyst, Risk Management and Financial Reporting Council, by phone (+1 202/332-5958) or email (getachew@actuary.org).

Sincerely,

A handwritten signature in cursive script that reads "Larry Stern".

Larry Stern
Chair, Reinsurance Subcommittee
Risk Management and Financial Reporting Council
American Academy of Actuaries