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**SCOR**

Swiss Re  


Mr Hans Hoogervorst  
Chairman  
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8 July 2011

## **Insurance Contracts Project – Reinsurance Topics**

Dear Mr Hoogervorst,

We are writing to you as five leading reinsurers with all of us having headquarters located in Europe and a strong presence in the United States. This letter represents a consensus view of Hannover Re, Mapfre Re, Munich Re, SCOR and Swiss Re on several issues that are of high relevance from a reinsurance company's perspective.

We are fully supportive of the Boards' objective of developing one robust global accounting regime for insurance contracts and would highly appreciate a final IFRS being issued as soon as is practicable. As global reinsurance groups with subsidiaries in many international markets and business in almost all regions of the world, a uniform accounting standard ensuring international comparability is of critical importance. We not only encourage you to continue your ongoing efforts to develop a high quality accounting standard for insurance contracts but also continue to offer our active support and cooperation both via the CFO Forum and as reinsurers in doing so. We are firmly convinced that a separate accounting standard for insurance contracts is necessary because we consider applying such a future high quality insurance-specific accounting standard as being far more useful and relevant than having to rely on other accounting standards, such as those for financial instruments, revenue recognition or general provisions since these have not been developed with the particular considerations of insurance in mind.

In this context, we believe that the objective of convergence of IFRS and US GAAP resulting in a single global standard should remain as an ultimate target of the Boards. However, given the shared interest of users and preparers in an IFRS standard on insurance contracts, it is important that the commitment to convergence does not subject the development of an IFRS standard to unnecessary delay. Convergence is very important but should be seen as an issue which, if not achieved within the IASB's own timeframe, can still be addressed once an insurance contracts standard for IFRS reporters has been developed and issued.

We have followed the recent papers and debates regarding the accounting treatment of reinsurance business with huge interest. However, in reading the Staff Paper prepared for the joint IASB and FASB meeting on 31 May (IASB Paper 3A, FASB Paper 69A) we consider

that this paper neither fully reflects the comment letter positions nor some of our concerns. These concerns and issues were addressed together with proposed draft solutions in the letter of Hannover Re, Mapfre Re, Munich Re and Swiss Re dated 30 November 2010 commenting on the IASB's Exposure Draft on Insurance Contracts (CL # 120, the "Reinsurers' comment letter"). As a consequence, we believe that the Boards came to conclusions and tentative decisions that may have been based on an incomplete basis of information.

To us it is very important that an accounting standard for insurance contracts correctly reflects the economics of the underlying business. However, from our perspective the accounting treatment currently proposed for reinsurance does not fully reflect the economic effects of reinsurance transactions nor does it sufficiently prevent the risk of accounting arbitrage opportunities. In essence this could result in a misleading and non-transparent measurement and presentation of reinsurance business which would likely not be decision-useful, and may have unintended consequences.

In particular we are concerned about the following aspects stipulated in the most recent proposals on reinsurance accounting:

- Definition Insurance Contract: Significant Risk Transfer
- Definition Insurance Contract: Interdependent Contracts
- Reinsurance: Recognition
- Reinsurance Asset: Measurement

Appendix 1, 2 and 3 to this letter set out our concerns in more detail, provide generic examples and present respective proposals for resolving these issues. For different types of contracts and scenarios the numerical examples provided in Appendix 3 illustrate that the reinsurers' proposal, in contrast to the ED and the staff proposal, clearly presents "on the face of the balance sheet" how much insurance risk has been transferred to the reinsurer by the cedant. We therefore believe that this is a transparent and reliable solution which accurately reflects the substance of the transactions.

We should be grateful if the Boards would revisit their conclusions and tentative decisions on the issues described above and take our concerns into consideration.

As in the past, we support the elaboration of a high quality standard for insurance contracts. Therefore, we are committed to pursue an active dialogue and cooperation with the Boards and their staff, which includes assisting you in developing appropriate regulations in relation to reinsurance. We are prepared to discuss these topics in person with Board members or project staff and we would also like to offer an educational session about reinsurance during one of the forthcoming Board meetings.

Yours sincerely,

Roland Vogel, CFO Hannover Re  
Daniel Quermia, CFO Mapfre Re  
Dr. Jörg Schneider, CFO Munich Re  
Paolo De Martin, CFO SCOR  
George Quinn, CFO Swiss Re

c.c.:

Ms Leslie F. Seidman, Chairman of the Financial Accounting Standards Board  
Mr Dieter Wemmer, Chairman of the European Insurance CFO Forum

## **Overview and Executive Summary**

We consider our statements contained in the Reinsurers' comment letter as still being valid. In the following, we therefore reiterate the relevant parts of that letter where appropriate and expand on our statements in detail where necessary. In order to provide specific feedback we refer in some sections directly to certain items of Paper 3A / 69A to the IASB / FASB meeting on 31 May 2011 ("Paper 3A").

### **Our key positions can be summarised as follows:**

#### **Definition Insurance Contract: Significant Risk Transfer**

- We support the staff's recommendation as per items 4a and 36 (Question 1) of Paper 3A to incorporate the substantially-all concept
- We agree with the staff's statements and conclusions in item 35 of Paper 3A where virtual economic equivalence of the cedant and the reinsurer is applied as a sufficient criterion for complying with the substantially-all concept. However, the substantially-all concept should be the leading principle, which, in rare cases, could be fulfilled by virtual economic equivalence.
- The significant risk transfer assessment of a contract should only be carried out once, i.e. at inception. This also implies that no reassessment of the existing portfolio will have to be carried out at the date of transition

#### **Definition Insurance Contract: Interdependent Contracts**

- As already expressed in our comment letter we have understood that a potential scope exclusion of fronting, retrocession and reinsurance has never been intended by the Boards. Therefore, we would recommend to clarify this by the inclusion of a specific reference to these types of contracts.
- In general, we appreciate the direction taken by the Boards as published in the IASB Update of 7 June 2011 by changing the wording of the requirement to "An insurer should assess the significance of insurance risk at the individual contract level. Contracts entered into simultaneously with a single counterparty for the same risk, or contracts that are otherwise interdependent that are entered into with the same or a related party, should be considered a single contract for the purpose of determining risk transfer."
- The phrase "or contracts that are otherwise interdependent that are entered into with the same or a related party" still will cause an inappropriate treatment of fronting arrangements. We consider fronting is a form of regular (re)insurance business and therefore are fully justified to measure and present these transactions according to the insurance contracts standard.
- A clear and suitable definition of the term "related party" should be included in the standard based on the provisions of IAS 24 "Related Party Disclosures".
- Should the wording "otherwise interdependent" remain to be a general criterion for the risk transfer test then this term, in our view, needs to be defined. We think that interdependent should be defined narrowly to include only cases where non performance under one contract can prevent performance under another contract. A possible solution to assess whether contracts are "otherwise interdependent" may include a catalogue of indications and counter-indications.

#### **Reinsurance: Recognition**

- It is necessary that both reinsurance assets and reinsurance liabilities are recognized (and measured) on a consistent basis. Currently wording in item 49 of Paper 3A does not mention liabilities.
- It is currently unclear what is meant by the term "onerous contract liability in the pre-coverage period" as mentioned in item 4c of Paper 3A. This term should be clearly defined.

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- In our view, a reinsurance treaty is to be regarded as onerous by the cedant in the pre-coverage period if according to the measurement a loss would have to be recognised at the beginning of the coverage period (i.e. loss at inception at the beginning of the coverage).

### Reinsurance Asset: Measurement

- The staff proposals contained in Paper 3A do not take account of our concerns, as detail in the Reinsurers' comment letter as well as in direct contact with the IASB staff. We consider it necessary that the insurance standard fully reflects the economics of the reinsurance business and therefore recommend that our input is made transparent in the Boards' meetings in order to ensure proper consideration.
- We do not consider appropriate the staff's recommendation in item 86 (Question 6) of Paper 3A that the cedant should estimate the present value of fulfilment cash flows for the reinsurance contract without reference to the residual / composite margin on the underlying contracts. Consequently, as expressed in the Reinsurers' comment letter, we disagree with the respective proposal. Further, this appears somewhat in contradiction with item 62, which explicitly proposes that the risk adjustment of the reinsurance asset should be based on the underlying business.
- The recommendations in items 4d i and 4d ii of Paper 3A do not reflect the actual economic profit or loss that can result for a cedant from a reinsurance treaty.
- In item 75 of Paper 3A a measurement approach based on the underlying business was rejected due "operational complexities". We do not regard an assumed "operational complexity" as a viable argument, and consider a measurement based on the underlying business as the only meaningful approach.
- The examples presented in item 53 of Paper 3A constitute very special cases that are in no way appropriate or representative for a generalised view. They assume complete mirror accounting and identical measurement in the cedant's financial statements (as a reinsurance asset) and the reinsurer's financial statements (as a (re-)insurance liability). This is usually not the case and should be revisited.
- In item 71 of Paper 3A, it is mentioned that recognising a gain at inception could cause accounting arbitrage. This is not the case in our view. If suitable accounting approaches are developed, possibilities for arbitrage will not arise.
- From our perspective the possibilities of commutation cited inter alia in items 71 and 77 of Paper 3A are not tenable as arguments in this form.
- We propose that the measurement of the residual margin of the reinsurance asset should be based on the risk transferred from the cedant to the reinsurer. This could be achieved if, at the initial measurement, the residual margin of the reinsurance asset is equal to the proportion of the risk adjustment of the reinsurance asset to the risk adjustment of the liability applied to the residual margin of the liability. Subsequently, the amortization of the residual margin of the reinsurance asset should be based on the same pattern as the amortization of the residual margin of the liability.

## **Detailed Analysis**

### **Definition Insurance Contract: Significant Risk Transfer**

In the Reinsurers' comment letter we stated the following:

#### **"Guidance on risk transfer test**

*We note that the changes made to the guidance in B25 only import certain aspects of US GAAP but not other elements related to the respective risk transfer test guidance under US GAAP. We therefore do not fully agree with the stipulations in B25 that a contract does not transfer significant insurance risk if there is no scenario that has commercial substance in which the present value of the net cash outflows paid by the insurer can exceed the present value of the premiums.*

*The definition of an insurance contract in IFRS 4 Phase I has worked quite well. Therefore, our preferred solution would be not to include any explicit risk transfer test in IFRS 4 Phase II and hence B25 should be deleted.*

*Alternatively, if such an explicit risk transfer test would be deemed necessary in the final standard, we consider it indispensable particularly for reinsurance business that other conceptual guidance currently included in US GAAP will also be included in the final standard, because those have to be seen as integral parts of an explicit risk transfer test, such as the substantially-all concept and the reasonably-self evident argument.*

*The main reason is that the smallest unit of account for reinsurance business – in contrast to primary insurance business – is a single reinsurance treaty, i.e. it is already a portfolio of single policies. Such portfolios in many cases benefit from diversification effects. Consequently, they often produce relatively stable expected results (i.e. only a small range of possible outcomes) and the probability of a loss (i.e. present value of net cash outflows exceeding the present value of net cash inflows) is relatively low. However, the overarching principle should be that business that meets the definition of an insurance contract in the primary insurance sector also should be considered as (re)insurance if this business (or parts of it) is reinsured and the reinsurer covers the risks related to the reinsured portion of this portfolio."*

We welcome the direction of the proposal in Paper 3A and are pleased that the concerns we expressed in our comments on the ED have been addressed. Consequently, we support the staff's recommendation as per items 4a and 36 (Question 1) of Paper 3A to incorporate the substantially-all concept. In addition, given the way these items are worded, it is self-evident for us that the transfer of "substantially all of the insurance risk" is not influenced by reinsurance conditions that put cedants in a more favourable position than their own conditions.

Furthermore, we agree with the staff's statements and conclusions in item 35 of Paper 3A where virtual economic equivalence of the cedant and the reinsurer is applied as a sufficient criterion for complying with the substantially-all concept. This rationale is in line with that of FASB ASC 944-20-55-55 (FAS 113, item 67) where it is recognised that virtual equivalence only exists under very limited circumstances and is likewise applied as a sufficient criterion. However, the additional requirement proposed during the meeting on 31 May that a criterion described as "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" should be a necessary prerequisite would almost completely counteract the solution achieved by the integration of the substantially-all concept.

Usually the economic positions of a cedant and a reinsurer are by far not virtually the same, although a reinsurance transaction fulfils the substantially-all concept and transfers significant insurance risk. For the vast majority of reinsurance treaties this is inter alia due to

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the following reasons: The premium level for the primary insurance cover and the reinsurance cover is different, reinsurance commissions and reinsurance profit commissions are paid that are different to primary insurance commissions, the cost structure on the cedant's side is different to that of the reinsurer and the risk adjustments are different (due to different portfolios with differing diversification effects).

Moreover, for most of the reinsurance treaties neither the cedant nor the reinsurer is in a position to assess whether it is in virtually the same economic position than the respective counterparty due to confidentiality reasons.

As a consequence, we would like to point out the importance of only taking over the relevant parts of FASB ASC 944-20-15-53 (FAS 113, item 11) into IFRS, as has been done in items 4a and 36 (Question 1) of Paper 3A. The substantially-all concept should be the leading principle, which, in rare cases, could be fulfilled by virtual economic equivalence as described in FASB ASC 944-20-55-55 (FAS 113, item 67).

For further details and background in relation to certain reinsurance products we refer to Appendix 2.

According to our understanding the inclusion of the above mentioned US GAAP concepts into IFRS does not cause any unintended consequences for primary insurance policies. Due to the different unit of account for each primary insurance policy a scenario with commercial substance exists where the loss requirement can be fulfilled. The substantially-all concept is not relevant for primary insurance products since it refers explicitly to reinsurance only.

Furthermore, the following issue addressed in the Reinsurers' comment letter is of particular relevance with regard to the definition of an insurance contract and should be carefully considered when finalising transition guidance:

*“General requirement in relation to contract classification*

*In addition, it should be made clear that - in the case that changes in the definition or related guidance are introduced - the assessment of a contract has to be carried out only once, i.e. at inception. This also implies that no reassessment of the existing portfolio will have to be carried out at the date of transition (otherwise, this would be overly burdensome and expensive as well as almost not practical if a large number of existing reinsurance treaties would have to be reassessed).”*

We are not aware that this topic has already been discussed and we assume that it will be brought to the Boards' attention at a future meeting.

## Definition Insurance Contract: Interdependent Contracts

In the Reinsurers' comment letter we stated the following:

### "Guidance on contractual linkage

*Another issue relates to paragraph B28 of the ED, which prescribes the risk transfer being assessed on a contract by contract basis, rather than by reference to the materiality to the financial statements. In parentheses, it also advises that for the purpose of assessing the risk transfer, "contracts entered into simultaneously with a single counterparty, or contracts that are otherwise interdependent, form a single contract". Here, guidance previously included in a footnote to B25 of the existing IFRS 4 has been taken over into B28 of the ED unchanged but without the possibility to apply e. g. US GAAP as it was the case under phase I.*

*In consequence, this could imply that fronting, retrocession and reinsurance programs might be excluded from the scope of the future standard on insurance contracts. However, these are typical business activities of reinsurers by which the reinsurer transfers some of the assumed risks to another reinsurer, the retrocessionaire. From our communication with the IASB Staff we have understood that this potential scope exclusion has never been intended by the IASB.*

*Therefore, it should be made clear that fronting, retrocession and reinsurance programs are not "contracts that are otherwise interdependent" in the sense of paragraph B28 of the ED and consequently, the assumed contracts and the ceded contracts, respectively, shall be checked independently from each other for significance of risk transfer."*

As already expressed in our comment letter we have understood that a potential scope exclusion of fronting, retrocession and reinsurance has never been intended by the Boards. Therefore, we would still recommend to clarify this by the inclusion of a specific reference to these types of contracts.

Although preferred by us, it is our current interpretation of the most recent discussions of the Boards that they, however, do not wish to include such a guidance.

In general, we appreciate the direction taken by the Boards as published in the IASB Update of 7 June 2011 by changing the wording of the requirement to *"An insurer should assess the significance of insurance risk at the individual contract level. Contracts entered into simultaneously with a single counterparty for the same risk, or contracts that are otherwise interdependent that are entered into with the same or a related party, should be considered a single contract for the purpose of determining risk transfer."*

We would like to draw your attention to Paper 3 / 70 to the IASB / FASB meeting in the week commencing 13 June 2011. The wording contained on pages 15 and 16 of this paper is different to that in the IASB Update and reads as follows: *"An insurer should assess the significance of insurance risk at the individual contract level. Contracts entered into simultaneously with a single counterparty for the same risk, or contracts that are otherwise interdependent, should be considered a single contract for the purpose of determining risk transfer."* This version would be much more unfavourable and would not solve the issues in relation to retrocession and reinsurance. However, we assume in the following that the wording published in the IASB Update as quoted above represents the most recent status.

We are pleased to note that the amendment of the wording according to the IASB Update addresses our concerns with regard to conventional retrocession and reinsurance provided that a clear and suitable definition of the term "related party" will be included in the standard. In our view, two interpretations of the term "the same or a related party" are possible:

- A pure formal view with a focus on the respective, legally separated stand-alone entities.
- A more economic view with a focus on the respective group with its group units.

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We believe that the economic interpretation is more suitable and would therefore suggest to assume the existence of “the same or a related party” if (i) the contracts are signed with companies of one group (under the control of one ultimate parent) or (ii) if other contractual control relationships exist between the counterparties. The definitions given in IAS 24 “Related Party Disclosures” par. 9a and b provide a workable basis for the definition required here.

Of course, certain practical limitations to the definition have to be considered due to the “knowledge horizon” about the counterparty / counterparties at inception of the contracts. This important point should be mentioned in the guidance. We suggest to include respective wording taken from FASB ASC 944-20-15-40 (EITF D-34 Q&A 10): “*This risk transfer assessment shall be made at contract inception, based on facts and circumstances known at the time.*”

However, the phrase “or contracts that are otherwise interdependent that are entered into with the same or a related party” still will cause an inappropriate treatment of fronting arrangements.

From our perspective, fronting is a form of regular (re)insurance business. Therefore it is absolutely justified to measure and present these transactions according to the insurance contracts standard. This is the only way to ensure an appropriate, transparent and comparable depiction of this type of transaction and to provide decision-useful information. We believe that an application of any other standard to these contracts that undoubtedly transfer insurance risks would be less meaningful and in consequence misleading.

Fronting arrangements come in various forms. An example of a fronting arrangement is commonly employed by captive insurers. Commonly, a commercial insurer licensed in the jurisdiction from which the risk emanates issues a policy to the insured. Subsequently, the risk is transferred to a captive insurance company by way of a reinsurance contract also known as a fronting agreement. The insured receives a policy written by the licensed commercial insurer, but the economic risk of that policy resides in the captive insurance company, although from a legal point of view the ultimate liability remains with the fronting insurer. In some jurisdictions, it is a legal requirement for either all, or certain classes of business, to be written by a local insurer. Hence, if the captive is established in a domicile other than that where the risk resides, then fronting arrangements are mandatory. The captive and the insured may be related but this does not have to be the case.

From a legal point of view under these contracts the ultimate liability normally remains with the fronting entity who has no recourse to the insured if the captive defaults. Thus, generally these contracts should be considered as independent for risk transfer purposes.

Should “otherwise interdependent” remain to be a general criterion for the risk transfer test, then this term, in our view, needs to be defined. We think that interdependent should be defined narrowly to include only cases where non performance under one contract can prevent performance under another contract. For example in Contract 1 ‘A’ cedes risk to ‘B’. In Contract 2 ‘B’ cedes the same risk to ‘C’ a related party of ‘A’. The contracts are only interdependent if non performance of ‘C’ to ‘B’ under contract 2 allows ‘B’ to non perform under contract 1. Thus if ‘B’ is still required to pay ‘A’ under contract 1 even though ‘C’ has not performed under contract 2 then these contracts are not otherwise interdependent.

A possible solution to assess whether contracts are “otherwise interdependent” may include a catalogue of indications and counter-indications. Such a list could e. g. be added after paragraph B28 of the ED. Of course, we remain at your disposal should you wish to discuss potential criteria with us.

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### Reinsurance: Recognition

In the Reinsurers' comment letter we stated the following:

*"We fully support the objectives around recognition of an insurance contract in paragraphs 13 to 15 of the ED but are concerned that the proposals may have unforeseen consequences where a reinsurance treaty is written before the coverage period commences. In many cases of practical importance the reinsurance contracts cover future new business of the ceding entity. Such a contract often is underwritten several months in advance of the underlying direct insurance contract(s) being written. The proposals would require the recognition of an insurance liability for the reinsurer at the date the contract was signed even though no direct insurance contracts exist and the direct insurer would also have to recognise a reinsurance asset at that time even though they had no liability as they had not yet written the underlying policies."*

As expressed in the Reinsurers' comment letter we believe that it is necessary that both reinsurance assets and reinsurance liabilities are recognized (and measured) on a consistent basis. In our understanding that does not become clear in item 49 of Paper 3A because it leaves out the liabilities. Furthermore, in this context, it is not clear to us what is meant by the term "onerous contract liability in the pre-coverage period" as mentioned in item 4c of Paper 3A.

In order to provide background on this issue we would like to note the following:

We take items 47 and 48 of Paper 3A to mean that, for the purposes of recognition for both treaty and facultative business, a distinction is made between proportional reinsurance (item 47) and non-proportional reinsurance (item 48). We consider this distinction, which is furthermore based on the underlying business, appropriate. This division certainly makes sense and is relatively simple to apply in practice.

Important in our view is that the recognition criteria refer equally to reinsurance assets and reinsurance liabilities, as in items 47 and 48, which each contain the phrase "reinsurance asset or liability". The staff's recommendations as per items 4c and 49 (Question 3) of Paper 3A, however, do not mention liabilities. This ought to be added in our view. In addition, item 49 should be clarified insofar that a "reinsurance recoverable" is being referred to.

With the above additions and clarifications, we consider the staff's recommendations for recognition to be appropriate.

If the rules on recognition of reinsurance assets were to deviate from those for reinsurance liabilities, we believe that this could have at least the following two undesirable consequences:

- Differences in recognition timing might open up possibilities for arbitrage using suitably chosen reinsurance constructions.
- Differing recognition criteria could be problematic for intra-group consolidation purposes.

Item 4c of Paper 3A suggests that an "onerous contract liability" would have to be recognised in the "pre-coverage period" if management becomes aware of those circumstances. We wish to point out that – as far as we know – the term "onerous contract" for a reinsurance asset still needs to be defined. As we see it, this certainly cannot mean that the cedant passes on to the reinsurer parts of its expected profits calculated on an expected value basis, since reinsurance treaties are also priced by the reinsurer with the intention of writing profitable business. In our view, "onerous contract in the pre-coverage period" ought to be linked directly to the measurement at the beginning of the coverage period (not only for the reinsurance asset, but generally).

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This would mean the following for the reinsurance asset:

A reinsurance treaty is to be regarded as onerous by the cedant in the pre-coverage period if according to the measurement a loss would have to be recognised at the beginning of the coverage period (i.e. loss at inception at the beginning of the coverage).

We propose to clarify this in the final standard.

The above issues also depend on the decisions on how the reinsurance asset will be measured, particularly the residual margin of the reinsurance asset (cf. the remarks in the following section "Reinsurance Asset: Measurement").

## **Reinsurance Asset: Measurement**

In the Reinsurers' comment letter we stated the following:

*“As previously communicated to the IASB Staff, we are concerned that the measurement of reinsurance ceded does not fully reflect the underlying economics of the business particularly in relation to the measurement of the residual margin of a reinsurance asset.*

*In our view, the measurement of assets and liabilities needs to be based on consistent principles. In light of this, it is essential that the measurement of reinsurance assets needs to reflect an assessment of the risk relief for the reinsured party by the reinsurance contract. In particular, this implies that in a net view the obligation on the side of the cedant should just reflect the part of the obligation which economically stays with the cedant.*

### *Calibration of the residual margin to the reinsurance premium*

*In our opinion the proposal in the ED to calibrate the residual margin of the ceded business to the reinsurance premium leads to a misleading presentation. In most cases (i.e. when the reinsurance premium is not exactly the same as the respective premium of the business assumed by the cedant) the reader will get a wrong impression about the percentage of the primary insurer's risks reinsured.*

*If the reinsurance contract appears to be non-profitable from the primary insurer's perspective (if the reinsurer assesses the risk higher than the primary insurer and assumes business on conditions worse than the original conditions) the application of the proposal in the ED will result in a residual margin on the asset side that we consider as being too high. Due to this calibration of the residual margin the expected loss will be deferred rather than recognized immediately. In addition, a balance sheet reader gets the wrong impression that the reinsurance asset is higher than the share ceded in fact to the reinsurer.*

*Vice versa, a reinsurance premium that is beneficial for the cedant would result in a residual margin on the asset side that we consider as being too low. Preferred conditions the reinsurer can give under a contract should result in a gain. To the extent this benefit is irrevocable it should be realized at inception of the contract and not be deferred. Furthermore, a balance sheet reader gets the wrong impression that the reinsurance asset is less than the share ceded in fact to the reinsurer.*

*We believe that the total reinsurance asset should reflect the economics of the contract and this is the relief generated by the reinsurance cover – independent of the level of the reinsurance premium.*

*For the purpose of simplification the above description does not consider the risk of non-performance of the reinsurer. Of course, and as expressed in reply to question 16(a) this has to be taken into account in the measurement of all components of the reinsurance asset (i.e. the present value of fulfilment cash flows and the residual margin).*

### *Considerations with regard to revenue recognition*

*We understand the objective of the IASB that parallels between revenue recognition and the measurement of insurance contracts should be maintained wherever possible. In this respect we have thoroughly analyzed that some might argue that the current proposal in the ED Insurance Contracts on the calibration of the residual margin of the reinsurance asset would be largely in line with the requirements in the ED Revenue Recognition, e.g. for the treatment of principal / agent (subcontractor) relationships. However, we came to the conclusion that in the case of the residual margin of the reinsurance asset, parallels to revenue recognition should not be the guiding principle, mainly due to the following reasons:*

*The IASB itself acknowledges in both the ED on revenue recognition and the ED on insurance contracts that the measurement of insurance contracts is different from that proposed in the ED on revenue recognition. As a consequence, insurance contracts are scoped out from revenue recognition. We support the rationale behind this decision.*

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*In the ED on revenue recognition the accounting of assets and liabilities is described in some way via its concept of performance obligations. However, we believe that there are remarkable differences compared to the liability measurement approach proposed in the ED Insurance Contracts. This is based on the following considerations:*

- *The revenue recognition approach does not follow a building block approach as applied to the measurement of insurance contracts.*
  - *The measurement proposed by revenue recognition does not contain components like probability-weighted discounted future cash flows, a risk adjustment, or a residual margin.*
  - *Revenue recognition knows a profit margin. However, this is conceptually not the same as the residual margin in the approach proposed for insurance contracts since this profit margin is not an independent component that can be identified separately.*
  - *The measurement of insurance contracts is based on a current valuation whilst revenue recognition proposes the concept of an onerous contract test.*
- *The measurement of a liability relating to customer payments in advance (which might be somehow comparable to insurance) is presented in one example in the ED on revenue recognition (Example 22 in B84). However, according to our understanding, this example which is clearly not using the building block approach underpins the differences in liability measurement between the two Exposure Drafts. Furthermore, the ED on revenue recognition does not contain any proposals on assets directly relating to liabilities which have to be set up as a “corrective element” in order to arrive at an appropriate net view.*
- *Even if insurance contracts were to be regarded according to the proposals in the ED on revenue recognition, we believe that the substance over form principle of paragraph 35 of the IASB Framework for the Preparation and Presentation of Financial Statements should apply. This implies that in an example of a 100% quota-share reinsurance the cedant only acts as an agent since in substance there remains no economic obligation with the cedant to deliver any service in the form of risk carrying. The complete risk is assumed by the reinsurer. Hence, the cedant should immediately realize the revenue relating to this transaction. This example can be generalized for all types of reinsurance transactions and this generalization will lead to the same conclusions.*

### Conclusion

*Therefore, we propose that the measurement of the residual margin of the reinsurance asset should be based on the risk transferred from the cedant to the reinsurer. This could be achieved if, at the initial measurement, the residual margin of the reinsurance asset is equal to the proportion of the risk adjustment of the reinsurance asset to the risk adjustment of the liability applied to the residual margin of the liability. Subsequently, the amortization of the residual margin of the reinsurance asset should be based on the same pattern as the amortization of the residual margin of the liability.”*

We note that the staff proposals contained in Paper 3A and the conclusions of the Boards based thereon do not take account of our concerns, arguments and proposals as laid out in detail in the Reinsurers’ comment letter as well as in direct contact with the IASB staff. As a consequence, these points obviously could not be discussed by the Boards. We consider it necessary that the insurance standard fully reflects the economics of the reinsurance business and therefore recommend that our input is made transparent in the Boards’ meetings in order to ensure proper consideration.

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On the contrary, as we understand it, the current proposals contain changes compared to the ED that deviate further from an economic view of the effect of risk transfer through reinsurance.

As we expressed in the Reinsurers' comment letter it is important that the measurement of both the reinsurance liability as well as the reinsurance asset is based on the underlying business. However, we believe that the proposals in items 4d i and ii of Paper 3A do not reflect the economic profit or loss that a cedant receives from reinsurance. The latter is especially true in situations of favourable or unfavourable reinsurance conditions compared to those of the cedant, in other words when the pricing of the reinsurer is taken into account. As we read Paper 3A these situations are not described.

In essence, the cedant is not on risk anymore subsequent to the signing of a reinsurance treaty for the part of the risks reinsured. As a consequence, there is no reason for deferring any gain or loss since from the cedant's perspective no uncertainty exists anymore.

According to items 47 and 48 of Paper 3A, recognition of reinsurance assets is in principle to be based on the underlying business. We also think that this should similarly be applied to measurement. However, this principle is breached by the proposals in Paper 3A for recognition of the amount, i.e. for measurement of the reinsurance asset. In our view, this could give rise to the following two problems:

- We see this as an inconsistency between recognition and measurement.
- Measurement requirements that are based on the underlying business for the cedant's liabilities but not on the underlying business for the corresponding reinsurance assets always create scope for reinsurance constructions that exploit possibilities for arbitrage (as an example, see our remarks below regarding the deferral of a loss from ceded reinsurance).

If the measurement of the reinsurance asset were also to be based on the underlying business, this would quite naturally result in the proposal we made in the Reinsurers' comment letter. This proposal states in particular that the residual margin of the reinsurance asset should be based on the residual margin of the insurance liability, i.e. on the underlying business, proportional to the ceded risk (measured as the ratio of the risk adjustment of the business ceded to that of the business assumed).

Based on the above, we do not consider appropriate the staff's recommendation in item 86 (Question 6) of Paper 3A that the cedant should estimate the present value of fulfilment cash flows for the reinsurance contract without reference to the residual / composite margin on the underlying contracts. Consequently, as expressed in the Reinsurers' comment letter, we disagree with the respective proposal.

In this regard, we would like to emphasize that Paper 3A, item 62, explicitly proposes that the risk adjustment of the reinsurance asset should be based on the underlying business.

The recommendations in items 4d i and 4d ii of Paper 3A do not reflect the actual economic profit or loss that can result for a cedant from a reinsurance treaty. Item 4d i would also enable a cedant to defer actual losses that may arise from a reinsurance treaty (in the event that it accepts unfavourable reinsurance conditions). As we see it, unfavourable reinsurance conditions for the cedant should be defined in relation to the conditions at which the cedant wrote the business (i.e. based on the underlying business). In our view, item 4d ii represents a further distancing from the proper economic representation of ceded reinsurance compared with the proposals of the ED. According to the current proposals, profits that arise from reinsurance conditions which are more favourable than the "expected present value of future cash outflows plus risk adjustment" to be recognised by the cedant for the ceded business now also have to be deferred and not be shown at inception as proposed in the ED.

## Appendix 1

In item 75 of Paper 3A a measurement approach based on the underlying business is rejected due to suggested “operational complexities”. We do not regard an assumed “operational complexity” as a viable argument. We consider a measurement based on the underlying business as the only meaningful approach.

In addition, we suggest that the following should be taken into consideration:

- In our view, the examples presented in item 53 of Paper 3A constitute very special cases that are in no way appropriate or representative for a generalised view. In particular, the determination of the cash inflows and the cash outflows is based on a very specific structure of the proportional reinsurance in question (in this context we refer to our examples included in Appendix 3). The examples in item 53 of Paper 3A assume complete mirror accounting and identical measurement in the cedant’s financial statements (as a reinsurance asset) and the reinsurer’s financial statements (as a (re-)insurance liability). This is usually not the case since – besides the premium level – amongst others best estimate expectations and cost structures differ between a cedant and a reinsurer. In addition, the quantifications of the risk adjustments of the reinsurance asset and the reinsurance liability do not take account of the fact that the cedant and the reinsurer generally have different portfolios with differing diversification effects, which result in risk adjustments of different amounts.
- In item 71 of Paper 3A, it is mentioned that recognising a gain at inception could cause accounting arbitrage. This is not the case in our view. Rather, accounting arbitrage could be caused by the desire to avoid an economic gain at inception through unsuitable accounting approaches (see remarks above). If suitable accounting approaches are developed, possibilities for arbitrage will not arise.
- From our perspective the possibilities of commutation cited inter alia in items 71 and 77 of Paper 3A are not tenable as arguments in this form. A cedant that sets up a reinsurance treaty only to terminate this shortly afterwards would have to take this into account properly in estimating the future cash flows. If this is done, no accounting arbitrage can be exploited. If it is not, that constitutes a violation of fundamental accounting principles. Furthermore, a commutation is always based on a negotiation process with an open outcome between cedant and reinsurer. Thus when signing a reinsurance treaty, cedants can never estimate with any certainty in advance whether a commutation will have the economically desired effect for them.

Quantitative generic examples of proportional and non-proportional reinsurance transfers can be found in Appendix 3. The different cases depict different levels of reinsurance conditions granted by the reinsurer and reflect for each of these cases the proposed accounting treatment according to (i) the IASB’s ED Insurance Contract, (ii) Paper 3A to the IASB/FASB Meeting on 31 May and (iii) the solution proposed in the Reinsurers’ comment letter. We would like to point out that these are high level examples.

In addition, according to our current understanding the following point addressed in the Reinsurers’ comment letter still seems to be open:

### “Open point

*We are unclear as to how the reinsurance asset should be measured where the modified approach (“PAA”) is used for the liability measurement and believe that it should be made clear that the simplified model should be available for reinsurance contracts where it is used for the related direct insurance contracts. We would also point out that certain contracts that meet the definition of short duration may be covered by a longer term reinsurance agreement which is less likely to meet the definition or longer term insurance contracts may be covered by a short duration (i.e. one-year) reinsurance contract. Accordingly, the mandation of the PAA could result in different measurement approaches between the underlying direct insurance contract and the reinsurance contract.”*

## **Definition Insurance Contract: Significant Risk Transfer: Further Details and Background**

### Unintended consequences for reinsurance with and without profit commissions

Many traditional reinsurance contracts are proportional contracts with profit participation. The reinsurer assumes a defined proportion of the premium and covers for its share all insurance claims from the portfolio reinsured, refunds an amount for the cedant's costs and reimburses as profit commission a portion of the net benefits on the reinsured part. Such contracts should undisputable be classified as reinsurance, i.e. insurance contracts.

For the avoidance of doubt we would like to point out that the term profit commission in this context always refers to a positive amount paid by the reinsurer to the cedant, i.e. no negative profit commissions.

If some kind of "virtual equivalence" would be required in order to ensure that such proportional treaties were reinsurance, such contracts would not be classified as reinsurance, unless there is no profit participation. This would be contradictory to the concept of insurance risk transfer, since the risk of adverse developments and the reinsurer's costs are higher for a contract with profit participation than for a contract without profit participation.

As far as measurement and presentation are concerned it would be misleading to account for a proportional treaty without profit participation as reinsurance and for a proportional treaty with some profit participation, subject to the materialization of insurance profits, for instance as a financial instrument.

### Motivation for reinsurance with profit commissions

Ceding companies enter into (long-term) reinsurance transactions not only in order to avoid IFRS losses in certain years over the lifetime of the transaction. In many cases the main motivation for entering into reinsurance contracts rather is to stabilize the profit expected<sup>1</sup> from the underlying business over time. This applies in particular to business that is expected to be highly profitable over its whole lifetime. By means of a reinsurance contract a reduction of profit volatility will be guaranteed by the reinsurer at low cost. To achieve this goal typically proportional reinsurance contracts with profit participation are utilized where the reinsurer shares the full downside risk, whereas the upside potential is (partially) reimbursed by the profit sharing.

To achieve the economic goal described above with a contract that puts the reinsurer into a situation "virtually equivalent" to the ceding company would mean that the full upside potential should have to be left with the reinsurer. Such a contract would not meet the economic needs of a ceding company as described above.

### Difference between current US GAAP and future IFRS

In some rare cases the concept of reinsurance has been abused by reporting on loans entered into as "reinsurance" in the past. Due to an inappropriate measurement the ceding company was able to present an excess of assets over liabilities from such a transaction that did not reflect the economic reality. In view of this, US GAAP (FAS 113) gave clear guidance on the criteria that a reinsurance contract has to satisfy in order to qualify for insurance accounting.

Under a forthcoming IFRS for insurance contracts an abuse as observed in the past should be avoided by utilizing the fulfilment value concept for (re-)insurance contracts. On the basis of the above, we are convinced that any contract where the reinsurer assumes the underlying risk under original conditions or under conditions adverse to the reinsurer should be within the scope of the standard of insurance contracts. An alternative measurement

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<sup>1</sup> It is of special importance for certain solvency and rating assessments that profits are stable over time since the present value of expected future profits is (partially) considered as capital in these regimes which should not fluctuate too much.

## Appendix 2

approach, e.g. according to financial instruments might open new room for arbitrage solutions where valuation differences between the economic transfer of risk and reward (based on the fulfilment value concept) and a different measurement for e.g. a financial instrument would be utilized.

## **Accounting for Reinsurance - Proportional Reinsurance**

### **For all examples on proportional RI the following holds for the PI business:**

The primary insurer assumes business at the following conditions:

Premium	100
Discounted best estimate cash outflow (DCF)	70
Risk Adjustment (RIA)	20
Residual Margin (REM)	10

**Proportional RI - Case 1**

RI assumes business on **original conditions**, no profit commission

The reinsurer will pay 50% / 100% of all cash outflows

The risk adjustment on reinsurance share is 50% / 100%

**Case 1.1: 50% Quota Share**

50% Quota share, i.e. the reinsurer assumes 50% of all liabilities of the primary insurer's portfolio

Reinsurance Premium 50 (identical for all proposals)

RI DCF in RI Asset 35 (identical for all proposals)

Risk Adjustment in RI Asset 10 ; 50% of all risks are transferred (identical for all proposals)

**ED proposal: Primary insurer's B/S**

Assets		Liabilities
Cash	100	
Cash	-50	
RI Asset (DCF)	35	70 Ins. Liability (DCF)
RI Asset (RIA)	10	20 Ins. Liability (RIA)
RI Asset (REM)	5	10 Ins. Liability (REM)

Residual Margin in RI Asset 5  
 (ED proposal: Calibrated to RI Premium)  
 Economically no gain and no loss  
 No deferral of gain/loss  
 Reinsurer's share acc. to B/S 50%

**Paper 3A proposal: Primary insurer's B/S**

Assets		Liabilities
Cash	100	
Cash	-50	
RI Asset (DCF)	35	70 Ins. Liability (DCF)
RI Asset (RIA)	10	20 Ins. Liability (RIA)
RI Asset (REM)	5	10 Ins. Liability (REM)

Residual Margin in RI Asset 5  
 (Paper 3 A proposal: Calibrated to RI Premium)  
 Economically no gain and no loss  
 No deferral of gain/loss  
 Reinsurer's share acc. to B/S 50%

**Reinsurers' proposal: Primary insurer's B/S**

Assets		Liabilities
Cash	100	
Cash	-50	
RI Asset (DCF)	35	70 Ins. Liability (DCF)
RI Asset (RIA)	10	20 Ins. Liability (RIA)
RI Asset (REM)	5	10 Ins. Liability (REM)

Residual Margin in RI Asset 5  
 (Reinsurers' proposal: Prop. to Underl. PI Portf.)  
 Economically no gain and no loss  
 No deferral of gain/loss  
 Reinsurer's share acc. to B/S 50%

**Case 1.2: 100% Quota Share**

100% Quota share, i.e. the reinsurer assumes 100% of all liabilities of the primary insurer's portfolio

Reinsurance Premium 100 (identical for all proposals)

RI DCF in RI Asset 70 (identical for all proposals)

Risk Adjustment in RI Asset 20 ; 100% of all risks are transferred (identical for all proposals)

**ED proposal: Primary insurer's B/S**

Assets		Liabilities
Cash	100	
Cash	-100	
RI Asset (DCF)	70	70 Ins. Liability (DCF)
RI Asset (RIA)	20	20 Ins. Liability (RIA)
RI Asset (REM)	10	10 Ins. Liability (REM)

Residual Margin in RI Asset 10  
 (ED proposal: Calibrated to RI Premium)  
 Economically no gain and no loss  
 No deferral of gain/loss  
 Reinsurer's share acc. to B/S 100%

**Paper 3A proposal: Primary insurer's B/S**

Assets		Liabilities
Cash	100	
Cash	-100	
RI Asset (DCF)	70	70 Ins. Liability (DCF)
RI Asset (RIA)	20	20 Ins. Liability (RIA)
RI Asset (REM)	10	10 Ins. Liability (REM)

Residual Margin in RI Asset 10  
 (Paper 3 A proposal: Calibrated to RI Premium)  
 Economically no gain and no loss  
 No deferral of gain/loss  
 Reinsurer's share acc. to B/S 100%

**Reinsurers' proposal: Primary insurer's B/S**

Assets		Liabilities
Cash	100	
Cash	-100	
RI Asset (DCF)	70	70 Ins. Liability (DCF)
RI Asset (RIA)	20	20 Ins. Liability (RIA)
RI Asset (REM)	10	10 Ins. Liability (REM)

Residual Margin in RI Asset 10  
 (Reinsurers' proposal: Prop. to Underl. PI Portf.)  
 Economically no gain and no loss  
 No deferral of gain/loss  
 Reinsurer's share acc. to B/S 100%

**Proportional RI - Case 2**

RI assumes business on **beneficial conditions**, no profit commission  
 (reinsurer can assume the liability at a price below 50% of the original premium, e.g. due to diversification benefits)  
 The reinsurer will pay 50% / 100% of all cash outflows  
 The risk adjustment on reinsurance share is 50% / 100%

**Case 2.1: 50% Quota Share**

50% Quota share, i.e. the reinsurer assumes 50% of all liabilities of the primary insurer's portfolio  
 Reinsurance Premium 45 (identical for all proposals)  
 RI DCF in RI Asset 35 (identical for all proposals)  
 Risk Adjustment in RI Asset 10 ; 50% of all risks are transferred (identical for all proposals)

**ED proposal: Primary insurer's B/S**

Assets		Liabilities	
Cash	100		
Cash	-45		
RI Asset (DCF)	35	70 Ins. Liability (DCF)	
RI Asset (RIA)	10	20 Ins. Liability (RIA)	
RI Asset (REM)	0	10 Ins. Liability (REM)	

Residual Margin in RI Asset 0  
 (ED proposal: Calibrated to RI Premium)  
 Economic gain of 5  
 Gain deferred  
 Reinsurer's share acc. to B/S 45%

**Paper 3A proposal: Primary insurer's B/S**

Assets		Liabilities	
Cash	100		
Cash	-45		
RI Asset (DCF)	35	70 Ins. Liability (DCF)	
RI Asset (RIA)	10	20 Ins. Liability (RIA)	
RI Asset (REM)	0	10 Ins. Liability (REM)	

Residual Margin in RI Asset 0  
 (Paper 3 A proposal: Calibrated to RI Premium)  
 Economic gain of 5  
 Gain deferred  
 Reinsurer's share acc. to B/S 45%

**Reinsurers' proposal: Primary insurer's B/S**

Assets		Liabilities	
Cash	100		
Cash	-45		
RI Asset (DCF)	35	70 Ins. Liability (DCF)	
RI Asset (RIA)	10	20 Ins. Liability (RIA)	
RI Asset (REM)	5	10 Ins. Liability (REM)	

Residual Margin in RI Asset 5  
 (Reinsurers' proposal: Prop. to Underl. PI Portf.)  
 Economic gain of 5  
 Gain recognised immediately  
 Reinsurer's share acc. to B/S 50%

**Case 2.2: 100% Quota Share**

100% Quota share, i.e. the reinsurer assumes 100% of all liabilities of the primary insurer's portfolio  
 Reinsurance Premium 90 (identical for all proposals)  
 RI DCF in RI Asset 70 (identical for all proposals)  
 Risk Adjustment in RI Asset 20 ; 100% of all risks are transferred (identical for all proposals)

**ED proposal: Primary insurer's B/S**

Assets		Liabilities	
Cash	100		
Cash	-90		
RI Asset (DCF)	70	70 Ins. Liability (DCF)	
RI Asset (RIA)	20	20 Ins. Liability (RIA)	
RI Asset (REM)	0	10 Ins. Liability (REM)	

Residual Margin in RI Asset 0  
 (ED proposal: Calibrated to RI Premium)  
 Economic gain of 10  
 Gain deferred  
 Reinsurer's share acc. to B/S 90%

**Paper 3A proposal: Primary insurer's B/S**

Assets		Liabilities	
Cash	100		
Cash	-90		
RI Asset (DCF)	70	70 Ins. Liability (DCF)	
RI Asset (RIA)	20	20 Ins. Liability (RIA)	
RI Asset (REM)	0	10 Ins. Liability (REM)	

Residual Margin in RI Asset 0  
 (Paper 3 A proposal: Calibrated to RI Premium)  
 Economic gain of 10  
 Gain deferred  
 Reinsurer's share acc. to B/S 90%

**Reinsurers' proposal: Primary insurer's B/S**

Assets		Liabilities	
Cash	100		
Cash	-90		
RI Asset (DCF)	70	70 Ins. Liability (DCF)	
RI Asset (RIA)	20	20 Ins. Liability (RIA)	
RI Asset (REM)	10	10 Ins. Liability (REM)	

Residual Margin in RI Asset 10  
 (Reinsurers' proposal: Prop. to Underl. PI Portf.)  
 Economic gain of 10  
 Gain recognised immediately  
 Reinsurer's share acc. to B/S 100%

**Proportional RI - Case 3**

RI assumes business on **even more beneficial conditions** than in case 2, no profit commission

(reinsurer can assume the liability at a price far below 50% of the original premium, e.g. due to high diversification benefits)

The reinsurer will pay 50% / 100% of all cash outflows

The risk adjustment on reinsurance share is 50% / 100%

**Case 3.1: 50% Quota Share**

50% Quota share, i.e. the reinsurer assumes 50% of all liabilities of the primary insurer's portfolio

Reinsurance Premium 40 (identical for all proposals)

RI DCF in RI Asset 35 (identical for all proposals)

Risk Adjustment in RI Asset 10 ; 50% of all risks are transferred (identical for all proposals)

**ED proposal: Primary insurer's B/S**

Assets		Liabilities	
Cash	100		
Cash	-40		
RI Asset (DCF)	35	70 Ins. Liability (DCF)	
RI Asset (RIA)	10	20 Ins. Liability (RIA)	
RI Asset (REM)	0	10 Ins. Liability (REM)	

Residual Margin in RI Asset 0

(ED proposal: Calibrated to RI Premium, but limited)

Economic gain of 10

Gain deferred 5; gain recognised immediately 5

Reinsurer's share acc. to B/S 45%

**Paper 3A proposal: Primary insurer's B/S**

Assets		Liabilities	
Cash	100		
Cash	-40		
RI Asset (DCF)	35	70 Ins. Liability (DCF)	
RI Asset (RIA)	10	20 Ins. Liability (RIA)	
RI Asset (REM)	-5	10 Ins. Liability (REM)	

Residual Margin in RI Asset -5

(Paper 3 A proposal: Calibrated to RI Premium)

Economic gain of 10

Gain deferred

Reinsurer's share acc. to B/S 40%

**Reinsurers' proposal: Primary insurer's B/S**

Assets		Liabilities	
Cash	100		
Cash	-40		
RI Asset (DCF)	35	70 Ins. Liability (DCF)	
RI Asset (RIA)	10	20 Ins. Liability (RIA)	
RI Asset (REM)	5	10 Ins. Liability (REM)	

Residual Margin in RI Asset 5

(Reinsurers' proposal: Prop. to Underl. PI Portf.)

Economic gain of 10

Gain recognised immediately

Reinsurer's share acc. to B/S 50%

**Case 3.2: 100% Quota Share**

100% Quota share, i.e. the reinsurer assumes 100% of all liabilities of the primary insurer's portfolio

Reinsurance Premium 80 (identical for all proposals)

RI DCF in RI Asset 70 (identical for all proposals)

Risk Adjustment in RI Asset 20 ; 100% of all risks are transferred (identical for all proposals)

**ED proposal: Primary insurer's B/S**

Assets		Liabilities	
Cash	100		
Cash	-80		
RI Asset (DCF)	70	70 Ins. Liability (DCF)	
RI Asset (RIA)	20	20 Ins. Liability (RIA)	
RI Asset (REM)	0	10 Ins. Liability (REM)	

Residual Margin in RI Asset 0

(ED proposal: Calibrated to RI Premium, but limited)

Economic gain of 20

Gain deferred 10; gain recognised immediately 10

Reinsurer's share acc. to B/S 90%

**Paper 3A proposal: Primary insurer's B/S**

Assets		Liabilities	
Cash	100		
Cash	-80		
RI Asset (DCF)	70	70 Ins. Liability (DCF)	
RI Asset (RIA)	20	20 Ins. Liability (RIA)	
RI Asset (REM)	-10	10 Ins. Liability (REM)	

Residual Margin in RI Asset -10

(Paper 3 A proposal: Calibrated to RI Premium)

Economic gain of 20

Gain deferred

Reinsurer's share acc. to B/S 80%

**Reinsurers' proposal: Primary insurer's B/S**

Assets		Liabilities	
Cash	100		
Cash	-80		
RI Asset (DCF)	70	70 Ins. Liability (DCF)	
RI Asset (RIA)	20	20 Ins. Liability (RIA)	
RI Asset (REM)	10	10 Ins. Liability (REM)	

Residual Margin in RI Asset 10

(Reinsurers' proposal: Prop. to Underl. PI Portf.)

Economic gain of 20

Gain recognised immediately

Reinsurer's share acc. to B/S 100%

**Proportional RI - Case 4**

RI assumes business on **conditions worse** than the original conditions (e.g. if RI assesses the risk higher than the primary insurer), no profit commission (reinsurer assumes the liability at a price of more than 50% of the original premium, e.g. due to the reinsurer's higher risk assessment)

The reinsurer will pay 50% / 100% of all cash outflows

The risk adjustment on reinsurance share is 50% / 100%

**Case 4.1: 50% Quota Share**

50% Quota share, i.e. the reinsurer assumes 50% of all liabilities of the primary insurer's portfolio

Reinsurance Premium 55 (identical for all proposals)  
 RI DCF in RI Asset 35 (identical for all proposals)  
 Risk Adjustment in RI Asset 10 ; 50% of all risks are transferred (identical for all proposals)

**ED proposal: Primary insurer's B/S**

Assets		Liabilities	
Cash	100		
Cash	-55		
RI Asset (DCF)	35	70 Ins. Liability (DCF)	
RI Asset (RIA)	10	20 Ins. Liability (RIA)	
RI Asset (REM)	10	10 Ins. Liability (REM)	

**Paper 3A proposal: Primary insurer's B/S**

Assets		Liabilities	
Cash	100		
Cash	-55		
RI Asset (DCF)	35	70 Ins. Liability (DCF)	
RI Asset (RIA)	10	20 Ins. Liability (RIA)	
RI Asset (REM)	10	10 Ins. Liability (REM)	

**Reinsurers' proposal: Primary insurer's B/S**

Assets		Liabilities	
Cash	100		
Cash	-55		
RI Asset (DCF)	35	70 Ins. Liability (DCF)	
RI Asset (RIA)	10	20 Ins. Liability (RIA)	
RI Asset (REM)	5	10 Ins. Liability (REM)	

Residual Margin in RI Asset 10  
 (ED proposal: Calibrated to RI Premium)  
 Economic loss of 5  
 Loss deferred  
 Reinsurer's share acc. to B/S 55%

Residual Margin in RI Asset 10  
 (Paper 3 A proposal: Calibrated to RI Premium)  
 Economic loss of 5  
 Loss deferred  
 Reinsurer's share acc. to B/S 55%

Residual Margin in RI Asset 5  
 (Reinsurers' proposal: Prop. to Underl. PI Portf.)  
 Economic loss of 5  
 Loss recognised immediately  
 Reinsurer's share acc. to B/S 50%

**Case 4.2: 100% Quota Share**

100% Quota share, i.e. the reinsurer assumes 100% of all liabilities of the primary insurer's portfolio

Reinsurance Premium 110 (identical for all proposals)  
 RI DCF in RI Asset 70 (identical for all proposals)  
 Risk Adjustment in RI Asset 20 ; 100% of all risks are transferred (identical for all proposals)

**ED proposal: Primary insurer's B/S**

Assets		Liabilities	
Cash	100		
Cash	-110		
RI Asset (DCF)	70	70 Ins. Liability (DCF)	
RI Asset (RIA)	20	20 Ins. Liability (RIA)	
RI Asset (REM)	20	10 Ins. Liability (REM)	

**Paper 3A proposal: Primary insurer's B/S**

Assets		Liabilities	
Cash	100		
Cash	-110		
RI Asset (DCF)	70	70 Ins. Liability (DCF)	
RI Asset (RIA)	20	20 Ins. Liability (RIA)	
RI Asset (REM)	20	10 Ins. Liability (REM)	

**Reinsurers' proposal: Primary insurer's B/S**

Assets		Liabilities	
Cash	100		
Cash	-110		
RI Asset (DCF)	70	70 Ins. Liability (DCF)	
RI Asset (RIA)	20	20 Ins. Liability (RIA)	
RI Asset (REM)	10	10 Ins. Liability (REM)	

Residual Margin in RI Asset 20  
 (ED proposal: Calibrated to RI Premium)  
 Economic loss of 10  
 Loss deferred  
 Reinsurer's share acc. to B/S 110%

Residual Margin in RI Asset 20  
 (Paper 3 A proposal: Calibrated to RI Premium)  
 Economic loss of 10  
 Loss deferred  
 Reinsurer's share acc. to B/S 110%

Residual Margin in RI Asset 10  
 (Reinsurers' proposal: Prop. to Underl. PI Portf.)  
 Economic loss of 10  
 Loss recognised immediately  
 Reinsurer's share acc. to B/S 100%

## **Accounting for Reinsurance - Non-Proportional Reinsurance**

### **For all examples on non-proportional RI the following holds for the PI business:**

The primary insurer assumes business at the following conditions:

Premium	100
Discounted best estimate cash outflow (DCF)	70
Risk Adjustment (RIA)	20
Residual Margin (REM)	10

### **For all examples on non-proportional RI the following holds for the non-proportional RI contract:**

The RI assumes the risk of an adverse development under extreme scenarios which have a relative small probability of realisation.

Assume for all following considerations:

The reinsurer will pay an amount of 100, if the worst case scenario realises

The probability of realisation of the worst case scenario is 1%

The reinsurance contract reduces the economic risk for the primary insurer by 20%

**Non-proportional RI - Case 5**

Reinsurance in a **hard market**. The reinsurer can demand a **high price**. The reinsurer's risk diversification benefit is not shared with the primary insurer.

Reinsurance Premium	8	(identical for all proposals)
RI DCF in RI Asset	1 ; 1% of 100	(identical for all proposals)
Risk Adjustment in RI Asset	4 ; 20% of all risks are transferred	(identical for all proposals)

**ED proposal: Primary insurer's B/S**

Assets		Liabilities
Cash	100	
Cash	-8	
RI Asset (DCF)	1	70 Ins. Liability (DCF)
RI Asset (RIA)	4	20 Ins. Liability (RIA)
RI Asset (REM)	3	10 Ins. Liability (REM)

**Paper 3A proposal: Primary insurer's B/S**

Assets		Liabilities
Cash	100	
Cash	-8	
RI Asset (DCF)	1	70 Ins. Liability (DCF)
RI Asset (RIA)	4	20 Ins. Liability (RIA)
RI Asset (REM)	3	10 Ins. Liability (REM)

**Reinsurers' proposal: Primary insurer's B/S**

Assets		Liabilities
Cash	100	
Cash	-8	
RI Asset (DCF)	1	70 Ins. Liability (DCF)
RI Asset (RIA)	4	20 Ins. Liability (RIA)
RI Asset (REM)	2	10 Ins. Liability (REM)

Residual Margin in RI Asset (ED proposal: Calibrated to RI Premium)	3	Residual Margin in RI Asset (Paper 3 A proposal: Calibrated to RI Premium)	3	Residual Margin in RI Asset (Reinsurers' proposal: Prop. to Underl. PI Portf.)	2
Economic loss of 1		Economic loss of 1		Economic loss of 1	
Loss deferred		Loss deferred		Loss recognised immediately	

**Non-proportional RI - Case 6**

Reinsurance in a **balanced market**. The reinsurer can demand a **reasonable price**.

Reinsurance Premium	7	(identical for all proposals)
RI DCF in RI Asset	1 ; 1% of 100	(identical for all proposals)
Risk Adjustment in RI Asset	4 ; 20% of all risks are transferred	(identical for all proposals)

**ED proposal: Primary insurer's B/S**

Assets		Liabilities
Cash	100	
Cash	-7	
RI Asset (DCF)	1	70 Ins. Liability (DCF)
RI Asset (RIA)	4	20 Ins. Liability (RIA)
RI Asset (REM)	2	10 Ins. Liability (REM)

**Paper 3A proposal: Primary insurer's B/S**

Assets		Liabilities
Cash	100	
Cash	-7	
RI Asset (DCF)	1	70 Ins. Liability (DCF)
RI Asset (RIA)	4	20 Ins. Liability (RIA)
RI Asset (REM)	2	10 Ins. Liability (REM)

**Reinsurers' proposal: Primary insurer's B/S**

Assets		Liabilities
Cash	100	
Cash	-7	
RI Asset (DCF)	1	70 Ins. Liability (DCF)
RI Asset (RIA)	4	20 Ins. Liability (RIA)
RI Asset (REM)	2	10 Ins. Liability (REM)

Residual Margin in RI Asset (ED proposal: Calibrated to RI Premium)	2	Residual Margin in RI Asset (Paper 3 A proposal: Calibrated to RI Premium)	2	Residual Margin in RI Asset (Reinsurers' proposal: Prop. to Underl. PI Portf.)	2
Economically no gain and no loss		Economically no gain and no loss		Economically no gain and no loss	
No deferral of gain/loss		No deferral of gain/loss		No deferral of gain/loss	

**Non-proportional RI - Case 7**

Reinsurance in a **soft market**. The reinsurer will have risk diversification benefits on its own balance sheet and will share them with the primary insurer.

Reinsurance Premium	6	(identical for all proposals)
RI DCF in RI Asset	1 ; 1% of 100	(identical for all proposals)
Risk Adjustment in RI Asset	4 ; 20% of all risks are transferred	(identical for all proposals)

**ED proposal: Primary insurer's B/S**

Assets		Liabilities
Cash	100	
Cash	-6	
RI Asset (DCF)	1	70 Ins. Liability (DCF)
RI Asset (RIA)	4	20 Ins. Liability (RIA)
RI Asset (REM)	1	10 Ins. Liability (REM)

**Paper 3A proposal: Primary insurer's B/S**

Assets		Liabilities
Cash	100	
Cash	-6	
RI Asset (DCF)	1	70 Ins. Liability (DCF)
RI Asset (RIA)	4	20 Ins. Liability (RIA)
RI Asset (REM)	1	10 Ins. Liability (REM)

**Reinsurers' proposal: Primary insurer's B/S**

Assets		Liabilities
Cash	100	
Cash	-6	
RI Asset (DCF)	1	70 Ins. Liability (DCF)
RI Asset (RIA)	4	20 Ins. Liability (RIA)
RI Asset (REM)	2	10 Ins. Liability (REM)

Residual Margin in RI Asset 1  
 (ED proposal: Calibrated to RI Premium)  
 Economic gain of 1  
 Gain deferred

Residual Margin in RI Asset 1  
 (Paper 3 A proposal: Calibrated to RI Premium)  
 Economic gain of 1  
 Gain deferred

Residual Margin in RI Asset 2  
 (Reinsurers' proposal: Prop. to Underl. PI Portf.)  
 Economic gain of 1  
 Gain recognised immediately

**Non-proportional RI - Case 8**

Reinsurance in a **very soft market**. The reinsurer will have risk diversification benefits on its own balance sheet and will share them with the primary insurer.

In addition, the current competitive environment in the reinsurance market is reflected in the reinsurance premium as a further discount.

Reinsurance Premium	4	(identical for all proposals)
RI DCF in RI Asset	1 ; 1% of 100	(identical for all proposals)
Risk Adjustment in RI Asset	4 ; 20% of all risks are transferred	(identical for all proposals)

**ED proposal: Primary insurer's B/S**

Assets		Liabilities
Cash	100	
Cash	-4	
RI Asset (DCF)	1	70 Ins. Liability (DCF)
RI Asset (RIA)	4	20 Ins. Liability (RIA)
RI Asset (REM)	0	10 Ins. Liability (REM)

**Paper 3A proposal: Primary insurer's B/S**

Assets		Liabilities
Cash	100	
Cash	-4	
RI Asset (DCF)	1	70 Ins. Liability (DCF)
RI Asset (RIA)	4	20 Ins. Liability (RIA)
RI Asset (REM)	-1	10 Ins. Liability (REM)

**Reinsurers' proposal: Primary insurer's B/S**

Assets		Liabilities
Cash	100	
Cash	-4	
RI Asset (DCF)	1	70 Ins. Liability (DCF)
RI Asset (RIA)	4	20 Ins. Liability (RIA)
RI Asset (REM)	2	10 Ins. Liability (REM)

Residual Margin in RI Asset 0  
 (ED proposal: Calibrated to RI Premium, but limited)  
 Economic gain of 3  
 Gain deferred 2; gain recognised immediately 1

Residual Margin in RI Asset -1  
 (Paper 3 A proposal: Calibrated to RI Premium)  
 Economic gain of 3  
 Gain deferred

Residual Margin in RI Asset 2  
 (Reinsurers' proposal: Prop. to Underl. PI Portf.)  
 Economic gain of 3  
 Gain recognised immediately