Working Draft

# Targeted Improvements to Long-Duration Contracts Implementation Issue

**Issue #11AC**: Ceded reinsurance - recognition of the reinsurance recoverable and cost of reinsurance measurement and application of the 100% net premium ratio cap and “floor” (no negative liability) provisions relating to the liability for future policy benefits on ceded reinsurance transactions.

**Wording to be Included in the Audit and Accounting Guide: Life and Health Insurance Entities.**

### Ceded Reinsurance

1. Reinsurance agreements for which the ceding entity remains primarily liable to the contract holders would not result in the removal of the related assets and liabilities from the ceding entity's records. For these agreements, in accordance with FASB ASC 944-310-25-2, the ceding entity should report estimated reinsurance recoverables arising from those agreements separately as assets[1]. Amounts paid to the reinsurer relating to the unexpired portion of reinsured contracts (prepaid insurance premiums) also should be reported separately as assets. Amounts receivable and payable between ceding entities and assuming entities are offset only when a right of setoff exists, as defined in the FASB ASC glossary.

*Long-Duration Reinsurance - Ceded*

2. FASB ASC 944-40 provides the following guidance on accounting for ceded reinsurance contracts:

   Paragraphs 25-33 and 25-34 of FASB ASC 944-40 state,

   > Reinsurance contracts do not result in immediate recognition of gains unless the reinsurance contract is a legal replacement of one insurer by another and thereby extinguishes the ceding entity's liability to the policyholder.
   >
   > Reinsurance recoverables shall be recognized in a manner consistent with the liabilities (including estimated amounts for claims incurred but not reported and future policy benefits) relating to the underlying reinsured contracts. Assumptions used in estimating reinsurance recoverables shall be consistent with those used in estimating the related liabilities.

   FASB ASC 944-605-30-4 states, “The difference, if any, between amounts paid for a reinsurance contract and the amount of the liabilities for policy benefits relating to the underlying reinsured contracts is part of the estimated cost to be amortized.”

[1] As noted in FASB ASC 326-20-15-2d, reinsurance recoverables that result from insurance transactions within the scope of Topic 944 on insurance are in the scope of FASB ASC 326. CECL Implementation Issue #34: *Considerations Related to ASC Topic 326: Financial Instruments - Credit Losses*, for Reinsurance Recoverables, contains considerations for applying ASC 326 to reinsurance recoverables, and is available in this Guide.

3. With regard to the manner and assumptions used in recognizing the liabilities relating to the underlying reinsured contracts, FASB ASC 944-40 states, in part, the following guidance:

   FASB ASC 944-40-30-7 notes that the liability for future policy benefits “shall be estimated using methods that include assumptions, such as discount rate, mortality, morbidity, terminations and expenses.”

   FASB ASC 944-40-30-9 states,

   > The liability for future policy benefits shall be discounted using an upper-medium grade (low credit-risk) fixed-income instrument yield. An insurance entity shall consider reliable information in estimating the upper-medium grade (low-credit-risk) fixed income instrument yield that reflects the duration characteristics of the liability for future policy benefits (see paragraph 944-40-55-13E). An insurance entity shall maximize the use of relevant observable inputs and minimize the use of unobservable inputs in determining the discount rate assumption.

   FASB ASC 944-40-35-6A (b), with regard to discount rate assumptions, requires that,

   > ...Net premiums shall not be updated for discount rate assumption changes.
   >
   > 1. The difference between the updated carrying amount of the liability for future policy benefits (that is, the present value of future benefits and expenses less the present value of future net premiums based on updated cash flow assumptions) measured using the updated discount rate assumption and the original discount rate assumption shall be recognized directly to other comprehensive income (that is, on an immediate basis).
   > 2. The interest accretion rate shall remain the original discount rate used at contract issue date.

4. For traditional and limited payment long-duration insurance contracts, future policy benefits relating to the direct policies are recognized using a net premium approach with retrospective updating of cash flows as discussed in FASB ASC 944-40-35-6A. FASB ASC 944-40-35-6A(b) requires that entities use a locked-in upper-medium grade fixed-income instrument yield discount rate assumption for income statement purposes (locked in at contract issue date), and use a current upper-medium grade fixed-income instrument yield discount rate assumption for balance sheet remeasurement purposes. For liabilities subject to the modified retrospective transition approach under FASB ASC 944-40-65-2(d), entities should retain the discount rate assumption that was used to calculate the liability immediately before the transition date for income statement purposes, and should use a current upper-medium grade fixed-income instrument yield discount rate assumption for balance sheet remeasurement purposes.

5. FinREC believes that to comply with the FASB ASC 944-40-25-34 requirement that the reinsurance recoverable be recognized in a manner consistent with the liabilities relating to the underlying reinsured contracts, the recognition of ceded reinsurance recoverables for traditional and limited payment long duration contracts should also employ a net premium approach with retrospective updating of cash flows. As noted in the FASB’s Background Information and Basis for Conclusions paragraph BC50 in ASU 2018-12, under the net premium insurance accounting model, total cash inflows and outflows over an entire contract’s life are aggregated to calculate a net premium ratio that is used to derive a constant profit margin over the entire contract life. FinREC believes that to satisfy the requirement to recognize reinsurance recoverables in a manner consistent with the liabilities relating to the underlying reinsured contracts, the constant profit margin concept should be employed to ceded reinsurance contracts as well.

6. Sometimes, insurers enter into ceded reinsurance contracts on a prospective basis, meaning that the reinsurance covers insurance contracts issued contemporaneous with or for some period subsequent to the inception date of the reinsurance contract. The reinsurance recoverable is increased as each new underlying insurance contract is recognized. To comply with the FASB ASC 944-40-30-9 and 944-40-35-6A(b) requirements relating to discount rates, aicpa.org/FRC FinREC believes that for prospectively reinsured contracts, the locked-in discount rate assumptions used to recognize the reinsurance recoverable at the date that each new portion of the reinsurance contract is recognized in the financial statements and for subsequent income statement measurement purposes should be consistent with the upper-medium grade (low credit-risk) fixed-income instrument discount rate assumptions used for each of the underlying reinsured contracts at their issue dates and for subsequent income statement measurement purposes. FinREC also believes that in subsequent periods, the current discount rate assumptions should be used for balance sheet remeasurement purposes, consistent with the requirements in FASB ASC 944-40-35-6A(b)(1).

   *Please note that the five paragraphs immediately below on "Cession of an Existing Group of Inforce Contracts" address a different issue, Issue #11B: Ceded reinsurance – What is the liability for future policy benefits to be used to reinsure existing traditional life insurance contracts, for which the comment period ended on July 17, 2020. The paragraphs are included below for completeness as the final Insurance Guide will include the final versions of both issue #11B and #11AC, integrated in this format. Content currently out for informal comment within Issue #11AC continues in numbered paragraph 7.*

   <u>Cession of an Existing Group of Inforce Contracts</u>

   Sometimes, insurers enter into ceded reinsurance contracts in periods subsequent to inception of the underlying reinsured contracts, and market interest rates may have changed between the date that the underlying insurance contracts were issued and the date the reinsurance contract is recognized in the financial statements. In such instances, a balance representing the cumulative changes in discount rates will exist in accumulated other comprehensive income relating to the underlying insurance contracts due to the application of FASB ASC 944-40- 35-6A(b).

   The guidance addressing ceded reinsurance accounting in FASB ASC 944-40-25-34 was not amended by ASU 2018-12. However, ASC 944-40-30-9 was amended by ASU 2018-12, resulting in a change to the measurement of the underlying contracts on which reinsurance accounting is based. In applying the reinsurance guidance in ASC 944-40 applicable prior to the adoption of ASU 2018-12, the reinsurance recoverable was also measured using assumptions consistent with the underlying liability for future policy benefits, which prior to the adoption of ASU 2018-12 included an entity specific investment yield rate. Because the measurement of the reinsured liability for future policy benefits has changed under the adoption of ASU 2018-12 to require the use of an updated discount rate (per ASC 944-40-35-6A), the reinsurance recoverable measurement also changes.

   FinREC believes that, for contracts that reinsure existing ("inforce") traditional and limited payment long-duration insurance contracts, the direct liabilities for future policy benefits relating to the underlying reinsured contracts used to recognize the reinsurance recoverable and to determine the cost of reinsurance should be the direct liabilities as remeasured using the upper-medium grade fixed-income instrument yield discount rate assumption at the date the reinsurance contract is recognized in the financial statements. FinREC believes that this is consistent with the requirements of FASB ASC 944-40-25-33 as there is no immediate comprehensive income or loss relating to the initial recognition of the reinsurance recoverable.

   FinREC believes that using the upper-medium grade fixed-income instrument yield discount rate assumption at the reinsurance contract recognition date as the locked in interest rate for the recognition and initial measurement of the ceded reinsurance contract and subsequent income statement measurement is also consistent with the guidance in FASB ASC 944-40-25-34, 944-40-30-9, and 944-40-35-6A(b). FASB ASC 944-40-35-6A(b)2 states that "the interest accretion rate shall remain the original discount rate used at contract issue date." Applying this guidance to ceded reinsurance would result in the use of the interest rate at the date the ceded reinsurance contract is recognized.

In periods subsequent to the reinsurance contract recognition date, the current upper-medium grade fixed-income instrument yield discount rate assumption would be used for balance sheet remeasurement purposes in accordance with FASB ASC 944-40-35-6A(b)(1), with the difference between the updated carrying amount of the reinsurance recoverable measured using the updated discount rate assumption and the locked-in discount rate assumption recognized in other comprehensive income. As a result of the use of different locked-in discount rates in measuring the liability for future policy benefits and the related reinsurance recoverable when reinsuring an aicpa.org/FRC existing block of inforce business, the different amounts in accumulated other comprehensive income relating to the underlying reinsured contracts and relating to the ceded reinsurance contract will not be completely offset.

Net Premium Ratio Cap and Floor

7. For direct traditional and limited payment long-duration insurance contracts, FASB ASC 944-40-30-7A and 944-40-35- 7A note that "to the extent the present value of future benefits and expenses exceeds the present value of future gross premiums, an immediate charge shall be recognized in net income (see paragraph 944-40-45-4) such that net premiums are set equal to gross premiums." Consistent with that accounting, ASC 944-40-35-6A(a) states "the revised ratio of net premiums to gross premiums shall not exceed 100 percent."

8. FASB ASC 944-40 does not provide specific guidance on how the 100 percent net premium cap in ASC 944-40-35- 6A(a) should be applied to reinsurance ceded. ASC 944-40-25-34 provides only general guidance that reinsurance recoverables should be recognized in a manner consistent with the liabilities. FinREC believes that to the extent the insurer has recognized a loss on the reinsured portion of the direct contracts in the current period, the insurer should recognize an immediate gain on the reinsurance ceded contract. However, FinREC also believes the insurer should not recognize a gain at inception of a reinsurance transaction to offset a previously recognized loss on direct business as that would violate the ASC 944-40-25-33 prohibition of gain recognition upon entering into the reinsurance contract.

9. For direct traditional and limited payment long-duration insurance contracts, FASB ASC 944-40-30-7A and 944-40-35- 7B note that "in no event shall the liability for future policy benefits balance be less than zero (i.e. an asset) for the level at which reserves are calculated." Such situations for direct insurance contracts can result from the application of the net premium methodology for certain types of life insurance contracts, in particular those for which the contractual rate of premium increases over the term of the contract.

10. FASB ASC 944-40 does not provide specific guidance on how the prohibition of the recognition of an asset for the liability for future policy benefits in ASC 944-40-30-7A and 944-40-35-7B should be applied to a reinsurance recoverable asset and whether it is ever appropriate for the reinsurance recoverable to be less than zero (i.e., recognized as a liability). ASC 944-40-25-34 provides only general guidance that reinsurance recoverables should be recognized in a manner consistent with the liabilities relating to the underlying reinsured contracts. FinREC believes that in a situation where the insurer calculates a direct liability less than zero due to the present value of future benefits being less than the present value of future net premiums, and as a result the insurer follows the guidance in ASC 944- 40-30-7A and 944-40-35-7B and floors that balance at zero, the insurer should generally follow consistent accounting for the related reinsurance recoverable and floor the reinsurance recoverable asset at zero as well.

11. However, there may be certain fact patterns where the recognition of a liability rather than a reinsurance recoverable asset for the reinsurance contract held may be appropriate. For example, a noncancellable yearly renewable increasing premium term or excess of loss reinsurance contract may be purchased to reinsure level premium direct insurance contracts. In that circumstance, in following the net premium approach and constant margin principle noted in paragraph 5 above for the ceded reinsurance transaction, a ceded reinsurance liability (i.e., a recoverable asset less than zero) may result. Conceptually, a net liability can result in various situations where cash flows relating to ceded premium are lower (or where benefits are higher) in earlier periods but where the cost of reinsurance is being recognized for accounting purposes on a constant margin basis.

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| Comments should be received by September 25, 2020, and sent by electronic mail to Kim Kushmerick at kim.kushmerick@aicpa-cima.com, or you can send them by mail to attention: Kim Kushmerick, 1345 Avenue of the Americas, New York, N.Y., 10105. |