Working Draft:

Targeted Improvements to Long-Duration Contracts Implementation Issue

Issue #11B: Ceded reinsurance - When reinsuring existing traditional and limited payment long-duration insurance contracts, what are the direct liabilities for future policy benefits relating to the underlying reinsured contracts that should be used to recognize the reinsurance recoverable and to determine the cost of reinsurance.

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

Long-Duration Reinsurance – Ceded

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

1. An entity may enter into a contract to reinsure existing ("inforce") traditional and limited payment long-duration insurance contracts. 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 notes that: "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."

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

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.

3. 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).

4. 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.

5. 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.

6. 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.

7. 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 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.

Comments should be received by July 17, 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.