Article from

The Financial Reporter

September 2020

Accounting for Ceded Reinsurance Under LDTI—Introduction

By Steve Malerich

Editor's note: The views expressed in this article are those of the author and do not necessarily reflect the views of the author's firm.

Since the release of Accounting Standards Update 2018-12, Targeted Improvements to the Accounting for Long-Duration Contracts (LDTI), there have been many questions and much discussion about accounting for reinsurance. I expect that further guidance from the American Institute of Certified Public Accountants (AICPA) will answer some questions but leave many unanswered. In this and future articles, I will offer my insights into some of these concerns.

REINSURANCE PROVISIONS AFTER LDTI

GAAP provisions that directly address ceded reinsurance saw very little change under LDTI.

Recognition

LDTI does not alter the assessment of risk transfer (ASC 944-20-15-1B and several other paragraphs within subtopics 944-20 and 944-40) or the distinction between long- and short-duration reinsurance contracts (ASC 944-20-15-2, 15-34 and 15-34A).

LDTI does add to reinsurance the same new market risk benefit (MRB) classification as for direct annuitization, death or other insurance features. Any such feature must be evaluated first as a possible MRB and, if it's not an MRB, under the derivative and embedded derivative criteria of topic 815 (ASC 944-40-25-40). If the reinsurance of such a feature is not an MRB, a derivative, or an embedded derivative, then it is accounted for as an insurance feature under the same guidance as accounting for the direct feature (ASC 944-40-25-41).

Deferred Acquisition Costs

LDTI does not change the requirement that allowances for acquisition costs be applied such that "net acquisition costs are capitalized …" (ASC 944-30-35-64). Only the clause describing amortization is amended to reference the updated deferred acquisition costs amortization requirements.

Cost of Reinsurance

LDTI does not change any of the provisions directly addressing the cost of reinsurance.

The requirement that a "cost to be amortized" include "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" (ASC 944-605-30-4) prevents "immediate recognition of gains when the reinsurance contract is not a legal replacement of one insurer by another" (ASC 944-40-25-33).

For reinsurance of long-duration contracts, any such "cost shall be amortized over the remaining life of the underlying reinsured contracts if the reinsurance contract is long-duration or over the contract period of the reinsurance if the reinsurance contract is short-duration" (ASC 944-605-35-14). "The assumptions used in accounting for reinsurance costs shall be consistent with those used for the reinsured contracts" (ASC 944-605-35-15).

Reinsurance Recoverable

LDTI does not change any of the provisions directly addressing the reinsurance recoverable.

"Reinsurance recoverable" is defined to be "All amounts recoverable from reinsurers for paid and unpaid claims and claim settlement expenses, including estimated amounts receivable for unsettled claims, claims incurred but not reported, or policy benefits" (ASC 944-40-20). "Reinsurance recoverables shall be recognized in a manner consistent with the liabilities (including estimated amounts for claims … and future policy benefits) relating to the underlying reinsured contracts" (ASC 944-40-25-34). As with the cost of reinsurance, "Assumptions shall be consistent with those used in estimating the related liabilities" (ASC 944-40-25-34).

INDIRECT CHANGES

The lack of explicit changes to reinsurance valuation provisions does not mean that reinsurance valuation is unchanged.

Though there is no reference to the method of amortizing the cost of reinsurance, the reference to consistent assumptions means that its amortization must align assumptions with the updated assumption requirements for the reinsured contracts.

With respect to the reinsurance recoverable, the references to consistent manner and assumptions mean that measurement must align with both the updated manner and the updated assumptions of the underlying contracts.

To assess indirect effects on reinsurance recoverable amounts for paid claims, unpaid claims and policy benefits, it is necessary to consider each of these direct liabilities separately. Indirect effects on amortization assumptions for the cost of reinsurance will follow the changes to assumptions for direct liabilities.

Paid Claims

Since paid claims have been settled with the policyholder (or a designated beneficiary) there are no "liabilities … relating to the underlying reinsured contracts." LDTI does not change the measurement of reinsurance recoverable for paid claims.

Unpaid Claims

LDTI does not change any of the provisions for unpaid claims and claim adjustment expenses (ASC 944-40-25-1), whether reported or unreported (ASC 944-40-25-2), or the requirement to accrue these liabilities when insured events occur (ASC 944-40-25-9). Subsequent measurement is also unchanged, "Changes in estimates of claim costs resulting from the continuous review process and differences between estimates and payments for claims shall be recognized in income of the period in which the estimates are changed or payments are made" (ASC 944-40-35-1).

With no change to the unpaid claim liability provisions or to the reinsurance provisions addressing consistent manner and assumptions, it is generally true that the measurement of reinsurance recoverable for unpaid claims is also unchanged. There is, however, an exception.

For some contracts, claims are settled over an extended period and future payments are contingent upon future developments. Disability income and long-term care insurance are two products that commonly include such contingent payments. In considering the relationship between unpaid claim liabilities and other contract liabilities, principally the liability for future policy benefits, the AICPA has concluded that amounts subject to future contingencies are properly classified as future policy benefits —not unpaid claims—even if the contract is in a current claim status.

Considering the new AICPA guidance, some amounts that were calculated and reported as unpaid claim liabilities will now have to be calculated as part of the liability for future policy benefits (or additional liability for other insurance benefits if the contract is universal life). Accounting for the corresponding reinsurance

> The only explicit requirement for amortizing the cost of reinsurance is to use assumptions "consistent with those used for the reinsured contracts."

recoverable amounts, therefore, will have to change along with accounting for the underlying reinsured contracts.

Future Policy Benefits

For reinsurance recoverable relating to future benefits, consistent manner and assumptions will require a net premium method with retrospective remeasurement for assumption updates, including the substitution of actual experience for expected, whenever those are applied to the direct liability.

The new requirements complicate the relationship between a direct liability and the corresponding reinsurance recoverable. Depending on how a company applies the new requirements, accounting for reinsurance recoverable might or might not align results consistently with cash flow effects. Having considered the more complex dynamics, the AICPA is considering additional guidance about the application of retrospective updates, discount rates and constraints to reinsurance recoverable balances.[1] Beyond this, there is no general guidance about the measurement of net premium reserves for reinsurance recoverable.[2]

Cost of Reinsurance

Unlike reinsurance recoverable, accounting standards define only "part of" the cost of reinsurance. That reference implies that there is (or might be) more cost but there is no codified description (or other general guidance) of what that might be.

The only explicit requirement for amortizing the cost of reinsurance is to use assumptions "consistent with those used for the reinsured contracts." Accounting standards say nothing about the manner of amortizing the cost of reinsurance.

Under LDTI, companies will have to update assumptions periodically with changes in assumptions of the reinsured contracts. Otherwise, companies must consider broader accounting principles to determine the most appropriate way of amortizing this cost, including the manner of applying assumption updates.

A FRESH LOOK

The dynamic assumption update requirements of LDTI will affect the reported performance of business that is reinsured. When added to existing reinsurance accounting practices, this could result in reinsurance effects on net income that are consistent with—or dramatically different from—its effects on net cash flows. In the next article, I will take a fresh look at reinsurance accounting, as if there were no precedents about how to interpret and apply the requirements described in this article. ■

Steve Malerich, FSA, MAAA, is a director at PwC. He can be reached at *steven.malerich@pwc.com*.

ENDNOTES

1 Draft guidance was made available for public comment on July 24 with comments due Sept. 25.

2 Audit firms may provide more detailed guidance but that is outside the scope of this article.