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Accounting for Ceded Reinsurance Under LDTI—A Fresh Look

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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.

Despite little change to explicit reinsurance accounting provisions, GAAP’s Targeted Improvements to the Accounting for Long-Duration Contracts (LDTI) will complicate the relationship between direct and ceded reinsurance accounting. In the September issue of *The Financial Reporter*, I gave an overview of ceded reinsurance accounting under LDTI.¹ In this article, I examine the amended standards as if there were no precedent and with a focus on products that require net premium reserves. Conclusions could differ for other products, such as universal life with no additional liabilities.

OBJECTIVES

This article considers only interpretations that satisfy the following objectives. Other interpretations will be addressed in a future article.

Compliance

The first objective of accounting for reinsurance must be to comply with the standards. Any set of standards, however, is a combination of principles and rules. Though its very name suggests that GAAP is a set of principles, its level of detail includes a substantial element of rules. Finding the balance between principle and rule can be challenging, for the people writing the standards and for the people who must comply with them. This is especially true of accounting for ceded reinsurance and opinions do vary around this distinction.

Performance

Beyond compliance, LDTI’s Background Information and Basis for Conclusions noted in paragraph BC10 that “the Board



decided to retain the existing net premium reserving model.” In paragraph BC50, “The Board observed that under the existing 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.”

Given the decision to retain the net premium model as described, it seems unlikely that the Board would want accounting for reinsurance to counter that effect unless the economics of the treaty itself were significantly different from the reinsured contracts. Short-duration reinsurance, for example, would affect performance for only a portion of the underlying contract life.

In practice, therefore, I look for long-duration reinsurance accounting to preserve the constant margin inherent in accounting for the reinsured contracts. The net cost of the long-duration reinsurance should affect only the size of the margin. Also, for assumption updates, remeasurement of the reinsurance

asset or liability should, to the extent cash flows are reinsured, align with remeasurement of the corresponding direct liability.

Simplicity

Though not required, companies might prefer a method that can be applied consistently to a variety of reinsurance contracts. Besides the practical benefit, this could ensure that differences in results reflect differences in contract characteristics rather than differences in accounting.

A CLEAN SLATE

Accounting Standards Codification (ASC) defines reinsurance recoverable in the ASC 944-40-20 glossary. The definition includes “estimated amounts receivable for ... policy benefits.” ASC 944-40-25-34 requires recognition of reinsurance recoverable “in a manner consistent with the liabilities (including ... future policy benefits)” using “Assumptions ... consistent with ... the related liabilities.” Together, these suggest that it would be correct to recognize a reinsurance recoverable asset corresponding to the direct liability for future policy benefits.

There is no definition of cost of reinsurance other than the reference in ASC 944-605-30-4 stating that it includes “The difference, if any, between amounts paid for a reinsurance contract and the amount of the liabilities relating to the underlying reinsured contracts” ASC 944-605-35-14 requires “Amortization of the estimated cost of reinsurance ... over the remaining life of the underlying reinsured contracts if the reinsurance contract is long-duration” The standards do not prescribe a manner of amortizing the cost of reinsurance, but ASC 944-605-35-15 does require “assumptions ... consistent with those used for the reinsured contracts.”

Some reinsurance treaties permit net settlement of cash flows between the ceding and assuming companies. This “right of setoff,” defined in the ASC master glossary, could support a decision by the ceding company to net reinsurance recoveries and premiums into the calculation of a single asset or liability for the net recoverable or cost.

The following analysis does not include the special considerations involved in accounting for new reinsurance of existing contracts. These will be addressed in a future article.

Reinsurance Recoverable

A reinsurance recoverable amount relating to the liability for future policy benefits will include estimated amounts recoverable in the future. For now, I consider only recoverable benefits without regard to any right of setoff. Recoverable amounts include future benefits and any allowances corresponding to non-level expenses included in the direct liability.

To be consistent with the related liabilities, reinsurance recoverable must be calculated using a net premium method with retrospective update for assumption changes and actual

experience. To achieve the performance and simplicity objectives described above, direct and ceded reserves need to accrue on the same base—direct premiums.

Cost of Reinsurance

With reinsurance recoverable as described above, the performance and simplicity objectives also require that the “estimated cost to be amortized” (ASC 944-605-30-4) includes all reinsurance premiums, and that these costs be amortized on a direct premium base using a net premium method with retrospective updates for assumption changes and actual experience.

Net Recoverable or Cost

“A right of setoff ... by contract or otherwise” (ASC Master Glossary) could justify netting reinsurance premiums and recoveries into the calculation of a single ceding reserve. Again, to achieve the desired objectives, this must accrue on the same direct premium base as the liability for future policy benefits, using a net premium method with retrospective update for assumption changes and actual experience.

For coinsurance, reinsurance premiums are already proportional to direct premiums and the asset will be the same as if it were accrued only for recoverable benefits. For yearly renewable term, the contribution of reinsurance premiums will substantially offset the contribution of recoverable amounts, producing a much smaller reserve that could be either an asset or a liability.

Expense Allowances

In the above calculations, reinsurance premiums should not be reduced for most coinsurance allowances.

Non-level allowances are mostly subtracted from deferred acquisition costs or added to recoveries. Level allowances (including inflation-adjusted maintenance allowances) mostly correspond to costs that must be charged to expense as incurred.

Only the remaining allowances would be applied to reduce reinsurance premiums.

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Precedent

Looking at standards as they are written, together with current knowledge about the dynamics of various calculation methods, can help to visualize an ideal. The approaches described in this article are all aimed at that ideal. They are not, however, universally recognized as proper interpretations of GAAP and they differ from some established practices in ways that go beyond updating for LDTI.

Since the reinsurance accounting provisions themselves have not changed, we can't ignore precedent. In the next article, I will look at some established practices and consider how they might change. ■



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ENDNOTE

- 1 "Accounting for Ceded Reinsurance under LDTI—Introduction" by Malerich, *The Financial Reporter*, September 2020