

# FASB Education Session – Insurance Contracts

## PricewaterhouseCoopers Summary of Meeting

30 September 2009

FASB Education Sessions are informational meetings only, where no decisions are reached, and any tentative thoughts expressed by the staff or Board may change at future Board meetings. In addition, decisions of the FASB that are reached at the more formal Board meetings become final only after completion of a formal ballot to issue a final standard.

### Highlights

The objective of the Education session was for representatives of the International Association of Insurance Supervisors (IAIS), and the National Association of Insurance Commissioners (NAIC), to present the insurance regulatory viewpoint about several aspects of the insurance contracts project, including:

- Treatment of acquisition costs
- Cash flows and contract boundaries
- Inclusion of a surrender value floor
- Discretionary participation features
- Run off of margins

The IAIS view was represented by Rob Esson, an employee of the NAIC, and the NAIC was also represented by Rob and by Joe Fritch, from the NY State Insurance Department. The majority of the one hour discussion centered on the treatment of acquisition costs. The FASB Board maintained its view that acquisition costs should be expensed as incurred with no revenue offset.

### Detailed Discussion

In explaining the IAIS position relating to the first four items on the agenda, its representative referenced the 2007 IAIS response to the IASB discussion paper on Insurance Contracts. He explained that its position was based on the view that the use of probability-weighted cash flows (often referred to as "building block 1") is the appropriate approach for measuring cash flows relating to the contract. It was noted that insurance cash flows consist of both positive and negative cash flows, and that all of these cash flows need to be considered together in the valuation. For example, in measuring the liability for a life insurance contract with death benefit coverage provided for a long duration and premiums occurring over multiple years, one should not include the projected negative cash outflow in year 10 upon death without including the prior cash inflows from premiums in the first 9 years. This is because the policy would have lapsed prior to death if the premiums were not received, and no death benefit would have been payable.

### Acquisition costs

Regarding acquisition costs, the IAIS representative expressed the view that acquisition costs should be included in the building block 1 probability-weighted cash flows, as they are cash flows relating to the contract. That is, at time zero (immediately before issue) the projected cash flows under the contract should include the first year premium (as well as any renewal premiums), benefits expected to be paid, and the related commissions expected to be paid. Inclusion of acquisition costs in estimated cash flows is consistent with the cash flows assumed in the pricing of the contracts, as the premium is set to recover such costs.

The Board response was that inclusion of commissions in the contract cash flows is not appropriate. Various Board members noted that:

- acquisition costs are not cash flows that relate to satisfying the obligation to the customer
- as a result, they should be expensed as incurred with no revenue offset
- such costs are no different than overhead costs incurred in other industries that are expensed
- when a policy is sold and the buyer "pays for" acquisition costs, he is really buying an intangible (a customer relationship), not reimbursing acquisition costs

### Contract boundaries

The IAIS believes the boundary of an existing contract is the first "termination date" from the perspective of the insurer, which would include any insurer option to re-underwrite. The Board agreed with this perspective but took issue with a specific reference to "in-the-money" policyholder options stating that they expect nearly all contract options to be out-of-the-money when issued. One Board member then took the opportunity to reiterate his long standing view that annual premium insurance is a one year contract with a series of written options.

## **Surrender value floor**

The IAIS view differs from the NAIC view in that the IAIS believes that a surrender floor is inconsistent with a probability-weighted cash flow approach. FASB members responded that one should not confuse cash inflows and outflows with assets and liabilities. In reality they are obligations and settlement of obligations.

## **Discretionary Participation Features**

Little time was left in the one hour session to devote to this issue. The IAIS believes that all future policyholder dividends should be included in the expected cash flows (i.e. the liability measurement). The FASB responded that this differs from the treatment of future preferred stock dividends, which are not recorded as liabilities.

## **Risk Margins**

There was limited discussion of this issue due to lack of time. The IAIS representative referenced a paper prepared by the International Actuarial Association on risk margins, which included discussion on the cost of capital approach for determining risk margins. The IAIS representative indicated that while the IAIS is somewhat concerned about the lack of agreement about the parameters used in the cost of capital method, the group supports its use. The IAIS believes that the insurance contracts project's "composite margin" approach is similar to a method described by the IAIS as "margin over current estimate," which represents a calibration of the risk margin.

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