

Sharing insights on key industry issues

FASB education session – Insurance contracts

PricewaterhouseCoopers summary of meeting

October 22, 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 purpose of the meeting was to discuss

- the use of risk margins in the measurement of an insurance contract, and
- the presentation of the performance statement for insurance contracts.

These two topics will be discussed at the upcoming joint FASB/IASB meeting in Norwalk on October 28. The ultimate purpose of next week's joint meeting is to discuss whether the Boards can resolve their differences in significant areas where they have reached different decisions to date. These areas include the liability measurement approach and acquisition costs. The Boards will also discuss whether policyholder accounting should be excluded from the insurance contracts exposure draft.

Because Education Sessions are informational meetings only, there were no decisions reached at the October 22 meeting. However, it did appear from the various comments made that Board members were now open to the idea that a fulfillment value approach could include an explicit risk margin.

On the topic of the performance statement, the Board and staff briefly discussed the four models proposed in the IASB staff paper from the IASB October 20 meeting, which included:

- Traditional life model
- Traditional non-life model
- Fee approach
- Margin approach

At least several members seemed to gravitate towards a method that would either partly or entirely record premium as revenue in a manner consistent with the revenue recognition project (either the traditional non-life model or fee approach). There seemed to be little support for the margin approach, which would present premiums as deposits and record revenue only for the release of the margin.

In preparation for next week's joint meeting, the issue of acquisition costs was briefly raised at the end of the meeting. One Board member suggested that perhaps, in an attempt to reach convergence with the IASB on this issue, the Board should entertain the idea of deferring a "skinned down" version of acquisition costs. There was limited discussion of this idea at the current meeting.

Detailed discussion:

Risk margin

To date, the FASB and IASB have each discussed various potential overall measurement approaches for insurance contracts, and have narrowed their discussion down to two possible approaches:

- Current fulfillment value
- Measurement approach based on an updated IAS 37 model

Both of these approaches have as their foundation the same three building blocks:

- current estimate of the expected (i.e., probability weighted) future cash flows
- time value of money
- a margin

However, depending on how each of these components of the building block approach is measured (i.e., the inputs used and their objective), the valuations can differ significantly. The current fulfillment value approach is the insurer-specific expected present value of the cash flows necessary to fulfill the obligation to policyholders with a "composite margin," calculated as the day one difference between the expected present value of these cash flows and the present value of expected premiums. There is no explicit risk margin in this model, which the FASB tentatively selected as the measurement approach for insurance contracts at its July 21 meeting.

In contrast, a slight majority of the IASB tentatively selected the proposed IAS 37-based model, which includes an explicit risk margin and a service margin in addition to a residual margin in its building block measurement. In addition, the proposed IAS 37-based model requires using the lowest of the building block amount; the price that the market would demand to assume the liability (an exit value notion), if available; and the price that a counterparty would demand to cancel the liability, if cancellation is possible (a settlement notion).

At the October 22 FASB Education Session, the FASB discussed the risk margin in more detail, using as background two handouts: a paper prepared by PwC actuary Sam Gutterman, and an International Actuarial Association (IAA) research paper on risk margins, *Measurement of Liabilities for Insurance Contracts: Current Estimates and Risk Margins*, published in April 2009. Sam Gutterman was present at the meeting to answer questions for the Board and staff.

In his paper, Gutterman presented his personal view that whether the applicable accounting objective for the insurance liability is expressed in terms of a contract fulfillment or a transfer value, an adjustment for uncertainty is appropriate. Those that support inclusion of an explicit risk margin in the estimate note that it is necessary to reflect the fact that an insurer would rationally pay different amounts to be relieved of two liabilities that differ in riskiness but otherwise have the same probability weighted cash flows. As an example, inclusion of a risk margin appropriately distinguishes a liability with a certain cash outflow of \$50 from a second liability with a 50% probability of requiring cash outflows of \$0 and a 50% probability of requiring cash outflows of \$100. Both of these liabilities have the same probability weighted cash flows of \$50 but the second liability is considered to be riskier than the first.

The Board had previously concluded that a fulfillment value approach should not include an explicit margin because the objective of the fulfillment approach is to report a value based on the insurer's fulfillment of its contractual obligation to its policyholders rather than to measure the amount at which the liability could be transferred. Some Board members had expressed a belief that a risk margin was only appropriate in a fair value or transfer approach. In addition, the FASB had previously voiced concern that estimating an explicit risk margin may not be a reliable measure, adds unnecessary conservatism, reduces comparability and complicates the calculation of the liability.

At the October 22 Education Session, the Board reconsidered whether a risk margin could be included in a non-fair value measurement, and what that uncertainty adjustment would represent. It appeared from the various comments made at the meeting that Board members were now open to the idea that a fulfillment value approach could include an explicit risk margin.

One Board member commented that the actuarial paper examples clarified that a risk margin could be appropriate in a non-fair value measure to capture the uncertainty in one set of probability-weighted cash flows versus another set of probability-weighted cash flows with the same mean. The Board member indicated that her initial view was based on the fact that Concept Statement 7 describes cost accumulation and cost accrual methods as methods that would typically exclude the risk premium (the price for bearing uncertainty) that third parties would incorporate in the price they would charge to assume the liability. Another Board member noted that it was therefore important to distinguish a measurement method based on cost (which excludes a risk margin), from a measurement method based on the value to the entity (which could include a risk margin). The FASB staff and IASB staff seemed to agree with this distinction, with the IASB staff noting that the proposed IAS 37-based model specifically speaks to "the value" of not having to fulfill the obligation to the policyholder.

One Board member who had previously been strongly against a risk margin in the fulfillment value approach for insurance liabilities noted that if the measurement objective was expressed as reflecting the "value to the entity," rather than a cost-based objective, he could possibly agree to inclusion of a risk margin. He noted that the examples in the actuarial paper with a skewed distribution (using a "value to the entity" concept) were especially helpful to him as insurance payouts typically had such a distribution. In addition, he noted that in a non-skewed distribution, if one were risk neutral, there should theoretically be no risk margin, but because entities are typically risk averse, a risk margin could be appropriate.

The same Board member then walked through the application of an explicit risk margin model in an onerous contract situation, and then in estimating the liability for insurance claims. He noted that the revenue recognition model as currently proposed would not include a risk margin. However, in the case of an insurance liability and similar measurements with contingent cash flows, inclusion of a risk margin (and thus deviation from the proposed revenue recognition model) could be appropriate, as users would get an earlier signal as to a potentially onerous contract. In estimating a claim liability, including an explicit risk margin would result in a lower profit margin being recognized earlier on, until the uncertainty is resolved, which made sense. He put a caveat on his remarks, noting that reliable measurement would be a key factor in whether an explicit margin should be part of the model.

Another Board member expressed his concern, as he had done in the past, about whether there was a reliable and consistent way to estimate the risk margin that would result in comparability among entities. Gutterman described the two most popular methods currently employed in practice or currently being considered by regulators. Those included the quantile method, which is a statistical approach currently used in Australia for property/casualty claims liability and being considered by the NAIC in the US, and the cost of capital method, to be required in Europe under Solvency II.

Several comments were made by the FASB Board and staff that even if a single method were used, there could be still be a lack of comparability depending on the parameters chosen. For example, in the quantile method, there are various confidence levels that could be selected. A staff member noted that he was told that in Australia, which establishes a statutory minimum, practice has converged at a confidence level above this minimum. One Board member noted that even if the confidence level is fixed, there could still be differences in measurement due to the probability distribution and the parameters chosen.

Gutterman was asked if actuarial practice could come to agreement on a specific model to use. Gutterman replied that actuaries typically develop principles and interpretations on how to apply principles (for example, the "actuarial central estimate" concept used in valuing property/casualty liabilities), but typically do not prescribe specific methods. One reason for this approach is not to suppress the development of new methods (for example the cost of capital method being implemented

as part of Solvency II was developed over the last six years or so). A FASB staff member noted that today, there are various methods used to make actuarial estimates of expected cash flows, both in insurance as well as in other areas, such as pensions. A Board member noted that an attempt at standardization by prescribing a single method to achieve comparability could result in false comparability.

Performance statement

On the topic of the performance statement, the Board and staff briefly discussed the four models proposed in the IASB staff paper from the IASB October 20 meeting, which included:

- Traditional life model
- Traditional non-life model
- Fee approach
- Margin approach

The staff paper provided definitions and numerical examples for each of the approaches. Under the traditional life model, premiums are recognized immediately as revenue and at the same time a corresponding increase in the liability is recognized as an expense. Under the traditional non-life model, premiums received are recognized as a liability (unearned premium) and are then transferred to revenue as deemed earned. Under the fee based approach, only the part of the premium that the policyholder pays for services under the contract would be reported as revenue, not the deposit receipt that relates to expected future repayments to the same policyholders. The parts of the premium for services, including risk protection, would be recognized as revenue based on performance under the contract. For example, a contract may have both an insurance element and a separate asset management service. The margin approach treats all premiums as deposits and all claims and benefits as repayments to the policyholder. Recognition of the margin(s) as revenue would occur as the margin is released, under a method to be discussed at a future meeting.

It was noted that the fee approach, in the simplified example presented which included no deposit element, seemed similar in many respects to the traditional non-life model in terms of presentation of revenue and expense, and more in line with the revenue recognition project concepts, and several members gravitated toward this method. It was noted that the margin approach, in contrast, is more of a financial instruments model in which only the margin would be recorded as revenue, not the gross premium received.

The staff reiterated that the fee approach example did not include a deposit element, but if it did, the deposit premium element would not be included in revenue. One Board member commented that he did not understand the idea that in general, money a policyholder paid in as premium that would be paid back as a claim would be considered to be a deposit.

The staff noted that the different approaches highlight the difference between a service model, where gross revenue is recognized, and a financial instrument model, which reports margins. Several Board members commented that they did not understand exactly what was in the "service element." For example, would this relate only to non-insurance related services, such as asset management, or would it also include other "services," such as claims management? Would the latter be embedded in the building block 1 cash flows, or separate?

One Board member asked the staff why they were reviewing the performance statement presentation, while not being asked to look at the IASB unbundling paper at the same time. The staff responded that the meeting next week was scheduled to only cover the performance statement, which was only a presentation issue. The unbundling issue, while related, deals with whether there should be separate recognition and measurement for the deposit, insurance, and service elements.

Acquisition costs

Both Boards view acquisition costs as past incurred costs and not a part of the future costs incorporated in the liability estimate for any of the proposed measurement approaches and, therefore, believe they should be expensed as incurred. The FASB, in accordance with the principles of the revenue recognition project, would not recognize any revenue to offset such costs, thus potentially resulting in a loss in the income statement when a contract is sold equal to the acquisition costs. This difference would be a major change for insurance companies that have large costs of selling and large deferred acquisition cost assets on their books currently.

The IASB, in recognizing that insurance companies include recovery of acquisition costs in their pricing, believe that the premium relates to the recovery of direct incremental acquisition costs (primarily commissions) and would recognize revenue to offset these acquisition costs. These incremental costs would be expected to be less than the amount of acquisition costs capitalized under current US GAAP practice.

In preparation for next week's joint meeting, the issue of acquisition costs was briefly raised. One Board member suggested that perhaps, in an attempt to reach convergence with the IASB on this issue, the Board should entertain the idea of deferring a "skinned down" version of acquisition costs. Members commented that deferral was in their view a better way of dealing with the acquisition costs issue than recognizing an offsetting amount of revenue, which the Board feels is inconsistent with the revenue recognition model being proposed.

One member noted that perhaps there was room for a deferral notion in light of their decision last week with regard to "FAS 91." Although this point was not explained, we note that the Board, in its financial instruments project discussion last week, decided that capitalizing transaction costs is appropriate for those instruments for which changes in fair value are recorded in other comprehensive income. Another Board member reminded members that their decision related to an amortized cost measure through income, versus a remeasurement approach being contemplated for insurance contracts. Nevertheless, the idea of deferral for certain acquisition costs was not dismissed.

Additional information

If you have further questions on either the FASB or IASB project, please contact:

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