Insurance alert

FASB Board Meeting, March 6, 2013

Since a variety of viewpoints are discussed at FASB and IASB meetings, and it is often difficult to characterize the FASB and IASB's tentative conclusions, these summaries may differ in some respects from the actions published in the FASB's Action Alert and IASB Observer notes. In addition, tentative conclusions may be changed or modified at future FASB and IASB meetings. Decisions of the FASB and IASB become final only after completion of a formal ballot to issue a final standard.

PwC summary of meetings:

- *Discount rate for asset- affected cash flows*
- *Sweep issues*
- *Fair value option*

Highlights

The FASB clarified its decisions relating to the discount rate and accretion rate for insurance contracts with asset-affected cash flows. The board noted that an insurer would not be required to disaggregate cash flows of a contract into those affected by returns from assets and those not affected by returns from assets when determining discount rates that reflect the characteristics of the contract's cash flows. Instead, a "blended rate" could be used. Upon any change in expectations of the crediting rate used to measure the insurance contracts liability, an insurer would reset the interest accretion rates in a manner that recognizes any changes in estimated interest crediting and related ultimate expected cash flows on a level-yield basis over the remaining life of the contracts.

The board covered the remainder of open items in the project, including premium allocation criteria and measurement, captive insurer accounting, the recognition point for deferred annuity contracts, and tax cash flows.

The FASB decided to eliminate the fair value option for insurance contracts and for various other types of financial instruments (whether included in the proposed insurance standard or not)including guarantees, warranties, contingencies, written loan commitments, and certain other firm commitments. The board decided that the effective date and transition provisions for each of these items would be consistent with the effective date and transition provisions for the applicable proposed Accounting Standards Update.

The FASB plans to address costs and benefits of the insurance project's tentative decisions to date in an upcoming meeting, a required step before issuing an exposure draft. to exposing new guidance.

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Treatment of changes in estimated interest crediting and accretion rates

The staff brought back two issues relating to contracts with "asset-affected" cash flows such as universal life insurance and fixed deferred annuities. For these contracts, interest credited to policyholder balances is declared from time to time at the insurer's discretion (typically based in part on a referenced portfolio of investments held by the insurer). The first issue relates to determining the discount rate used to discount cash flows for liability measurement when a contract includes a discretionary crediting rate. The second addresses how changes in that discretionary crediting rate impact the "locked-in" discount rate used to recognize interest expense in the income statement, and how changes in the discretionary crediting rate impact the reporting of changes in estimates of policyholder interest credited.

At the November board meeting, the boards tentatively decided that for contracts with cash flows affected by asset returns, the discount rate should reflect the extent to which estimated cash flows are affected by the return from those assets, even if the rate is discretionary. The boards also decided that if there is a change in expectations of those cash flows (for example, the future crediting rate) used to measure the insurance contracts liability, an insurer should reset the locked-in discount rates that are used to present interest expense for those cash flows. This approach views the discretionary crediting rate as similar to a variable return.

The FASB staff believed that clarification of the boards' November decisions was needed in light of subsequent questions from constituents. An example in a staff paper from the prior meeting suggested to some that an insurer would be required to use a discount rate for asset-affected cash flows different from the discount rate for non-asset affected cash flows within a single contract. This could be operationally challenging and, conceptually. In addition, it was not always clear which cash flows are asset affected. For example, a death benefit might be partially asset dependent if the death benefit is a function of the account balance. As another example, an annuity might be asset dependent in the accumulation phase but not in the payout phase.

The FASB staff believed that the board intended the example to be an illustration depicting a principle rather than a prescriptive requirement. The FASB staff believed the boards' intent was to allow an option for insurers to use either a weighted-average discount rate for the whole set of cash flows (a "blended rate") for a contract or two different rates with splitting of the cash flows.

At the March meeting, the FASB clarified its previous decision and noted that an insurer would not be required to split the cash flows of a contract and use two separate rates when determining discount rates that reflect the characteristics of the contract's cash flows but instead could use a blended rate.

In the discussion preceding the vote, the staff reiterated the principle that the discount rates for the portfolio's cash flows should reflect the extent to which the amount of any estimated cash flows subject to insurer discretion are affected by asset returns. This could be accomplished with a blended rate. The staff noted that as an example, an insurer might be able to look at correlation between invested asset and insurance liability changes to determine the amount of asset default risk that is passed along to policyholders. Several board members noted that while they agreed with use of a blended rate, as long as it was consistent with the principle, developing a blended rate would still be an operationally complex exercise.

The FASB moved on to the second issue relating to changes in expectations of the discretionary crediting rate and how such changes impacted the "locked in" discount rate and the reporting of changes in policyholder interest credited cash flows.

The FASB decided that for asset-affected cash flows, upon any change in expectations of the crediting rate used to measure the insurance contract liability, an insurer would reset the interest accretion rates in a manner that recognizes any changes in estimated interest crediting and related ultimate expected cash flows on a level-yield basis over the remaining life of the contracts. An insurer would recognize in net income the difference between the prior expected cash flows discounted at the prior interest accretion rates and the revised expected cash flows discounted at the reset interest accretion rates. A board member noted that this approach focuses on providing a more stable effective interest yield through income rather than an alternative approach that would have recognized changes in expected cash flows for interest credited to policyholders immediately in income.

For non-asset-affected cash flows, an insurer would apply the tentative decision on accumulated other comprehensive income (AOCI). That is, an insurer

would present as part of AOCI the difference between the insurance contract liability recorded on the statement of financial position (using the current discount rate) and the amount the insurance contract liability would be if it were determined at the interest accretion rates.

Sweep issues

The board made decisions on a number of miscellaneous topics in the project. The only remaining meeting will address the costs and benefits of the tentative decisions on the insurance project, a required due process step for issuing an exposure draft.

Premium allocation criteria

In the first sweep issue the board voted to eliminate the second of the two proposed criteria to account for contracts under the premium allocation approach (PAA). These proposed criteria, agreed to in February 2012, stated that insurers should apply the building block approach (BBA) rather than the PAA if, at the contract inception date, either of the following conditions is met:

(a) It is likely that, during the period before a claim is incurred, there will be a significant change in the expectations of net cash flows required to fulfill the contract; or

(b) Significant judgment is required to allocate the premium to the insurer's obligation to each reporting period. This may be the case if, for example, significant uncertainty exists about:

(i) the premium that would reflect the exposure and risk the insurer has for each reporting period; or

(ii) the length of the coverage period.

The board decided that criterion (b) needed to be removed in light of its subsequent decision to adopt an earned premium approach. That is, under the earned premium approach, premium is in fact required to be allocated. Implementation guidance will be added to clarify the remaining sole criterion (criterion (a) above). This will include the following indicators and observations:

- The existence of guarantees or options (if there is no corresponding change in premium) may indicate the likelihood of a significant change in expected cash flows.

- Some cash flows changes may be *likely,* but will not *significantly* change expectations at contract inception. Other circumstances could cause expected cash flows to change *significantly*, but may not be *likely* at contract inception (e.g., catastrophes).

- At contract inception, if an insurer expects that during the contract's coverage period it will significantly change premium pricing for future contracts written with identical or similar risks, this could indicate a significant change in cash flows is likely at contract inception.

- The longer the coverage period, the more likely there will be a significant change in expected net cash flows.

Related party guarantees

At a meeting in February, the FASB decided that the insurance contracts proposal should not apply to a guarantee (including a guarantee in the form of an insurance contract) between related parties or entities under common control when the issuer of the guarantee does not issue similar guarantees to third parties. However, an unintended consequence of this wording would have been to disallow application of the insurance contract model in the standalone financial statements of a captive insurer that insures only its parent and its affiliated entities. Therefore, the board decided at the March 6 meeting to add the phrase "unless issuance of such guarantees is the primary business purpose of the issuing entity." As a result, in the standalone captive financial statements, insurance contracts issued and reinsurance purchased would be accounted for as insurance.

During the board deliberations, in response to a board member question, the staff confirmed that, assuming the board adopts the staff suggested additional wording, a parent would still need to eliminate the intercompany insurance in its consolidated accounts. This would mean that on a consolidated basis the group would not have written any insurance. As a result, the consolidated entity would record its obligations under the "FAS 5" (now ASC 460) liability guidance, which is not typically a discounted expected value model.

Another board member asked the staff whether this would pose any operational or auditing issues, to have two different measurement bases for the same obligation. The staff responded that aside from discounting, it might be hard to argue that there should be two different estimates, despite the explicit difference between the FAS 5 "best estimate" obligation measurement and the insurance contract proposed "expected value" measurement. The chair said that any potential difference between these two approaches did not concern her, as there were other instances in GAAP where different measurements were applied at different levels in an organization.

Excess of the insurance liability measurement over the fair value of the insurance contracts in a business combination

The staff noted that the board had previously decided that any excess of fair value over the present value of expected cash flows for a portfolio of contracts acquired in a business combination would be recorded as the positive single margin under the BBA. At the current meeting, the board decided (in a narrow 4/3 vote) that in situations where the fair value of a portfolio of BBA insurance contracts is *less than* the present value of expected cash flows for that portfolio, the difference should be recorded as a loss at the acquisition date. The IASB, on the other hand, decided in a previous IASB only meeting that any negative difference would increase goodwill.

The staff clarified at the current meeting that under the PAA, the fair value would be allocated between the present value of cash flows relating to incurred claims with the remainder recorded as the liability for remaining coverage. The liability for remaining coverage would then be subjected to the onerous contract test, with any loss recorded at the acquisition date.

The staff rationale for recording a loss where fair value is less than the insurance contract liability at the purchase date was that it was consistent with the accounting in a non-purchase situation. The staff had proposed as an alternate solution that the difference be recorded as an increase to goodwill but rejected that proposal on the basis that it would overstate goodwill.

The three board members who voted against the staff proposal objected to the idea that a business combination should result in an immediate loss. They noted that there was no other situation in business combinations where this could occur.

One board member suggested that perhaps the difference should be recorded as an intangible asset rather than as goodwill. The staff said that this view was previously rejected by the board at its November 14 meeting, (although the staff November proposal suggested recording "implied acquisition costs" rather than an intangible asset as a component of the purchase accounting measurement). It was unclear why the board did not consider retaining the current business combination accounting guidance whereby the difference between the fair value and insurance contract measurement is recorded as an intangible asset (if a net debit) or "other liability" if a credit.

Another board member asked what the FASB and IASB had decided with regard to assumed reinsurance contracts where the amount of consideration received was less than the present value of expected cash flows. The staff responded that the difference would be recorded as an immediate loss. The board member thought that the two situations should be aligned, and thus ultimately voted to record an immediate loss in the business combination.

Liability for remaining coverage under the PAA

The board decided to clarify that for contracts reported under the premium allocation approach, an insurer would not include expectations of future changes in coverage (for example, policyholder cancellations) in the cash flows for purposes of measuring the liability for remaining coverage or the gross premium receivable. The board did not discuss application of this principle to the onerous contract test.

The rationale given by the staff for this approach was that the PAA was meant to be a simplified approach that did not require updating of cash flows during the pre-claims period. In addition, the staff noted this approach is consistent with the majority of current practice for those applying the short duration model.

Recognition point for deferred annuity contracts

A deferred annuity has both an accumulation phase (where deposits are accumulated) and an option for a payout phase under which benefits may be life-contingent. If the life-contingent payout phase results in significant mortality risk, the entire contract (accumulation and payout phase combined) would be

accounted for as an insurance contract under the proposal. Under current U.S. GAAP, the payout phase is considered a separate contract.

At its January meeting, the IASB noted that there was a misunderstanding expressed by some constituents that the coverage period would not begin until the payout phase begins. The IASB clarified that the recognition point for deferred annuities is the earlier of the start of the coverage period or the date on which the first premium becomes due in the accumulation phase.

Like the IASB, the FASB believes that the recognition point should be at the beginning of the accumulation phase rather than the beginning of the payout phase. However, the FASB believes that this point can be made by clarifying that the coverage period begins when the insurer is "on risk" to the policyholder. In a deferred annuity, the insurer is on risk from the point at which the accumulation phase of the contract begins, because this is the point at which the insurer has committed to the future annuitization options.

Treatment of Income Tax Payments and Receipts

The board decided to clarify in the implementation guidance that cash flows excluded from the measurement of the liability would include income tax payment obligations of the insurer even if the insurance contract permits the insurer to charge back those amounts to policyholders. However, any tax obligations that are incurred by the policyholder and in which the insurer pays those obligations in a fiduciary capacity would be included in the present value of fulfillment cash flows along with any amounts the insurer expects to receive from the policyholder related to those tax amounts.

Fair value option

The FASB decided to eliminate the fair value option for insurance contracts and for various other types of financial instruments. These include guarantees, warranties and contingencies (whether included in the proposed insurance standard or not), warranties that fall under the proposed revenue recognition standard, written loan commitments, and firm commitments that would otherwise not be recognized at inception and that involve only financial instruments to purchase loans. The board also agreed to clarify that forward and option contracts to purchase loans should be accounted for consistently with the specialized model for forward and option contracts to purchase securities that do not meet the definition of a derivative.

The board decided that the effective date and transition provisions to eliminate the fair value option for these items would be consistent with the effective date and transition provisions for the applicable proposed Accounting Standards Update (ASU), i.e., the proposals for insurance contracts, the financial instruments recognition and measurement and revenue recognition. The staff will draft consequential amendments to the fair value option section of ASC 825 and include them in the relevant proposed standards.

In the detailed discussion, each of the above mentioned categories of financial instruments was discussed and voted on separately. However, the general theme was that the board wanted to eliminate the fair value option relating to all financial instruments other than in those instances specifically referenced in the classification and measurement project. In essence, the guidance that was originally in FASB 159 would be superseded.

In the discussion on insurance and warranties, the board noted that certain types of warranties might be included in the scope of the insurance contracts proposal whereas others would not. For example, some warranties would be accounted for under revenue recognition guidance. Neither category would have a fair value option.

The board also decided to eliminate the fair value option for certain guarantees and other contingencies that would not be within the scope of the forthcoming proposed insurance contracts guidance. These include transactions accounted for in accordance with Topic 460, Guarantees, or contingencies accounted for in accordance with Topic 450, Contingencies.

With regard to written loan commitments, the staff noted that the financial instruments classification and measurement exposure draft was intended to establish a new accounting model for written loan commitments. This would thereby override and eliminate the fair value option in ASC 825. However, some constituents noted that a large population of loan commitments will remain off balance sheet (i.e., those that are remote and those that are not remote but for which the loans are expected to be classified and measured at amortized cost). Some requested that the fair value option remain for these loan commitments.

The staff noted that the fair value option was originally provided for loan commitments because it offered companies that economically hedge these commitments a natural offset. However, the board decided that consistent with its other decisions, it would eliminate the fair value option. The chair noted that a company could avail itself of hedge accounting guidance if it sought accounting offset.

Additional information

Questions on this summary and the FASB/IASB joint project can be directed to: Mary Saslow (860-241-7013) a Managing Director in the National Professional Services Group, who is part of both the U.S. and Global Accounting Consulting Services groups.

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