

# FASB-IASB Phase II Insurance Contracts Joint Project

## Project Status Update with Securities & Exchange Commission Staff

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## Overview

**Subsequent to our November 19, 2009 meeting, elements of the FASB-IASB Phase II Insurance Contracts Joint Project have been impacted by the following tentative decisions:**

- **Boards added a fourth building block to calibrate the measurement obtained from the original three building blocks to premium (or anticipated premium) at inception to produce “no gain at inception” as per the revenue recognition paper;**
- **Boards also tentatively concluded that margin at inception should be separated into two components – (a) a risk adjustment, and (b) the residual margin measured by reference to premium to eliminate day one gains. Day one losses are recognized immediately;**
- **Boards tentatively concluded that residual margins should be recognized on a straight-line basis over the coverage period unless another allocation method is more representative.**
- **Boards diverged in opinions on acquisition costs. IASB voted 9-6 to consider acquisition costs as part of cash flows in measuring an insurance liability whereas FASB voted unanimously to expense acquisition costs at inception without any offsetting revenue;**
- **FASB held an Educational Session to discuss use of an unearned premium reserve (“UPR”) for NLICs and a measurement model for NLICs that does not require discounting or risk margins**

**Pace of joint Board discussions accelerated considerably due to FASB and IASB reaffirming commitment to Memorandum of Understanding in late 2009 and SEC’s recent vote to reaffirm support for a single set of high-quality, globally accepted accounting standards and to establish a work plan as it evaluates whether to recommend incorporating International Financial Reporting Standards (“IFRS”) into the U.S. financial reporting system**

## Fourth Building Block – No Gain at Inception

### **Boards decision to require separate measurement of risk and residual margins**

- GNAIE does not support separate measurement of risk and residual margins; do not believe separation can be accomplished in a reliable manner;
- Risk margins and residual margins may not be comparable between reporting entities and across implementing jurisdictions

### **GNAIE does support a composite margin that is calibrated to no gain at issue and is released as the insurer is released from risk**

- No gain at issue should be measured using all expected cash flows including acquisition and other expenses
- Margin released over coverage period (i.e., period insurance risk protection is provided);
  - Insurance risk protection not provided beyond the coverage period
- Composite margin implicit in UPR for NLICs

## NLICs – Unearned Premium Reserve

### IASB has deliberated use of a UPR; FASB has not

- IASB tentatively decided to **require** use of a UPR for short-duration NLICs
  - IASB indicated at least one field test participant expressed desire to discretionarily apply UPR to NLICs;
  - Response associated with a predominate life insurance company with non-life operations
- FASB discussed UPR in a March 4<sup>th</sup> Educational Session
  - No decisions rendered;
  - Discussion focused on short-duration (contracts with a coverage period of one year or less), short-tail (80% of total incurred claims settled within three years following the year of loss) NLICs;
  - Discussed whether a measurement model for NLICs utilizing a UPR with no discounting or explicit risk margins for uncertainty can meet requirements for a global accounting standard
  - GNAIE believes above model would be appropriate (See correspondence from GNAIE to FASB dated February 5, 2010 and March 12, 2010)
  - GNAIE believes use of a UPR should be **required** for NLICs that are executory (i.e., premiums fully refundable throughout the coverage period for any reason)

# NLIC's – Separate Measurement Model

## FASB Education Session focused on short-duration, short-tail NLICs

- GNAIE Proposal for Short-duration, Short-tail NLICs
  - Utilize UPR; earn premiums pro-rata over coverage period;
  - Measure claims and claims expense reserves at gross ultimate values;
    - Discounting impact insignificant due to short claim resolution period;
    - Impact of risk margins also insignificant due to short resolution period. Absence of objective evidence that risk margins can be implemented and subsequently administered to produce comparable, transparent, decision-useful information for investors does not support their introduction at this time
- GNAIE Proposal for Short-duration, Long-tail NLICs
  - Utilize UPR; earn premiums pro-rata over coverage period;
  - Measure claims and claims expense reserves at gross ultimate values;
    - Discounting incorporated where amount and timing of claims is reliably determinable on an individual claim basis (e.g., Worker's Compensation) consistent with requirements in SEC Staff Accounting Bulletin No. 62;
    - Do not discount in situations where amount of timing of cash flows is not reliably determinable on an individual claim basis;
    - For risk margins; we believe their introduction would not provide relevant, decision-useful information to investors due to the nature of the underlying risk, which is not reliably measurable on an ex-ante basis, and the inputs necessary to develop relevant, reliable, comparable risk margins simply do not exist. Also, relevant information typically would not be available to support changes in risk margins each reporting period



# NLIC's – Separate Measurement Model & Presentation

## Benefit of GNAIE Proposal for Short-duration, Short and Long-tail NLICs

- Long history of reliable, transparent information; easy to understand and capable of verification and audit;
- Under GNAIE proposal if estimated gross undiscounted cost of settling a claim remains unchanged from one period to next, no change in claim reserve recognized. Under four building blocks, even when estimated cost of settling a claim remains unchanged from one period to next, claim reserve may change due to changes in risk margins or interest rates;
- Over time, as multiple vintage years of claims aggregated, will become exceedingly difficult for investors to understand underlying drivers of changes in claim reserves, and linkage to rich historical information in Statutory Schedule P will be lost.

## Boards Not in Agreement on Presentation Model for Insurance

- IASB favors an expanded margin approach;
- FASB favors a summarized margin approach;
- FASB and IASB agreed a traditional premium allocation presentation should not be selected as the presentation model for all insurance contracts but agreed it would be appropriate for contracts required to be measured using a UPR



## LICs – Measurement of Acquisition Costs

### **Boards discussed four alternatives for acquisition costs on March 16<sup>th</sup>**

1. Recognize all acquisition costs as expense when incurred with no premium offset
  2. Direct measurement of contract liability calibrated to premium reduced by excluding incremental acquisition costs
  3. Incremental acquisition costs included in contract cash flows to determine residual margin at contract inception
  4. Intangible asset recognized at amount of incremental acquisition costs
- Nine IASB members voted to support either 2 or 3 whereas FASB voted unanimously for alternative 1
    - Despite vote, FASB members expressed desire to continue consideration of other alternatives;
    - GNAIE believes a substantial mismatching of revenue and expenses will result if acquisition costs are expensed as incurred at issue and no revenue is recognized at that time
    - Would return financial reporting to pre-SFAS 60 situation where analysts would make their own adjustments to earnings for acquisition expenses
    - Many companies would show a negative equity if required to implement retrospectively

## LICs – Discount Rates

### **GNAIE Proposal for LICs Matches Liability Discount Rate with Asset Earned Rate**

- IASB tentative conclusion that discount rate for insurance contracts should capture the characteristics of the liability rather than those implicit in assets supporting the liability;
- FASB has not made any decisions on this topic and will discuss at a future meeting;
- GNAIE believes a mismatching of asset and liability values will result if rates at which liability cash flows are discounted are inconsistent with discount rates used to value the asset cash flows to which the liability cash flows are matched;
- The mismatching would produce artificial volatility of reported financial results that is inconsistent with actual economics of the contracts; resulting in financial information that is not relevant, reliable, or decision-useful for investors.

## LICs – Participating Features

### IASB & FASB Reach Inconsistent Tentative Decisions

- IASB expressed preference for an approach that includes all cash flows that arise from a participating feature in the measurement of the insurance contract on an expected present value basis;
- FASB, in contrast, expressed initial preference for an approach that analyzes cash flows expected to arise from a participating feature to determine whether those flows are required (e.g., by contract or by statute) or are discretionary. Required cash flows would be included in the measurement of the insurance contract whereas discretionary cash flows would not until reporting entity has obligation to make payments;
- GNAIE believes all expected future cash flows attributable to a participating feature should be included in the measurement of the insurance contract on an expected present value basis consistent with the view expressed by the IASB