MINUTES

To:	Board Members
From:	Insurance Contracts Team (Milne, ext. 393)
Subject:	Minutes of the May 18, 2009 Board Meeting: Insurance Contracts
Date:	July 13, 2009
CC:	FASB: Bielstein, Golden, Stoklosa, Chookaszian, Posta, Sutay, Klimek, Gabriele, McGarity, Proestakes, Cropsey, Trench, Milne, Lott, Hood, Brickman, Galloway (GASB), FASB Intranet; IASB: Leisenring, Clark, van der Veen, Hack, Jordan

The Board meeting minutes are provided for the information and convenience of constituents who want to follow the Board's deliberations. All of the conclusions reported are tentative and may be changed at future Board meetings. Decisions become final only after a formal written ballot to issue a final Statement, Interpretation, or FASB Staff Position.

Topic:	Insurance Contracts—Risk Margins and Acquisition Costs
Basis for Discussion:	Board Memorandums No. 21 and No. 22, Appendix A: IASB Agenda Papers and FASB Cover Memorandum
Length of Discussion:	9:50 a.m. to 10:50 a.m.

Attendance:

Board members present:	FASB: Herz, Linsmeier, Seidman, Smith, and Siegel
Board members absent:	IASB: Leisenring
Staff in charge of topic:	Cropsey and Trench
Other staff at Board table:	Golden, Brickman, and Milne
Staff participating by phone:	IASB: Clark and van der Veen

Summary of Decisions Reached

The Board continued deliberations of its joint project on accounting for insurance contracts. The discussion focused on the risk margins an entity would use to measure an insurance liability and how an entity would account for the costs it incurs to acquire insurance contracts (such as sales commissions and underwriting costs).

The Board discussed several aspects of the accounting for risk margins: (1) the need for a risk margin in the measurement of an insurance liability, (2) measurement of the risk margin, and (3) remeasurement of the risk margin. The Board did not reach any decisions on these issues.

The Board decided that an entity should expense all acquisition costs when incurred. It also decided that an entity should not recognize any revenue (or income) to offset those costs incurred.

Objective of Meeting:

The objectives of this meeting were to discuss (1) the use of a risk margin in the measurement of insurance liabilities and (2) the accounting for acquisition costs.

The objectives of the meeting were met.

Matters Discussed and Decisions Reached:

Issue 1—Risk Margins

1. Mr. Cropsey stated that, as defined in the IASB Discussion Paper, *Preliminary Views on Insurance Contracts*, the insurance liability is comprised of three building blocks: the contract cash flows, explicit margins, and the time value of money. He further stated that this meeting will focus on (a) the need for a risk margin in the measurement of an insurance liability, (b) the measurement of the risk margin, and (c) the remeasurement (day 2) of the risk margin.

2. Mr. Cropsey observed that there are many techniques to measure a risk margin. He noted that the most commonly mentioned techniques are those that (a) measure the margin based on achieving a specified confidence level for the liability or (b) measure the cost of bearing the risk in terms of the capital required by a regulator or rating agency to support the risk inherent in the line of business being evaluated.

Staff Recommendations

3. The staff recommends the following:

a. If a contract incurs a day one loss (expected contractual liabilities are greater than expected contractual premium), the loss should be recognized immediately in earnings.

b. The risk margin is the indicator that distinguishes cash flows that otherwise appear to be the same. Without that indicator, the user would not be able to discern the differences in the liabilities that would represent the expected cash flows on the insurer's balance sheet.

c. The measurement method for the risk margin should not be specified. There are numerous acceptable methods by which to measure the risk margin and requiring a particular measurement method is inconsistent with a principles-based approach.

d. The measurement approach for insurance contracts should include a separate risk margin that is remeasured at each reporting date. Because the risk margin is linked to the variability of the expected cash outflows and is intended to be an indicator of the risk (volatility) for those cash flows, it seems appropriate that the risk margin should be updated each time the underlying cash flow is updated (which is every reporting period).

Board Vote

4. No Board decision was reached.

Board Comments

5. Mr. Herz stated that, conceptually, there should be a difference between a contract th*at has* less uncertainty and one that has significant uncertainty. He further stated that understandability and practicality of this measurement are important and, if the uncertainty is not based on a scientific methodology and the numbers tend to vary significantly, he supports uniformity with detailed disclosure of how one arrived at the range estimates. He noted that he did not support a FASB Statement No. 157, *Fair Value Measurements*, Level 3 treatment that relies on significant subjectivity. However, he stated that if insurance companies and actuaries have developed strong, uniform methodologies, he is comfortable using that information. Mr. Cropsey stated that a risk margin is a mathematical construct that is based on the volatility of cash flow stream. He noted that there are assumptions that are part of that number and even though the risk margin is based on a confidence level, it is a calculated number.

6. Mr. Linsmeier stated that he supported not specifying a method for measuring the risk margin, but that he would like the staff to inform the Board about the different ways a risk margin could be calculated.

7. Ms. Seidman stated that the amount reported in relation to the potential cash outflow needs to be updated depending on a current assessment of fulfilling the current obligation. She further stated that updating a risk margin depends on if someone finds that margin useful in evaluating financial statements.

8. Mr. Herz observed that the same methods currently used in practice by regulators and actuaries may be used here. Ms. Seidman noted using the methods used by regulators would be a possibility unless the objective of current practice is to use a worst-case calculation.

9. Mr. Linsmeier stated that linking risk to a profit margin seems to imply a transfer notion. Mr. Golden agreed that *margin* implies *profit* and that there should not be a margin in the estimated claim liability. Mr. Linsmeier pointed out that the probability weighted cash flows should already incorporate the uncertainty of the cash flows in the probability-weighting. He stated that under a fulfillment value notion, an additional risk adjustment is not appropriate because that additional risk adjustment represents the

amount to transfer the contract in a market to arrive at a market price (which is an exit value notion). He further stated that he questioned whether the risk margin represents uncertainty about uncertainty or risk aversion by a market participant.

10. Mr. Herz stated that there needs to be a component related to measurement uncertainty.

11. Mr. Siegel stated that the distinction lies with whether the Board is trying to identify the performance obligation or the claim liability. He stated that if one is measuring the performance obligation, a risk margin is included, but if one is trying to measure the claim liability, the uncertainty should be embedded in the expected cash flows.

12. Mr. Golden stated that to reach a decision in the future, the staff needs to bring to the Board how uncertainty is measured in practice. He also stated that the Board needs to be clear if it is measuring the uncertainty in the claim liability, and not in the performance obligation. He observed that contract boundaries need to be identified first, and then the discussion can focus on what is being measured and how it should be measured.

13. Ms. Seidman stated that even though decisions were not reached, the discussions are consistent with the notion of updating uncertainty in cash outflows. She further stated that the Board needs clarification on the difference between uncertainty and risk margin.

14. Mr. Herz stated that the same single point estimate can result from a probability-weighted normal distribution as well as from a skewed distribution. He further stated that, conceptually, these two distributions should result in different probability-weighted cash flows. He noted that there should be two different cash flow amounts as long as there is some rigor behind calculating these different points and it is directionally correct and justifiable; otherwise, he supports having enhanced disclosures around the uncertainty.

Issue 2—Acquisition Costs

Expense or Defer

15. Mr. Trench stated that under U.S. GAAP, certain acquisition costs can be deferred. He pointed out that paragraph 28 of FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, describes acquisition costs as costs that vary with and are

primarily related to the acquisition of new and renewal insurance contracts. He noted that Statement 60 goes on to identify commissions and other costs, such as salaries of certain employees involved in underwriting and policy issue functions, as potential costs to be deferred.

Staff Recommendation

16. The staff was unable to reach a consensus on this issue for a recommendation.

Board Vote

17. Board members unanimously agreed to expense acquisition costs.

Recognize Revenue (or Income) to Offset Acquisition Costs

18. Mr. Trench stated that some believe that revenue (or income) should be recognized to offset acquisition costs because the premium charged to policyholders incorporates an amount representing the recovery of acquisition costs. He noted that others believe that expensing acquisition costs and not recognizing a portion of the premium provides a simple solution and removes a significant amount of complexity in the financial reporting of insurance contracts.

Staff Recommendation

19. The staff was unable to reach a consensus on this issue for a recommendation.

Board Vote

20. Board members unanimously agreed that no revenue (or income) should be recognized to offset the costs incurred.

Board Comments

21. Mr. Smith questioned why the insurance industry is so different than other industries. He noted that, for example, a car dealership makes a profit from the maintenance on cars rather than the sale of the car. However, car dealerships do not recognize revenue to offset incremental costs related to selling a car.

<u>Follow-up Items:</u>

None.

General Announcements:

None.