

The Financial Reporter

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- 1 Who Makes the Rules (Principles)?**
By Henry Siegel
- 2 Chairperson's Corner**
By Steve Malerich
- 12 Calculating Liquidity Premiums for Insurance Contracts**
By Leonard Reback
- 16 Santa Claus, the Easter Bunny, and the Illiquidity Premium**
By Tricia Matson
- 19 Redefining the DAC Landscape - EITF 9G**
By Rachel Bott and Erik Fasano

Who Makes the Rules (Principles)?

By Henry Siegel

By now, it should be obvious to everyone that the insurance regulatory game has changed. I know you realize that suddenly (or what probably appears suddenly to many) the International Accounting Standards Board (IASB) has become a partner with the Financial Accounting Standards Board (FASB) when it comes to setting GAAP accounting standards.

Nearly every developed country around the world has committed to adopting some form of IFRS well before the end of the decade. The Securities and Exchange Commission has also committed to revisit adopting IFRS in 2011. Further, for many of these countries IFRS will be used for regulatory as well as general purpose reporting. The National Association of Insurance Commissioners (NAIC) is also revisiting that issue as part of its Solvency Modernization Initiative through a Commissioner level task force.

More recently, a similar transformation is taking place in solvency regulation. It's less evident to many because there is no international organization with the authority to impose a single solvency standard on any other country. Europe would like Solvency II to become the standard but there are many who think there are important flaws in this untried system. So where is the impetus for this transformation coming from?

It's coming from the highest level of economic oversight; from the G20, the International Monetary Fund (IMF) and the World Bank. These groups have instituted a Financial Sector Assessment Program (FSAP). Conducted worldwide, the FSAP is designed to address financial sector stability issues through an evaluation of the regulatory rules and practices in all countries measured against internationally recognized standards and codes. For insurance, the Insurance Core Principles developed by the IAIS form the basis for the assessment of regulators' observance of international standards. In other words, the principles of the IAIS are now the international standard

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CHAIRPERSON'S CORNER

As I write this, we're still waiting for an exposure draft for phase II of the International Financial Reporting Standards (IFRS) on accounting for insurance contracts. The International Accounting Standards Board (IASB) had planned to release a draft several months ago. The latest expectation is for release sometime in July, with comments due back to IASB by this fall, about the time you receive this newsletter.

Last year, we began a research project to study the performance of several U.S. products under the draft standards. (We sponsored similar research a few years ago, with an earlier discussion paper.) Given all the delays in the exposure draft, the current study has proven to be a longer project than originally contemplated. We are grateful to all of the volunteer actuarial task forces (ATFs) who have continued to run models and submit results to our researchers throughout the study. Barring any further delays at the IASB, we should have results of the latest study available this fall as well.

About the time we started our IFRS research project, the American Academy of Actuaries formed an IFRS task force to review and comment on the insurance contracts exposure draft. This task force (of which I am a member) has met several times by telephone and even came together in New York City for a face-to-face meeting in June. We have tried to keep abreast of the latest developments in this joint project of the IASB and the Financial Accounting Standards Board (FASB), so that we would be prepared to quickly write a response whenever the draft is finally released.

MARGINS IN INSURANCE CONTRACT MEASUREMENT

Among the issues being discussed between IASB and FASB are margins to be included in the liability, on top of a discounted current estimate of cash flows. Our expectation is the exposure draft will include two alternatives—a composite margin and a combination of risk margin with residual margin—of which only one will be selected for the final standard. Last I heard, the boards are divided on this issue, with FASB favoring (by one vote) the composite margin and IASB favoring (by one vote) the combination of risk and residual margins.

The debate over margins seems to highlight a simple, underlying characteristic of measuring an insurance liability—there is no single right way to measure something that can't be precisely measured. Fundamentally, we really can't know when or what amount of money we will be required to pay under any given contract. Nor can we know precise distributions for measuring the risk. Only when we look at pools of contracts do the mathematics of probability and statistics allow us to make a reasonable, reliable estimate of our commitments. But even then, we're only estimating probabilities and distributions. No matter how precise our calculations, they remain estimates because these key aspects of measurement are themselves estimates.

From what I've heard of the debate, the most forceful argument made in favor of a composite margin is that risk margins would be unreliable. Some have pointed out that different methods of measuring a risk margin can lead to very different results. And, there is so much judgment inherent in any measurement of a risk margin that it would be easy to manipulate results without that manipulation being evident.

Such manipulation might be avoided if the standards were to be very specific about how to measure the margin, but we in the actuarial profession are generally loath to support such a solution to this problem. Given the diversity of risks in all the different types of insurance, we know that there is no single reliable method of measuring risk that works well for all insurance risks. Some methods are simpler and less prone to manipulation, but they are poor measures for at least some insurance risks. Some methods work well for some risks, but poorly for others. What good is a precise, reliable tool that doesn't measure what it's supposed to measure?

On the other side of the debate, the standards setters have generally favored movement toward a market based valuation. Where market values are known or knowable, such values have ruled for some time. Under FAS 115 (now Topic 320) or IAS 39, we have carried most of our invested assets at market value for several years. FAS 157 (now Topic 820) set out standards for the calculation of fair values, even where there is no active market, but did not extend the scope of market valuation to any new categories of assets or liabilities.

Use of a composite margin would essentially calibrate to a market measure at issue of an insurance contract. Arguably, at point of sale a composite margin calibrated to no-gain-at-issue is a market-based measure of risk at that point in time. In subsequent valuations, however, the remaining margin is an amortization of that initial margin; it is no longer a current market-based measure of risk. Whether the objective is called market value, fair value or fulfillment value, an amortized composite margin doesn't do it.

Both sides of this debate accurately depict the weaknesses of the other side. Presumably, the accounting standards boards will eventually decide on one approach to be used in the valuation of insurance contracts. We, in the actuarial profession, hope to influence that decision but doing so will be difficult since we also have differing views in weighing the merits and failings of the alternatives. My hope is that our responses will openly acknowledge the problems of both approaches but go on to emphasize how we, as a profession, can address those problems.

PRINCIPLES OR RULES

Emphasizing our professional abilities in our response to the insurance contracts exposure draft brings to mind the discussions of accounting rules versus accounting principles.

Although we call them principles, GAAP and statutory accounting as we've known them are more sets of accounting rules than principles. Both are founded on principles, but whatever they might have been at one time, they are now sets of rules with which we must comply. IASB has tried to emphasize principles, though we could easily debate how successful they've been in that regard. And, of course, the jury is still out on insurance contracts and IFRS.

Now, let's suppose new IFRS and GAAP standards do shift back to principles, with much less detail about how to comply with those principles. How might we, as a profession, work differently so that the accounting standards setters don't later feel compelled to develop new accounting rules in response to significant innovations in our business? I'll offer one possible scenario. Actuarial support for a set of principles begins at the reporting entity.

First, we discard any past practices where we searched for ways, within the letter of the law, to get an answer we liked with little regard for the principles underlying the law. Instead, we try to answer the question, "How should we apply this to get results consistent with the principles?"

For new products, we would look for a valuation method that produces results consistent with the principles. We know from experience that a method that produces substantial profits in the early years but minimal or negative profits in later years, when substantial risk remains, is probably not a fair application of the principles. (I assume the principles will, in this respect, closely reflect recent communications coming from IASB and FASB.) So we look for a method that spreads expected profit reasonably over the life of the risk.



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CONTINUED ON PAGE 4

Once we determine how to value these new products, we carefully document that process. Documentation will explain not only how we perform the valuation, but how we determined that the method was appropriate, as well.

Support for a set of principles then moves to the auditors (or regulators).

Once again, the question must move away from, "Is it possible to interpret the principles in this way?" to, "Is this method, and the company's stated reasons for choosing it, a good application of the principles?"

Especially in the past 10 years, auditors have shown that they can be tough on interpretation. That will be very important under a true set of accounting principles. Auditors and examiners will look for consistency among reporting entities and take exception to practices that are significantly at odds with others, even if they are not clearly at odds with the letter of the standards. Yet, when something is new, there will need to be some room for differences of application. It would be unreasonable to expect everyone to initially come up with or agree upon the same new method of approaching some new valuation challenge.

Next, we move to the professional actuarial associations.

In the United States, the Actuarial Standards Board (ASB) will publish formal guidance on how much variability should be allowed in the development of new methods, how quickly such methods should converge and, perhaps, what is the best way to document that convergence. Further, the ASB will provide guidance on divergence from established methods when new ideas and new tools bring us possibly better valuation methods.

The Actuarial Board for Counseling and Discipline will be an important source of independent guidance to financial reporting actuaries who are finding it difficult to separate principle-based responsibilities from rule-based responsibilities.

Assuming the new accounting standards are truly international, we may need the International Actuarial Association to provide similar guidance for documentation and convergence across national boundaries.

A PRACTICAL EXAMPLE

Let's suppose now that the international standard of accounting for insurance contracts does move to a valuation using discounted current estimates of cash flows plus a risk margin and a residual margin. Suppose further that the standard setters leave the question of valuing the risk margin to our profession. We will then have a need for guidance in an area where there is no clear answer.

Different actuaries in different practice areas will have to find methods that most effectively value their different products over time. In this example, we already have some literature on the subject. That would be a good starting point for most. Even so, early efforts to put this into practice will likely see some inconsistencies among entities. Through some process, perhaps as I described above, we will see gradual convergence in technique.

WHAT DO YOU THINK?

Do you have any thoughts or opinions about the ideas expressed in this column? Come to our sub-group on LinkedIn and share them with your peers in the Financial Reporting section. ■

against which national insurance regulators are measured.

Now, the IAIS has never been thought of in those terms. The United States, through the NAIC, basically thought of it as a place for less-developed countries to go for help in establishing their own regulatory system. Now it's become suddenly important to the world. This gives all of us another complex organization to monitor and comment on and puts pressure on the NAIC to take an active role at the IAIS.

This doesn't mean we can ignore the NAIC, however. The IAIS only provides the principles; it's up to our domestic regulators to implement them.

At the same time, the new Federal Insurance Office (FIO), included in the Dodd-Frank Act, is authorized "to coordinate Federal efforts and develop Federal policy on prudential aspects of international insurance matters, including representing the United States, as appropriate, in the International Association of Insurance Supervisors (or a successor entity) and assisting the Secretary in negotiating covered agreements. ..." Of course, exactly what "as appropriate" means needs to be worked out, probably between the FIO and the NAIC. What is for certain however, is that we now have a federal office that we need to develop a cooperative relationship with, hopefully similar to the one we have with the NAIC.

Not one to be left behind, the International Actuarial Association (IAA) is also moving to become more relevant to the developed countries. Already, the IAA is the place the IASB goes for actuarial input. The same is largely true for the IAIS. Lacking a large staff, the IAA is heavily reliant on volunteers from its member organizations. That means all of us will need to get active in international activities if we want accounting and regulation to work for us.

That's not all, however. The IAA is also looking into creating an international actuarial standard setting process. The IAA has had a standard setting process for some time but it has been limited to documents similar to practice notes. With the advent of IFRS, however, actuarial standards for compliance may be needed. Additionally, the IAA has created a Task Force on Convergence of Actuarial Standards to study how to



bring actuarial standards together worldwide. This will be a long process and it's not by any means an agreed upon target; but there are many people who do think it would be a good thing.

So let's see what this means to us.

We'll be looking toward the IASB for accounting standards, the IAIS for regulatory standards and the IAA, perhaps, for actuarial standards. None of which were even on the long-distance radar of actuaries 10 years ago. Talk about a complete change in who writes the rules!

WHERE DOES THE ACCOUNTING PROCESS STAND?

The IASB and FASB spent extensive time this quarter on insurance. In addition to multiple hours at the "regular" joint meetings, there were three special meetings in June that dealt primarily with insurance. In fact, there was so much time spent on the insurance contracts project that I can't review it all here.

The June 23 joint meeting seemed to represent a turning point of a sort as the boards appeared to resolve many issues that they were in disagreement about until then and whose resolution was essential to producing a coherent Exposure Draft (ED). Since it is almost certain that the IASB will have issued its Exposure Draft by the time this article is published (Yes, I know the

CONTINUED ON PAGE 6

Boards have said this kind of thing before and I always said to ignore it, but this time I think they really mean it!) I'm only going to try to give a feeling for how the process went and some of the remaining issues rather than to explain their discussions in detail.¹

APRIL

Margins

The IASB and FASB discussed the two approaches to margins they are considering:

- A separate risk adjustment (previously called a risk margin) and a residual margin
- A single composite margin

The boards have given up on trying to resolve their differences on this issue, particularly since each is split almost evenly on it. Accordingly, they decided to discuss what to do if one or the other was eventually agreed upon and they expect to ask for comments on both positions in the Exposure Draft.

inception, the expected present value of the outflows exceeds the expected present value of the premiums. In other words, no separate risk adjustment would be included in determining whether there is a day-one loss under a composite margin approach.

The boards tentatively decided that the composite margin should be released over both the coverage period and the claims handling period and displayed with the insurance liability rather than as a separate liability outside the insurance liability.

Both Boards reached the same contrary conclusions on interest accretion for the composite margin as they had for residual margins.

Discounting

The IASB and FASB discussed what discount rate should be used for insurance contracts and tentatively decided that the discount rate should reflect the characteristics of the contracts, rather than the characteristics of assets actually held to back the contracts, unless the contracts share those characteristics. They tried to clarify this by saying that if the cash flows for the insurance contracts do not depend on the performance of specific assets, the discount rate should be a risk-free rate plus an adjustment for illiquidity.

They also stated that if the amount, timing or uncertainty of cash flows for the insurance contracts depends, wholly or partly, on the performance of specific assets, the measurement of these contracts should consider that fact.

It's important in reviewing these decisions to note that "depend on" is a fairly loose term. For instance, the benefits payable under a universal life policy can directly depend on the earnings of the general account less a margin. Does this fit the definition? A par-whole-life contract pays dividends that largely depend on earnings of the general account—does that count? Probably, the intention is they shouldn't but it could be argued otherwise.

The boards tentatively decided that the residual margin should be part of the insurance liability, rather than a separate liability ...

Risk adjustment and residual margin

The boards tentatively decided that the residual margin should be part of the insurance liability, rather than a separate liability outside the insurance liability and that the residual margin should be disclosed separately. The boards briefly discussed whether interest should be accreted on the residual margins, with the IASB tentatively deciding that interest should be accreted and the FASB tentatively deciding that it should not be accreted.

Composite margin

The IASB and FASB tentatively agreed that, if the initial measurement of an insurance contract results in a negative day-one difference the insurer should recognize that difference (loss) immediately in profit or loss. For this purpose, a day-one loss would arise only if, at

FOOTNOTES

¹ In what follows, much of the language is copied from the IASB's Updates which give the Staff's view of what was accomplished at the meeting being reported on. I do this because just listening to the discussion it's sometimes difficult to tell what was actually decided. Editorial comments, of course, are mine.

Furthermore, the concept of an adjustment for illiquidity was first raised several years ago in this project and no one still seems to know how to determine it. The Europeans are desperately trying to figure it out because they need it for their Embedded Value work and for their Solvency II; but it's far from well-defined at this point.

During the discussion the boards acknowledged and considered concerns raised by some commentators about the discount rate, particularly for long-duration non-participating insurance contracts. Those concerns include the possibility of significant losses at the inception of some contracts (particularly Long-Term Care and Immediate Annuities) and possible accounting mismatches if the discount rate for insurance contracts does not change in response to changes in market credit spreads. [Subsequent to this discussion, the Canadian Finance Minister sent a letter to the IASB strenuously opposing the boards' position and threatening to delay adoption of IFRS if it is not changed.]

After the discussion, the boards did not change their tentative decision but they decided that the forthcoming exposure draft on Insurance Contracts should ask for specific input on this issue.

Contract boundary

The IASB discussed what conditions determine the boundary of an insurance contract. The Board tentatively decided that the boundary of an insurance contract is the point at which the insurer either:

- Is no longer required to provide coverage; or
- Has the right to reassess the risk of the particular policyholder and, as a result, can set a price that fully reflects that risk.

MAY

Margins

The boards once again discussed the measurement approach for insurance contracts and once again ...

- By a narrow margin, the IASB tentatively selected an approach that includes a risk adjustment plus a residual margin;

- By a narrow margin, the FASB tentatively selected an approach that includes a single composite margin.
- The Exposure draft will ask for input on both alternatives. They then continued to discuss each alternative.

Risk adjustment

The boards spent a lot of time discussing the objective for a risk adjustment, together with draft supporting guidance, and tentatively decided:

- That the objective is to reflect the maximum amount that an insurer would rationally pay to be relieved of the risk, taking into consideration that the amount of benefits and claim costs actually paid may exceed the amount expected to be paid. This was confirmed in June;
- That the guidance accompanying this objective should clarify that a risk adjustment would capture the level of uncertainty inherent in the cash flows from the insurance liability from the perspective of the insurer, rather than from the perspective of a market participant, and;
- To limit the range of available techniques to measure the risk adjustment.



CONTINUED ON PAGE 8

This last point is a significant issue for the actuarial profession. There is no good reason why the IASB is competent to set standards on this issue. In fact, if anything, the discussion on the topic would suggest otherwise. They discussed this more in June.

Composite margin

The boards discussed how to amortize a composite margin and considered the application of two possible factors:

- The insurer’s exposure from the provision of insurance coverage, and;
- The insurer’s exposure from uncertainties related to future cash flows.

The boards tentatively decided that these factors should be implemented through the following formula:

$$\frac{\text{(Premium allocated to current period + current period claims and benefits)}}{\text{(Total contract premium + total claims and benefits)}}$$

The boards also affirmed that an insurer should not adjust a composite margin for changes in cash flow estimates.

Exactly how this formula would work in practice is not entirely clear and the ED will no doubt contain additional guidance. For instance, not adjusting for changes in cash flow estimates would not seem to follow earlier discussions on making the composite margin remeasurable. Furthermore, it’s not clear if any of these amounts are discounted or not. All of this would need to be explored by the research expected from the SOA and CAS on this subject.

Level of Measurement

The boards then discussed the issue of the level of measurement and tentatively decided:

- That an entity should measure any risk adjustment at a portfolio level of aggregation;
- To retain the definition of portfolio of contracts in the existing IFRS 4 as Contracts that are subject

to broadly similar risks and managed together as a single portfolio, and;

- That residual or composite margins should be determined at a cohort level of aggregation, by grouping insurance contracts by portfolio and, within the same portfolio, by date of inception of the contract and by length (or life) of the contract.

JUNE

At the special June 1 meeting, the IASB and FASB discussed transition and the measurement of insurance contracts assumed in a portfolio transfer and in a business combination. I won’t deal with the latter here.

Transition

The boards tentatively decided that, at the beginning of the earliest period presented, for each portfolio of insurance contracts that already exists at that date, an insurer:

- Should measure that portfolio as the expected present value of cash flows arising from the portfolio of contracts plus a risk adjustment. The risk adjustment would be included not only when using the approach that uses a separate risk adjustment (the IASB’s approach), but also in the approach that uses a single composite margin (the FASB’s approach);
- Should recognize in opening retained earnings the difference between that measurement and the measurement under the insurer’s previous accounting policies;
- Should not include a residual margin;
- For the approach that uses a single composite margin, the insurer should treat the risk adjustment determined at the beginning of the earliest period as the composite margin at that date. The insurer should disclose the subsequent run-off of that composite margin separately from disclosure of the run-off of composite margins arising after transition, and;
- Should derecognize any intangible assets arising from insurance contracts assumed in previously-recognized business combinations, with a cor-

responding adjustment to retained earnings. (That adjustment would not affect intangible assets, such as customer relationships and customer lists, which relate to possible future contracts.) Similarly, an insurer should derecognize any existing balances of deferred acquisition costs, with a corresponding adjustment to retained earnings.

The boards also tentatively decided that an entity issuing insurance contracts should be permitted, when it adopts the future insurance contracts standard, to redesignate a financial asset as measured at fair value through profit or loss at the start of the earliest period presented, if doing so would eliminate or significantly reduce an inconsistency in measurement or recognition.

The boards did not discuss the effective date, or whether to permit early adoption. The boards plan to consider those matters collectively for standards to be completed by June 30, 2011. The staff reminded the boards that in developing the requirements published in November 2009 in IFRS 9 Financial Instruments, the IASB noted that it would consider delaying the effective date of IFRS 9 if the new IFRS on insurance contracts had a mandatory effective date later than 2013, so that an insurer would not have to face two rounds of changes in a short period.

These decisions are different from the staff proposal to use the existing liability as the starting point and to determine a composite margin (if that's the approach used) by subtracting the current cash flow estimate from that reserve.

On June 10, 2010 the boards discussed participating investment contracts and risk adjustment techniques.

Participating investment contracts

The boards discussed whether investment contracts with a discretionary participation feature should be within the scope of a future standard on Insurance Contracts or else within the scope of a standard on Financial Instruments.

The IASB tentatively decided to include investment contracts that both contain a discretionary participating feature and also participate in the same pool of assets as

participating insurance contracts within the scope of the future standard on Insurance Contracts. The FASB tentatively decided to include these investment contracts in the scope of standards on Financial Instruments.

Nothing new was decided on risk adjustment techniques.

At its June 14 – 17 meeting the IASB and FASB discussed:

- Draft application guidance on cash flows;
- Draft application guidance on risk adjustment techniques;
- Insurance contracts with cash flows denominated in foreign currency;
- Reinsurance follow-up issues, and;
- An overview of the proposed model for insurance contracts, focusing on the main differences between the tentative decisions of the boards.

Draft application guidance on cash flows

Staff presented an initial paper on how to estimate cash flows. For life contracts it was a reasonable first cut but it's likely that the IAA and other actuarial organizations will have important comments on whatever is included in the ED.

Draft guidance on risk adjustment techniques

The boards discussed draft guidance on risk adjustment techniques, for inclusion in the approach that uses a risk adjustment plus a residual margin, and tentatively decided to permit the following techniques for determining risk adjustments and no others:

- Confidence interval;
- Conditional tail expectation (CTE), and;
- Cost of capital.

One can, again, only be amazed that the boards feel competent to make this kind of rules-based decision in what is supposed to be a principle-based system.

CONTINUED ON PAGE 10

Furthermore, it makes it impossible to reflect improvements in techniques and technology should they happen in the future. It would be far better if the IASB simply required that the risk margins fit actuarial standards promulgated by the IAA and any domestic actuarial standards. This would put the IAA to the test, one I believe it can and should be able to pass.

With regard to areas of difference, not much progress was achieved at this meeting.

...the FASB affirmed that the proposed unbundling principle would apply to embedded derivatives ...

Insurance risk

The boards discussed the notion of insurance risk in the context of the definition of an insurance contract. The FASB affirmed, and the IASB tentatively decided (since they had not considered it previously) that a contract does not transfer insurance risk if there is no scenario in which the present value of net cash outflows can exceed the present value of premiums. This point was not included in IFRS 4.

Embedded derivatives

The boards tentatively adopted an unbundling principle that requires an insurer to account separately for components of an insurance contract, unless the components are so interdependent that they cannot be measured separately. The boards reconsidered their previous decisions on the interaction of this principle with existing requirements for embedded derivatives and:

- The FASB affirmed that the proposed unbundling principle would apply to embedded derivatives, so that an insurer would separate them from the host insurance contract unless they are so interdependent that they cannot be measured separately from the host contract. This would replace existing requirements to bifurcate some embedded derivatives embedded in insurance contracts, and;

- The IASB noted that if a derivative embedded in an insurance contract does not qualify for separate accounting under the proposed unbundling principle, existing requirements in IAS 39 Financial Instruments: Recognition and Measurement would never require the insurer to account for the derivative separately. Accordingly, the proposed unbundling principle would suffice and it would be unnecessary to apply the criteria in IAS 39 as well.

The June 23 meeting

All of this was a prelude to the June 23 meeting. At this meeting, staff introduced a paper that defined which cash flows would be included in the cash flows used for measuring the liability. Amazingly, it included incremental acquisition expenses as well as policyholder dividends on participating policies, all renewal premiums and discretionary benefits on universal life and similar contracts. Even more amazingly, both boards agreed to this definition. After years of disagreement and false starts, both boards have come very close to accepting the principles that had been proposed years ago by the industry and the actuarial profession. While the language remains to be written and things can certainly change, for the first time it appears that the joint project has a chance at success.

No one has said what caused this change of mind on behalf of both boards, most importantly by FASB. Undoubtedly there has been a lot of pressure on them to resolve the acquisition cost issue and the other cash flow issues also gave rise to strange results that appeared wrong on their face.

At this meeting, the boards also asked staff to develop an unbundling principle based on whether a component can introduce variability in the overall cash flows of the insurance contract for risks that are not considered part of the provision of insurance protection. If such a notion is not practicable, then the ED will be based on the old interdependence principle.

The Board also clarified the principle for presentation even further. They confirmed the margin approach to presentation (premium will be a deposit but included in disclosures) and will ask specific questions about this approach in the ED.

What's next?

Assuming the Exposure Draft will be out by August, we'll be spending the next three or four months preparing comments. There are likely to be lots of those. What type of margin to hold is not resolved nor is the discount rate. The proposed presentation methodology is also likely to raise complaints from those who comment on the ED since it will significantly alter the income statement for life insurance.

Every actuary needs to read the Exposure Draft carefully—unless changed it will form the basis for all public entity accounting, and possibly regulatory accounting, for the foreseeable future. There will be enough concerns for everyone to take a hand.

And remember:

Insurance accounting is too important to be left to the accountants! ■



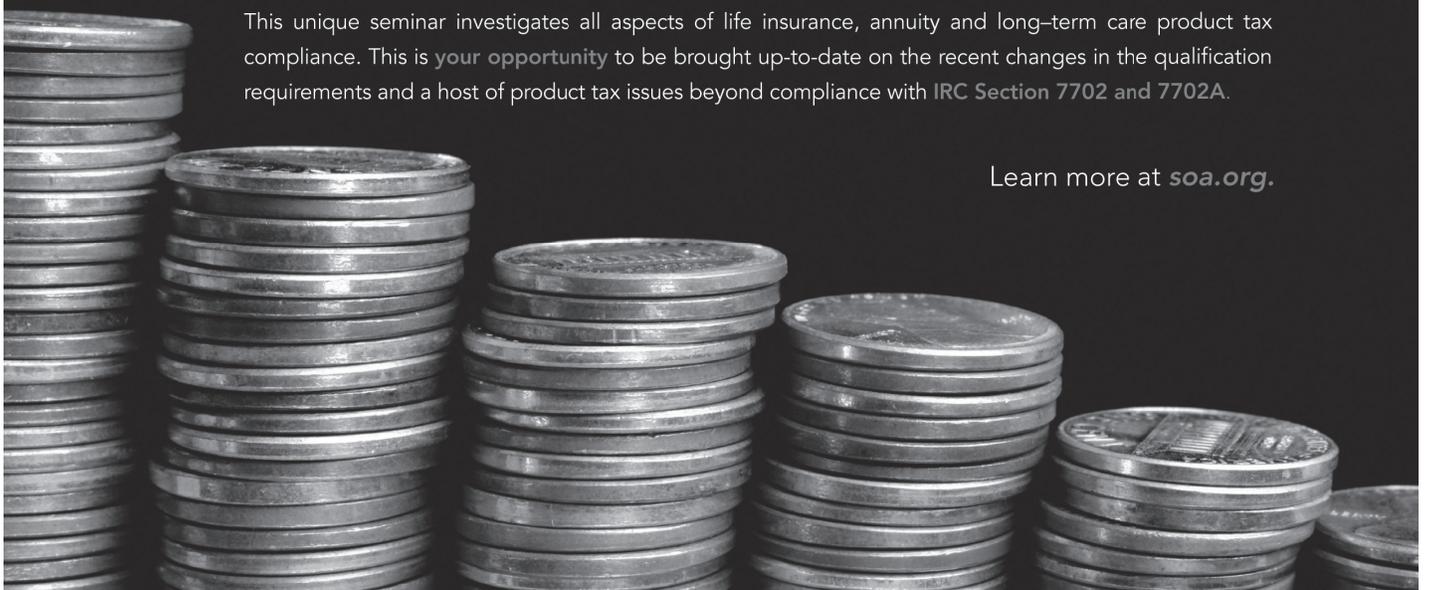
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Calculating Liquidity Premiums for Insurance Contracts

By Leonard Reback



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The current decision by the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) in their joint insurance contracts project is to discount liabilities at a risk-free rate plus an adjustment for the difference in liquidity between certain insurance contracts and risk-free instruments. How to calculate this liquidity premium has not been specified, and there is clearly confusion as to how this would be done. Even board members have expressed concerns about how a liquidity premium could be calculated.

The Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) has made a proposal for calculating liquidity premiums that was included in the appendix to the agenda paper used by the boards in their discount rate discussion. Under the CEIOPS proposal, the liquidity premium would usually be insignificant, but in times of financial market stress a significant liquidity premium could be calculated using a structural model or by comparing the spread on corporate bonds with the spread on credit default swaps.¹ However, the liquidity premium in the CEIOPS proposal addresses illiquid financial markets. It does not deal with the illiquidity associated with particular insurance contracts, which appears to be the objective of the IASB/FASB decision.

significantly higher than risk-free rates, some other factor must account for insurers' willingness to pay such rates, while still achieving acceptable returns on capital in a competitive market. And contract illiquidity is likely a significant factor, since many insurance contracts have significant restrictions on a policyholder's ability to access the value of the contract for cash. In contracts such as disability income insurance or life payout annuities, the policyholder's ability to access cash in exchange for the value of his or her contract is far less than in any publicly traded financial instrument, since by definition a holder of a publicly traded instrument can quickly access cash by selling the instrument. The illiquidity of insurance contracts is a factor under all market conditions, not just in stressed markets such as during the financial crisis. Thus the CEIOPS approach would understate the discount rate and overstate the liability value under most market conditions. This would likely result in artificial losses being reported upon the issue of contracts that are expected to be profitable.

MEANING OF LIQUIDITY PREMIUM

It may be worth a brief digression to describe how illiquidity may impact an insurance liability. Financial textbooks are not unanimous in their definition of liquidity and illiquidity, but they generally define liquidity in terms of the ability of the asset holder to

... the liquidity premium represents the amount the liability holder ... needs to compensate the asset holder.

Nor do I believe the CEIOPS approach would generate an appropriate insurance liability value. After all, many insurance contracts credit an interest rate greater than the risk-free rate.² While some of the excess interest credit could be related to own credit risk, the own credit risk for an insurance contract issued by a regulated insurance entity is very small. This was acknowledged by the boards when they decided that including own credit in the insurance contracts discount rate is unnecessary.³ If own credit is not the reason for insurance contracts carrying interest rates

FOOTNOTES

- ¹ Under a structural model, a company's credit risk is determined by valuing the company's equity as a call option on the company's assets, using a Black-Scholes model. Under the CEIOPS proposal, in times of stressed markets the company's credit risk would be determined using a structural model, such as the Merton model. This credit spread would then be deducted from the interest rate on the company's debt to determine the liquidity premium.
- ² For this purpose, the credited rate might be explicitly stated (as in a universal life contract or deferred annuity) or implicit in the premium or dividend (as in a traditional contract). In the case of an explicitly stated credited rate, the credited used for this purpose needs to be the rate before deductions for the cost of services and guarantees. Although credited rates are typically reduced for the cost of services (such as acquisition costs) and guarantees (such as minimum interest guarantees) these items are not elements of the time value of money, and should be considered as separate fees for purposes of determining the discount rate within the context of the insurance contracts project.
- ³ The Boards' joint paper *Reducing Complexity in Reporting Financial Instruments* (2008) makes similar points about customer obligations of regulated entities.



quickly convert the fair value of the instrument to cash.⁴ So the liquidity premium represents the amount the liability holder, in this case the insurer, needs to compensate the asset holder, in this case the policyholder, for the fact that the asset holder is unable to quickly convert the fair value of the instrument into cash. A less liquid instrument would generally require a larger liquidity premium. For example, a bank checking account is very liquid since the account holder need only write a check to access cash. A bank savings account is at least somewhat less liquid because the bank has the right to delay payment (although in practice this right is rarely exercised) and might not provide cash access by simply writing a check. And bank savings accounts generally carry higher interest rates than checking accounts.

Taking an insurance example, a three-year SPDA with a market value adjustment and a surrender charge is less liquid than a three-year zero coupon Treasury bond. Both instruments' values should respond similarly to changes in interest rates. But the Treasury bond holder can quickly and easily convert the fair value to cash by selling the bond in a deep secondary market. The SPDA asset holder cannot quickly access a deep secondary market, and will incur a surrender charge reduction to fair value by surrendering the SPDA to the insurer. The insurer may also have the right to delay payment, which is a reduction in liquidity, even though such rights are rarely exercised. So, even without reflecting any credit quality differences between the Treasury bond and the SPDA, the insurer would need to credit a higher interest rate to compensate the policyholder for the SPDA's relative illiquidity. A life payout annuity is even less liquid than an SPDA, since there is generally no cash surrender at all. So we should expect that a life payout annuity would generally carry a larger liquidity premium than a market value adjusted SPDA.

POSSIBLE MEASUREMENT APPROACH

So how can a liquidity premium be measured? Probably not from looking at transactions of market traded instruments, since any market traded instrument is likely to have significantly greater liquidity than many

insurance contracts, such as disability income insurance or life payout annuities. However, there are arms-length transactions of insurance contracts that indicate the appropriate interest rate for an insurance contract—the initial sale of a contract between the insurer and the policyholder. The interest rate included in newly sold insurance contracts should include an appropriate liquidity premium. If the liquidity premium in the contract interest rate in newly sold contracts is too low, then customers would not be induced to purchase the contract.⁵ If the liquidity premium in newly sold

FOOTNOTES

⁴ For example, Downs & Goodman (2010) Dictionary of Finance and Investment Terms defines liquidity as "ability to buy or sell an asset quickly and in large volume without substantially affecting the asset's price. ... Liquidity also refers to the ability to convert to cash quickly." Morowski (2008) *Investment Decisions on Illiquid Assets* notes that "a quick sale of an illiquid asset is only possible at a discount to the fair value, but a higher price can be achieved if a time consuming liquidation process is conducted."

⁵ Arguably, the liquidity premium included in the credited rate for some insurance contracts is too low. An example may be life payout annuities. Although the risk of outliving one's income is well known, customers are reluctant to buy life annuities because they are reluctant to tie up their money in this manner. This is a classic and extreme liquidity issue. If insurers were able to credit a high enough liquidity premium to overcome customers' reluctance to tie up their money, more life annuities would be sold to meet the social need of insuring against outliving one's income. The fact that insurers are unable to credit a high enough liquidity premium (in large part because illiquid enough assets with high enough liquidity premiums are unavailable) is an indication that the liquidity adjustment within newly sold life annuities premiums is too low.

CONTINUED ON PAGE 14

contracts is too high, insurers would not be willing to sell the contract. So the appropriate liquidity premium for the valuation discount rate could be measured as the difference between the credited rate on newly sold contracts and the risk-free rate.⁶ A clear advantage of this approach is that the discount rate for newly issued contracts would be consistent with the credited rate, avoiding artificial losses when contracts are sold.

Of course, the interest rate in newly sold contracts also includes an element for own credit, but for a regulated insurance entity, the impact from own credit should be very small, and so only a small adjustment, if any, should be necessary. Even if the adjustment for own credit is difficult to measure⁷, it still could not be wrong by more than a few basis points.

Another issue with using the credited rate on newly issued contracts to determine the liquidity premium for the discount rate is that newly issued contracts may not have identical characteristics as in-force contracts. Of course, to the extent that new issues are significantly different from in-force contracts, the liquidity premium derived from new issues may not be directly applicable to the in-force contracts. But to the extent that the new issues do have similar characteristics to in-force contracts, the credited rate on new issues at least provides a starting point for determining the liquidity premium on the in-force contract. For example, a newly issued disability income contract may not have the exact same liquidity characteristics as a disability income contract sold five years earlier, but the liquidity characteristics of the new disability income contract is probably more similar to those of the five-year-old contract than those of any market traded instrument. In an extreme case, for a pure life-contingent payout annuity, the liquidity of a newly issued contract will be identical to that of any in-force, pure life-contingent payout annuity to the same customer.

A more serious problem with using the credited rate on newly issued contracts to determine liquidity premiums is that this approach presumes the pricing of the new contracts is correct. There are a number of reasons why this may not be the case. The insurer may be pricing over aggressively in an attempt to win market share,

for example. Or the insurer may be underestimating the potential default losses from high-yield bond investments, and passing the gains to the policyholders.⁸ Alternatively, the insurer may be overpricing a particular contract for strategic reasons. There is a way to avoid this problem. Reinsurers are also regulated entities that transact at arms length in insurance risks. Thus the current interest rate that a reinsurer would credit if it assumed the insurance contract being valued would incorporate an appropriate liquidity premium. That rate would also incorporate own credit, but as a regulated entity, the impact of own credit should be very small, similar to that of most direct insurers. Since reinsurers may assume in force contracts as well as newly issued contracts, the rate a reinsurer would credit could be valid for either type of contract.

A problem with using the liquidity premium that a reinsurer would credit is that reinsurance transactions do not take place all the time, and the pricing is not transparent. However, this is no different than the situation faced when applying fair value guidance for insurance contracts (in a business combination, for example) or embedded derivatives within insurance contracts (such as variable annuity guarantees). These contracts or benefits do not trade in active, observable markets. But the accounting rules still require the valuation to apply assumptions that a market participant would use in determining a transaction price. And insurers are

FOOTNOTES

- ⁶ As noted above, the credited rate may be implicit or explicitly stated, and if explicitly stated, the rate used for this purpose needs to be the rate before any deductions for the cost of services and guarantees, which may be higher than the actual stated credited rate.
- ⁷ One possible approach to estimating the own credit impact within the insurance contract credited rate would be to look to historical default rates net of recovery percentages for insurance companies with the same credit rating. This would likely be 10 basis points or less for any regulated U.S. insurer. This approach would not be consistent with a risk-neutral valuation, but since the measurement attribute in the insurance contracts project is not fair value, deviations from a risk-neutral valuation should be appropriate.
- ⁸ If the measurement objective for the insurance contracts project was fair value, then arguably any assumption of potential earnings over risk-free rates would be too high. In other words, the default assumption would have to equal any excess spreads, and no liquidity premium would emerge. However, the measurement objective for the insurance contracts project is current fulfillment value, not fair value, and so there is no necessity of assuming any earnings over risk free would be offset by defaults. In any case, under a fair value measurement objective, the discount rate would be increased for own credit.

able to apply the fair value guidance for these contracts and benefits, sometimes using hypothetical reinsurance pricing bases as inputs to determining the appropriate valuation assumptions. Similarly, insurers could use hypothetical reinsurance pricing bases to estimate the appropriate liquidity premium for an insurance contract valuation under the proposed IFRS/GAAP guidance.

In most cases, the insurer would not even need to go so far as trying to estimate the hypothetical reinsurance pricing basis. Generally, an insurer would have good reason to believe that its pricing is consistent with how a reinsurer would price the contract. In that case it would be clear that the insurer's credited rate would be similar to the rate a reinsurer would credit and so the insurer's credited rates would be appropriate for determining the liquidity premium. In such cases, the insurer's own credited rates would be an appropriate basis for determining the liquidity premium, without explicit reference to any particular reinsurer's hypothetical credited rate. Only in cases where an insurer is pricing over-aggressively (or under-aggressively) would the insurer need to estimate a reinsurance pricing basis (either on its own volition or under prodding from its auditor). Similarly, an appropriate replicating portfolio approach would likely generate a similar liquidity premium to a hypothetical reinsurance pricing rate, under an assumption that the reinsurer would likely base its pricing on a similar portfolio. Although in most cases looking to a reinsurer credited rate would not produce a different liquidity premium from the insurer's own credited rates, using a hypothetical reinsurer's credited rate as part of the measurement objective would add an important element of discipline to the process, and provide a basis for auditors to challenge the insurer's assumption. For example, if an insurer is aware that its credited rates are out of line with other insurers, those rates would likely be out of line with reinsurance credited rates as well. In such cases, an adjustment to the insurer's credited rate would be appropriate when calculating its liquidity premium.

SUMMARY

In summary, IASB and FASB have tentatively decided that the discount rate used when calculating insurance

liabilities in their joint insurance contracts project should include a liquidity premium. But they provide no guidance as to how such a liquidity premium should be calculated. In the absence of such guidance, auditors may be reluctant to permit any liquidity premium. Alternatively, under the proposed CEIOPS approach, a liquidity premium to the discount rate would only be permitted in times of general market illiquidity. This could generate artificial GAAP/IFRS accounting losses upon the sale of profitable contracts. This would be especially problematic for insurance contracts such as disability income or life payout annuities, which are far more illiquid than any publicly traded instrument.

However, insurers have information on the rate over risk free that they need to credit new policyholders at the point of sale. Although this rate includes compensation for both own credit and illiquidity, the boards have acknowledged that own credit in an insurance contract issued by a regulated insurer is small. Thus, the rates at which insurers sell contracts provide a good estimate of the appropriate liquidity premium for contracts with similar illiquidity characteristics. However, using an insurer's own credited rates has the disadvantage of possibly misstating the liquidity premium if the insurer's credited rates are significantly different from other insurers.

One method to add rigor to the process would be to determine the liquidity premium by reference to the liquidity premium that a hypothetical reinsurer would include in its credited rates on assumed business. Like the insurer, nearly all of a regulated reinsurer's credited rate in excess of risk free rates could be attributed to liquidity. This reference to a reinsurer's credited rate would be a hypothetical construct, similar to the approach taken in FAS 157 for fair value calculations, where assumptions are based on a hypothetical exit market participant even if an exit market for the product does not exist. Although it would be a hypothetical construct and generally not actually calculated, thinking about the liquidity premium from the standpoint of a different entity would add discipline to the process and provide a basis for auditors to challenge aggressive or conservative assumptions. ■

Santa Claus, the Easter Bunny, and the Illiquidity Premium

By Tricia Matson



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There has been a significant amount of interest and debate in the U.S. industry recently regarding the use of fair value or market consistent measurement for the valuation of insurance liabilities. This has been driven by a variety of factors, including:

- Development of and growth in insurance products that “look like” financial instruments,
- Increased globalization of the insurance industry leading to increased use of international measurement metrics (such as Market Consistent Embedded Value (MCEV)) in the United States,
- Changes in accounting standards, including Financial Accounting Standards No. 133 and No. 157 and IFRS Phase II for insurance contracts, and
- Evolution of European regulatory requirements including the United Kingdom’s Individual Capital Assessment rules and the recently developed guidance of Solvency II.

As a result, “fair value” is increasingly being used as a measurement metric for insurance liabilities, and significant debate is underway as to its appropriateness and definition, in particular with respect to the treatment of returns on underlying assets backing the liabilities and associated discount rates.

This article covers the following key areas of debate with respect to the fair valuation of liabilities:

- Assumed Returns on Assets,
- Use of an Illiquidity Premium, and
- Adjustment for Own Credit

ASSUMED RETURNS ON ASSETS

The valuation of liabilities in the United States has historically been based on assumed returns on assets (and therefore discount rates) that reflect the expected earned rates on the assets backing those liabilities. In the case of a “real world” valuation (most U.S. statutory and US GAAP approaches), this would be roughly equivalent to the expected return on a high quality corporate bond portfolio.

A typical fair value approach would use a risk neutral valuation, consistent with methods commonly used to value financial instruments. Under a risk neutral approach, the assumed earned rate is typically set equal to the risk free rate, and the liability is valued by projecting the liability cash flows using a range of scenarios that are designed to reflect the current market view of the volatility of those cash flows.

A basic premise that underlies the risk neutral approach is that market pricing does not allow for arbitrage—that in an actively trading market an investor cannot earn a greater return than the risk-free rate without taking on additional risk. Therefore, in pricing a financial instrument, it is assumed that the investor will earn the risk-free rate since any additional return, over and above the risk-free rate, is “offset” by an increase in the possibility of loss.

To illustrate by example, take the case of a portfolio of corporate bonds owned by an insurer to back a portfolio of fixed annuities. Under traditional “real world” actuarial measures, the assumed earned rates on the bond portfolio would be used to value the liabilities. If the risk-free rate (assuming a flat yield curve) were 3 percent and credit spreads 2 percent, the assumed earned rate would be 5 percent.

Under a risk-neutral valuation, the rate used in the liability valuation would be 3 percent. Although it is true that the bond portfolio has an expected return of 5 percent, this is prior to consideration of the risk of loss. The reason investors in the bonds are offered a rate greater than the risk-free rate is precisely because of the additional risk—in this case the risk of default of the issuers of the bonds (for simplicity, no additional illiquidity risk exists in this example). At the time of the valuation, if credit spreads are 2 percent, it means that the market’s view of the default cost on the bonds is a loss of approximately 2 percent of the return over time. While it is true that the actual level of default may ultimately be less, and therefore the bondholder may ultimately earn more than the risk-free rate, market pricing does not allow the bondholder to take credit for that additional return until it has occurred—i.e., over time as the investor is released from risk.

Valuation of insurance contracts under a real world approach is generally based on historical levels of returns which have clearly exceeded the levels of risk-free rates. The risk-neutral premise does not preclude recognizing “excess” returns, it just does not allow for their recognition until the investor has been released from the associated risk of loss.

It can be viewed in a very similar way as the treatment of insurance risk in traditional valuation techniques. Most would likely agree that the expected provisions for adverse deviation or margins in insurance product prices should not be recognized up front at the time the product is sold, but should be earned over time as the insurer is released from risk. This same concept is what drives the use of a risk-free return assumption in a fair valuation. Not until the investor is released from the risk is the excess return recognized as earned.

USE OF AN ILLIQUIDITY PREMIUM

Even in instances in which there is general agreement that the current market’s view of future default cost on the investments supporting the liability should be reflected in the fair value of a liability, there remains debate on the extent to which current credit spreads are entirely related to expected default or whether there is an additional component of spread due to illiquidity of the underlying instruments. In general, it is expected that, all else equal, a higher return is required by an investor for an instrument that is not actively traded as compared to one that is. Since insurance liabilities are generally not tradable instruments, but are held to maturity (other than those that lapse), they logically would qualify for an illiquidity premium adjustment under a fair valuation.

The challenge of course is quantifying the illiquidity premium. Because risk neutral valuation generally relies on calibration to market pricing in liquid markets, treatment of illiquidity premium is one of the areas that is not handled easily within a risk-neutral valuation. Discussion of the quantification of the illiquidity premium is outside the scope of this article. There is an excellent paper on the topic produced by CEIOPS’ Task Force on the Liquidity Premium (<http://www.ceiops.eu/content/view/724/1/>) for those

interested in further details. However, I will address one common misperception with respect to illiquidity premium—that the spread for illiquidity can be determined by comparison of implied default risk (e.g., credit spreads), to actual historical defaults. Consider a simple example, in which we are ignoring any components of spread beyond default and illiquidity. If 2008 credit spreads were 500 bps on high quality corporate bonds, and we observe over the next 30 years an actual default rate on those bonds of 100 bps, could that imply a 400 bps liquidity premium? The answer is no. As described above, the market’s price (e.g., current spread) is meant to incorporate both amount of risk AND volatility of risk (as well as other components), so credit spreads will not fully translate into actual losses, since a component of the spread is the cost of the potential volatility in default cost. Therefore, in the example, if 100 bps was the actual default cost, another component (say 200 bps) was to cover the cost of the potential of even higher losses, or the volatility risk, and another component may be to cover illiquidity, depending on how liquid the bonds are.

ADJUSTMENT FOR OWN CREDIT

Possibly the most contentious item associated with fair valuation is the adjustment for own credit risk. This adjustment involves reflecting in a liability valuation the chance of non-payment by the issuer of the contract, namely the insurer. If the financial stability of the insurer decreases, and therefore the insurer is less likely to pay the policyholder (ignore for simplicity the potential payment from a State Guarantee Fund), the fair value of the liability will decrease.

Historically, valuation of insurance liabilities has been founded in conservatism. Statutory valuation is designed to protect the policyholder. Even early GAAP valuation under FAS 60 involved margins for adverse deviation. If the goal of a valuation is policyholder protection as it is under U.S. Statutory, then of course you would not want a mechanism by which reserves *decrease* when the insurer’s financial stability is impaired.

However, if the goal is to report a market-consistent fair value, all market participant considerations should

CONTINUED ON PAGE 18

be included, including the risk of non-payment. If a corporation issues a bond, the fair value of that bond on the holder's financials *and* the issuer's financials would fully reflect the likelihood that the issuer does not pay (e.g., defaults). Similarly, the valuation of liabilities would reflect a market participant's view on the likelihood of payment of the obligations. This market participant view would reflect all components of the risk of nonpayment, including items such as the relative seniority of the payments.

SUMMARY

The above discussion covers just a portion of the significant debate in the industry regarding fair value of liabilities for insurance. The goal of this article is not to advocate for fair value as the "correct" measurement metric, nor that determining the right approach to fair value is easy. It is one approach that in the right circum-

stances can provide useful information to management and shareholders, but certainly not the right approach in every circumstance. It is fraught with challenge, and illiquidity premium is one very relevant example of the challenge. A large premium for illiquidity, like Santa Claus, is appealing for many reasons. And like the parents that put the presents under the tree, there is a component of it that is real. However, if fair value is the goal, we can't believe in Santa Claus.

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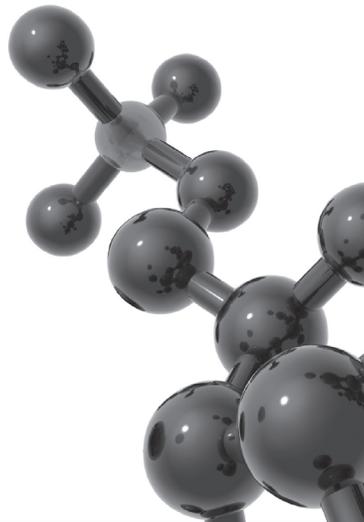
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Redefining the DAC Landscape – EITF 9G

by Rachel Bott and Erik Fasano

Insurance companies defer a number of costs that relate to the sale of insurance policies and those deferred policy acquisition costs (DAC) are a significant asset on a company's balance sheet. The types of costs deferred in DAC vary across companies and possibly across product lines within the same company. Following a review of certain insurance companies' financial statements, the Securities and Exchange Committee (SEC) staff informally questioned the nature of certain costs being included in DAC. From the financial statement disclosures and inquiries, we believe the SEC staff observed a variety of practices as to the costs insurance companies capitalize in DAC. Concerns arose about the possible capitalization of certain costs, such as advertising and overhead costs, that were not consistent with the SEC staff's view of the intent of the existing guidance.

Currently, US GAAP specifies that an acquisition cost may be capitalized if it varies with and is primarily related to insurance contracts issued or renewed (ASC 944-30).¹ The definitions of "vary" and "primarily related" are imprecise and, as a result, diversity in practice has developed around whether certain costs are capitalizable. During the SEC staff's informal questioning process, they posed the issue to the FASB staff to seek clarification of the phrase "vary with and are primarily related to the acquisition of insurance contracts." The question to the FASB staff resulted in this item being added to the Emerging Issues Task Force (EITF) agenda.

The initial EITF discussion in November 2009 resulted in proposed changes to the definition of acquisition costs and EITF Issue 09-G, "Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts" (EITF 09-G), was issued for comment. The proposed definition of deferrable acquisition costs would include those costs "directly related to the successful acquisition of a new or renewal insurance contract."

Next, in March 2010, the EITF discussed the comment letters received on the proposed changes and revised their previous conclusions for the guidance. Following the March meeting, an EITF 09-G working group, consisting of professionals from industry, insurance

companies and auditing firms, was formed and met with the FASB staff and several EITF members to discuss the practical implications of the revised proposed changes, including concerns for transition and timing of the effective date.

The EITF continued its discussion of EITF 09-G at the July 29 EITF meeting and instructed the FASB staff to post a "staff draft" of the consensus on the FASB website², which allows the EITF members and others to review the revisions to the guidance. The EITF intends to vote for a final consensus on this issue at its September 16 meeting. We expect the amendment will define acquisition costs as, "Costs that are directly related to the successful acquisition of new or renewal insurance contracts." In addition, the consensus of the EITF was that the guidance for deferrable costs is to be aligned with the loan origination cost capitalization model in ASC 310-20, *Receivables – Nonrefundable Fees and Other Costs*, (formerly referred to as FASB Statement No. 91), which is a more restrictive standard than the proposal that was exposed following the March meeting.

Based on the amended definition, the following costs would be capitalizable:

- Incremental direct costs of a successful contract acquisition incurred with independent third parties—those costs that result directly from and are essential to the acquisition of the contract and would not have been incurred had the contract not been acquired. For example, a non-employee agent or broker commission and/or bonuses and third-party medical or inspection fees.
- The portion of an employee's total compensation and payroll related fringe benefits directly related to time spent performing acquisition activities for a contract that has actually been acquired. Acquisition activities include under-



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FOOTNOTES

¹ ASC 944-30-20 defines acquisition costs as, "Costs incurred in the acquisition of new and renewal insurance contracts. Acquisition costs include those costs that vary with and are primarily related to the acquisition of insurance contracts."

² EITF section of the FASB website at: <http://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1218220137512>

writing, policy issuance and processing, medical and inspection, and sales force contract selling.

- Other costs related to acquisition activities that would not have been incurred if the contract had not been acquired.
- Advertising costs that meet the capitalization criteria in ASC 310-20.

The EITF concluded that costs paid to an independent third party should follow different criteria for capitalization than similar costs incurred internally. This led to an extended discussion on the difference between an employee and an independent third party and whether previous accounting literature would be adequate to determine what constitutes an employee.

We expect the revised guidance to be consistent with the EITF's previous conclusions and affirm that all other acquisition-related costs, such as costs incurred by the insurer for soliciting potential customers, market research, training, administration, product development, and unsuccessful acquisition or renewal efforts would be charged to expense as incurred. Administrative costs, rent, depreciation, occupancy, equipment and all other general overhead costs also would be charged to expense as incurred.

The EITF concluded that costs paid to an independent third party should follow different criteria for capitalization than similar costs incurred internally.

At the July meeting, the EITF concluded that a company should follow the requirements in ASC 340-20³ to determine what costs can be capitalized as direct-response advertising, and then include them as DAC for classification, subsequent measurement, amortization, and deficiency analysis once they have been capitalized.

The proposed guidance includes an election that permits an entity to continue using its current accounting policy if it results in fewer costs being capitalized than

will be required under the final guidance, provided that all the costs currently capitalized by the company would qualify for capitalization under the proposed model.

The most recent consensus proposes an effective date of fiscal years beginning after Dec. 15, 2011, and interim periods within those fiscal years. Companies may apply the revised guidance either prospectively or retrospectively. For calendar-year companies, the guidance would apply as of Jan. 1, 2012. If a company chooses to implement the guidance retrospectively, the company would include an opening adjustment to retained earnings as of Jan. 1, 2010 with subsequent financial information for individual periods adjusted to reflect application of the guidance (for example, DAC amortization expense for the years ending Dec. 31, 2010 and 2011).

As discussed, EITF 09-G permits retrospective application to all periods prior to the adoption date. To retrospectively adopt, a company would need to be able to reasonably estimate the portion of previously capitalized expenses that would continue to qualify for capitalization under the new guidance and revisions should consider all direct effects of the changes from the adoption of EITF 09-G for all prior periods. Companies will need to consider whether sufficient historical data is available for the company to determine the effects of the changes in the accounting principle or whether it is impracticable. If it is impracticable to determine the effects of the accounting change for all prior periods, ASC 250-10-45-6 allows a company to determine the effects as of the beginning of the earliest period to which the new accounting guidance can be applied.

As a prescribed accounting change, the reduction to the existing DAC asset caused by retrospective application to periods preceding those presented in the financial statements would not be reflected in net income, but rather as a reduction to GAAP equity, and would be disclosed at the point of adoption (e.g., as of the first

FOOTNOTES

³ ASC 340-20, *Other Assets and Deferred Costs – Capitalized Advertising Costs* (formerly, AICPA Statement of Position 93-7, *Reporting on Advertising Costs*).

period presented in the financial statements if adopted retrospectively). However, SEC registrants would need to consider the effect to net income for the two years presented prior to the year of adoption for inclusion in the table that shows five-year historical information. Companies with the capability of accessing the required historical data, would therefore evaluate the benefits of applying the EITF 09-G guidance as it compares to the cost of analysis/implementation and the financial statement impact (i.e., reduced GAAP equity, and increased future earnings resulting from the immediate reduction in DAC at the time of adoption). Companies not electing to retrospectively adopt, would still provide estimates of the potential impact of adoption in their financial statement disclosures, as a means of providing comparable information relative to their peers for analysts.

Adoption of EITF 09-G will require companies to develop and/or refine their procedures for determining the deferrable expenses attributable to successful contract issuances and renewals. With a targeted effective date of Jan. 1, 2012 companies should not encounter the same data issue in producing prospective estimates as they might for the potential retrospective adoption.

EITF 09-G may result in companies exploring ways to alter their expense and compensation structures, so as to maximize the deferrable portion of expenses. As an example, some companies may place a greater emphasis on independent distribution systems, for which 100 percent of commissions can be capitalized, compared to an employee-based distribution system where only a portion of the compensation paid is deferrable.

It should also be noted that the new Insurance Contracts standards⁴ being developed by the FASB and IASB would eliminate DAC. However while

eliminating DAC as an asset, the proposed Insurance Contracts standard allows for recognition of incremental acquisition expenses in the initial liability calculation. The result being that for a hypothetical Universal Life (UL) block of business with one year of new business⁵ projected under the aforementioned three standards, it is in fact the proposed EITF 09-G guidance which produced the lowest first year net income. The results are displayed in the projected net income chart and table below.

FOOTNOTES

⁴ The IASB released an Exposure Draft for the accounting for insurance contracts on July 30 and the FASB plans to issue a Discussion Paper by the end of the third quarter that will compare the IASB's proposed model, the FASB's tentative decisions reached to date and current US GAAP.

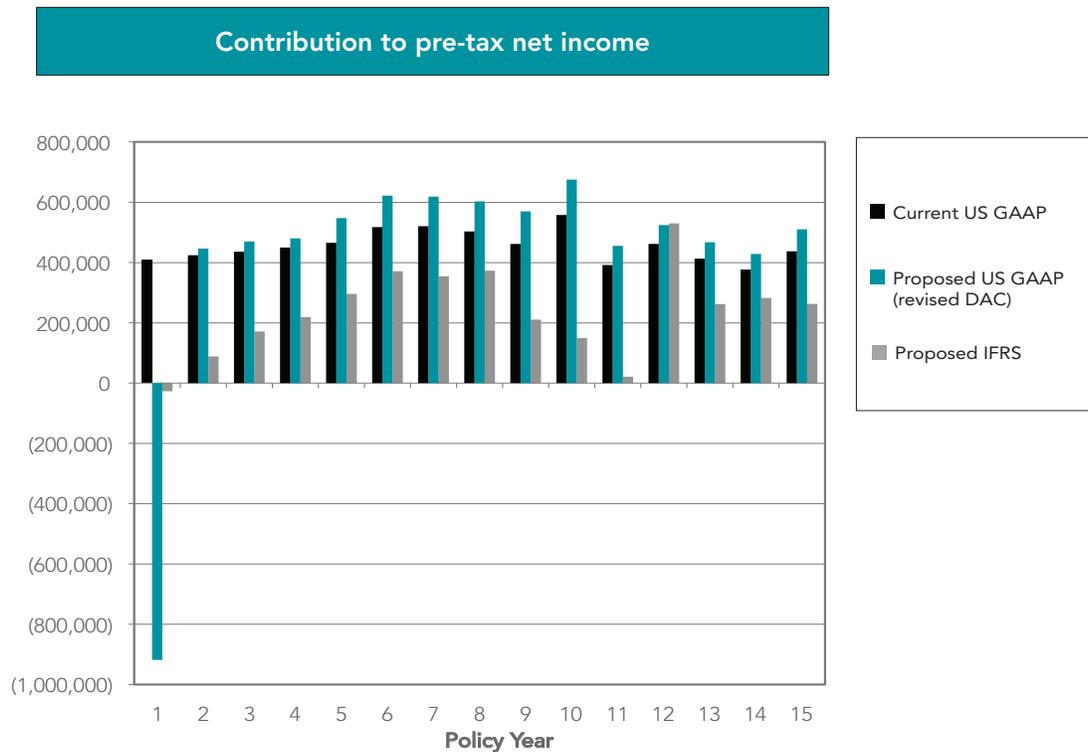
⁵ Hypothetical Universal Life example assumes: i) all sales are made by employee agents (i.e., no commissions to independent third parties), ii) 70 percent successful sales ratio, and iii) first year deferrals are more than 95 percent attributable to commissions.

⁶ Premium income, Benefits paid, and Expenses paid are shown under the Proposed IFRS as a means of comparison to the Current and Proposed US GAAP.

Table 1 – UL new business contribution to pre-tax net income (\$)

	Current US GAAP	Proposed US GAAP	Proposed IFRS ⁶
Premium income	8,125,000	8,125,000	8,125,000
Benefits paid	400,850	400,850	400,850
Expenses paid	5,222,562	5,222,562	5,222,562
Increase in reserves	5,908,391	5,908,391	2,610,475
Increase in DAC & URL	(3,579,858)	(2,253,621)	-
Subtotal	173,056	(1,153,181)	(108,887)
Investment income	234,788	234,788	81,770
UL new business contribution to pre-tax net income	407,844	(918,393)	(27,117)

Chart 1 – UL projection of new business contribution to pre-tax net income



EITF 09-G represents the first hurdle in what will be a challenging period for companies as they attempt to incorporate this series of new accounting requirements into its financial reporting framework and to communicate the resulting potential volatility of earnings to investors, as they move from the relatively level earnings produced by the current US GAAP framework, to proposed future frameworks that will potentially result in losses at issue. ■

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