

Ralph S. Blanchard, III, FCAS, MAAA

To: AAA P&C RBC Committee

Date: September 7, 1999

Subject: SSAP 68 - RBC treatment of insurance subsidiaries where the carrying value includes Goodwill

Below is an analysis of SSAP 68 implications for RBC, to be discussed at our September 9, 1999 meeting. Please review and be ready to discuss.

Issue

Effective with codification, any goodwill resulting from the purchase of a subsidiary will be included in the carrying value. Previously there were several ways the goodwill might have been recorded, some of which (such as recording the goodwill as a miscellaneous asset) might have resulted in RBC charges. Should there be any RBC charge associated with this goodwill amount, relative to insurance subsidiaries?

Discussion

Goodwill in an insurance subsidiary's carrying value results from the purchase of the subsidiary for an amount greater than statutory surplus. It initially equals the difference between purchase price and statutory surplus.

Immediately after purchase, the parent records the subsidiary at the purchase price (or statutory book value, plus goodwill), subject to certain limitations as to the maximum amount of goodwill allowed as an admitted asset. Over the next 10 years, the goodwill amount is amortized down to zero.

Relative RBC treatment of various insurance subsidiary scenarios

Insurance sub. status	Carrying value	RBC
wholly owned	Statutory surplus	sub's Company Action Level RBC
new purchase	Statutory surplus plus unamortized goodwill	Same
publicly traded	Statutory surplus plus excess of (haircut) market over book	same, plus 22.5% of "excess" added to R2

Should the goodwill amount be treated the same as the excess of (haircut) market over statutory book?

Arguments for:

- Both goodwill and (haircut) market over book represent "market" valuations of the subsidiary. The goodwill amount represents market at the time of purchase, while subs held at market reflect the current market.
- The goodwill amount has risk associated with it, not reflected in the current RBC formula.
- Many purchases are at a premium, so that the goodwill amount can start out well above an "excess of market over book" amount. While an even higher charge than that used for subs-held-at-market may be called for, this is at least a simple approach to recognizing the RBC need.

Arguments against:

- The goodwill amount is continually reduced each year, so after a few years it can be viewed as a drastically haircut "excess of market over book". I.e. it is already conservatively valued, so that it doesn't need an RBC charge.
- If sold, the sub should again be able to command a "premium" over book, if not over "market", so the goodwill amount may not be at risk in the event of the parent's insolvency.

The paragraph by paragraph analysis of SSAP 68 is included below.

SSAP 68: Business Combinations and Goodwill Issues to Consider for Risk Based Capital

Paragraphs applicable to P&C	Consideration in RBC Formula
3. Statutory purchase method of accounting.	R0(?), R2 impact. Surplus impact
4. Recording of goodwill.	R0(?), R2 impact. Surplus impact
6. Push down accounting.	?
7. Amortization of goodwill.	R0(?), R2 impact. Surplus impact
8. Recording of impairments.	R0(?), R2 impact. Surplus impact
13. Treatment of Goodwill after a merger.	R2, R3 impact. Surplus impact

Summary: Paragraph 4 raises an issue of how to treat goodwill included in the carrying value of a subsidiary. RBC treatment should probably be consistent with that for subsidiaries held at market value.

Current versus Proposed Accounting Treatment of Each Item

Paragraph 3: Statutory purchase method of accounting	
Current	Proposed
The acquired company can be valued by the acquirer using one of <u>5</u> different methods: GAAP <u>equity</u> (substituting statutory equity for any underlying insurance sub), <u>book</u> , <u>cost</u> , <u>market</u> , <u>value of underlying lawful investments</u> .	" The acquiring insurer shall record its investment at cost."

Conclusion: Not clear what the impact might be. Issue isn't so much whether past RBC treatment was correct, but whether treatment under codification makes sense. Issue is treatment of goodwill.

Paragraph 4: Recording of goodwill	
Current	Proposed
Silent on where goodwill is to be reported.	" Goodwill resulting from assumption reinsurance shall be recorded as a separate write-in for other than invested assets. All other goodwill shall be reported in the carrying value of the investment."

Conclusion: Proposal for goodwill from an investment may have an RBC impact. To the extent it used to be recorded as a write-in invested asset, the charge would be 5% (in R2). If it used to be in the carrying value of the sub, then no charge would apply if an insurance subsidiary, or a 22.5% charge would apply if a misc. U.S. subsidiary. We need to decide what the charge should be going forward (and it should probably be consistent with the charge for subs held at market value). (Not sure what to do with assumption reinsurance discussion. Is this a life issue only?)

Paragraph 6: "Push down" accounting not allowed under purchase accounting.	
Current	Proposed
Silent.	"Under the statutory purchase method the historical bases of the acquired entity shall continue to be used in preparing its statutory financial statements except in those instances provided for in subparagraph 7 b. iii. of SSAP No. 46. Therefore, pushdown accounting is not permitted." ("Push down" accounting apparently would push an allocation of the cost of the transaction down into the accounts of the acquired company.)

Conclusion: Not aware if this is an issue. Assume it isn't unless informed otherwise.

Paragraph 7: Amortization of goodwill.	
Current	Proposed
Generally, amortized over 10 years, and capped in the aggregate at 10% of prior year's surplus. (Note: Some states non-admit all goodwill.)	Generally, the same as current (other than "note"), except the cap is 10% of current year's surplus before goodwill and other similarly capped amounts.

Conclusion: No apparent material change assumed to exist, so no RBC impact.

Paragraph 8: Recording of impairments.	
Current	Proposed
Silent, except "where warranted in exceptional cases, the Securities Valuation Office may require a more rapid write-off of goodwill than is otherwise provided."	" For any decline in the fair value of an entity, acquired through a purchase, that is other than temporary, the investment shall be written down to fair value as the new cost basis." These impairments are applied first to any non-admitted portion of the asset.

Conclusion: Assumed to be relatively rare for now, so no RBC action is contemplated.

Paragraph 13: Treatment of goodwill after a merger.	
Current	Proposed
Same as proposed, per the NAIC's Emerging Issues Task Force.	" Goodwill on the historical books of any merged entity that arose from a previous business combination involving the merged entities shall be charged or credited to surplus immediately."

Conclusion: No change, hence no RBC impact.