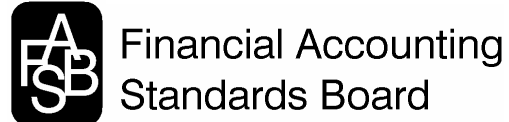


MINUTES



To: Board Members
From: Detling (ext. 354)
Subject: Minutes of December 6, 2006 Board Meeting: Risk Transfer in Insurance and Reinsurance Contracts—Discussion of Invitation to Comment and How to Proceed
Date: December 13, 2006
cc: Leisenring, L. Smith, Bielstein, MacDonald, Risk Transfer Project Team, Upton (IASB), Clark (IASB), Polley, Gabriele, Carney, Allen, FASB Internet

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 FSP.

Topic: Risk Transfer in Insurance and Reinsurance Contracts—Discussion of Invitation to Comment and How to Proceed

Basis for Discussion: Board Memoranda dated October 27, 2006 and November 29, 2006 respectively

Length of Discussion: 2:15 p.m. to 3:05 p.m.

Attendance:

Board members present: Herz, Batavick, Crooch, Linsmeier, Seidman, Trott, and Young

Board members absent: None

Staff in charge of topic: Cropsey

Other staff at Board table: Detling, L. Smith, and Trench

Outside participants: Leisenring (IASB)

Summary of Decisions Reached:

The Board discussed the comment letters received on the FASB Invitation to Comment, *Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting*, and how to proceed with the risk transfer project. The Board directed the staff to focus on the following items in enhancing the current risk transfer guidance:

1. Propose editorial changes, principally to FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, to clarify the minimum level of insurance risk transfer required for a contract to be accounted for as reinsurance under Statement 113.
2. Develop improved insurance and reinsurance disclosure requirements highlighting (a) how and why the entity uses insurance and reinsurance, (b) how those contracts are accounted for, (c) any risk-limiting features included in those contracts, and (d) the effect of those contracts on the financial statements.
3. Clarify that noninsurance company policyholders must evaluate whether the insurance contracts they hold transfer significant insurance risk using criteria like those for reinsurance contracts in Statement 113.

Objectives of the Meeting:

The objectives of this Board meeting were to:

1. Review the results of the comment letters received on the Invitation to Comment.
2. Discuss the alternative(s) for proceeding with the insurance risk transfer project.
3. Determine the Board's directions for the project.

The objectives of the meeting were met.

Matters Discussed and Decisions Reached:

Review of Comment Letters Received

1. Mr. Cropsey reviewed the objectives of the meeting. Mr. Detling stated that the Invitation to Comment was issued on May 26, 2006. Sixty-three organizations in various constituent categories sent in comment letters. A detailed analysis of the comment letters received was distributed to the Board and posted to the FASB website.
2. Mr. Detling explained that, generally, respondents did not think bifurcation of insurance and reinsurance contracts would provide more decision-useful information. They asserted that bifurcation would be too costly, complex, and arbitrary. However, a few respondents believed bifurcation of certain contracts would be appropriate.
3. Many respondents suggested alternatives that the Board could pursue. The principal suggestions included the following:
 - a. Refocus the project to provide improved practical guidance utilizing risk transfer principles that already exist in U.S. generally accepted accounting principles (GAAP).
 - b. Narrow the scope of contracts subject to bifurcation to those with contractual components that don't transfer significant risk.
 - c. Require additional disclosure for contracts that don't result in complete risk transfer.
4. Mr. Detling then stated that many of the other issues raised in the Invitation to Comment addressed implementation of a broad bifurcation requirement and explained that the responses to those issues would not be discussed during the meeting. A summary of responses to those issues is in the comment letter analysis document mentioned previously.

Alternatives for the Board's Consideration

5. Mr. Cropsey explained that a joint IASB/FASB insurance project will likely be added to the agenda next year and the FASB is planning to create an Invitation to Comment in the first quarter of 2007 as a wrap-around to the IASB's initial discussion document. However, a final FASB Statement is at least three years away and the final effective date of that Statement would likely be at least three years beyond that. The issue of finite risk is therefore likely to remain for several years. Mr. Cropsey explained that the staff is presenting the Board with several issues that the Board could explore further in the project.

Issue 1: Require Narrow Bifurcation of the "Obvious"

6. Mr. Cropsey stated that the first option would be to develop a very narrow approach to bifurcation of insurance or reinsurance contracts to require separation of the obvious, such as (a) contracts that contractually bundle an insurance arrangement with a deposit arrangement or (b) contracts where all or a portion of the premiums paid are contractually certain of repayment through claims payments and premium refunds. He then stated that this might be a very narrow set of contracts and, in fact, might result in almost no contracts being bifurcated. Mr. Cropsey stated that a benefit to this approach, however, is that it would affirm that bifurcation of insurance and reinsurance contracts is currently an acceptable accounting treatment. According to some knowledgeable sources, even contracts that have elements that are obviously deposits may not be bifurcated today because some in practice do not believe that bifurcation is allowed under U.S. GAAP. Mr. Trott and Mr. Linsmeier agreed that this approach would likely result in very few, if any, contracts being subject to bifurcation. Board members did not support this alternative.

Issue 2: Require Deposit Accounting for Financing Contracts

7. Mr. Young stated that some respondents said that if a contract appears to be a financing arrangement then it should be treated as a financing arrangement and not bifurcated. He stated that testing for financing might be easier than testing for significant risk. A cash flow test could examine the similarity between the cash flows of a contract and the expected cash flows in a financing arrangement. If a contract

failed to transfer significant risk or had similar expected cash flows to a financing arrangement, it would be accounted for as a deposit in its entirety. This would only apply to reinsurance contracts, not insurance contracts. Many constituents requested disclosure of the risk-limiting features of contracts. This seems to suggest that they want to know what the expected cash flows are so they can determine if the contract is really a deposit arrangement.

8. Mr. Cropsey stated that if the Board chooses not to require bifurcation, the Board could require deposit accounting in its entirety for contracts that have a cash flow stream with a discount rate similar to the company's interest rate. He reiterated that it might be easier to define what a financing arrangement is than to define a transfer of significant insurance risk. In a financing test, a reporting entity could calculate an internal rate of return and if that is comparable to the entity's borrowing rate it might indicate that the contract should be accounted for as a deposit.
9. Mr. Trott agreed that one can distinguish contracts that transfer insurance risk from those that don't by examining the compensation that is demanded in the contract. However, that analysis can be performed with parts of the contract or the entire contract. It might be difficult to determine when the components should be evaluated separately. Mr. Smith suggested that if it is difficult to determine that a contract transfers significant insurance risk it would likely not be easier to determine whether that contract is a deposit. He said that it seems that a financing test is just the other side of the risk transfer test. Mr. Linsmeier suggested that requiring a financing test would still likely result in very few contracts being accounted for as deposits since people still might structure the contracts around that guidance as well.
10. Mr. Herz stated that this approach also might be difficult because two variables (probability and severity) lead to the expected cash flows. Some contracts have very low probabilities of very high expected losses, which many view as insurance. These contracts might have an internal rate of return that is comparable to a reporting entity's borrowing rate. Board members did not support this alternative. Mr. Batavick, however, stated that parts of this approach could be incorporated into editorial changes to risk transfer guidance. For example, if a reporting entity does not

have an in-substance deposit, that could be an indicator that significant risk transfer does exist.

Issue 3: Refine Definitions of Insurance Contracts and Insurance Risk

11. Mr. Cropsey stated that another option is to refine the definitions of insurance contracts and insurance risk. Many respondents agreed with the definitions in the Invitation to Comment except that many felt that the definition of insurance should allow for indemnification only, rather than compensation. The Board will likely address these issues in the upcoming joint project on insurance. Changing the definition of insurance contract would likely not address risk transfer issues. Board members did not support this alternative.

Issue 4: Develop Additional Practical Guidance

12. Mr. Cropsey then stated that another option would be to provide additional practical guidance on evaluating insurance risk transfer, as suggested by some respondents, including the AICPA. Other respondents did not feel that additional guidance is necessary because they believe that the guidance in Statement 113 is principles-based and is sufficient. Mr. Cropsey stated that some constituents seem to be requesting rules on how to account for specific types of contract provisions. Making editorial changes to Statement 113 (as explained below in Issue 6) should help to clarify the current guidance.

13. Mr. Trott believes that these concerns could be addressed by making editorial changes to Statement 113. He stated that perhaps the risk transfer guidance in Statement 113 could be reworded to explain what the Board meant more clearly. He stated that the guidance is not being interpreted in the way that the Board meant it to be interpreted. Board members did not support this alternative.

Issue 5: Require Noninsurance Company Policyholders to Evaluate Risk Transfer

14. Ms. Seidman suggested that the staff propose changes to FASB Statement No. 5, *Accounting for Contingencies*, or Statement 113 to make it explicit that policyholders need to make an assessment about whether a contract transfers significant insurance risk. The Board agreed that the staff should propose guidance for insurers to clarify

that noninsurance company policyholders must evaluate whether the insurance contracts they hold transfer significant insurance risk using criteria like those for reinsurance contracts in Statement 113. This might involve amendments to Statement 113 or Statement 5.

Issue 6: Make Editorial Changes to Statement 113

15. Mr. Herz, Mr. Linsmeier, and Ms. Seidman stated that they support making editorial changes to Statement 113 as suggested by the staff in the November 29, 2006 Board memorandum and looking at requiring better disclosures. Mr. Herz stated that the existing wording in Statement 113 might have led constituents to apply the 10/10 rule when evaluating contracts. He then said that the changes suggested by the staff are a good change because they don't lead readers to believe that only a low level of risk transfer is required. Mr. Batavick stated that once editorial changes are made, they should be reviewed by practitioners in the insurance industry to see if they will actually change practice. If the modifications don't result in any changes to practice then perhaps they shouldn't be made.

16. Mr. Linsmeier stated that he was concerned that it might be difficult to make editorial changes to Statement 113 that will be an improvement. The original criteria that were used to determine if significant risk transfer had occurred might be so convoluted that it will be difficult to make it much better. It seems that the two criteria in paragraphs 9(a) and 9(b) of Statement 113 are interrelated and are not independent. Therefore, thinking about them independently in making changes to Statement 113 may be challenging because they might be related to one another. Mr. Herz said that the criteria can be viewed jointly or independently. Mr. Cropsey stated that Statement 113 was designed with two different tests in mind. EITF Topic No. D-35, "FASB Staff Views on Issue No. 93-6, 'Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises'", explains that the tests in paragraphs 9(a) and 9(b) are two different tests. The test in paragraph 9(a) is a variability notion and not a discounted cash flow analysis of reasonably possible outcomes like that found in paragraph 9(b).

17. Mr. Trott stated that often probability of the occurrence of a loss and magnitude of the loss are viewed as being independent of another. The 10/10 rule treats probability and severity as being independent. He stated that probability and severity are not necessarily independent of another, they are related.
18. The Board agreed that the staff should propose editorial changes, principally in Statement 113, to clarify the minimum level of insurance risk transfer required for a contract to be accounted for as reinsurance under Statement 113. The Board also agreed that the staff should evaluate how the clarifications will affect the accounting treatment of different contracts.

Issue 7: Develop Enhanced Disclosure Requirements

19. Mr. Cropsey stated that the suggestion that enhanced or additional disclosures for contracts that don't result in complete risk transfer might be useful came from various constituent categories including users, preparers, and auditors. Mr. Trott stated that the comments did not specifically identify when disclosures would be necessary or explain how the disclosures would be useful. Mr. Cropsey agreed that, even though those respondents who suggested disclosure as a solution did not provide much detail about what information should be disclosed, several referred to the recent additional statutory disclosures required by the National Association of Insurance Commissioners as a good starting point. An issue with addressing risk transfer questions by only using disclosures of risk-limiting features is that, although rating agencies and highly sophisticated users might be able to use the information to make financial projections, other users might not be able to make judgments using only the disclosed information. Notwithstanding these issues, the staff still recommended that the Board consider requiring additional disclosures.
20. The Board agreed that the staff should develop improved insurance and reinsurance disclosure requirements, starting from the suggestions included in the Board memorandum dated October 27, 2006. These requirements would highlight (a) how and why the entity uses insurance and reinsurance, (b) how those contracts are accounted for, (c) any risk-limiting features included in those contracts, and (d) the effect of those contracts on the financial statements.

Issue 8: Require Alternative Reinsurance Model

21. Mr. Cropsey also stated that a constituent suggested an accounting approach for reinsurance that would defer any gains from reinsurance contracts until the ceding company has no further obligation to pay additional premiums to the reinsurer. The Board decided not to pursue that approach.

Follow-up Items:

None.

General Announcements:

None.