MINUTES

To:	Board Members
From:	Choi (ext. 446)
Subject:	Minutes of July 25, 2007 Board Meeting: Insurance Risk Transfer -- Applying Risk Transfer Requirements of Statement 113 to Insurance Contracts
Date:	August 10, 2007
cc:	Leisenring, Golden, Bielstein, MacDonald, Cropsey, Roberge, Upton (IASB), Clark (IASB), Chookaszian, Polley, Gabriele, Allen, K. Johnson (GASB), 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:	Insurance Risk Transfer – Applying the Risk Transfer Requirements of Statement 113 to Insurance Contracts
Basis for Discussion:	Board Memorandum dated July 10, 2007
Length of Discussion:	10:20 a.m. to 11:10 p.m.
Attendance:	
Board members present:	Herz, Batavick, Crooch, Linsmeier, Smith, and Young
Board members absent:	Seidman
Staff in charge of topic:	Trench
Other staff at Board table:	Choi, Cropsey, and Golden
Outside participants:	Leisenring (IASB)

Summary of Decisions Reached:

1. The Board discussed the application of the insurance risk transfer conditions of FASB Statement No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts, to insurance contracts between noninsurance enterprise policyholders and insurers. The Board also discussed other elements of an Exposure Draft including amendments to FASB Statement No. 5, Accounting for Contingencies, and Statement 113, enhanced disclosures, transition, effective date, and exposure period. The Board reached the following decisions:

    a. The risk transfer conditions of Statement 113 should be applied to insurance contracts between noninsurance enterprise policyholders and insurers.

    b. The risk transfer conditions of Statement 113, as amended and discussed at a prior Board meeting, should be amended to include a qualitative screen prior to the quantitative test (paragraph 9(b) of Statement 113) that would allow those insurance and reinsurance contracts that transfer all but a trivial amount of insurance risk to pass risk transfer. Further, if the qualitative screen is failed, a quantitative test pursuant to paragraph 9(b) would be used to determine if it is reasonably possible that a significant loss may be realized.

    c. Statement 5 should be amended to incorporate the amended guidance for insurance risk transfer conditions in Statement 113 (modified for insurance contracts).

    d. Disclosure requirements should be developed to enhance users' understanding of an entity's insurance and reinsurance activities and the related accounting.

    e. The Exposure Draft would provide transition guidance on retrospective application of the amended insurance risk transfer but would include a question requesting commentary on an entity's ability to apply retrospective transition.

    f. The Exposure Draft should be effective for financial statements issued for fiscal years beginning after December 15, 2008. Earlier application would not be permitted..

    g. The exposure period of the Exposure Draft should be either 90 days or 120 days based on its release date coinciding with an entity's year-end reporting requirements.

Objective of the Meeting:

2. The objectives of the meeting were to discuss:

    a. Whether the insurance risk transfer conditions of Statement 113 should be applied to insurance contracts between non-insurance enterprise policyholders and insurers

    b. Amending the risk transfer conditions of Statement 113 to include a qualitative screen prior to a quantitative test (paragraph 9b)

c. Amending Statement 5 to incorporate the amended guidance for insurance risk transfer conditions located in Statement 113 (modified for insurance contracts)

d. Reconfirming the Board's previous discussions regarding enhanced disclosures discussed at the December 6, 2006 Board meeting

e. Providing transition, effective date, and exposure period for an exposure document

f. Allowing the staff to begin drafting an exposure document incorporating the above changes.

3. The objectives of the meeting were met.

Matters Discussed and Decisions Reached:

Issue 1: Should the same risk transfer conditions in Statement 113 for reinsurance contracts be applied to insurance contracts between policyholders and insurers?

4. Mr. Trench started by stating the objectives for this meeting. He noted that currently Statement 113 provides guidance in relation to insurance risk transfer for reinsurance contracts but does not address risk transferred by an insurance contract. He further noted that a question was included in the Invitation to Comment, *Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting,* asking respondents to comment on whether the risk transfer conditions in Statement 113 could be applied to insurance contracts. Mr. Trench stated that the majority of respondents that answered the question agreed that the insurance risk transfer conditions should be the same for the policyholder, insurer, and reinsurer. However, he pointed out that these same respondents raised concerns with the ability of noninsurance enterprises to perform the quantitative tests required by paragraph 9b of Statement 113 and the possibility of insurance contracts that clearly transfer insurance risk not passing that quantitative test.

5. After Mr. Trench addressed the Board with the issue, Mr. Linsmeier clarified that the risk transfer conditions referred to are the revised risk transfer conditions that were included in the Board memorandum. The Board agreed that the revised insurance risk transfer conditions of Statement 113 should be applicable to insurance contracts between noninsurance enterprise policyholders and insurers.

Issue 2: Does the Board agree with applying a qualitative screen prior to the 9b quantitative test that would allow those insurance and reinsurance contracts that transfer all but a trivial amount of insurance risk to pass risk transfer? If so, does the Board agree

with the staff's recommendation that if the qualitative screen is failed, a quantitative test should be used to determine if it is reasonably possible that a significant loss may be realized?

6. Mr. Trench explained that currently, under Statement 113, insurance risk is transferred only if two conditions are met (paragraphs 9a and 9b). The first condition is that the reinsurer assumes significant insurance risk under the reinsured portions of the underlying insurance contract (paragraph 9a). The second condition is that it is reasonably possible that the reinsurer may realize a significant loss from the transaction as determined by a quantitative test (paragraph 9b). Mr. Trench then stated that the exception to the second condition, as described in the second sentence of paragraph 11, could be used as the basis for a qualitative screen prior to the quantitative test required by paragraph 9b of Statement 113. This screen would allow those insurance and reinsurance contracts that transfer all but a trivial amount of insurance risk to pass risk transfer without having to conduct the quantitative test. If the qualitative screen is failed, the quantitative test pursuant to paragraph 9b of Statement 113 would be used to determine if it is reasonably possible that a significant loss may be realized.

7. Mr. Herz raised concerns about applying the new guidance to certain insurance contracts containing risk-limiting features that insure against events that have a remote possibility of occurring. He noted that he was particularly concerned about the interaction of the words "trivial" in the qualitative screen and "reasonably possible" in the quantitative test. Mr. Herz argued that while some contracts containing risk-limiting features (for example, a deductible) effectively transfer insurance risk, other contracts containing similar risk-limiting features (but to a larger degree) do not transfer risk. He noted that under the proposed guidance, distinguishing between the two contracts may be difficult. As an example, Mr. Herz provided the following fact pattern: an insurance contract covering a building for $10 million with a deductible of $1 million. He noted that he believes that this insurance would fail the qualitative screen because it had a significant risk-limiting feature (the large deductible). The contract would also fail the quantitative test because the low probability of the fire actually occurring makes the possibility of the insurer realizing a significant loss remote, rather than reasonably possible. Mr. Trench agreed with Mr. Herz's assessment noting that if a determination has been made that the deductible is above and beyond a trivial amount, then it would fail the risk transfer conditions. Mr. Herz noted that he believes that

this contract is clearly insurance. Mr. Smith disagreed with Mr. Herz's assessment pointing out that the "reinsured portion" is the amount above the deductible and, therefore, the insurance contract would meet the qualitative screen (and therefore transfer insurance risk). Mr. Golden and Mr. Cropsey agreed with Mr. Smith's assessment. Mr. Cropsey pointed out that the words "reinsured portion" have resulted in different interpretations. Mr. Cropsey further noted that a key factor is the amount being paid for the insurance contract taking into consideration the deductible. Mr. Trench stated that, in the extreme, one could interpret "reinsured portion" to mean the amount left over after risk limiting portions have been removed and, therefore, by definition, the "reinsured portion" always transfers insurance risk. Mr. Smith stated that the screen is a qualitative screen and therefore the relationship between the amount of the deductible, the premium charged, and the loss must all be considered.

8. Mr. Linsmeier stated that in creating a qualitative screen prior to the quantitative test, more pressure is being placed on the qualitative screen. He further noted that the discussion at the education session and this Board meeting about risk-limiting features and how deductibles affect risk transfer is very important and that somehow the wording will have to resolve these different interpretations. Mr. Linsmeier noted that he believes the voting at this Board meeting is for the concept of applying first a qualitative screen and then a quantitative test. Mr. Cropsey argued that the current guidance in Statement 113 is flawed because the quantitative test does not allow contracts covering events that have a remote possibility of occurrence (such as catastrophe reinsurance) to pass risk transfer. Mr. Batavick stated that examples would help to clarify the wording.

9. Mr. Batavick suggested a market premium test to serve as the qualitative screen, in which the parties compare the contract to similar contracts in the market to determine if risk-limiting features are appropriate for the contract to be considered to transfer insurance risk. Mr. Trench pointed out that the notion of a "market premium" is difficult because as products evolve, what is defined as "the market" will change.

10. Mr. Linsmeier then questioned the "reasonable possibility" threshold provided in the quantitative test. He believes the insurance risk should be considered transferred if the price paid for the policy is reasonably close to the probability-weighted amount of the loss to be incurred if the event were to occur. Further, if a policy costs much more than the probability-

weighted loss that would be incurred, the contract would not transfer risk. Mr. Linsmeier questioned whether "reasonably possible" is the correct threshold as most insurance contracts cover tail events. Mr. Golden suggested that the language in the quantitative test should be worded that it is "reasonably possible that the insurer or reinsurer may realize a significant loss, if the insured event were to occur" thus not having to characterize or consider the likelihood of an event. Mr. Linsmeier suggested that the staff provide several examples walking through different insurance contracts and how they would be assessed under the proposed risk transfer conditions.

11. The Board agreed with the objective of providing a qualitative screen prior to the quantitative test in developing the risk transfer conditions. The Board also requested that several simple, real-world examples be included to further clarify the application of the risk transfer conditions.

Issue 3: Does the Board agree with amending Statement 5 to incorporate the amended guidance for insurance risk transfer conditions located in Statement 113 (modified for insurance contracts)?

12. Mr. Batavick stated he believes it is important that the amended guidance be included in Statement 5 so that all noninsurance enterprises will not be forced to look into Statement 113, which focuses on reinsurance, for guidance on primary insurance contracts. All Board members present agreed that the new guidance should be reproduced in Statement 5.

13. Mr. Linsmeier noted that there may be an educational issue because noninsurance enterprises are not looking to Statement 5 for guidance on insurance contracts even though they should be. He questioned the form in which the guidance should take when issued. Mr. Golden suggested it could be an FSP or a new Statement. Mr. Herz noted his concern regarding the possibility that not all noninsurance entities may look to Statement 5 in how to account for insurance contracts. Mr. Cropsey suggested a freestanding Statement with an amendment to Statement 5. Mr. Smith stated that he would look into what is currently in the codification project as an insurance topic and determine the best location for the risk transfer conditions for insurance contracts.

Issue 4: Does the Board agree with the proposed disclosure requirements to enhance users' understanding of an enterprise's insurance and reinsurance activities and the related accounting?

14. Mr. Trench explained that of the four proposed disclosures included in Appendix B of the Board memorandum, the first two (a and b) on risk-limiting features apply to all enterprises while the last two (c and d) address only insurance enterprises.

15. Mr. Leisenring addressed a flaw in the wording of the disclosures noting they did not specify which party (the insurer or the insured party) should be providing the disclosures. For example, disclosures of risk-limiting features would only apply to an insurer. These features are, in fact, risk enhancing to the insured parties.

16. Mr. Linsmeier and Mr. Smith also raised concerns about noninsurance enterprises providing guarantees to other noninsurance enterprises of losses based on the occurrence of an event. Such arrangements are effectively insurance contracts, but may not be included in the proposed disclosure requirements. Mr. Trench stated that he believed that because the project was dealing with Statement 113, the disclosures would apply to insurance enterprises and contracts sold by insurance enterprises to noninsurance enterprises. Mr. Linsmeier stated that he did not object to the spirit of the disclosures, however clarification would be needed when drafting an exposure document. The Board agreed with Mr. Linsmeier (that is, to develop disclosures to enhance user's understanding of an enterprise's insurance activities and the related accounting) and urged the staff to carefully define the disclosure requirements as well as the enterprises to which the disclosures requirements apply in drafting.

Issue 5: Transition Guidance

17. Mr. Batavick initially argued that companies should apply the new guidance to all insurance contracts existing as of the effective date, without having to restate prior year financial statements to include contracts that had already expired. Mr. Batavick feared that retrospective application would overly complicate transition because companies would be forced to evaluate expired contracts under the new risk transfer conditions. Rather than retrospective application, he suggested a cumulative-effect adjustment to beginning retained earnings be used to capture the effects of the new guidance applied to existing contracts written prior to the effective date. This adjustment would exclude any analysis of expired contracts. Under this transition guidance, a company would not have to recast its financial statements for prior years.

18. Mr. Herz noted that Ms. Seidman had communicated to him a preference for retrospective application and to include a question on the costs involved as compared to the resulting benefit of that transition.

19. Mr. Golden pointed out that regardless of whether limited retrospective (that is, limited to existing contracts) or cumulative-effect transitions were selected, the preparer would have to go back to when they entered into the transaction to determine whether risk was transferred.

20. Mr. Smith favored limited retrospective application over both retrospective and cumulative effect adjustment. Under a limited retrospective approach, a company would need to recast its financial statements for prior years as well as provide a cumulative effect adjustment to beginning retained earnings in the earliest year presented to capture all adjustments required for only contracts existing as of the effective date. That is, no analysis of expired contracts would be required. Mr. Golden stated that this transition would provide more benefit to users at the same cost to preparers as a cumulative-effect adjustment. He reasoned that both methods require the same information, however, limited retrospective application provides a more detailed presentation in the financial statements.

21. Mr. Golden's primary concern with limited retrospective transition was for expired contracts that were either renewed or replaced with a similar policy. Under limited retrospective application, only the renewed policy (essentially, an extension of the old policy) would be assessed under the new risk transfer conditions while the expired contracts would not be assessed. Mr. Golden pointed out that such treatment would provide inconsistencies in the accounting for similar contracts.

22. Mr. Cropsey asked the Board whether an insurance contract that has expired but has an open claim would be considered an existing insurance contract under a limited retrospective application. Mr. Batavick stated that he did not believe that situation would be considered an active insurance contract. Mr. Linsmeier pointed out that he viewed an open claim as merely a settlement and that since there are no longer any premium payments the policy is not considered active for purposes of transition.

23. The Board agreed to provide retrospective transition in the exposure document. Mr. Herz stated his belief that policyholders have schedules of expired and existing insurance policies that would allow for retrospective transition. However, it is still unclear to the Board whether

the costs of retrospective application would outweigh the benefits to users. The Board asked the staff to include a question in the exposure document requesting commentary on an enterprise's ability to apply retrospective transition. Mr. Smith further explained that constituents need to be informed of the other transition alternatives (limited retrospective and cumulative-effect adjustment) so that they consider relevant information requirements when evaluating the alternatives.

Issue 6: Effective Date

24. The Board agreed that the new guidance should become effective for financial statements issued for fiscal years beginning after December 15, 2008, with no provision for early adoption.

Issue 7: Exposure Period

25. The Board agreed to provide an exposure period of either 90 days or 120 days based on the release date of the exposure document coinciding with an entity's year-end reporting requirements.