MINUTES

Financial Accounting Standards Board

To:	Board Members		
From:	Insurance Contracts (Silva x445)		
Subject:	Minutes of the December 20 Roundtable on the FASB Discussion Paper *Preliminary Views on Insurance Contracts* and the IASB Exposure Draft *Insurance Contracts*	**Date:**	November 28, 2011
cc:	Mechanick, Bielstein, Chookaszian, Posta, Klimek, Gabriele, Lott, Donoghue, Glotzer, Proestakes, Weiner, Ampofo, Irwin, North, Alexander		

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 an Accounting Standards Update or a Statement of Financial Accounting Concepts.

Topic: Insurance Contracts

Basis for Discussion: [Agenda]

Length of Discussion: 1:00 p.m. to 4:30 p.m. (EST)

Attendance:

Board members present: Seidman, Golden, Linsmeier, Siegel, Smith

Board members absent: None

IASB Board Members: Finnegan

Staff in charge of topic: Weiner

Other staff at Board table: Kuhaneck, Hildebrand, North, Montgomery

IASB staff present: Upton

Outside participants: See Participant Listing

Summary of Decisions Reached:

The FASB held this public roundtable meeting with constituents to discuss the FASB Discussion Paper *Preliminary Views on Insurance Contracts* and the IASB Exposure Draft *Insurance Contracts*. No decisions were reached during this discussion.

Objective of the Meeting:

The objective of this meeting was to engage in a constructive dialogue about the FASB Discussion Paper *Preliminary Views on Insurance Contracts* and the IASB Exposure Draft *Insurance Contracts* with a variety of stakeholders and provide the Boards with additional information on their Insurance Contracts project in order to help the Boards determine how to proceed with their Insurance Contracts project. This particular roundtable meeting focused on the views of users, preparers, and practitioners on the topics of the probability-weighted expected cash flows, the discount rate, unbundling, the composite margin versus the risk adjustment and residual margin, the modified approach for short-duration contracts, and presentation.

Matters Discussed:

Topic 1: Probability-Weighted Expected Cash Flows

Jennifer Weiner (FASB staff) stated that many of the participants in this roundtable had questions on this topic including whether probability-weighted estimates is the appropriate method to calculate cash flows; which cash flows (e.g. incremental or other acquisition costs, investment income, taxes, overhead, etc.) should be included in the estimate; whether they should be determined at the contract or portfolio level; when the insurer should start accounting for these cash flows; and how far out the cash flows should be considered.

Ralph Blanchard (AIA) noted that the morning session had not included much discussion of the timing of cash flows. He stated that there were many techniques to come up with the amount that will be paid but few for determining when payment will be made and the timing of payments are rough estimates. He stated that claims adjusters are required to come up with the amount that will be paid but less attention is given to when the claim will be paid.

Alan Zimmermann (Macquarie Securities) stated that the whole idea of a single best estimate is outmoded and it would be much better to talk about a distribution of estimates. Kevin Spataro (Allstate) expanded on Zimmermann's point. He stated that estimating P/C reserves is much more sophisticated than a simple best estimate under FAS 5, *Accounting for Contingencies,* and there are a number of methodologies used today that have been honed over decades. He was concerned that the proposal would replace those tested methodologies with probability-weighted cash flows that has little if any track record and he and argued that before taking such a step more work needed to be done to substantiate its usefulness and reliability to deal with a whole host of different environments and markets.

Wayne Upton stated that the IASB did not intend that the probability-weighted cash flows method be a mechanic that would require stochastic modeling; the objective of the estimate is to formulate the statistical mean based on explicit and unbiased assumptions and is intended to ensure that one understands the distribution around the mean. It also provides a mechanism for capturing uncertainties and probabilities as to the timing of cash flows.

Mr. Spataro later suggested that unless humans are taken out of the picture it is impossible to eliminate bias from the estimation process. With respect to a statistical mean, he suggested that proposal may be inconsistent with ASOP 43, *Property/Casualty Unpaid Claim Estimates*, which states that the estimate is a conceptual mean rather than a statistical mean because it uses a variety of different methods, some of which are statistical and some of which are not.

Mr. Linsmeier replied that the term *unbiased* means that there is no effort to insert directional changes in the estimate to either to move numbers upward or downward and if best efforts are used there will be no upper or lower bias.

Sam Gutterman (International Actuarial Association - IAA) questioned why acquisition costs are singled out in the proposal as the only contract-based measurement approach. He stated that it is the consensus of the IAA that it would be more reflective of the economics and the industry business model if the measurement was portfolio-based. He also noted that overhead is included in the liability and he suggested that it should be in the first building block.

Dave Christensen (USAA/GNAIE – P/C) stated that the liability for P/C claims would not include acquisition costs; it would only include costs to settle the claim. Doug Miller (ACLI) commented that this difference between the two business models is another reason why there should be two models.

Tricia O'Malley (Canadian Accounting Standards Board - AcSB) stated that the AcSB strongly supports the expected value approach and suggested that people were concerned with the approach because they wrongly assumed it would always require stochastic modeling. She added that the AcSB shared Gutterman’s concern that the acquisition costs had to be at the portfolio level.

Mr. Christensen made a pitch for separate models for life and nonlife. He argued that life contracts bear no resemblance to nonlife contracts such as a homeowner’s policy. The risks are fundamentally different; life insurers are concerned with asset performance whereas for P/C insurers it's all about underwriting and pricing. He agreed with Mr. Zimmermann that probability- weighted cash flows was just one method for measuring the liability.

Sharon O'Sullivan (Swiss Re) commented on contract boundary. She noted that her company enters into many catastrophe reinsurance treaties many months before their effective dates because companies want to lock-in reinsurance protection. This means that the ceding company has a legal contract with the reinsurer and she was concerned that this puts the ceding company into a negative position.

Pinto Suri (Corporate Reporting Users Forum) stated that one of the questions he keeps getting from US investors is what is a probability-weighted cash flows method. Investors understand that convergence is important but Mr. Suri argued the insurance industry has been very resilient through the credit crisis and investors are concerned with the consequences of changing the accounting, especially Presentation. Suri said that the life insurance industry was a very important sector for the bond market in this country and anything that affects its cost of capital is a problem; investors believe that these accounting changes will cause the cost of capital to rise sharply.

At the conclusion of the Roundtable, Patrick Finnegan (IASB) commented that those who argue that US GAAP is not broken are not taking into account the importance of comparability with financials produced in other jurisdictions.

Topic 2: Discount Rate

Ms. Weiner summarized the issues regarding the discount rate which she stated was one of the most controversial issues in the proposal. The proposal uses the risk-free rate plus a liquidity adjustment as a means of reflecting the volatility in the liability. Ms. Weiner stated that some commenters have argued that the changes in the discount rate are caused by volatility in the income statement; others have argued that the volatility is caused by an accounting mismatch rather than an economic mismatch.

Kevin Spataro (Allstate) noted that the IASB and the FASB had been discussing the P/C discounting issue but that due to turnover and other reasons those discussions had come to a stop in the summer. He wanted them to restart these discussions to consider whether there should be a discount rate, to which contracts it should apply, and what the discount rate should be. He suggested that the discussions would be most productive if they were separated between different types of contracts and he made a pitch for no discounting for short- duration personal line contracts.

Dave Christensen (GNAIE – P/C) agreed that short-duration personal line contracts should not be discounted because, unlike life contracts, their pricing does not depend upon investment returns; that investors evaluate P/C companies on the basis of the combined ratios that do not include investment income.

Tricia O'Malley (CASB) commented on what rate should be used. She noted that the proposed discount rate leaves out credit spread, that leaving out credit spread, the sector is completely inconsistent with the literature, and that a life annuity should not be treated any differently from annuity coming out of the pension plan.

John Doyle (Liberty Mutual) addressed the issue of whether the adjustment should be reported as part of income or through Other Comprehensive Income (OCI). His company strongly supports putting it through OCI so it does not impact core earnings. He noted Mr. Christensen's comments about the P/C combined ratio and suggested that investors and analysts would like to be able to look at consistent information. Regarding whether there should be a discount rate, Mr. Doyle opined that the current model is appropriate but if there is going to be a discount rate he asked that the Boards consider using portfolio yield and he recommended extensive field testing of the various alternatives.

Alan Zimmermann (Macquarie Securities) stated that the time value of money is the most fundamental economic concept and he does not understand the US opposition to discounting of loss reserves. He commented that it was easy to separate out what management has done to itself as opposed to what the market has done to it.

Bill Findlay (Assured Guaranty Ltd) noted the vast diversity of opinion on what would be an appropriate discount rate. He favored a much more principles-based model which would allow the company to select the discount rate it believes appropriate and disclose its methodology.

Mr. Spataro noted that several participants seemed agreeable to using a discount rate even if it was contrary to their business model. He thought this was problematic because the objective of this project was to come up with a model that is better than the one in existence today; one that will provide users with better insight into what the risks are in the insurance business, how insurers make money, and management performance. He believes they if they are to fulfill their objective they must develop a model that is consistent with the business model so that reporting will be representationally faithful.

Mr. Spataro stated that the P/C model was an underwriting model and for this reason investors want to be able to assess a P/C company's underwriting results and get comfortable with the adequacy of its claims reserves. In response to Mr. Zimmermann, Mr. Spataro stated that unlike life companies, if the rate of return on investments of a P/C company dropped to zero its underwriting model would still work.

Pinto Suri (Corporate Reporting Uses Forum) agreed that there are two different models and that is how investors look at them; they do not understand how interest rates would impact the combined ratio and are concerned with their ability to assess P/C insurers' historical data should the accounting rules change.

Ralph Blanchard (AIA) noted that the discount rate in the US may be the risk free rate but in the rest of the world the high-grade corporate rate is used. Rick Lynch (Ernst & Young) pointed out another difference between the life and nonlife industries, stating that nonlife companies get their cash up front but life insurers will collect their cash over a long period of time and the amount they will collect is based on a one-time assumption of their investment income. He stated that although the high quality corporate rate would be a practical solution, it is not a perfect solution because life companies do not invest only in bonds, they also invest in equities, real estate, derivatives, etc.

Topic 3: Unbundling
Ms. Weiner asked the participants for their views on whether components should be unbundled and if so what should be the principles governing unbundling. She acknowledged that the DP was not clear on this issue and that its examples only added to the confusion.

Tricia O'Malley (CASB) noted that this proposal was heavily based on US GAAP and questioned whether the unbundling was necessary given the measurement changes in the draft. Chris Swift (Hartford) stated that they were dealing with an integrated set of commitments and generally his company does not believe that unbundling is necessary. However on the life side some products such as annuities could be measured either at fair value or fulfillment. He stated Hartford would prefer not to have to unbundle because it would be confusing to have two different models for very similar products.

Dave Doherty (Health Insurers Group) asked how this would interact with the revenue recognition model noting that some of his business is administration of self-insured clients and the argument could be made that the administrative portion of the contract should be unbundled. He added that some of these clients also purchase stop-loss coverage.

Leslie Seidman noted that all the participants in this roundtable except for one disagree with the margin presentation approach which would indicate that they want broad presentation on the income statement and she wondered how this issue related to unbundling. Rick Lynch (Ernst & Young) replied that the net margin might not present enough information and that the companies must provide more information in supplemental exhibits as under the proposal the primary statements will have less useful information that they have now. Ms. Seidman agreed stating that that is why she thought some unbundling was needed, perhaps for deposits. Mr. Lynch noted that some people classify cash surrender value is as deposits and theoretically every policy has a deposit because by law there must be a provision for return premium for every policy including homeowners and auto policies.

Mr. Swift was concerned that, depending on how insurers managed their risks (e.g., via derivatives or reinsurance), they could get different answers especially with respect to the variable annuity business. William Hines (AAA) stated that pre funding or deposit information is very important information that should be disclosed separately but that the measurement should be the same.

Topic 4: Composite Margin versus Risk Adjustment and Residual Margin
The FASB version of the model has composite margin whereas the IASB has a separate risk adjustment and residual margin. Ms. Weiner asked the participants to give their views on which approach they favor and why.

Alan Zimmermann (Macquarie Securities) opined that the risk adjustment was the most useful part of the whole exercise even though companies calculated it differently. In fact he thought that their different approaches added value to the risk adjustment because analyses will disclose the different views companies have on the volatility in their reserves. He thought that it was appropriate to amortize the residual margin over time.

Larry Smith asked Mr. Zimmermann if the measurement of uncertainty could be provided in a disclosure rather than through the risk adjustment. Mr. Zimmermann replied that providing the information on the income statement was a better approach than disclosure.

Tricia O'Malley (AcSB) supports the risk adjustment approach because insurers claim to make their money by assuming and releasing risk and the risk adjustment shows how effective they are at releasing risk. With respect to the residual margin, she said if there is going to be one they needed to know what it represented. She believed it either accounts for mis-measurements or the insurer has omitted some factor that was included in the premium, such as acquisition costs, in which case she thought it would be appropriate to spread it over the coverage period rather than the claims paying period because the residual margin is supposed to provide a current measure of the change in the risk. She preferred not to use a composite margin unless someone can figure out how to run it off in a way that is related to type of risk.

Andrew Heiskell (Wellington Management) wanted convergence in order to get comparability. Larry Smith asked of other investors agreed with that position. Pinto Suri (Corporate Reporting Users Forum) agreed with Mr. Heiskell but not just for the sake of convergence. He stated that the risk margin had been described to him as "an estimate of an estimate about uncertainty in the original estimate" and in the US there is a settled accounting system which works for capital providers. He does not see the value of investing so much effort to try to get more mathematical precision on what is inherently an imprecise business.

Mr. Upton acknowledged that the vote on this issue at the IAIS was split but, he stated, the purpose of the risk margin is to attempt to assign a price to uncertainty and if this is not done when it comes time to do the onerous contract or premium deficiency test one would only be testing the sufficiency of cash flows and not the price of uncertainty, with the result that it would inappropriately delay recognition of onerous contracts. He added that this was an area in which he believed US GAAP was broken.

Rick Lynch (Ernst & Young) stated that initially his firm had agreed on the composite margin with disclosure of the risk adjustment. However after considering whether the composite margin should be unlocked and whether information should be disclosed on the degree of uncertainty of the data, E&Y concluded that the risk adjustment was needed. Another problem with the composite margin is how it would be amortized. Mr. Linsmeier suggested another approach using the composite margin but Mr. Lynch said they had tried it and it did not work.

Kevin Spataro (Allstate) stated the objective of a risk margin was to determine the maximum that an insurer was expected to pay satisfy its obligations. Since this is not the amount insurer expects to actually pay, meaning the objective is contrary to the business model for a P/C company, Mr. Spataro concluded that the information provided by the risk margin would not be useful. He stated that Allstate was part of the field testing, that it had applied the three techniques for determining the risk adjustment to actual data and determined that the results were not understandable and would not be useful for decision-making. He attributed this to the fact that P/C policies are much more complex than life policies as they cover multi-perils and are written in different states with different coverage rules.

Dave Christensen (GNAIE – P/C) agreed with Mr. Spataro's comments and added that the job of the preparer is to establish the best estimate of ultimate loss and the regulatory filing in Schedule P provides 10 years of historical loss data from which users can assess the accuracy of the company's estimates.

Sam Gutterman (IAA) believes that both the residual and composite margins need a thorough review. He noted several problems with the margins that had been uncovered by the Society of Actuaries such as the impact of accreting interest on the residual margin and what benefits should be included in the measure (i.e., should surrender values be included as a benefit). He opined that the composite margin does not work for P/C or health contracts.

Topic 5: Modified Approach for Short-Duration Contracts
Topic 6: Presentation

These topics were discussed together. Regarding the modified approach to short-duration contracts, Ms. Weiner asked for views on whether the approach should be permitted or required, how it can be simplified, and how to treat reinsurance.

Ralph Blanchard (AIA) recommended that the onerous contract test only be required after a triggering event. With regard to the presentation of reinsurance, Mr. Blanchard preferred a net presentation on the income statement but said that a gross presentation would work for the balance sheet. He also made another pitch for separate models for life and nonlife.

Darryl Briley (KPMG) pointed out that the modified approach needed to be simplified and in particular the onerous test provision was overly burdensome and should not be required every period. He noted that IASB staff has said it is not the intent that it be done every period but that is not how the proposal reads. He recommended the test be done at the outset and thereafter only on the occurrence of a triggering event. He recommended that premiums for the pre claims liability not be discounted and that interest not the accrued on the pre claims liability. He stated that the definition of a short-duration contract does not work and suggested that the definition contained in US GAAP be used in its stead. Finally he stated that the proposal needed to clarify that the modified approach can be applied to reinsurance.

Kevin Spataro (Allstate) stated that there should be a modified approach for short-duration contracts but that it should be something simpler than what is proposed and Allstate would be more supportive of the UPR approach. He agreed with Mr. Briley's recommendation that the definition be replaced with the one found in US GAAP. Regarding presentation, he said that the presentation worked for the pre-claim period but not for the post-claim period. He recommended one model for both which would include no risk margin and no discounting because both are insignificant. He recommended that during re deliberation there be discussions with respect to what the underlying attributes of nonlife insurance contracts are.

Joe Fritsch (NYS Insurance Department) supported Mr. Spataro's comments and added that the approach needed to be mandatory worldwide for comparability. Weiner asked how he would handle companies that wrote both types of business. Fritsch replied that this is not permitted in the US.

Tricia O'Malley (AcSB) stated that her board was not sure that the modified approach should be limited to short-duration contracts. She suggested that a company should be allowed to use the modified approach if it could demonstrate that the results would approximate those that would be obtained using the building block approach. She would not make it mandatory because a company could have a portfolio of both types of contracts and she believed it should be able to choose the approach that makes the most sense.

Sam Gutterman (IAA) commented only on presentation. He stated that the IAA believes the modified approach is the right approach; and that a reconciliation of income to the liability measurement approach must be provided, either in the income statement or as a disclosure; as well as volume information and information needed to assess performance.

Doug Miller (ACLI) stated that the margin approach would provide useful information but important components are missing.