MINUTES

Financial Accounting Standards Board

To:	Board Members
From:	Insurance Contracts Team (Milne, ext. 393)
Subject:	Minutes of the February 25, 2009, Board Meeting: Insurance Contracts
Date:	April 15, 2009
cc:	FASB: Bielstein, Golden, Stoklosa, Chookaszian, Posta, Klimek, Gabriele, Sutay, McGarity, Proestakes, Cropsey, Trench, Milne, Lott, Hood, Brickman, Galloway (GASB), FASB Intranet; IASB: Leisenring, Clark, van der Veen, Hack, Jordan

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 FASB Staff Position.

Topic:	Insurance Contracts—Measurement
Basis for Discussion:	Board Memorandum No. 5–11, 13, and 14
Length of Discussion:	8:00 a.m. to 9:30 a.m.
Attendance:	
Board members present:	FASB: Herz, Linsmeier, Seidman, Smith, and Siegel IASB: Leisenring
Board members absent:	None
Staff in charge of topic:	Cropsey, Trench, and van der Veen
Other staff at Board table:	Golden, Proestakes, and Milne

Summary of Decisions Reached

The Board began deliberations on the joint project on accounting for insurance contracts by discussing measurement.

The Board agreed to explore an approach where an insurance contract is measured at a current fulfillment value rather than fair value as defined in FASB Statement No. 157, *Fair Value Measurements* (an exit value). The fulfillment value is currently not a defined measurement approach but would be based on entity-specific inputs that generally would not require consideration of market participant views. The Board discussed the potential components of a fulfillment value but did not come to any conclusions.

The Board agreed that in principle the initial recognition of an insurance contract should not result in the recognition of an accounting profit. However, some Board members acknowledged that future deliberations and decisions (such as the accounting for acquisition costs) may necessitate revisiting whether an accounting profit should be recognized at inception of an insurance contract.

Objective of Meeting:

The objectives of this meeting were to discuss (1) the composition of a measurement approach for insurance contracts, (2) potential measurement candidates for insurance contracts, (3) measurement of the margin at inception of the insurance contract, and (4) whether to add additional measurement candidates for consideration. The objectives of the meeting were met.

Matters Discussed and Decisions Reached:

Issue 1—Building Blocks of a Measurement Approach for Insurance Contracts

1. Mr. Trench stated that the Discussion Paper, *Preliminary Views on Insurance Contracts*, proposed several key building blocks that should be used in measuring insurance contracts. While the Discussion Paper proposed a current exit value

measurement approach for insurance contracts, the staff believes that the following key building blocks are relevant regardless of the measurement approach, and that they assist in developing a measurement for insurance contracts:

a. Use of estimates that are as consistent as possible with observable market prices
b. Use of explicit current estimates of the expected cash flows
c. Reflect the time value of money
d. Include an explicit margin.

2. Mr. Trench stated that the IASB tentatively decided at their February 18, 2009, meeting that a measurement approach for insurance contracts conceptually should include all of these features with one change. There was considerable discussion about the first building block. Several IASB Board members questioned the use of *prices*, noting that it indicates an exit value notion. Mr. Trench noted that there also was considerable discussion about whether market consistency is appropriate for all variables. In an effort to establish some common ground that any viable measurement candidate would satisfy, the IASB decided that the use of estimates that are consistent as possible with observable market prices should be limited to estimates of financial market variables.

Staff Recommendation

3. The staff recommends that all of the features described above should conceptually be part of the measurement of insurance liabilities.

Board Vote

4. The Board decided to move on without a vote.

Board Comments

5. Mr. Trench stated that the staff is looking for an indication of whether these building blocks are integral to developing a measurement candidate that would be used for this project. He stated that any decision reached may change as a result of future Board decisions, but that the staff is looking for a basis to begin its analysis of measurement candidates.

6. Mr. Smith asked for further explanation of what the staff means by *consistency with observable market prices* (building block (a)). Mr. Trench stated that if a fulfillment value notion were to be chosen, the measurement would use entity specific inputs, with a reasonableness test using any relevant market inputs. He further stated that an exit value notion would use a market participant view to derive inputs.

7. Mr. Smith questioned whether or not using market participant prices entails looking at what other insurance companies are charging for similar contracts. Mr. Golden stated that the building blocks are the critical components the staff needs to identify in a measurement once a fulfillment or exit value approach is decided on. He observed that if a fulfillment approach was decided upon by the Board, the staff could modify the building blocks to fit that approach. Mr. Smith stated that he supports a fulfillment approach and that he does not support using *observable market prices* as a building block for measuring insurance contracts.

8. Mr. Leisenring stated that the staff needs to clearly define what is meant by *observable market price*. He questioned whether the *price* is the same as *input*. He also stated that he cannot see a distinction between a fulfillment value approach and Level 3 estimates under Statement 157. He noted that if *prices* were changed to *factors,* it may not seem like transactions are being observed but it also may not change the substance of the analysis. Mr. Golden noted that the question is whether inputs should be as consistent as possible with observable market *inputs*. Ms. Seidman stated that *prices* should be changed to *inputs*.

9. Mr. Linsmeier stated that if the Board agrees to the building blocks, it is agreeing that any measurement basis uses a building block approach and that remeasurement will occur. He observed that proceeding with a building block approach suggests that a company would always have to build up the price of contracts. Mr. Smith stated he assumed the price charged by insurance companies had been built up based on the different variables.

10. Mr. Linsmeier stated that he does not want a remeasurement approach that builds up the price, but, rather, he wants to check the price and true up the underlying estimates as consistent as possible with observable market prices. Mr. Herz noted that this would be the same as entry value.

11. Mr. Linsmeier stated that these were good concepts to be thinking about. He believes the Board cannot lock into all the concepts until decisions on subsequent issues are made and the determination of what is implied by those decisions is made.

12. Mr. Golden pointed to Issues 2 and 3 (below) as the center of the measurement issue. Ms. Seidman stated that the use of estimates that are as consistent as possible with observable market prices is written with an exit price principle in mind, and, therefore, she objects to that building block. Mr. Trench clarified that the staff's intent was to start broad and tailor the building blocks after a measurement objective was determined by the Board.

Issue 2—Potential Measurement Candidates for Insurance Contracts

13. Mr. van der Veen listed the five potential measurement candidates the staff is considering for insurance contracts. These candidates include current exit value (as defined in the Discussion Paper), three variations of a fulfillment value approach, and unearned premium for the short-duration claims period. The focus of the meeting was on the first four candidates. He stated that the candidate for unearned premium will be revisited at a future meeting. The distinguishing characteristics of each candidate are the objective (transfer or fulfillment), the margin(s), and how day one differences should be treated.

Staff Recommendation

14. The staff recommended that current exit value may be conceptually preferable, but that current fulfillment value is consistent with the measurement objective for revenue recognition and is more practical regarding the issues with generating market-consistent estimates for liabilities that are not generally transferred.

Board Vote

15. All the Board members supported the staff recommendation.

Board Comments

16. Mr. Linsmeier stated that he does not view the question as exit value versus fulfillment value, but, instead, whether there should be a market participant view based on the measurement attribute or a *search and destroy mission* for market participant views.

17. Ms. Seidman stated that she believes progress would be made if the staff recharacterized current exit value as a Statement 157 approach and current fulfillment value as not a Statement 157 approach. She stated that if a fulfillment view was supported, depending on which fulfillment view, the measurement may result in a similar exercise to a fair value calculation with entity-specific cash flows. Mr. Linsmeier commented that by supporting fulfillment value, the measurement would not require using market participant views in Level 2 for expected cash flows. He observed that in applying the measurement approach, if the entity went through the process and determined there were no market participant views then the measurement would be a Level 3 estimate, which would include entity-specific cash flows, but that some market participant views would still be used for discount rates or margins. He further observed that these approaches may result in an identical measurement even though a different process was taken to get there. Mr. Linsmeier questioned whether it is worth creating another label when the outcomes would be identical. He stated that he believes fulfillment value is more fundamental because conceptually, it states that the contract will not be transferred but will be carried out. Ms. Seidman stated that she does not believe the outcomes would be identical.

18. Mr. Leisenring stated that by agreeing not to do current exit value, the decision would be a prejudgment about the level of bifurcation and segmentation that would be required under a measurement based on fulfillment value. He observed that some insurance contracts are not distinguishable from derivative instruments or any other bank deposit or financial instrument. He stated that if current exit value is rejected, it would be

necessary to explain (a) why financial instruments are derivative instruments if they are written by an entity other than an insurance company and (b) why different accounting is applied if the same instrument is written by an insurance company.

19. Ms. Seidman noted that at this point the Board needs to decide on a broad principle of how to approach measurement questions that does not preclude that, for example, an embedded derivative would be measured at fair value under FASB Statement No. 133, *Accounting by Derivative Instruments and Hedging Activities*.

20. Mr. Siegel stated that some annuity contracts are very similar to financial instruments but are labeled as insurance contracts. However, he noted that he wants to decide on a general approach now and then test the approach later with specific types of contracts, which will address some of the questions of other Board members. Mr. Proestakes agreed that the staff is looking for a model for insurance contracts and will later address what is considered insurance. Mr. Siegel stated that when he analyzes insurance companies, he looks at them differently depending on the line of business. He observed that for life insurance companies, if the underwriting is done the same across different companies the liability is not the issue. Rather, he looks at the asset side to evaluate how the company is performing. He further observed that for property and casualty insurance, he looks at the loss development triangles, Schedule P statutory information, statutory blanks, and entity-specific estimates the company has made versus how the actual amounts have developed to evaluate the company's performance. Mr. Siegel stated that he supports a fulfillment value objective.

21. Mr. Linsmeier noted that some of the information from loss triangles can be very valuable in analysis, but that he is concerned about duration mismatch. He stated that he does not think about the liability in isolation but rather that he has a bias for having the assets and liabilities measured under the same attributes and concepts or else it does not reflect the duration mismatch. Mr. Siegel noted that the last wave of insolvencies for the insurance industry in the 1990s was due to asset-liability mismatch. He stated that either measurement approach (exit value or fulfillment value) will result in better information.

22. Mr. Golden questioned how exit value versus fulfillment value helps with duration mismatch. Mr. Linsmeier expressed concern that the concept of fulfillment value may have drastically different measurement attributes for a liability than for an

asset. He noted that if there is a drastic difference between fulfillment value for the liability from the measurement for the asset (presumably fair value), a duration mismatch analysis may be rendered useless.

23. Ms. Seidman commented that currently most insurance companies have numerous available-for-sale assets and the liabilities are carried at cost. She questioned what would be derived from knowing if there is an accounting difference between the assets and liabilities. Mr. Leisenring commented that there was significant pressure on the IASB for a fair value option from the insurance industry so they could measure insurance liabilities at fair value.

24. Mr. Siegel stated that he supports a fulfillment value notion. He further stated that *an observable market price* is where problems would occur and that a fulfillment notion would be bound. He suggested looking to *observable market data* instead.

25. Mr. Smith agreed with Mr. Siegel in supporting fulfillment value. Mr. Leisenring questioned what the difference is between Level 3 in Statement 157 and the view that Mr. Smith and Mr. Siegel hold. Mr. Siegel stated that without digging into the question, he does not know that they are different. Mr. Smith stated that an insurance company would not be required to go to the marketplace to measure market prices charged for insurance coverage. Mr. Leisenring stated that there is no requirement to use the market to obtain pricing information in Level 3 under Statement 157 since there is no market for insurance contracts. Mr. Golden noted that new business is constantly being written so there is a market for insurance contracts. He stated that under a fulfillment notion, a company would not go to the market for pricing information, but would look at its own obligation. Mr. Smith stated that he views the fulfillment approach as more of an entry price notion than an exit price notion. Mr. Leisenring stated that a company does not fulfill anything at entry but that it fulfills the obligation when the contract is over.

26. Ms. Seidman stated that, under a fulfillment value approach, insurance companies would not be required to ask what it would cost to transfer the obligation to a disinterested third party. She stated that the fair value of a liability, under Level 3 of Statement 157, must include judgments about the current level of interest rates, current level of performance rates, any liquidity discounts, etc. She further stated that if a company negotiated with a lender what it would lend given the remaining terms, the

negotiated price would be an entry price and would not necessarily reflect any liquidity issues in the market. Mr. Leisenring noted that in the same market, the entry and exit price will be the same. Ms. Seidman stated that an entry price is not an exit price in cases dealing with a specific counterparty versus a disinterested third party. Mr. Leisenring observed that Ms. Seidman's view indicates there is fundamentally a different value between settlement with a counterparty and transfer, which is a fundamental difference with the IASB.

27. Mr. Herz stated that he wants the measurement approach to estimate future cash flows. He added that the measurement objective should not be to replicate a transfer, but should be a projection of estimated cash flows and present value of the cash flows using the best data available, whether it is internal or external. Ms. Seidman agreed. Mr. Siegel stated that he views the objective a little differently; the objective is the present value of cash flows, which is one technique to measure the fair value of liability. He stated that the ultimate result between a measurement based on exit value and a measurement based on fulfillment value may be the same, but the objective would be different. Mr. Smith also supported the measurement objective.

28. Mr. Linsmeier stated that he does not disagree but approaches the question differently. He questioned whether one of two things could be emphasized: (a) a search and destroy mission on market participant views, especially relating to cash flows, or (b) whether the Board even wants to embed the concept of having to find, in the estimated cash flows, the difference between what the market would charge and what the company believes cash flows would be. He noted that requiring a company to look at how the market would price the contract would be difficult, and that he does not want to make companies perform this type of measurement. He further noted that he is frustrated by having to choose between fulfillment value and exit value because fulfillment value is not yet defined.

29. Mr. Herz summarized that the Board agrees the objective is not the same as that of Statement 157. He stated that the majority of Board members support an estimated cash flow model. Ms. Seidman stated that it is extremely important to not use the same term to mean two different things. She clarified that the Board does not mean the exit price notion under Statement 157. She stated that although there may be many

similarities in the approaches that the Board ultimately decides on, the Board must be clear that it does not mean an exit price notion. Mr. Herz stated that while the estimation process may be similar, the objective is not the same.

30. Mr. van der Veen observed that on February 18, 2009, the IASB voted and five Board members were in favor of exit value, six Board members were in favor of fulfillment value, and three Board members were undecided. He noted that, for the time being, the IASB is going to proceed by developing both approaches until the IASB reaches a majority preference for one notion.

31. Mr. Leisenring commented that fulfillment value seemed to be an approach that allows an insurance company to embed its efficiency at the front end measurement to front end income. He stated that the IASB began to look at an insurance contract like writing a warranty, which does not allow for putting all efficiencies into the recording of a liability on day one.

32. Mr. Golden questioned what the IASB's approach is to resolve those Board members who were undecided. Mr. van der Veen stated that his team is going to continue to bring issues to the IASB for both the fulfillment value and exit value notions with the hope of eventually reaching a consensus.

33. Mr. Linsmeier stated that the Board may be calling it fulfillment, but actually may be talking about entry price. Mr. Herz stated that he is not talking about entry price. He further stated that the estimation process may be informed by entry price but there may be existing business in which new contracts are not originating. Mr. Herz noted that in this case there should not be a Level 2 adjustment, but a fulfillment value notion should be a measurement to reflect a good estimate of cash flows. Mr. van der Veen stated that insurance contracts typically originate in the wholesale market and are exited in the retail market so there is a difference between entry and exit market.

Issue 3—Measurement of the Margin at Inception of the Insurance Contract

34. Mr. van der Veen stated that there are the following views to address whether day one differences should be recognized in earnings at inception of a insurance contract (a day one difference would arise from how the margin is measured):

a. **View A—**Day one differences should be recognized in earnings. Under a current exit value measurement, the margin is measured based on a market participant's view. Under a current fulfillment value measurement, the margin represents the cost of bearing risk.

b. **View B—**Day one differences should not be recognized in earnings. Under a current exit value measurement, the margin is a separate explicit adjustment within the insurance liability. Under a current fulfillment value measurement, the overall margin is measured by reference to the premium.

Staff Recommendation

35. The staff recommends that day one differences should not be recognized in earnings at inception of the insurance contract (View B).

Board Vote:

36. Four Board members (Herz, Seidman, Siegel, and Smith) agreed with the staff recommendation that day one differences should not be recognized in earnings. Mr. Linsmeier supported View A.

Board Comments

37. Mr. van der Veen commented that on February 18, 2009, nine IASB Board members had voted for no day one differences to be recognized in earnings. Mr. Leisenring stated that the IASB's vote may have been persuaded because some members looked ahead at how the revenue recognition project seems to be progressing. He noted that the IASB did not want to answer the question about whether there should be *no day one net income* because the questions related to deferred acquisition costs remain open. Instead, he noted that the IASB focused on what should be done about revenue recognition and how much revenue recognition should be accelerated to break even on day one.

38. Mr. Herz supported no day one recognition of revenue and expensing acquisition costs because it would be consistent with the revenue recognition project. Ms. Seidman

acknowledged that a discussion of deferred acquisition costs is still warranted in relation to day one differences.

39. Mr. Linsmeier stated that he believes there is a performance obligation or some key economic activities that have occurred when an insurance entity obtains a customer. He observed that in the insurance industry, it appears that some companies view obtaining a customer differently than dealing with the risks in the contract, given that they pay so much upfront to obtain the customer. He questioned whether separable economic events occurred when obtaining a customer. He noted that this might suggest at least some revenue recognition to arrive at a zero gross margin. Alternatively, he noted that there could be a limit placed on the amount of profit margin. He stated that by proceeding with the revenue recognition project in the way the IASB did, some of the concepts of customer consideration did not flow through to other projects. He noted a point Ms. Seidman made about the fact that nothing is earned until the risk-bearing part of a contract has been addressed. He stated that the big issue that must be addressed by the insurance contracts and revenue recognition projects is whether there is a component of the contract that is separable for measurement. He further stated that there is a disconnect if the Board decides to remeasure the insurance contract on day two. He noted that if a decision is made that the insurance contract is measured at the entry price for day one and then only part of the insurance contract is remeasured on day two there would still be profit in the re-measurement. He noted that the Board still needs to determine how to remeasure the insurance contract before deciding how the insurance contract is measured on day one.

40. Ms. Seidman stated that the approach to the measurement of insurance contracts that she supports reflects the original compensation for the risk and updates the expected cash outflows, which would not result in a change in revenue recognition. Mr. Linsmeier stated that this is what he sees as the asset-liability value mismatch because the expected cash flows would not just be used on the asset side. Mr. Smith agreed with Ms. Seidman and stated that if remeasurement occurred on day two and there was no change in expected cash outflows, there would not be any remeasurement.

41. Mr. Siegel stated that assuming no deferred acquisition costs and limiting the question to earnings, not revenue, he is not in favor of day one recognition of earnings. He stated that he is leaning toward not recognizing revenue when a contract is signed.

42. Mr. Herz stated that his preference is no day one revenue, and when the Board discusses acquisition costs it should be consistent with the discussions in the revenue recognition project. He further stated that the issues of accelerating revenue or capitalizing acquisition costs are poor surrogates for the economics of whether there is a customer intangible. Mr. Leisenring noted that insurance contracts include a contract and a written option (and there may be an asset). Mr. Herz commented that the estimation of cash flows assumes there is some renewal pattern and possibly a customer intangible.

Issue 4—Additional Measurement Candidates to Consider

43. Mr. Cropsey asked the Board if there were any other measurement approaches it wanted the staff to reconsider. He referred to the candidates listed in paragraph 36 of FASB Memorandum #7, which was issued on February 6, 2009 (value-in use, FASB Statement No. 163, *Accounting for Financial Guarantee Insurance Contracts*, approach, allocated transaction approach, IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, approach, IAS 39, *Financial Instruments: Recognition and Measurement*, amortized cost approach, IAS 39 financial instrument approach, current entry value, and embedded value). He stated that the phrase *expected cash flows, undiscounted, and with no risk margins* is an important issue for some U.S. constituents and that the FASB will address that question in a future meeting. He noted that the IASB made a tentative decision about that issue in which expected cash flows should be discounted and include a margin.

44. Mr. Linsmeier suggested developing a fulfillment approach that includes both a risk margin and a service margin. He said the Board needs to understand when, how, and where entry value would differ from fulfillment value. He asked that if the Board were to decide to build up the price, would a relevant entry price be ignored.

45. Ms. Seidman noted Mr. Linsmeier's concern about asset-liability management and suggested the staff find out how users would deal with not having the same measurement on the asset side as on the liability side.

Follow-up Items:

None.

General Announcements:

None.