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: 8:30 a.m. to 12:00 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.

Marc Oberholtzer (AAA-P/C) stated that if the probability-weighted estimate objective is a mean, then yes it would be the appropriate method to measure insurance contracts but if it is a descriptive approach that requires probability-weighted cash flows the answer is no.

Before responding to the question, Henry Siegel (New York Life) noted that everything in this project is interconnected so his comments about cash flows will have repercussions for margins. He stated the principle should be to include all of the cash flows associated with the portfolio of insurance contracts because when the insurer prices the product it prices for everything. One of the problems with this model is that the IASB version results in a huge residual margin and the FASB version results in a very large composite margin because so many of the cash flows that are appropriate are not included in this building block.

Henry Siegel urged that all the cash flows be included but if the Boards decide to limit acquisition costs he urged that they use the FASB version. Larry Smith was concerned as to what cash flows should be included; he asked where they would draw the line. Henry Siegel responded that the determination should be made based on the company's business practices. Mr. Smith was concerned that unless all companies price in the same way's there would be a lack of comparability. Henry Siegel felt that this could be addressed with proper disclosures.

Nick Bauer (Canadian Life and Health Insurance Association) stated that this method has been in place in Canada since 1992. He agreed with Henry Siegel that all cash flows should be included in measuring the liability with very few exceptions, typically for expenses that are not expected to reoccur. Lynda Sullivan (GNAIE - Life) stated that in Canada there is a gain or loss at inception so it is important that all cash flows be included. She went on to explain the controls that are in place and noted they are very similar to US GAAP.

Peter Duarte (Factory Mutual) said that P/C companies currently calculate claims based on the mean. He was concerned as to how they would apply the method in the proposal which requires them to apply an estimate on top of an estimate which they may not be able to back up with data. He was also concerned with the disclosing the probabilities used because it could put the company at a competitive disadvantage and feared there would be tax issues if the IRS does not allow the method.

Craig Mense (CNA) agreed with Duarte and added his concerns from a P/C company perspective which included that the level of certainty implied by the use of the term *probability-weighted* and a statistical mean is wrongheaded and not valid. He stated that in reality P/C actuaries apply a number of different techniques to come up with a range for what claim reserves should be to which management judgment will be applied. He was concerned that the method appeared to preclude management judgment and he believes investors would be unable to understand how the reserves were arrived at.

Tom Linsmeier suggested it would be useful for the Board to understand the range of actuarial methods used to come up with other than a probability-weighted mean as well as their auditability, comparability, and uniformity, so that it can be convinced that the end result is not just the actuaries' or management's whim. He questioned why the insurance industry was so special that it needed to smooth out its results. He also asked why revenue and expense recognition for the insurance industry should be so drastically different from the accounting for revenue and expense for any other industry. (At the end of the discussion of this topic, Mr. Oberholtzer stated that the Academy would be happy to host an educational session to explain the application of the actuaries' methods.)

Mary Hoeltzel (Health Insurers Group) replied that insurance was different because it deals with pooled risks and she made the point that health insurance contracts are short-duration and that having to do all the work required to use probability-weighted cash flows would not be cost- effective, would not get to a better answer than the current system, and would misleadingly imply certainty to investors. She questioned why the Boards were proposing the same model for all types of insurers.

Wayne Upton (IASB staff) stated that the IASB had considered having two models but concluded that it was better to have one and that expected cash flows was shorthand for a statistical mean, for understanding distribution around the mean, and for understanding distribution over time to be able to apply present value. He questioned Mr. Mense about his comment that insurers needed to layer management judgment on top of the statistical mean; he asked what that judgment would be that would lead management to second-guess its actuaries.

Mr. Mense used an example to explain the need for management judgment which assumed five methods were used, each of which made a number of assumptions and arrived at a loss curve with a mean skewed to the right. He argued that management needed to apply its judgment to arrive at a final number. He noted that the methods, assumptions, and management judgments are all disclosed. Mr. Upton stated he appreciates the difficulty of the process and agreed it was appropriate to apply management judgment but he was concerned that it could be applied for other than predictive reasons. Keith Bell (Travelers) stated that management may have reasons to believe that the past is not predictive of the future. Mr. Upton seemed satisfied and stated he could write management judgment into the standard.

Tom Jones (AIG) stated that the current insurance accounting standards work well and have been around for over 60 years with few revisions and no outcry for changes. He stated that two models would be appropriate because the products sold by life and nonlife companies are drastically different. Later he added that the only reason he could think of that might justify establishing a new insurance accounting standard would be to achieve exact convergence.

Mark Wilcox (RenaissanceRe Holdings Ltd) explained that currently the industry does not maintain CAT reserves, that CAT reserves are booked after an event. He noted that the proposed building blocks model would require companies to reserve for potential CATs. Mr. Wilcox argued that this was not appropriate as CATs are uncertain and occur infrequently and it was highly unlikely any would occur during the one-year coverage period. He stated the insurers all use different CAT models so they would have different estimates of future CATs resulting in no comparability. He stated it would be preferable to establish a reserve after a catastrophe has occurred based upon best estimates of the incurred loss.

Mr. Bauer noted that in Canada the standards for P/C companies are different from US GAAP. His company does business in both Canada and the US so he has a problem with having two different standards and made a plea for a single worldwide standard. Henry Siegel, responding to Mr. Linsmeier's question about why the industry was so different, noted that the industry proposal was not that different from the revenue recognition model; industry was suggesting that the margin should run out over the coverage period. He stated that insurer results would never be smooth as the industry was too volatile. He also noted that insurance had been carved out of the revenue recognition model.

Joe Fritsch (NYS Insurance Department), representing the NAIC and the IAIS, stated that he was concerned with "unbiased and probability-weighted cash flows" because it is appropriate for management to make judgments; however as a P/C regulator he was also concerned that when there is a range, management often picks a number from the low end. With respect to CATs, Mr. Fritsch stated that regulators have been looking at establishing reserves. He was troubled that companies put a loading into their prices but rather than accumulating a reserve they dividend the money out when there is no loss during the coverage period with the result that there is nothing there to cover a catastrophe when one does occur.

Mr. Smith repeated Mr. Linsmeier's question as to why the insurance industry was so special and asked the participants to address that question when discussing the other topics. He noted that Mr. Hoeltzel had stated insurance was different because it deals with pooled risk but he said that is not so different from impairment of financial instruments. He told Henry Siegel he did not share his opinion that the industry's proposed model was not so different from the revenue recognition model; he thought it was vastly different. A MetLife representative suggested that having to set a price on day-one for something that will not be paid out for 30 to 50 years makes life insurance different from other industries.

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.

Lynda Sullivan (GNAIE – Life) stated that if a company's assets are valued at fair value its liabilities should also be discounted. She advocated using an asset-based rate. Tom Linsmeier said that when deciding on the appropriate discount rate one needed to think about underwriting risk and asset management risk. She believes dealing with the underwriting risk using the asset rate would intermingle the two risks and incorrectly imply that the asset risk matches the liability risk. Ms. Sullivan stated that pursuant to Canadian GAAP her company, Manulife, links its liability discount rate with its assets and does have volatility, most of which is on the asset side because actual returns may differ from expected returns for two reasons – credit, which goes up and down every quarter but more likely declining interest rates in the US.

Mr. Linsmeier replied that his interest was not in eliminating volatility but rather to accurately reflect it. He stated he did not want to mask underwriting risk by discounting it based on an asset return as if the asset return was taking care of the underwriting changes. Nick Bauer (Canadian Life and Health Insurance Association) stated there is only one liability measure on the balance sheet of a Canadian company but there is also a source of earnings analysis which allows the user to assess underwriting results separately from asset management results.

The analysis compares current year expected returns to actual returns and updates expectations for the coming year.

With respect to the discount rate, Mr. Bauer stated that theoretically it should make no difference whether it is the risk-free rate plus a liquidity adjustment or the asset-based rate but there was no academic or professional literature on how to calculate a liquidity adjustment so it made more sense to use the asset earned rate for which there is more data. He added that this method has been in use in Canada for 20 years and has worked very well.

Marc Siegel (FASB) liked the suggestion to use a rate that is implicit in the contract but he questioned its operationality. Mr. Upton wanted those who advocate using a cost method to explain what is meant by cost, noting that some say cost is the locked in interest rate at inception but others are more expansive.

Len Reback (MetLife) stated that he does not read the principle in the DP as risk-free rate plus a liquidity adjustment but even if that were the principle it is not clear how the liquidity adjustment would be calculated. He feels that it would be difficult if not possible to use a rate that is implicit in the contract based on its current exit price.

Donald Duran (PwC) suggested that it does not make sense to use asset rates because theoretically a company could invest in assets that had a 15 percent return so they would not be comparable. He noted this could not happen in the US because regulatory restrictions on investments ensure that they are of high quality. Duran also noted that the Boards have come up with four different discount rates in their standards so this is a bigger issue than just insurance.

Mr. Duarte noted that the concept of discounting does not make a lot of sense for P/C short-term contracts for which liabilities are settled in less than a year. Henry Siegel (New York Life) stated that assets and liabilities in a life company are connected. If interest rates go up healthy policyholders will let the policy lapse so they can get a better rate so morbidity and mortality are connected to interest rate movements. He also noted that in many jurisdictions there is no such thing as a risk-free rate as their governments cannot print money as is done in the US.

Mr. Linsmeier requested reactions to his observation that the shortcutting the Concept 7 description of a discount rate as being a risk-free rate plus a liquidity premium may have missed the boat. He wondered whether it might be better to use a liability discount rate that would allow the insurer to think through what those risks are comprised of. He would also like to hear more with respect to his concern that when the volatility in the assets is different from the volatility in the liabilities, that the difference between actual and expected is picked up during the period.

Wayne Upton (IASB staff) after acknowledging that FASB Concept 7 took the easy way out by saying that the objective was always fair value; noted that the IASB has four or five different objectives and the objective for this project is the current measurement of the fulfillment obligation. He asked for help to figure out why in a fulfillment world the Boards should think about things that seem detached from the liability.

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.

Len Reback (MetLife) said that his company was more supportive of unbundling than some of the other commenters. He stated there are components of some insurance products that look a lot like financial instruments and some life insurance products closely resemble financial instruments so life companies are concerned with using a model that is very different from IFRS 9, *Financial Instruments*. He stated MetLife therefore supports some unbundling such as lump sums within structured settlements where the payments are nonlife contingent as well as contracts with significant pre-funding and treating those components that are not really insurance as financial instruments.

Ms. Weiner asked if MetLife was supporting unbundling because of the potential for different a discount rate under this standard and whether if the models were consistent it would still support unbundling. Reback agreed that the fact that there is no consistency is what makes unbundling an issue.

Henry Siegel (New York Life) commented that if there is consistency it would not make a difference so they should not bother with unbundling. However he said there are certain situations when it is necessary to unbundle. For example, there should be requirement to unbundle a derivative that is unrelated to the insurance contract, particularly if the measurement does not capture the value of the derivative.

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.

Rick Lynch (AICPA/FINREC Insurance Expert Panel) preferred a single composite margin because of concern with the lack of clarity in the IASB proposal regarding the risk adjustment which he thought could result in its size varying from company to company, causing confusion and lack of comparability. Peter Carlson (MetLife) concurred.

Henry Siegel (New York Life) also supported the composite margin and distributed a copy of a slide prepared by the Society of Actuaries to illustrate why. The slide shows a very small risk margin for life insurers in comparison to the residual margin. He stated the residual margin is so large because it includes overhead, origination acquisition costs, and other items that are not related to risk. He noted however that if the cash flows were adjusted to remove these unrelated items the residual margin would only represent the risk provision and the premium for asset risk so the IASB proposal might work. With regard to the limitation on the techniques for calculating the risk adjustment, Henry Siegel stated it was a crazy thing to do because it precludes innovation.

Lynda Sullivan (GNAIE – Life) agreed with Siegel that before a risk adjustment could be considered they needed to get the underlying cash flows right. She noted that in Canada a risk margin is used and it includes all asset and underwriting risk.

Mark Oberholtzer (AAA) said that the Academy was split on this question. Referring to Henry Siegel's slide, he stated that for P/C companies the risk adjustment piece would be much larger and the split margin approach would have a better chance of matching economic realities but he believed the composite margin would be easier to calculate and to compare between companies. However when the results emerge differently from what was expected the composite margin would become less relevant and probably would not reflect economic reality.

Peter Duarte (Factory Mutual) also supported the composite margin although he agreed with Mr. Oberholtzer that it may not always be relevant. He commented that the risk adjustment may not be very informative for the user and may be difficult to compare.

Leslie Seidman asked Mr. Siegel how origination acquisition costs and overhead relate to the risk margin issue. Henry Siegel agreed that they were not related but said his point was that the risk margin requires a lot of work to calculate and since it is so small in relation to the residual margin he did not see the point of doing the calculation. He also noted that if the two margins were reported separately they could be interpreted to say that there is very little risk when in fact the asset risk is buried in the residual margin.

Keith Bell (Travelers) said that using the two separate margins would be difficult to understand, would not be comparable, and may not be reliable because companies with very similar risks could have different but reasonable approaches to calculating the risk adjustment. He said there were also problems with the composite as it does not fit all products and he thought that more work would need to be done if the composite margin approach were adopted.

Tom Linsmeier asked Mr. Oberholtzer if the composite margin would work better if it were remeasured. Mr. Oberholtzer replied that it depended on what approach was taken to do the remeasurement.

Larry Smith noted that the participants in the London Roundtable had mostly favored the two margins and he asked why the views were so different in the US. Siegel replied that it was because Solvency 2 required a risk margin. Mr. Lynch added that the two margins would also increase transparency and shed light on the insurers 'black box'. Mr. Linsmeier asked why disclosure could not be used to satisfy Solvency 2. Ms. Sullivan replied that if there are two items on the balance sheet it is easier to do a non-GAAP measure that is readjusting the liability through equity. She added that in Canada they are used to a risk margin and believe that it can be calculated. She was concerned with the suggestion of opening up the residual margin.

Wayne Upton (IASB staff) believes that one reason the IASB favors two margins was to deal with the onerous contract. He also stated that the assumption was that the residual margin would not be recalibrated because no one understood what that meant other than just reducing it to zero.

Donald Duran stated that PwC was unable to recommend either approach because it was not clear how amortization would work. For the composite margin, the concern on the life side had to do with how to allocate premium over the life of the contract given that most of the payments would be made at the end.

Mark Wilcox (RenaissanceRe) favored the composite margin approach because it is difficult to get at a best estimate of the risk adjustment or to determine the confidence level, especially for P/C companies. In addition he felt that the composite approach would provide better comparability and consistency.

Joe Fritsch (NYS Insurance Department) preferred the composite margin because profits are not taken too soon. He suggested the residual margin could be disclosed and he did not favor limiting the techniques for measuring the risk adjustment.

Pat Finnegan (IASB Board Member) stated that for life companies the risk margin was relatively modest as compared to the residual margin but for P/C companies the opposite was true. He believes that the two margin approach will provide investors with better insight into the variability of the measurement of insurance liabilities. He has heard from many in the P/C industry that they are reluctant to make their judgments explicit although they do calculate risk adjustments and embed them in their prices. He would be open to disclosing this information when it is material and not disclosing it when it is immaterial.

Henry Siegel pointed out that the risk adjustment calculation is flawed because the key risk in life insurance is investment risk and it is not included. He did not like Mr. Finnegan's proposed disclosure compromise because even when a standard does not require something to be done because it is immaterial a company must nevertheless do the calculation in order to satisfy its auditor that it is not material.

Nick Bauer (Canadian Life and Health Insurance Association) commented on Henry Siegel's statement that for life the risk adjustment is very small. He stated that for some products it is quite significant even for non-investment risk. In Canada the investment risk is included in the risk adjustment; he agreed it is significant and a risk adjustment that does not include investment risk is flawed. Mr. Bauer noted that when a premium is calculated it includes everything but under a composite margin approach the entire premium is allocated to the best estimate piece resulting in a much inflated composite margin. Using a residual margin greatly reduces this problem and makes the valuation of the contract consistent from one year to the next.

Craig Mense (CNA) stated that there were no proven actuarial techniques for determining the P/C risk adjustment and companies are reluctant to disclose their risk adjustments because of a lack of confidence in their modeling techniques. He stated CNA ran the three techniques contained in the IASB proposal and came out with "wildly different answers". Mr. Oberholtzer raised another issue specific to P/C companies: depending on whether diversification is considered across portfolios or individually for each portfolio the answers will be very different.

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.

Peter Carlson (MetLife) stated that his company supports the two model approach based on duration but instead of a bright line there should be a principal for identifying short-duration contracts. With respect to presentation, he was concerned about the focus in the performance statements being solely on profitability and their lack of volume information such as claims experience, market share, and comparability of period-to-period that users generally want to see. He was also concerned that having unique financial statements would further isolate the insurance industry and discourage investors.

Keith Bell (Travelers) also wanted two models based on duration. He stated that it is well understood globally what is a short-duration contract without the need for a bright line. However he felt that the approach is only simplified when compared to the building block approach and he preferred continuing with the current Unearned Premium Reserve (UPR) approach. He also believes the current presentation should not be changed.

Peter Duarte (Factory Mutual) suggested that there was no need to have a new model for insurance as the current one worked very well during the credit crisis. However if there is going to be a change he supports separate models for life and nonlife. With respect to the modified approach for short-duration contracts, he said that because the onerous test must be done on these contracts, it is not really a simplified approach. He also noted that his company writes three-year policies which are re-priced each year so the definition of a short-duration contract needed to be changed.

Marc Oberholtzer (AAA) also commented on the onerous contract issue. He stated that the definition appears to require that the test be done on a more granular basis; that it is no longer on the portfolio of contracts. In addition he argued the implication of having to prove that there is no premium deficiency is that the full model would always have to be done. He made a plea for retaining the current revenue recognition methodology for insurance because it works and it is understood. He did not think that making it a little more precise was worth the complications that would make it difficult to understand.

Bill Boyd (NAMIC) stated that the modified approach was not that simple and suggested it was not rational to scrap it simply to achieve convergence and urged continuation of the UPR method which he characterized as a good, usable, workable, and recognized method.

Mark Wilcox (RenaissanceRe) cautioned that the reinsurance on contracts that qualify as short- duration should be treated the same as the online contract.

Tom Jones (AIG) recommended that the FASB delay any decisions on convergence until it hears what the SEC has to say with respect to convergence of standards in its 2011 report.

Lynda Sullivan (GNAIE – Life) noted that in Canada insurers are required to provide the source of earnings exhibit which is public but not part of their GAAP financial statements.