FASB Education Session – Insurance Contracts PricewaterhouseCoopers Summary of Meeting

24 September 2009

FASB Education Sessions are informational meetings only, where no decisions are reached, and any tentative thoughts expressed by the staff or Board may change at future Board meetings. In addition, decisions of the FASB that are reached at the more formal Board meetings become final only after completion of a formal ballot to issue a final standard.

Highlights

At the September 24 education session, the FASB staff provided background to the Board in preparation for its September 30 Board meeting to discuss both the objective and the guidance for determining a discount rate used in measuring insurance liabilities. The staff noted that the IASB recently discussed whether guidance for discount rates should be based on:

- a principles-based approach in which the discount rate would reflect the characteristics of the liability,

or

- a practical approach; i.e., prescribing an observable market rate such as that used in pension or other accounting guidance

At its meeting, the IASB tentatively agreed that the exposure draft should state the principle of a discount rate, i.e., that it reflects the characteristics of the liability, rather than prescribe an observable market rate.

The FASB staff, in contrast, noted that it currently supports the practical approach of prescribing a rate. The Board will formally address this issue at the September 30 Board meeting.

The Board also discussed other issues relating to the project, including recent IASB decisions on the measurement method (slight majority vote for the updated IAS 37 model over the fulfillment value model) and policyholder accounting (exclude from the exposure draft in the interest of time).

Detailed Discussion

Discounting

The FASB staff referred the Board to the September 18 IASB staff paper on discounting (IASB agenda reference 17D) and summarised the choices presented by the IASB for guidance on the discount rate as:

- a principles-based approach in which the discount rate would reflect the characteristics of the liability,

or

- a practical approach aimed at reducing complexity and fostering comparability by prescribing an observable market rate such as that used in pension or other accounting guidance. A practical approach might result in the use of a rate for high quality fixed income debt instruments, as is used in some other accounting guidance, such as the discounting of pension obligations.

At its meeting, the IASB tentatively agreed that the exposure draft should state the principle of a discount rate, i.e., that it reflects the characteristics of the liability, rather than prescribe an observable market rate. The FASB staff noted that it currently supports the practical approach of prescribing a rate, such as the rate for high quality fixed income debt instruments. The staff noted that use of a prescribed rate is similar to other accounting guidance, such as pensions, and believes that the fulfillment value has a similar objective to a pension liability measurement. Use of a prescribed rate would also provide comparability among companies.

FASB Board members asked questions of the staff about the recent IASB tentative decision to use a principles-based approach reflecting the characteristics of the liability, and also made some preliminary comments about the two different approaches. Initial comments from the Board did not reveal a leaning in any particular direction. While there was acknowledgement of the benefits of a practical approach, including comparability, relative ease of estimation, and lack of subjectivity, there was also concern about the lack of an objective or principle in such a rate, and the potential disconnect with the economics of the insurance transaction.

With regard to the IASB decision, one FASB Board member asked the FASB staff to provide more detail on "the rate that reflects the characteristics of the liability." For example, would that rate include own credit risk? What particular "characteristics" were they referring to? The FASB staff's understanding was that "characteristics" would include items such as the timing, liquidity, and currency of the cash flows. With regard to own credit risk, the FASB staff noted that as described in the IASB paper, the issue of whether own credit risk should be included in the liability measurement was not discussed by the IASB during their recent discount rate discussion, as it was noted that this issue is being separately considered in the IASB's fair value project. The staff noted that feedback to date on the IASB's request for comment on its discussion paper on credit risk is that excluding own credit risk from liability measurement is a popular view.

One Board member questioned the principle behind using a prescribed rate such as the rate on high quality fixed income investments, arguing that a risk free rate seemed like the more appropriate conceptual rate, given that any expected uncertainties in cash flows were being reflected in the expected cash flow building block. The staff pointed out that there were issues with using the risk free interest rate observed from instruments such as certain government bonds, which are liquid, in situations where the insurance liability was illiquid. In such instances, a liquidity adjustment would theoretically be needed. Not making this adjustment could result in artificial Day 1 losses. However, there is some concern that a liquidity adjustment might not be easily or reliably estimable.

The Board will formally address this issue at the September 30 Board meeting.

Other Issues

The FASB staff provided the Board with an update on the IASB's recent eight to seven vote in favor of the updated IAS 37 model over the fulfillment value model. The staff said it was unclear whether the split support was due to the minority position favoring the fulfillment value model, or due to the fact that the IAS 37 model was not yet totally developed. Several Board members commented that it would be helpful to see "the movie version" of both models, including financial statement impacts and detailed journal entries, with separate examples for life and property/casualty contracts. The staff noted that they were in the process of preparing examples of the fulfillment value approach, to date on the "easier" property/casualty contracts and not life contracts.

The Board characterised the fulfillment value model as model being developed in its revenue recognition joint project, while the IAS 37 model was more of a liability measurement approach. It was still unclear to the FASB Board and staff how revenue recognition would be handled if the IAS 37 approach were adopted for insurance contracts, as the IASB had not provided any papers or examples in this regard in the May 2007 discussion paper or currently. The Board thought that a more detailed explanation of the two liability measurement approaches, and consideration of the revenue recognition model, should be key areas of discussion at the October joint Board meeting.

The staff also noted that the IASB had recently decided to drop the consideration of policyholder accounting from the exposure draft in order to meet its timetable for a December 2009 exposure draft. This prompted a question from the Board as to whether reinsurance would still be considered in the exposure draft, to which the staff replied that it would. A Board member asked what key measurement issues they had yet to discuss. The staff responded that policyholder behavior and the boundaries of the contract was a key issue which the FASB Board had only discussed at an education session to date.

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