CAS Fair Value Task Force
White Paper on Fair Valuing Property/Casualty Insurance Liabilities

Section A - Background

1) Definition of "fair value"

What is "fair value?" Accounting authorities do not currently have a consistent definition for this term. However, a short definition[1] could be:

a. the market value, if a sufficiently active market exists, OR
b. an estimated market value, otherwise.

If no active market exists, an estimated market value can be determined from the market price of similar assets (or liabilities). If no sufficiently similar assets (or liabilities) exist, the estimated market value is based on a present value of future cash flows. These cash flows are to be adjusted for "the effects of … risk, market imperfections, and similar factors if market-based information is available to estimate those adjustments."[2]

In adjusting these cash flows, one of the more controversial possible adjustments is the impact of the entity's (or obligor's) own credit standing. Under some proposals, the weaker the obligor's financial situation, the lower the fair value of their liabilities would be. The assumption is that the parties to the entity is indebted to would lower their settlement demands, recognizing the risk of possibly getting much less if the entity went insolvent. This would represent a major change to the accounting paradigm for "troubled" companies. A separate section of the white paper has been devoted to this issue, due to its controversial nature and its impact on almost every facet of the fair value discussion.

Note that the fair value is an economic value, but not the only possible "economic value." Other examples of economic values include economic "value-in-use" and forced liquidation value. Economic value-in-use can be defined as the marginal contribution of an item to the overall entity's value. The forced liquidation value is the cash value achievable in a forced sale. Due to the pressures involved, the forced sale price may be materially different from the normal market price.

While fair value accounting could be applied to any asset or liability, it is most commonly an issue for financial assets or liabilities. Financial assets are generally either cash or contractual rights to receive cash or another financial asset.[3] Financial liabilities are generally obligations to

---

[1] There is no universally accepted definition of "fair value" to-date, although they all follow the same general concept given by this short definition. The detailed definition that FASB is proposing can be found in FASB's Preliminary Views document titled "Reporting Financial Instruments and Certain Related Assets and Liabilities at Fair Value," dated December 14, 1999, and labeled "No. 204-B." The definition starts on paragraph 47, with discussion and clarification continuing through paragraph 83. Paragraph 47 states:

> *" Fair value is an estimate of the price an entity would have realized if it had sold an asset or paid if it had been relieved of a liability on the reporting date in an arm's-length exchange motivated by normal business considerations. That is, it is an estimate of an exit price determined by market interactions."*

The IASC has a similar definition (found on page A181 of their Insurance Issues Paper, released November 1999). It reads:

> *"The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction."*

[2] Paragraph 56 of the FASB Preliminary Views document mentioned above.

[3] This is a simplified definition. A more complete definition includes both options and equities in its scope. Note

provide financial assets.[4]

Lastly, a fair value accounting system focuses on the measurement of assets and liabilities, not income. The income statement in such a paradigm is just a consequence of the changing balance sheet.[5] This is in contrast to a "deferral and matching" approach, such as that used to justify prepaid expense assets (e.g., Deferred Acquisition Costs, or DAC), where the focus is to match revenues and expenses in the income statement. As a result, a fair value income statement could look very different from traditional income statements.

2) Recent history of the fair value concept - United States.

Financial assets and liabilities are accounted for in numerous ways under current U.S. accounting rules (GAAP, statutory insurance and tax). These include historical cost, amortized cost, market value, present value of future cash flows, etc. Each of the various measuring approaches has its advantages and disadvantages. Some approaches produce values that are more readily verifiable than others, but perhaps not as relevant. Others produce more relevant values, if done correctly, but they may not be feasible to use or may be too subject to manipulation.

Historically, many financial assets were accounted for at cost or amortized cost. These values were readily available and verifiable, resulting in balance sheet values that could be produced at minimal cost and that were relatively easy to audit. Likewise, many financial liabilities were at ultimate settlement value, a value that in many cases is contractually set and hence, readily available and auditable.[6]

During the U.S. banking crisis of the late 1980s, this accounting approach caused problems. Banks, which held many financial assets at historical cost, were undergoing financial strains. Many became aware that their reported balance sheet value could be improved by selling those assets with a market value greater than book value, where the book values were based on historical or amortized cost. Assets with market values less than book values were retained, as selling them would only decrease the reported book equity.[7] As a result, many banks were left with asset portfolios dominated by weak and underperforming assets, and many of these banks eventually went insolvent.

---

that this is considered to be a recursive definition, not a circular definition.

[4] This is a simplified definition. A more complete definition would include options-related obligations that would negatively impact the entity if executed.

[5] Accounting systems that focus on the balance sheet are labeled "asset-and-liability-measurement" approaches by the IASC Insurance Issues paper (e.g., paragraph 159). Fair value is an example of, but does not exclusively define, such approaches.

[6] This is clearly not the case for the property/casualty industry, where the amount of the loss is not set by contract, but instead determined via a settlement process.

[7] This process of selling those assets with market-over-book, while retaining those with book-over-market, is referred to as the "cherry-picking" of assets.

Section A - Background

The FASB,[8] and many others, felt that a balance sheet based on market values would have provided earlier warning of a bank's financial weakness. They proposed that all bank financial assets be reported at market value, at least for U.S. GAAP financial statements. These concerns resulted in FAS[9] 115, which requires market value accounting for those assets held in a "trading portfolio." These discussions also led to the discussion of fair value accounting for financial assets and liabilities.

New problems arose when determining the scope of FAS 115. Recognizing the fact that many financial institutions compete against one another, whether in the same narrowly defined industry or not, FASB proposed that all U.S. financial institutions be subject to their new asset reporting rules. This would include securities firms, life insurers and p/c insurers (although it is less obvious how p/c insurers compete directly with the others on this list). The FASB's concern was that to not treat all competitors equally in these rules would result in an uneven playing field.

Several parties raised concerns with requiring assets to be held at market value, when the liabilities were not reported at market. They believed that this would cause reported equity to become very volatile and not meaningful. Given the desire for consistency between asset and liability valuation, and the belief by many that market value (or even fair value) accounting for insurance liabilities was not possible, they proposed that the standard's scope exclude the insurance industry. The FASB was not swayed by this argument. They decided to include the insurance industry in the scope of FAS 115, and possibly address the balance sheet inconsistency at a later date.

Since then, the FASB has had a stated vision of having all financial assets and liabilities reported at fair value, pending resolution of any remaining implementation issues.[10]

<u>3) FASB Fair Value project</u>

In 1986, FASB added a broad-based project concerning the appropriate accounting for financial assets and liabilities (i.e., financial instruments) to its agenda. As of a result of the influences mentioned above (and others), it has evolved into the FASB Fair Value project.

The FASB has held discussions on this project during much of 1999. In December of 1999, they issued a "Preliminary Views" document on this project, which was intended to communicate their initial decisions and to "solicit comments on the Board’s views about issues involved in reporting financial instruments at fair value." The preliminary views document had a comment

[8] Financial Accounting Standards Board, the principal setter of GAAP accounting standards in the U.S. The FASB's standards are superceded only by the Securities and Exchange Commission (SEC). The FASB also must approve AICPA standards of practice before they can become effective.

[9] Financial Accounting Standard. Financial Accounting Standards, or FASs, are issued by the FASB.

[10] In paragraph 3 of the previously mentioned FASB Preliminary View document is a quote from FAS 133, that states as follows. "The Board is committed to work diligently toward resolving, in a timely manner, the conceptual and practical issues related to determining the fair values of financial instruments and portfolios of financial instruments. Techniques for refining the measurement of the fair values of all financial instruments continue to develop at a rapid pace, and the Board believes that all financial instruments should be carried in the statement of financial position at fair value when the conceptual and measurement issues are resolved. [paragraph 334]"

deadline of May 31, 2000.

This FASB document states that insurance obligations settled in cash (which represents nearly all insurance liabilities) are financial instruments, hence, the goal should be to have them reported at fair value. This includes reinsurance obligations. In addition, paragraph 46 of this FASB document "would prohibit capitalization of policy acquisition costs of insurance enterprises." Presumably, the effect of prepaying these expenses would be picked up in the fair valuing of unearned premium liabilities.

As to how to estimate the fair value of these, the preliminary views document references the new FASB Concepts Statement of Present Value-Based Measurements, released February 11, 2000, 2000.

4) IASC - fair value developments and Insurance Issues paper
Concurrent with the FASB developments discussed above, the International Accounting Standards Committee (IASC)[11] has been working to develop standards for financial instruments and for insurance accounting.

Efforts in the area of financial instruments in general include International Accounting Standard (IAS) 39, issued in 1998, and the Joint Working Group on Financial Instruments, currently working to develop a standard by the end of 2000. IAS 39 is very similar to FAS 115, in that it requires investments in a "trading portfolio" to be held at fair value. Unlike, FAS 115, it creates an exception to fair value accounting for any "financial asset ... that does not have a quoted market price in an active market and whose fair value cannot otherwise be reliably measured."[12]

During December 1999, the IASC released an "Issues Paper" focused solely on insurance accounting, with a comment deadline of May 31, 2000.

Among other findings, the IASC paper stated that

- Insurance liabilities should be discounted, and
- If a new international standard is released that requires fair value accounting for financial instruments, then "portfolios of insurance contracts should also be measured at fair value."[13]

(Note that neither the IASC nor the FASB documents, nor their GAAP consequences impact statutory accounting unless the NAIC takes explicit action.)

[11] Per the IASC web site as of January 18, 2000 (http://www.iasc.org.uk/frame/cen1.htm), "The International Accounting Standards Committee (IASC) is an independent private-sector body working to achieve uniformity in the accounting principles that are used by businesses and other organisations for financial reporting around the world."
[12] Chapter 30, paragraph 21 of "The IASC-U.S. Comparison Project: A Report on the Similarities and Differences between IASC Standards and U.S. GAAP," Second Edition, published by the FASB in 1999.
[13] These two bullets come from the IASC Issues Paper on Insurance, pages iv-v, bullets (d) and (k).