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**International Financial Reporting for Insurers:
IFRS and U.S. GAAP Seminar
September 2009**

Session 12: Fair Value – SFAS 157 & 159

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Session 12: Fair Value (SFAS 157/159)

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SFAS 157: Fair Value Measurement

Applies to any asset or liability where fair value measurement is already required:

- Certain Invested Assets (Trading Assets, Available-For-Sale Assets) under SFAS 115
- Freestanding Derivatives
- Certain Embedded Derivatives (GMAB, GMWB, certain reinsurance features)
- PGAAP Balance Sheet Including Intangible Assets (Initial Valuation, Impairment Values)
- Separate Accounts
- SFAS 107 Disclosures
 - SA liabilities
 - Mortgage loans
 - Debt



Fair Value Measurement - New Definition and Framework for “Fair Value”



- Exit price vs. entry (transaction) price
“The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.”
- Market-based assumptions vs. entity specific
- Clarifies that market participant assumptions include assumptions about risk
- Liability measurement includes nonperformance risk
- Establishes a fair value hierarchy based on observable and unobservable inputs
- Blockage factors excluded for trades in active markets
- Transaction costs excluded from FVM



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Fair Value Hierarchy



- Level 1: Quoted prices in active markets for identical assets or liabilities
- Level 2: Inputs other than quoted prices that are directly or indirectly observable
 - ◆ Quoted prices for similar assets or liabilities
 - ◆ Quoted prices from non-active market
 - ◆ Observable inputs such as Treasury yields & credit spreads
 - ◆ Market corroborated inputs
- Level 3: Unobservable inputs
 - ◆ Entity’s assumption of the assumptions that market participants would use to determine price
 - ◆ Significant disclosure requirements



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Fair Value Measurement - Hierarchy Table Example

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March 31 2008				
Fair Value Measurements at Reporting Date Using				
	Quoted Prices in Active Markets for Identical Assets and Liabilities (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Fair Value
	(in millions)			
Assets				
Fixed maturity securities				
U.S. corporate securities	\$ -	\$ 67,988	\$ 8,215	\$ 76,203
Residential mortgage-backed securities	-	54,653	1,866	56,519
Foreign mortgage-backed securities	2	30,159	7,622	37,783
U.S. Treasury/agency securities	5,737	16,288	62	22,087
Commercial mortgage-backed securities	-	18,096	552	18,648
Asset-backed securities	-	7,407	4,171	11,578
Foreign government securities	558	13,878	913	15,349
State and political subdivision securities	8	5,477	137	5,622
Other fixed maturity securities	11	15	273	299
Total fixed maturity securities	6,316	213,961	23,811	244,088
Equity securities				
Common stock	1,965	589	209	2,763
Non-redeemable preferred stock	113	700	1,957	2,770
Total equity securities	2,078	1,289	2,166	5,533
Trading securities	233	386	179	808
Short-term investments	1,348	798	156	2,302
Derivative Assets	14	4,434	1,230	5,678
Net embedded derivatives w/within asset host contracts	-	-	(144)	(144)
Separate account assets	117,653	33,336	1,581	152,570
Total assets	\$ 127,642	\$ 254,214	\$ 28,979	\$ 410,835
Liabilities				
Derivative liabilities				
Net embedded derivatives w/within liability host contracts	\$ 20	\$ 3,621	\$ 15	\$ 3,656
Trading liabilities	-	25	1,361	1,386
Total liabilities	\$ 29	\$ 3,646	\$ 1,376	\$ 5,071



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SFAS 159: Fair Value Option - Basics of the Standard

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- Mandatory adoption as of 1/1/08
- Irrevocable election to measure eligible items at fair value through income
- May be applied instrument by instrument, to entire instruments and not portions
- Election made on the date the entity first recognizes the eligible item
- Events that require remeasurement of eligible items at fair value (e.g. Purchase GAAP) also create an election date
- The effect of the first remeasurement to fair value (for existing items) reported as a cumulative-effect adjustment to the opening balance of retained earnings



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Example SFAS 159 Applications for Insurance

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- GMDBs and GMIBs with economic hedges
 - Improves matching of claims costs and hedge gains as compared to current accounting (SOP 03-1)
 - Issue is fair value of future fees
- Contracts with loss recognition concerns
 - If currently in LR, enables upside recognition
 - If potential future LR, can take now through OCI
 - Issue is disclosure of reason for applying 159 (cannot be to avoid current impairment)
- Contracts not getting SA treatment under SOP 03-1
 - Liabilities equal fair value of assets
 - If assets not trading, can apply FVO to get asset/liability match



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Changes for GMxBs under FAS 157

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- Risk margins
- Own credit standing



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Letter of the Law on Risk Margins

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- “*unobservable inputs shall reflect the reporting entity’s own assumptions about the assumptions that market participants would use in pricing the asset or liability (including assumptions about risk).*”



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So...

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- Non-market observable assumptions should include margin
- Margin should be what a *market participant* would add in
- Market observable assumptions/prices already include risk margin (no need to add)



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Classification of Inputs*

Input	Level	Risk Margin?	Significance
Swap curve	2	No	High
Short term volatility	2	No	High
Long term volatility	3	Yes	High
Correlation	2	No	High
Behavior	3	Yes	High
Mortality	3	Yes	Low
Expenses	3	Yes	Low



Methods for Risk Margin

- Cost of capital
- Quantile
- Explicit PAD
- Discount rate adjustment
- Calibration to market data



Cost of Capital

- Consistent with actuarial appraisal method
- Probably best theoretically if principal market is insurer market
- Challenge is complexity



Quantile

- Relatively simple application
- Does not work within a risk neutral framework
- Challenge is setting quantile level



Explicit PAD

- Easier than cost of capital with some of the benefits
- Challenge is determining appropriate PADs, particularly when directional impact on result is not intuitive



Discount Rate Adjustment

- Relatively simple application
- Does not work within a risk neutral framework
- Challenge is setting level of adjustment



Calibration

- Not mentioned in IAA paper
- Involves “calibrating” risk margin so that result ties to market data (quotes or deal prices)
- Favored by SEC, particularly when there is significant capital markets risk and public data



Industry Practice

- Significant interest in CoC, but often disregarded due to complexity
- Explicit PAD very common
- Where quantile, discount rate, or calibration are used is typically in conjunction with another method



“Own Credit” Adjustment

- Paragraph 15 of FAS 157 states “...Nonperformance risk includes but may not be limited to the reporting entity’s own credit risk. The reporting entity shall consider the effect of its credit risk (credit standing) on the fair value of the liability in all periods in which the liability is measured at fair value. ...”



“Own Credit” Adjustment (continued)

Reflecting “Own Credit” Risk

- In theory, reflect probabilities of default by scenario
- In practice, handle via discount rate
- Choose representative risk rate/spread
- Adjustment applied to liabilities, but not assets



Fair Value: Simple Application

- Block of VAs with GMWBs (FAS 133)
- Current FAS 133 valuation implies 40 bps of AV
- Current real world valuation implies 30 bps of AV
- Current reinsurance quote implies 80 bps of AV
- Recent acquisition implies 60 bps of AV

What is the appropriate approach for fair value?



Application (cont'd)

Method	Advantages	Disadvantages
Market Approach - Reinsurance	Level 2 inputs preferred Relatively easy	Reliability of market Not a full transfer Potentially volatile
Market Approach - M&A	Level 2 inputs preferred More consistent with internal view	Reliability of market Challenging to get market price just for GWMB Exposures different
Cost Approach - Simulated hedging	Level 2 inputs preferred Consistent with hedging	Complex & time consuming Model risk
Income Approach - Risk Neutral	Least change from current Able to isolate GMWB	Level 3 inputs Subjective Inconsistency with "market"
Income Approach - Real World	Consistent with capital and M&A approaches Able to isolate GMWB	Level 3 inputs Subjective Inconsistency with "market"



Recent Fair Value and Impairment Developments

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References (Recent Heads Up Publications):

- December 22, 2008, “Just in Time for the Holidays – FASB Proposes Guidance on Other-Than-Temporary Impairments and Discusses Plans for Other Financial Instruments Projects”
- January 9, 2009, “SEC Says Fair Value Is Fair – Study Finalized on Mark-to-Market Accounting”
- March 19, 2009, “FAST-B Moves Quickly – Guidance Proposed on Inactive Markets, Distressed Transactions, and Other-Than-Temporary Impairments”
- April 2, 2009, “Breaking News – Board Approves Three FASB Staff Positions in an Attempt to Clarify Fair Value Accounting”
- More to Come!!



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Fair Value of Illiquid Financial Instruments

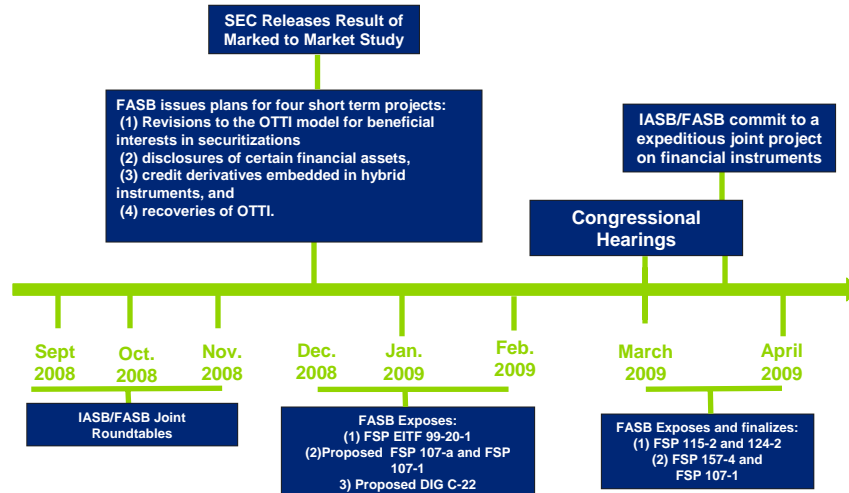
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- Can fair value be determined using a "longer-term view" of the market?
- Is it ever appropriate to assume that an entire market is in distress?
- If an entity is unwilling to transact, can the entity disregard observable market data?
- May an entity that uses a model rely on its own internal data if market participants would use different assumptions?



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A Bit of History



FSP FAS 157-4

Scope

- Applies to all assets and liabilities (financial and nonfinancial) subject to fair value measurement within the scope of Statement 157

What it Does

- Application guidance
 - Determining fair value when the volume and level of market activity has significantly declined
 - Identifying transaction that are not orderly
 - Use of Significant judgment
 - Reemphasize the exit price notion
- Amends disclosures
- Supersedes FSP FAS 157-3



FSP FAS 157-4

What Changed

- Significant change from Exposure Draft
 - Eliminates the presumption that all transactions are distressed in inactive markets
 - Exit price notion under current market conditions vs. hypothetical active market
 - Focus is on markets with a significant decline in market activity vs. markets which have always been inactive

Effective Date

- Effective for interim and annual periods ending after June 15, 2009, with early application permitted for interim and annual periods ending after March 15, 2009 (if early adopted, must adopt FSP FAS 115-2)



FSP FAS 157-4

Determining fair value when there has been a significant decline in volume and level of market activity

- Application guidance does not apply to Level 1 measurements
- Assess factors to determine if there has been a **significant** decline in market activity:
 - Few recent transactions
 - Price quotations are not current
 - Price quotations vary substantially either over time or among market makers
 - Wide bid-ask spread or significant increase in the bid-ask spread
 - Significant decline or absence of a market for new issuances

Note

These factors are not all inclusive. Refer to paragraph 12 of FSP FAS 157-4 for a listing of all factors. Entities may consider additional factors. Evaluate significance and relevance of factors

- If **significant** decline, the transaction price or quoted price may not be representative of fair value; perform additional analysis



FSP FAS 157-4

Determining fair value when there has been a significant decline in volume and level of market activity

- Consider change in valuation technique **or** multiple valuation techniques
 - Change from market approach (e.g. quoted price) to income approach (e.g., present value technique)
 - Multiple valuation techniques (e.g., market approach and income approach)
- Regardless of the approach taken, measurement objective remains unchanged
 - Fair value is the price that would be received to sell an asset or paid to transfer a liability (i.e., an exit price notion) in an **orderly** transaction between market participants at the measurement date under **current** market conditions
 - Fair value is a **market-based** measurement, not an entity-specific measurement (e.g., intention to hold is not relevant)



FAS FSP 107-1 and APB 28-1

Interim fair value disclosures

- Fair value disclosures are required for interim financial statements
 - Applies to all financial assets and liabilities within the scope of Statement 107 held by publicly traded companies
 - Present the fair value and related carrying amount
 - Does not amend Statement 107's practicability exception and related disclosures
 - No interim disclosures on credit or market risk
- Disclose method(s) and significant assumptions interim and annually
 - Discuss changes in method(s) and significant assumptions, if any, during the period
- Effective date
 - Interim periods ending after June 15, 2009, with early adoption permitted to periods ending after March 15, 2009 (if early adopted, must adopt FSP FAS 157-4 and FSP FAS 115-2)



What's Next for Fair Value?

Standard	Topic	Status	Effective Date
FSP FAS 157-?	Improving Disclosures about Fair Value Measurements	Projected to be exposed in Q3	The proposed guidance would be effective for periods ending after December 15, 2009
FSP FAS 157-g	Applying Fair Value to Interests in Alternative Investments	Projected to be exposed in Q2	TBD
FSP FAS 157-f	Measuring Liabilities under FAS 157	Exposed May 1 (Comment deadline June 1)/ Projected to be finalized in Q2	The proposed guidance would be effective for periods beginning after issuance (e.g. if finalized in June, effective for the Company July 1, 2009)
IASB ED	Fair Value Measurements	Exposed in May, Comments Due By Sept. 28	TBD
FSP FAS 115-?	Recoveries of Other-Than-Temporary Impairments (Reversals)	TBD	TBD
IASB/FASB Joint Project	Financial Instruments	Exposure draft expected by year-end	TBD



FSP FAS 157-f

- Proposes a new model for determining fair value of liabilities (including derivative liabilities):
 - Level 1 - Quoted price for the identical liability in an active market or quoted price (unadjusted) for the identical liability traded as an asset in an active market
 - Otherwise, use:
 - ♦ Quoted price of the liability traded as an asset and adjust that price for factors specific to the asset, or
 - ♦ Another valuation techniques, such as an income or market approach
 - FV of liability should consider liquidity risk and non-performance risk
 - FV of liability does NOT consider restrictions on transfer
- Effective Date
 - Potentially effective for periods beginning July 1, 2009 or after
- Comment period ended June 1

