Federal Accounting Standards Advisory Board

April 11, 2013

Memorandum

To: Members of the Board

From: Monica R. Valentine, Assistant Director

Through: Wendy M. Payne, Executive Director

Subject: Risk Assumed – **Tab B**[1]

MEETING OBJECTIVES

To review the Financial Accounting Standards Board's (FASB) proposed measurement approach on insurance contracts and discuss application to Federal insurance and guarantee programs.

BRIEFING MATERIAL

- ❒ Staff Memo
- ❒ Outline of FASB Proposal on Insurance Contracts
- ❒ Appendices (Optional Reading for Reference)
  - Appendix 1 – FASAB Standards on Contingencies
  - Appendix 2 – FASAB Standards on Insurance and Guarantees

BACKGROUND

The risk assumed project is taking a broad look at all types of transactions and events that may result in future outflows as a result of the federal government's mission, operations, and current or past actions. During the summer of 2012 staff held two task force meetings on two explicit groupings of risk assumed: (1) commitments and obligations, including contracts, grants, and treaties, and (2) insurance and guarantees. As a result of those meetings and related research, staff is recommending a three-

[1] The staff prepares Board meeting materials to facilitate discussion of issues at the Board meeting. This material is presented for discussion purposes only; it is not intended to reflect authoritative views of the FASAB or its staff. Official positions of the FASAB are determined only after extensive due process and deliberations.

phase approach which sequences the areas to allow development of principles for measuring and reporting risk where risk is most clearly identifiable—insurance and guarantees providing explicit indemnification to identified parties. The first phase will allow us to develop a framework for use in later phases.

There are currently established measures of risk assumed which can be considered for recognition and/or disclosure. In our review of the measurement approaches currently being used by federal entities, we thought it would be useful to explore the proposed measurement approaches being considered by FASB in its insurance contracts project.

We are very fortunate to have a presenter from the FASB staff to brief the Board. Ms. Jennifer M. Weiner, FASB Senior Practice Fellow, will discuss FASB's proposed approach to insurance contracts. Staff has also provided to the Board several suggested questions for the presenter that can further assist us as we consider FASB's approach to accounting for insurance contracts. The suggested questions are located on the last page of this document (page 13).

Member feedback on the information presented will direct staff on the next steps to take in the project.

STAFF ANALYSIS

The Connection between FASAB Insurance Standards and FASB Standards

➢ The FASAB insurance standards were developed to mirror Financial Accounting Standards Board (FASB) standards on contingencies and insurance liabilities for unpaid claims. The FASAB insurance standards also reference several related FASB standards. Given the coming changes in the FASB insurance standards, the Board may want to consider the need to refresh the current FASAB insurance standards.

Federal accounting standards for federal insurance and guarantee programs are outlined in SFFAS 5, *Accounting for Liabilities of the Federal Government*.

SFFAS 5, pars. 97 through 121 contain FASAB's standards on insurance and guarantee programs, other than social insurance and loan guarantees.

> SFFAS 5, par. 104 states that all federal insurance and guarantee programs (except social insurance and loan guarantee programs) recognize a liability for unpaid claims incurred, resulting from insured events that have occurred as of the reporting date. This liability is to include items that are known with certainty, items **that have been incurred but not yet reported (IBNR)**, and an accrual for **contingent liabilities** that are probable and measurable. Life insurance programs are to recognize a liability for future policy benefits (a liability to current policyholders that relates to insured events, such as death or disability) in addition to the liability for unpaid claims incurred. (Emphasis added)

SFFAS 5, pars. 35 through 42, contain FASAB's standards on contingencies.

> SFFAS 5, par. 38, requires that a contingent liability be recognized when (1) a past event or exchange transaction **has occurred**, (2) a future outflow or other sacrifice of resources is probable, and (3) the future outflow or other sacrifice of resources is measurable. Par. 39 states that the specific liability may be a specific amount or a range of amounts. If some amount within the range is a better estimate than any other amount within the range, that amount is recognized. If no amount within the range is a better estimate than any other amount, the minimum amount in the range is recognized and the range and a description of the nature of the contingency should be disclosed. (Emphasis added)
>
> SFFAS 5, par. 40 requires that a contingent liability be disclosed if any of the three conditions for liability recognition listed above are not met and there is at least a reasonable possibility that a loss or an additional loss has been incurred. Par. 41 states that the disclosure for contingent liabilities that are reasonably

possible should include the nature of the contingency and an estimate of the possible liability, an estimate of the range of the possible liability, or a statement that such an estimate cannot be made.

SFFAS 5, par. 42 notes that contingencies classified as remote need not be reported in general purpose federal financial reports, though law may require such disclosures in special purpose reports. Par. 42 further states that if information about remote contingencies or related to remote contingencies is included in general purpose federal financial reports (**e.g., the total face amount of insurance and guarantees in force**), it should be labeled in such a way to avoid the misleading inference that there is more than a remote chance of loss of that amount. (Emphasis added)

The Basis for Conclusions (BfC) for SFFAS 5, pars. 144 – 146 discuss the Board's decision about the amount to be recognized in par. 39. Par. 144 notes that a majority of respondents preferred that the "**expected value**" be recognized as a liability instead of the minimum amount. However, par. 145 states that the Board "noted that it would be difficult to use "expected value" to pinpoint an estimate within a range. The expected value method would assign a probability percentage to each of the numbers within the range, but these probabilities would usually be difficult to estimate." Par. 146 states that "the majority of the Board preferred the minimum amount because of established use in other accounting standards." (Emphasis added)

SFFAS 5, pars. 105 through 114 contain the bulk of FASAB's standards on risk assumed.

SFFAS 5, par. 105 states that risk assumed information is important for all federal insurance and guarantee programs (except social insurance, life insurance and loan guarantee programs) and is generally measured by the **<u>present value of unpaid expected losses net of associated premiums</u>**, based on the risk inherent in the insurance or guarantee coverage in force. (Emphasis added)

SFFAS 5, par. 106 states, "When financial information pursuant to FASB's standards on federal insurance and guarantee programs conducted by government corporations is incorporated in general purpose financial reports of a larger federal reporting entity, the entity should report as RSI what amounts and periodic change in those amounts would be reported under the "risk assumed" approach referred to in this section (see par. 105). In other words, in addition to the liability for unpaid claims from insured events that have already occurred (including any contingent liability that meets criteria for recognition), such reporting entities should also report as RSI risk assumed information."

Par. 111 explains that insurance programs are ongoing and may be viewed as having long-term characteristics. Thus, from a broader, longer-term perspective, the liability to be recognized, and the amount to be reported as risk assumed in supplementary information, may be conceptually different and materially different from each other. From the broader perspective, risk assumed would be a longer-term measure and a probabilistic estimate of future costs of these programs.

The BfC for SFFAS 5, pars. 189 and 190 further explain the Board's intent for reporting risk assumed. The Board noted that members considered two measurement perspectives for reporting risk assumed and decided that the risk assumed amount should be a broader and longer-term measure of the government's potential cost for on-going insurance programs beyond the cost of coverage outstanding during the reporting year. The Board noted that this approach to risk assumed could be regarded as an indicator of the "fair" or "full cost" premium that should be charged if taxpayers are not to subsidize the program. This measure would be a probabilistic estimate of the expected cost under certain assumed economic factors.[2]

- Two of the largest federal government insurance programs—the Pension Benefit Guaranty Corporation (PBGC) and the Federal Deposit Insurance Corporation (FDIC)—prepare financial statements using FASB principles.

SFFAS 34, *The Hierarchy of Generally Accepted Accounting Principles, Including the Application of Standards Issued by the Financial Accounting Standards Board*, par. 9, permits this practice, stating that "general purpose financial reports prepared in conformity with accounting standards issued by the FASB also may be regarded as in conformity with GAAP for those entities that have in the past issued such reports."

FASB's *Accounting Standard Codification*© (ASC), Sections 450-20–Loss Contingencies, and 944-40–Claim Costs and Liabilities for Future Policy Benefits, provide standards for recognizing and disclosing loss contingencies, including the risk of loss from catastrophes assumed by property and casualty insurance entities.[3] PBGC and FDIC apply ASC© 450-20 by recognizing probable and measurable losses as liabilities and disclosing information about reasonably possible losses in the notes to the financial statements.

[2] A probabilistic method of estimation uses assumed economic factors to generate a range of estimates and their associated probabilities.

[3] Accounting and reporting of contingencies related to the risk of loss that is assumed by a property and casualty insurance entity or reinsurance entity when it issues an insurance policy covering risk of loss from catastrophes is more specifically addressed in ASC© 944-40; however, entities most often reference ASC© 450-20 as the source of guidance for its loss contingencies note. FASB's current project on insurance contracts expects to improve, simplify, and converge the financial reporting requirements for insurance contracts.

> Specific to the insurance standards, SFFAS 5, par. 106 states, "When financial information pursuant to **FASB's standards** on federal insurance and guarantee programs conducted by government corporations is incorporated in general purpose financial reports of a larger federal reporting entity, the entity should report as RSI what amounts and periodic change in those amounts would be reported under the "risk assumed" approach referred to in this section (see par. 105). (Emphasis added)

- FASB's current project on insurance contracts is expected to propose an expected value cash flow measurement approach (a present value approach) similar to SFFAS 5's risk assumed measurement approach (present value of unpaid expected losses net of associated premiums).

> This FASB measurement approach depicts a current assessment of an insurance contract and would provide information about the main drivers of profitability in the current period. The measurement approach is the **expected value** (that is, explicit, unbiased, and probability-weighted estimate) **of future cash outflows, less future cash inflows** that will arise as the insurer fulfills the insurance contract. (Emphasis added)
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> SFFAS 5, par. 105 states that risk assumed information is important for all federal insurance and guarantee programs (except social insurance, life insurance and loan guarantee programs) and is generally measured by the **present value of unpaid expected losses net of associated premiums**, based on the risk inherent in the insurance or guarantee coverage in force. (Emphasis added)

Concerns with Current Practices for Reporting on Federal Insurance and Guarantee Programs

Members of the federal financial management community have expressed concern over what they perceive as a lack of clarity between FASAB standards on contingent liabilities and standards on risks assumed for federal insurance and guarantee programs.

In some cases with federal insurance programs, the recognized liability is also reported as risk assumed; while in other cases the reasonably possible amount is also reported as risk assumed. Our review of present RSI risk assumed reporting for insurance and guarantee programs has not revealed any "true expected value" information being reported. Given these reporting inconsistencies, the question is why federal entities appear to be incorrectly reporting risk assumed for insurance and guarantee programs. Perhaps, it is the nature of federal insurance and guarantee programs that make the risk assumed amount too difficult to estimate or the FASAB standards on risk assumed do not adequately differentiate between contingencies and risk assumed for the various insurance and guarantee programs.

As part of a review of agency financial reports and the consolidated financial report of the U.S. Government (CFR), staff noted the following examples of inconsistency:

➔ **PBGC risk assumed information is reported in the CFR as both basic and RSI (reasonably possible contingencies note and risk assumed RSI)**

Excerpt from Risk Assumed reported in CFR as RSI

Risk Assumed Information as of September 30, 2011, and 2010

(In billions of dollars)	2011	2010
Present value of unpaid expected losses, net of associated premiums:		
Pension Benefit Guaranty Corporation	250.2	190.0
Department of Agriculture	8.8	7.5
National Credit Union Administration	7.4	7.5
All other	0.9	2.0
Total	267.3	207.0
Periodic changes in risk assumed amounts:		
Pension Benefit Guaranty Corporation	60.2	21.8
Department of Agriculture	1.3	(1.4)
National Credit Union Administration	(0.1)	1.6
All other	(1.1)	0.4
Total	60.3	22.4

Excerpt from Note 22: Contingencies reported in CFR

Insurance Contingencies

At the time an insurance policy is issued, a contingency arises. The contingency is the risk of loss assumed by the insurer, that is, the risk of loss from events that may occur during the term of the policy. The Government has insurance contingencies that are reasonably possible in the amount of $267.0 billion as of September 30, 2011, and $224.2 billion as of September 30, 2010. The major programs are identified below:

- PBGC reported $250.2 billion and $190.0 billion as of September 30, 2011, and 2010, respectively, for the estimated aggregate unfunded vested benefits exposure to the PBGC for private-sector single-employer and multiemployer defined pension plans that are classified as a reasonably possible exposure to loss.
- Of the remaining $16.8 billion for 2011, FDIC reported $16.5 billion as of September 30, 2011, and $34.2 billion as of September 30, 2010, for identified additional risk in the financial services industry that could result in additional loss to the Deposit Insurance Fund should potentially vulnerable insured institutions ultimately fail. Actual losses, if any, will largely depend on future economic and market conditions.

➔ **The CFR's contingencies note includes, for FDIC, the reasonably possible amount and the total face amount of insurance in force, however there is no reporting for FDIC under risk assumed in the CFR's RSI.**

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Deposit Insurance

Deposit insurance covers all types of deposit accounts such as checking, NOW and savings accounts, money market deposit accounts, and certificates of deposit (CDs) received at an insured bank, savings association, or credit union. The insurance covers the balance of each depositor's account and shares, dollar-for-dollar, up to the insurance limit, including principal and any accrued interest through the date of the insured financial institution's closing. As a result, the Government has the following exposure from Federally-insured financial institutions:

- FDIC has estimated insured deposits of $6,777.0 billion as of September 30, 2011, and $5,423.0 billion as of September 30, 2010, for the Deposit Insurance Fund.
- NCUA has estimated insured shares of $782.4 billion as of September 30, 2011, and $750.9 billion as of September 30, 2010, for the National Credit Union Share Insurance Fund.

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(Note: no FDIC reporting)

➔ **National Credit Union Administration (NCUA) risk assumed information reports total insurance in force of $795.3 billion and the same contingency amounts that are reported in Note 7: Insurance and Guarantee Program Liabilities for the Share Insurance Fund (SIF) as of December 31st.**

Excerpt from Note 7: Other Liabilities reported in NCUA's Annual Report

The activity in the Insurance and Guarantee Program Liabilities from supervised credit unions and AMEs for the years ended December 31, 2011 and 2010 was as follows:

(Dollars in thousands)	For the Year Ended December 31, 2011	For the Year Ended December 31, 2010
Beginning balance	$ 1,225,281	$ 715,846
Reserve Expense (Reduction)	(525,678)	737,596
Insurance losse claims paid	(105,099)	(277,801)
Net Estimated Recovery/Claim on AMEs	12,113	49,640
Ending balance	$ 606,617	$ 1,225,281

The Insurance and Guarantee Program Liabilities at December 31, 2011 and 2010, were comprised of the following:

- Specific reserves were $16.4 million and $173.5 million, respectively. Specific reserves are identified for those credit unions where failure is imminent or where additional information is available that may affect the estimate of losses
- General reserves were $590.2 million and $1,051.8 million, respectively.

In addition to these recorded contingent liabilities, additional adverse performance in the financial services industry could result in additional losses to the NCUSIF. The ultimate losses for insured credit unions will largely depend upon future economic and market conditions, and accordingly, could differ significantly from these estimates.

Excerpt from RSI reported in NCUA's Annual Report

Risk Assumed Information

Insurance and Guarantee Program Liabilities

Insurance in Force

As of December 31, 2011, the aggregate outstanding insured shares of the insured credit unions were approximately $795.3 billion. This amount represents the maximum potential future guarantee payments that the NCUSIF could be required to make under the share insurance program, without consideration of any possible recoveries. Additionally, pursuant to Section 217 (b)(2)(A) of the FCU Act, to the extent that the required funding for the guarantee obligations exceeds the funds available in the TCCUSF, the NCUSIF will provide the necessary funds. These amounts bear no relationship to the NCUSIF's anticipated losses.

As discussed previously herein, NCUA identifies credit unions at risk of failure through the supervisory and examination process, and estimates losses based upon economic trends and credit unions' financial condition and operations. NCUA also evaluates overall economic trends and monitors potential credit union system-wide risk factors, such as increasing levels of consumer debt, bankruptcies, and delinquencies. NCUA applies the CAMEL rating system to assess a credit union's financial condition and operations. The CAMEL rating system is a tool to measure risk and allocate resources for supervisory purposes. NCUA periodically reviews the CAMEL rating system to respond to continuing economic and regulatory changes in the credit union industry. The aggregate amount of reserves recognized for credit unions at risk of failure was $606.6 million and $1.23 billion as of December 31, 2011 and 2010, respectively. At December 31, 2011 and 2010, the general reserves were $590.2 million and $1,051.8 million, respectively. At December 31, 2011 and 2010, the specific reserves resulting from supervised credit unions' failures were $16.4 million and $173.5 million, respectively.

➔ **NCUA risk assumed information reported in the CFR is made up of the reserve amounts in NCUA's SIF and Stabilization Fund as of September 30. The reserve amounts for SIF as of December 31 are reported as liabilities in NCUA's financial statements and Stabilization Fund liabilities are reported in separate fund financial statements.**

Excerpt from Risk Assumed reported in CFR as RSI

Risk Assumed Information as of September 30, 2011, and 2010

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All other	(1.1)	0.4
Total	60.3	22.4

Excerpt from support from NCUA for the amounts reported to Treasury for the CFR[4]

Fund	as of 9/30/11 (in millions)	
Share Insurance Fund Reserves	$ 998.5	
Stabilization Fund Reserves	6,365.5	
Total Reserves	$7,364.0	≈ $7.4 billion

The total amount reported as risk assumed and insurance and guarantee program liabilities for NCUA in the CFR as of September 30, 2011, was $7.4 billion.

Reserve amounts from NCUA's SIF and Stabilization Fund Published Financial Statements

Fund	as of 12/30/11 (in millions)
Share Insurance Fund Reserves	$ 606.6
Stabilization Fund Reserves	2,944.2
Total Reserves	$3,550.8

[4] Per NCUA supporting documents FASAB staff received from Treasury's Financial Management Service on August 7, 2012.

The total amount reported as risk assumed and insurance and guarantee program liabilities in published financial statements for the Share Insurance Fund and Stabilization Fund as of December 31, 2011, was $3.5 billion. The significant difference in the reserve balance between September 30, 2011, and December 31, 2011, of $3.8 billion or 52%, is due to program changes within the Stabilization Fund that apparently occurred during that timeframe.

➔ **Farm Credit System Insurance Corporation (FCSIC) does not disclose an amount for reasonably possible in its financial report.**

While FCSIC is required to maintain a reserve of two percent of outstanding insured obligations, includes a detailed discussion of risk management in its annual report, and discloses the total amount of insured obligations ($184.2 billion) in Note 1: Insurance Fund – Statutory Framework, the extent of FCSIC's reporting of estimated insurance obligations is that management is not aware of any probable insurance payments to be made in the future. This disclosure is made in its summary of significant accounting policies note (see below). There is no discussion of reasonably possible insurance payments to be made in the future, or whether the reserve of two percent of insured obligations is believed to be sufficient to cover those payments.

Excerpt from FCSIC's Note 2: Summary of Significant Accounting Policies

Liability for Estimated Insurance Obligations—The liability for estimated insurance obligations is the present value of estimated probable insurance payments to be made in the future based on the Corporation's analysis of economic conditions of insured System banks.

The insured System banks' primary lending markets are borrowers engaged in farming, ranching, and producing or harvesting of aquatic products, and their cooperatives. Financial weaknesses in these market segments and the effect of general market conditions on the System's borrowers could adversely affect the banks' financial condition and profitability. Insured System banks also face risks from changing interest rate environments and the need to maintain ongoing access to financial markets. Adverse changes in the financial condition and profitability of insured System banks resulting from increased levels of credit, financial, or other risks could occur in the future which would have a material effect on the liability for estimated insurance obligations.

The Corporation actively monitors the creditworthiness and financial position of the insured System banks. Management is not aware of any events or circumstances at this time which would require a liability for estimated insurance obligations to be recorded.

➔ **Export-Import Bank provides export-credit insurance to exporters but there is no risk assumed information reported as RSI in its annual report or the CFR.[5]**

Export-Import Bank's Export Credit Insurance Program helps U.S. exporters sell their goods overseas by protecting them against the risk of foreign-buyer or other foreign-debtor default for political or commercial reasons, allowing them to extend credit to their international customers. Insurance policies may apply to shipments to one buyer or many buyers, insure comprehensive (commercial and political) credit risks or only political risks, and cover short-term or medium-term sales. Export-Import Bank reported $9.3 billion in outstanding insurance at the end of fiscal year 2011.

Export-Import Bank's Annual Report contains extensive reporting on its loans, guarantees, and insurance in its management's discussion & analysis (MD&A) and notes to the financial statements, including schedules of authorized loans, guarantees, and insurance; risk of foreign currency fluctuation; repayment risk; concentration risk; operational risk; organizational risk; and interest risk, but it does not report "risk assumed" in RSI in conformance with the guidance in SFFAS 5. There is no information reported in the CFR on export insurance.

[5] Source: Export-Import Bank 2011 Annual Report; available online at http://www.exim.gov/about/reports/ar/; last accessed June 4, 2012.

Suggested Questions for FASB Presenter

1. During your outreach to the insurance community have you gained any sense as to the industry's capacity to produce expected value estimates?

2. What drawbacks/problems with expected value estimates have preparers, auditors, and analysts identified as you've been developing the proposal?

3. Are analysts currently using the expected value measures? If so, how are they obtaining the needed information?

4. Would the simple present value measurement method also be effective in measuring obligations/guarantees?

5. How would the measurement of onerous contracts[6] differ from those not meeting the onerous criteria?

[6] Onerous contract – a contract having or involving obligations or responsibilities, especially legal ones that outweigh the advantages. (*Source:* Dictionary.com)