

# Fair Value

Eric Clapprod, Hartford Life

Brian Jobe, Deloitte

Patricia Matson, Deloitte

David Rogers, PriceWaterhouseCoopers

May 21, 2007

# Overview

---

- **FAS 159** *The Fair Value Option for Financial Assets and Financial Liabilities*
  - Allows entities to measure eligible financial instruments at fair value
- **FAS 157** *Fair Value Measurements*
  - Defines Fair Value and provides guidance on how to measure assets and liabilities at fair value
- **FAS 155** *Accounting for Certain Hybrid Financial Instruments*
  - Allows entities to measure certain structured notes at fair value

# Overview

---

- Significant required areas of impact for actuaries:
  - FAS 133 fair valuation
  - Goodwill impairment testing
  - Investment contracts requiring fair valuation
- Other potential areas of impact (under FVO)
  - VAs with GMIBs and GMDBs
  - Contracts in loss recognition
  - Any other contract you want to fair value!
- Effective fiscal years beginning after 11/15/2007

# Basic Requirements

---

- Fair value is based on the *exit price* in the *principal* or *most advantageous* market
- Market-based, not entity-specific, measurement
- Assumptions should be based on *observable inputs* to the extent possible, and *unobservable inputs* if no observable

*Exit Price* - The price that would be received to sell the asset or paid to transfer the liability

*Principal Market* – The market in which the reporting entity would sell the asset or transfer the liability with the greatest volume and level of activity

*Most Advantageous Market* – The market that maximizes the amount that would be received for the asset or minimizes the amount that would be paid to transfer the liability, incl transaction costs

*Observable Inputs* – Inputs that reflect the assumptions that market participants would use in pricing developed based on market data obtained from sources independent of the reporting entity

*Unobservable Inputs* – Inputs that reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing based on the best information available in the circumstances

# Basic Requirements

---

- Market participant assumptions include risk margins
  - For risk inherent in valuation technique
  - For risk inherent in inputs
- Include assumptions about impact of restrictions on sale or use
- Should reflect nonperformance risk
  - Eg reporting entity's credit risk
  - May imply lower liability for lower rated company

# Basic Requirements

---

*Market participants are:*

- Independent of the reporting entity
- Knowledgeable
- Able to transact
- Willing to transact (eg not under duress)

# Valuation Techniques

---

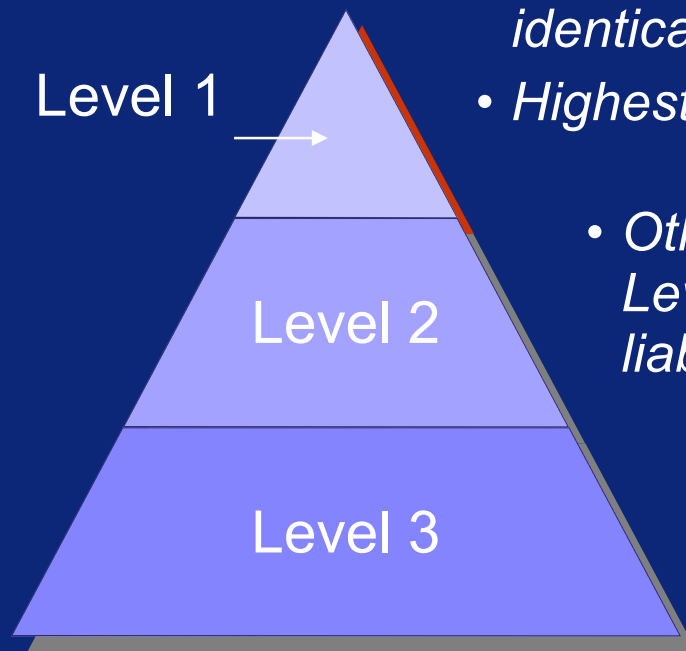
Market Approach	Uses prices and other relevant information generated by identical or comparable market transactions (eg market prices, M&A transactions, reinsurance quotes)
Income Approach	Uses valuation techniques to convert future amounts (eg cash flows) to a single, present, discounted amount (eg present value techniques, option pricing)
Cost Approach	Based on the amount that currently would be required to replace (ie replacement cost) the service capacity of an asset (eg simulated hedging)

*Inputs to these techniques should maximize use of observable inputs*

# Fair Value Hierarchy

---

Inputs to measurement fall into three categories:



- *Quoted prices (unadjusted) in **active** markets for identical assets and liabilities*
- *Highest priority, should maximize use of these*

- *Other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly*

- *Unobservable inputs*
- *Lowest priority, should minimize use of these*

# Fair Value Hierarchy

---

- Fair value measurements (in their entirety) must be classified and disclosed as Level 1, Level 2, or Level 3
- If Level 3, additional disclosures required
- Level of fair value measurement in its entirety determined based on the lowest level input that is significant to the measurement
- Availability of inputs and relative reliability might affect selection of valuation techniques