

Letter of Comment No:
File Reference: FSPTB85-4-A
DAte Received:

August 1, 2005

Mr. Lawrence Smith
Director of Technical Application and Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Re: Proposed FASB Staff Position No. TB 85-4-a, Accounting for Life Settlement Contracts by Investors

Dear Mr. Smith:

PricewaterhouseCoopers LLP appreciates the opportunity to respond to the proposed FASB Staff Position No. TB 85-4-a, Accounting for Life Settlement Contracts by Investors (the "Proposed FSP"). We commend the FASB for addressing the accounting for investments in life settlement contracts. Given that the market for these contracts has expanded and continues to grow, and has become more established with the entrance into the industry of financial institutions, the issuance of guidance on the accounting for such contracts is appropriate.

We agree that FASB Technical Bulletin 85-4, Accounting for Purchases of Life Insurance (TB 85-4), should not be applied to investments in life settlement contracts because it would require an investor to recognize a loss upon the acquisition of a contract when economically there is no loss. This is not a reasonable outcome since one would not expect an investor to enter into an arm's-length transaction with a willing seller only to incur a loss at the outset. We therefore agree that a different model needs to be developed for these transactions. We also have several other comments relating to the draft FSP, as described below.

Definition of "life settlement contract" and "insurable interest"

The Proposed FSP defines a life settlement contract, in part, as one in which "the life settlement provider does not have an insurable interest (an interest in the survival of the insured, which is required to support the issuance of an insurance policy)." We suggest that the wording be clarified to indicate (1) whether the term "insurable interest" is being used in

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the context of the legal definition of an insurable interest and (2) whether the parenthetical reflects a universal legal definition of that term. If the FASB determines that there is no single universal definition of insurable interest, it might consider defining the term for purposes of the FSP to avoid potential issues whereby some life settlement contracts are scoped in or out of the FSP depending on the applicable jurisdiction. We believe that a more appropriate and preferable definitional characteristic of a life settlement contract would be one where the life settlement provider does not have an economic interest (rather than an insurable interest) in the life of the insured previous to the acquisition of the contract.

### Secondary purchases vs. primary purchases of life insurance

Conceptually, we believe that insurance contracts purchased directly from the insurance provider (e.g., key-man life insurance, business-owned life insurance ("BOLI"), and Corporate-owned life insurance ("COLI")) and life settlement contracts should be accounted for using the same accounting model. The primary difference between a life settlement contract and key-man insurance, BOLI, and COLI is the manner in which the contract is entered into. Life settlement contracts are acquired in a secondary market, whereas key-man insurance, BOLI, and COLI are directly purchased from an insurance provider. But this difference is not, in our view, enough to justify use of different accounting models.

While originally key-man contracts, BOLI, and COLI programs were used primarily by small businesses to insure the economic consequences of business disruption caused by the untimely death of key employees, more recently they have been used by larger businesses as a tax effective investment. Where used for investment purposes, we believe that there is not a significant difference in the economics of the various life insurance arrangements to warrant different accounting treatment. Given the similarities, especially in situations where the contract is purchased primarily for investment purposes, we believe there is little justification for requiring that life insurance contracts purchased directly from an insurance provider use cash surrender value while allowing secondary purchasers of life insurance, that is, life settlement contracts to use an alternative measurement method.

Using a consistent accounting model for both primary and secondary purchases of life insurance could also reduce the potential for transaction structuring that would be designed to achieve "life settlement contract" status through such means as a sale of existing policies and repurchase of others, or purchases of contracts through intermediaries.

### Interaction of the Proposed FSP with FAS 133

Limiting the scope of the Proposed FSP to contracts in which an investor has no "insurable interest" implies that the distinguishing characteristic and perhaps the rationale for requiring different accounting for insurance contracts purchased directly from the insurance provider (e.g., key-man insurance, BOLI, and COLI) and life settlement contracts is the fact that a life settlement investor does not have an insurable interest.

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Using this logic, one could interpret the absence of an "insurable interest" as prohibiting a life settlement provider from utilizing the exception afforded certain insurance contracts by paragraph 10(c) of FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities (FAS 133). That is, if a life settlement investor has no "insurable interest," it might be viewed as not having purchased an insurance contract that "entitles the holder to be compensated only if, as a result of an identifiable insurable event, the holder incurs a liability or there is an adverse change in the value of a specific asset or liability for which the holder is at risk" This interpretation would also call into question whether the original writer of the insurance contract would now be required to account for the contract as a derivative, given the potential lack of identifiable insurable event.

Alternatively, it is possible that the Board intends to amend FAS 133 to extend the exception provided in paragraph 10(g) for life insurance contracts accounted for using cash surrender value under TB 85-4 to contracts covered by the Proposed FSP. It is unclear, however, what the basis for the extension of that exception would be. The original exception in DIG Issue B-31, Embedded Derivatives; Accounting for Purchases of Life Insurance, was based on the inability to separately value the host insurance contract at cash surrender value after bifurcation of an embedded derivative for the asset return component of cash surrender value, not on the consideration of a death benefit obtained from a non-insurable interest as a variable.

If not afforded the paragraph 10(c) or paragraph 10(g) exception, the contract entered into by the life settlement investor would be a derivative subject to FAS 133 fair value accounting, thereby obviating the need for this FSP. If the Board instead intends that life settlement contracts be afforded an exception from FAS 133 derivative accounting, either under paragraph 10(c), or perhaps under an amended version of paragraph 10 (g) or otherwise, the Board should clarify this point.

#### Fair Value Measurement Model

We believe that a fair value measurement would better reflect the economics of investments in life settlement contracts than the proposed cost accumulation model, and that for purposes of life settlement contracts fair value is a more relevant measure to users of the financial statements. We acknowledge that information regarding a specific insured's current medical status subsequent to purchase may not always be available to life settlement providers due to patient confidentiality laws (absent a waiver of those rights by the insured). Nonetheless, we believe that a reliable fair value estimate can be made, such estimates are already being made in the emerging life settlement tertiary market by using an actuarial asset share model and assumptions about mortality that consider the elapsed time since the insured's medical status was evaluated, thereby determining fair value by a life settlement's expected contribution to the cash flows of a portfolio.

In situations in which the investor has a portfolio of life settlement contracts, the timing of cash flows that are needed to determine fair value can be reasonably estimated. The price that buyers and sellers are willing to pay for any individual contract in both the secondary and tertiary markets is determined by its expected contribution to the cash flows of a portfolio.

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For many life settlement investors, the purchase model has evolved from one based on time to life expectancy, which would require updated medical information in order to determine a fair value (that is, the person has a life expectancy of seven years so therefore assume a payoff in year seven), to an actuarial asset share model where it is assumed that a fraction of the policy will payoff in each period typically based on a published mortality table (the life settlement industry refers to the first method of pricing as deterministic pricing and the second method as probabilistic pricing).

For example, many life settlement buyers utilize the 2001 Valuation Basic Table published by the Society of Actuaries when determining the price to offer to purchase a life settlement contract. The 2001 Valuation Basic Table has mortality rates that change based on the elapsed time since medical information was first obtained. For a 75 year old male non-smoker just underwritten, the table gives the following expected deaths for the first 5 years (where deaths are out of a population of 1000): 11.01, 14.46, 18.80, 23.35, and 26.84. For a 75 year old male with underwriting information that is 5 years old (referred to in actuarial literature as age 70 duration 5), the following would be the mortality rates for the next 5 years: 20.16, 22.53, 26.88, 31.49, and 38.17. By adjusting the mortality rates in the actuarial asset share (purchase model) to reflect the deterioration in the value of the medical information as per the published table, a fair value can be estimated. Similar adjustments to mortality are frequently used when fair valuing insurance liabilities for purchase accounting.

We believe that the fair value measurement approach we have described would be acceptable under the FASB's current *Fair Value Measurements* project and would be categorized as either Level 4 or Level 5 Inputs.

Other assets (e.g., real estate by investment companies, mortgage servicing rights, and interest-only strips on subprime debt) are frequently purchased based on a similar level of information and are recognized at fair value under GAAP. For example, using mortality assumptions to value life settlement contracts would be similar to the use of prepayment assumptions in the valuation of mortgage servicing rights (MSRs). Both are used to estimate the timing of a future event – death for life settlement contracts and the prepayment of a mortgage for MSRs - based on historical market data. Additionally, actual results could differ from expectations due to the occurrence of relevant events. For example, changes in an individual's health or advances in the medical industry could cause people to live longer, while changes in interest rates or in an individual's financial well-being could cause people to prepay their mortgages faster.

#### Disclosures under Fair Value Model

We agree with the disclosure requirements of the Proposed FSP and recommend that those disclosures be retained under a fair value model. In addition, we propose that the cost of the life settlement contracts and the method(s) and assumptions used in estimating the fair value of the contracts be disclosed. Further, we recommend that paragraph 8 of the Proposed FSP stipulate the maximum life insurance premiums to be paid be based on the remaining expected term of the life settlement contracts.

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### Transition under Fair Value Model

If the Board decides to require the valuation of life settlement contracts at fair value, we believe that retrospective application of the guidance, as the Proposed FSP currently would require, is not appropriate. Fair value relies on assumptions and estimates and this, coupled with the significant number of contracts that life settlement providers hold in their portfolios, would makes retrospective application difficult and costly to apply. Therefore, we recommend that the requirements of the FSP be applied to fiscal years beginning after the date the final FSP is finalized with the cumulative effect of the change to the new accounting principle being applied to the carrying amounts of life settlement contracts as of the beginning of the fiscal year with an offsetting adjustment made to the opening balance of retained earnings.

### Investment Company Issue

The typical "life settlement providers" are investment companies or other entities that account for their investments at fair value as required by the AICPA Investment Company Audit Guide (the "Guide"). However, the SEC staff has indicated that the guidance in TB 85-4 is applicable to investment companies. Therefore, there exists an inconsistency in the accounting by investment companies for investments; some investments (life settlement contracts and life insurance) are carried at cash surrender value and all other investments at fair value. For example, many life settlement providers pool their life settlement contracts into a "fund" and sell interests in the fund to third parties. The life settlement provider accounts for the fund using TB 85-4, but the Guide requires that investment companies investing in the "fund" account for their investments at fair value. To provide consistent accounting by investment companies for investments in life settlement contracts and all other investments, we believe that life settlement contracts, and other direct purchase life insurance accounted for under TB 85-4, should be accounted for at fair value and that this guidance be provided in the FSP.

### Other Comments on the Requirements of the Proposed FSP

If the Board decides to proceed with the Proposed FSP as currently drafted, we believe a number of our recommendations above would continue to be applicable. Consistent with the accounting for most "investments," we recommend that the FSP require that the carrying amount of the life settlement contract be analyzed for potential impairment. Under the Proposed FSP, it is only when the carrying amount of a life settlement contract equals the underlying life insurance policy's face value that all future premiums would be expensed. We recommend that a more robust impairment test be applied to life settlement contracts and that an impairment charge be recognized when it is determined that the carrying amount of the life settlement contract exceeds the face value of the underlying insurance policy minus all expected future premiums. Additionally, as a life settlement provider should receive the full face value of the life insurance contract upon the death of the insured, we recommend that the

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FSP require an impairment analysis of the recoverability of the face value of the life settlement contract based on the credit risk of the insurance provider.

If the Proposed FSP is adopted as currently drafted, along with the proposed disclosure requirements, we recommend that information related to any impaired contracts also be disclosed. The information to be disclosed should include the number of impaired life settlement contracts, the face value of those contracts, the impairment charged recognized, the remaining expected term for those contracts, as well as the expected premiums to be paid.

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We appreciate the opportunity to express our views on the Proposed FSP. If you have any questions regarding our comments, please contact Gerard O'Callaghan (973-236-7817), Donald Doran (973-236-7214) or Ken Dakdduk (973-236-7239).

Sincerely,

PricewaterhouseCoopers LLP