ACLI
Financial Security For Life

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LETTER OF COMMENT NO. 39

April 2, 2009

Mr. Adam Van Eperen
Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT

Re: Financial Crisis Advisory Group Written Submissions from Constituents

Dear Mr. Van Eperen:

The American Council of Life Insurers (ACLI)[1] appreciates the opportunity to provide input to the Financial Crisis Advisory Group (FCAG). The FCAG has an opportunity to address the concerns that have been raised by the life insurance industry since the broad introduction of fair value accounting with the issuance of FASB Statement No. 115. At that time, the ACLI and many other industry groups warned of the potential misleading results that fair value accounting could lead to by reflecting market behavior in the financial statements of financial institutions. During some of the early debates on FAS 115, the industry observed that due to extremely high treasury rates in the late 1980s most, if not all, insurance companies would have been insolvent according to their GAAP balance sheets. Reflecting this result was a concern expressed by the industry as unrealized losses due to high interest rates should not impair an insurer's ability to continue as a going concern. In fact, there were no insurance insolvencies resulting from this phenomenon during that period.

During most of the 15 years that FAS 115 has been in effect, the markets have been rather benign for corporate bonds with relatively low risk free rates and corporate spreads well in check. But the insurance industry continued to argue against the introduction of additional fair value standards. Instead, the FASB pressed forward with the introduction of new fair value standards resulting in not only a continuation but a worsening of the mixed attribute accounting model. Today the balance sheet and the income statement of financial institutions are plagued with accounting rules that drive results with no meaningful distinction. For example, mortgage loans acquired through a securitized pool of hundreds of individual loans are carried at fair value on the balance sheet and marked to fair value when other-than-temporarily impaired, yet whole loans are carried at cost and reserved against when permanently impaired. Why the distinction between these two instruments? They have different liquidity characteristics, but is the resulting disparity in accounting justified and accurate to reflect this? We don't believe so.

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[1] The American Council of Life Insurers represents 340 member companies operating in the United States, of which 332 are legal reserve life insurance companies, and 8 are fraternal benefit societies. These 340 member companies account for 93% of total life insurance company assets, 94% of the life insurance premiums, and 94% of annuity considerations in the United States.

There is also no meaningful distinction in current GAAP for an impairment recorded on the balance sheet and one taken through income. The guidance calls for other-than-temporary as the distinction between the two, but with the intent and ability to hold requirement in FAS 115, the difference between recording an impairment on the balance sheet or through income becomes a combination of other-than-temporary and lacking an intent and ability to hold until recovery. Because of the rigid interpretations of intent and ability, the application of this rule has become inconsistent and somewhat arbitrary.

We believe that a thorough analysis of both the fair value and impairment models needs to be undertaken by the standard setters. We believe that a meaningful distinction between the use of fair value versus cost-basis accounting should be the nature of operations of the acquirer. Life insurance companies acquire bonds and other fixed income investments to support the cash flows of insurance liabilities. This is a significant difference from a trader that may be acquiring a security for the intent to trade that security for short term profits, such as the common activities of an investment company. Making a distinction between the accounting of investments by these two companies would be meaningful to the users of the financial statements. In this example, the life insurance company should not record a gain from the security if it trades in an unrealized gain position nor should it take a charge if it trades in an unrealized loss position. Only if the company deems the cash flows to be impaired should a loss be recorded and the security written down to its net present value of cash flows discounted at the original purchase yield. This would also prevent the distortion caused by writing a security down to fair value and accreting the security back into income at a higher rate in future periods as permitted under current GAAP.

The framework exists today in U.S. GAAP to provide this accounting. The Held-to-Maturity (HTM) category in FAS 115 provides for an accounting model consistent with this approach. Unfortunately the HTM category does not provide an insurance company with the necessary flexibility to trade securities to manage a dynamic asset liability management (ALM) model. This ALM model may result in only a small number of trades, but it is still an amount deemed to taint the HTM designation. Also, most insurance companies treat securities within a year of maturity as short term investments and would normally consider trading it to acquire another long bond or to meet cash flow needs. Therefore, it could be that some insurance companies have very few securities that will actually be held until the day they mature. While this taints the use of the HTM category, the ACLI still believes that the nature of this type of investing still warrants cost-basis accounting. The FASB should consider superseding FAS 115 to provide a new category similar to HTM but designed for cash flow investors such as insurance entities or revise FAS 115 to loosen the restrictions of the HTM category to provide for its use by insurance entities.

As stated above, there is currently no meaningful distinction or consistency for the recognition of write-downs in the income statement. There are significant differences between the timing and level of write-downs for similar types of assets. These issues cause confusion to users of the financial statements and reduce transparency as to the cause and result of such write-downs on the financial strength and future earnings power of the entity. The response by some is to record all fair value changes of financial instruments in the income statement, but this approach misses the opportunity to draw meaningful analysis from asset write-downs. The ACLI supports the position that an asset write-down should be the result of an impairment of the underlying cash flows of a financial instrument. We believe that this provides for a meaningful distinction between impairments recorded in the income statement and those recorded in either the balance sheet or those disclosed in the notes to the financial statements. We further believe that recording a write-down for the incurred loss of cash flows is also meaningful with any further impairment due to market values continuing to be reflected in the balance sheet or disclosed in the footnotes. This would align the accounting for financial instruments with other assets such as whole loans and receivables.

We do not support the belief that fair value accounting caused the current economic and financial crisis and we do not believe that fixing fair value accounting will lead to a recovery in the economy. But it is generally supported, and we concur, that fair value accounting has pro-cyclical effects that can exaggerate and challenge the economic conditions impacting companies and eventual recovery of financial instruments. We do not believe that markets always provide the most reliable or decision-useful information to investors. We acknowledge that markets are objective and can be indicative of broad economic and issuer-specific issues and concerns, but they can also be emotional and irrational at times too. Markets overvalued real estate assets and undervalued risk leading into this crisis. Similarly today, the markets are likely overreacting on the other side by undervaluing certain assets and overstating business risks. Markets very often overshoot on both the positive side and the negative side leading to corrections that can cause significant volatility. We believe that markets represent a source of liquidity for companies and a proxy for value of assets. They do not represent the most meaningful basis for asset measurement. Given the importance of liquidity, though, for an insurance entity, we support robust disclosure of market values for a company's financial instruments. This will provide the full transparency of the impact of market values to the users of the financial statements while retaining a more meaningful measure of assets and liabilities for the basic financial statements.

In conclusion, we support a thorough revision of FAS 115. A distinction should be provided to allow cash flow investors, such as insurance entities, to carry their financial instruments at cost. We further support a change in the impairment rules to provide for a more meaningful analysis of income statement write-downs. For a cash-flow investor, write-downs should only reflect the permanent impairment of cash flows of a financial instrument. We understand the desire to provide robust market analysis for financial statement users and support the inclusion of footnote disclosure of market values and the impact of those values on the liquidity of the entity. We believe that these changes can be made within the framework of U.S. GAAP and will provide more meaningful analysis for financial statement users.

The following are the individual responses to the questions proposed:

From your perspective, where has general purpose financial reporting helped identify issues of concern during the financial crisis? Where has it not helped, or even possibly created unnecessary concerns? Please be as specific as possible in your answers.

We believe that general purpose financial reporting has provided a very limited benefit in identifying issues of concern during the financial crisis. The speed at which the crisis took hold in the fourth quarter of 2008 and into 2009 did not provide a timeframe for financial reporting to work through its normal process. Companies either provided separate reports that accompanied statistical supplements or provided information on exposure to certain asset classes on conference calls with analysts, investors and rating agencies.

We believe that the reporting of unrealized losses that were well in excess of expected losses during the fourth quarter reporting period led to signficant concerns for investors and rating agencies. There will be losses experienced due to the economic slowdown but the losses are expected to be well within the amount that insurance companies are capitalized to withstand. However, on a liquidation basis, some insurance entities appear to have very little, if any, tangible capital to meet policyholder demands. This is not an accurate reflection of our businesses as a going concern and has resulted in unnecessary concerns about the solvency of the industry.

If prudential regulators were to require 'through-the-cycle' or 'dynamic' loan provisions that differ from the current IFRS or US GAAP requirements, how should general purpose financial statements best reflect the difference: (1) recognition in profit or loss (earnings); (2) recognition in other comprehensive income; (3) appropriation of equity outside of comprehensive income; (4) footnote disclosure only; (5) some other means; or (6) not at all? Please explain how your answer would promote transparency for investors and other resource providers.

We do not support a financial reporting model that has pro-cyclical accounting basis such as fair value accounting accompanied with a regulatory reserving or capital requirement model to offset the pro-cyclicality impact of the model. For one, it is not always that easy to determine the cycles that an economy is in at any given time. Therefore, the ability of a prudent regulator to manage this type of counter-cyclical reserve requirement is unrealistic. We believe that a more prudent step would be to remove pro-cyclical accounting methods from general purpose financial statements. Instead, companies should provide information on market values and market behaviors as a footnote to the financial statements and attempt to align general purpose reporting with regulatory reporting as much as possible. It is not beneficial during down cycles to show less reserve requirements for regulatory reporting while it appears that a company is losing massive amounts of capital in its general purpose reporting. There can be differences between regulatory reporting and general purpose reporting since they each seek to accomplish different objectives, but the general trends and directions of the two should be aligned, otherwise credibility of regulators will be compromised.

Some FCAG members have indicated that they believe issues surrounding accounting for off-balance items such as securitizations and other structured entities have been far more contributory to the financial crisis than issues surrounding fair value (including mark-to-market) accounting. Do you agree, and how can we best improve IFRS and US GAAP in that area?

We do not agree with this statement. We see isolated occurrences in certain high profile cases that this has created issues for large financial institutions. But the financial crisis has impacted many more than just these large institutions. While the activities of hedge funds and SIVs get significant attention, these activities are limited to only the largest of institutions. Decisions by these institutions to backstop these off-balance sheet instruments were business decisions at the time due to firm reputation and a thorough cost benefit analysis. Entities have the ability to walk away from these obligations and they do not represent liabilities until they decide to back them up. The activity of these high profile abuses, though, should not result in accounting requirements for all entities. Most companies use similar vehicles to reduce risk and mitigate losses. Most instruments will never be backstopped by company assets and should not have balance sheet treatment. We believe that current accounting guidance in the area of consolidations is already the result of driving a solution to an isolated problem at a troubled entity to broad-basis financial reporting and as a result it has had signficant unintended consequences.

We support the direction of the FASB towards a more principles-based approach to the determination of consolidation of off-balance sheet instruments. A decision resulting from these occurrences and the direction now set by regulators to record many more instruments on the balance sheet has the risk of more unintended consequences. While it may have prevented the isolated abuses of the past, it will create confusing and potentially misleading financial statements for many, many more companies than those it is intending to correct.

In the event that it is determined that off-balance sheet structures should be brought back onto our balance sheets, we support the use of the tabular reporting of these instruments. Specifically, to avoid the potential regulatory and legal issues with grossing balance sheets up with the securitized assets as well as the resulting obligations, we advocate use of the link-presentation model as that principle is applied under Financial Reporting Standard 5: *Reporting the Substance of Transactions* (FRS 5) as issued by the Accounting Standards Board (ASB)[2]. This presentation also eliminates the need for bank regulators to adjust their capital adequacy models to compensate for a significant increase in the amount of debt that is likely to be brought on our balance sheets.

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[2] FRS 5 was issued by the Accounting Standards Board in respect of its application in the United Kingdom and by the Institute of Chartered Accountants in Ireland in respect of its application in the Republic of Ireland.

Most constituents agree that the current mixed attributes model for accounting and reporting of financial instruments under IFRS and US GAAP is overly complex and otherwise suboptimal. Some constituents (mainly investors) support reporting all financial instruments at fair value. Others support a refined mixed attributes model. Which approach do you support and why? If you support a refined mixed attributes model, what should that look like, and why, and do you view that as an interim step toward full fair value or as an end goal? Whichever approach you support, what improvements, if any, to fair value accounting do you believe are essential prerequisites to your end goal?

This issue was discussed extensively in our opening comments to the response. We do not support the investor view of reporting all financial instruments at fair value. We do not believe that markets always reflect the most appropriate valuation of financial instruments. Markets are generally short-term and speculative. We invest for the purpose of providing cash flows with long maturities. The impact of market value changes can impact our flexibility to liquidate securities to meet policyholder obligations or to rebalance portfolios but it is not an accurate reflection on our ability to collect future cash flows to meet our long-term obligations to policyholders. Therefore, we support the continued use of a mixed attribute model. We believe that the issue with the current mixed attribute model is that it is haphazard and meaningless as to the selection of the measurement attribute from instrument-to-instrument and from company-to-company. We believe if a meaningful distinction is provided for the selection of an attribute based on the intended use of the underlying assets, then a mixed attribute model would provide superior analysis for financial statement users.

Given the importance for transparency and the need for investors to have fair value information to compare across companies and industries, we support the inclusion of fair value disclosures in the footnotes to the financial statements. Investors will then have the information necessary for transparent reporting to understand the company's financial condition and liquidity concerns that may arise in a period of high interest rates or market dislocation.

What criteria should accounting standard-setters consider in balancing the need for resolving an 'emergency issue' on a timely basis and the need for active engagement from constituents through due process to help ensure high quality standards that are broadly accepted?

We believe that action is required immediately to correct the misperceptions that fair value reporting is creating in financial statements. Given the need for immediate action, we believe that a two phase approach would be appropriate by the Boards. The first phase would need to be focused on fixing the impairment model and the reporting of financial instruments in dislocated markets. The FASB has already begun to address the first phase through Proposed FSP FAS 115-a, FAS 124-a, and EITF 99-20-b, *Recognition and Presentation of Other-Than-Temporary Impairments*, and Proposed FSP FAS 157-e, *Determining Whether a Market Is Not Active and a Transaction Is Not Distressed*. We believe these changes, with certain revisions as outlined in our comment letters on these Proposed FSPs, could easily be incorporated into existing US GAAP and are already largely reflected in IFRS.

The second phase should then reexamine fair value accounting on a broader level. The Boards will need to determine where fair value is being used today and determine if that is the most appropriate measurement basis for reporting. We believe that a thorough analysis should focus on the intended use of the asset being considered. A refined mixed attribute model can then be created which provides a meaningful distinction between the use of the different attributes within the financial statements.

Are there financial crisis-related issues that the IASB or the FASB have indicated they will be addressing that you believe are better addressed in combination with, or alternatively by, other organizations? If so, which issues and why, and which organizations?

We believe that the independent Boards of the FASB and IASB can adequately address these issues or concerns. We remain concerned though about the direction of the FASB and IASB towards fair value reporting and believe that the Boards are over-influenced by investor group views. While investors should have an important voice at the table for the deliberations on these issues, we do not believe that the views represented by large investor organizations are consistent with views of average investors or even many analysts. This is evidenced by the dichotomy of the consistent support for exit prices of the investor groups in contrast with the positive reaction of stock prices for financial institutions every time suspension of mark-to-market is mentioned in the media. This is indicative of a disconnect between investor organizations and investors themselves. The FASB needs to find a mechanism to collect the views of individual investors and analysts on the Street. We welcome any questions or comments and to engage in dialogue on this very important matter.

Sincerely,

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Michael M. Monahan
Director, Accounting Policy