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Financial Accounting Standards Board
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Re: *File Reference No. 1810-100: Proposed Accounting Update – Accounting for Financial Instruments and Revisions to the Accounting for Derivatives Instruments and Hedging Activities*

The American Insurance Association (AIA) is the leading property-casualty insurance trade organization, representing approximately 300 insurers that write more than \$117 billion in premiums each year. We are commenting on the above referenced exposure draft (“ED”) because the proposed changes for accounting for financial instruments, along with the changes that may result from the ongoing insurance contracts project, will fundamentally alter the financial statements of insurance companies. Thus, it is important that the Financial Accounting Standard Board (“FASB”) hear from the insurance industry.

At the outset, we must express our concern about the divergence in approach that the FASB and the International Accounting Standards Board (“IASB”) have taken. The FASB and the IASB have regularly affirmed their intention to pursue a single set of high-quality global standards that will benefit investors. It is troubling to find that the IASB and the FASB have moved so far apart on an issue that both boards identified as a key convergence topic in the 2006 Memo of Understanding, which was updated in 2008.

The joint statement issued in June 2010, stating that the IASB and the FASB intend to submit their respective exposure drafts to public round table discussions among key stakeholders is a good start to addressing the boards’ differences. We agree that such a process may improve the quality of standards. We hope both boards will use that opportunity to work toward a converged standard for financial instruments.

Some of the key differences between the IASB and FASB financial instrument proposals are:

- *Financial instruments classified at fair value with qualifying changes in fair value recognized in other comprehensive income (“FV-OCI”):* the FASB ED permits this classification for only debt instruments that meet certain conditions. However, the IASB’s IFRS 9, Financial Instruments (IFRS 9) allows the election of this classification only for equity instruments. Further, under US GAAP, realized gains and losses for FV-OCI

securities would be recognized in net income; however, under IFRS 9, realized gains and losses for FV-OCI securities will not be recycled through net income.

- *Financial instruments classified at amortized cost:* The FASB ED permits this classification only for financial liabilities under certain conditions. However, IFRS 9 requires this classification for financial assets if: (a) the entity's business model is to hold assets for contractual cash flows; and (b) the asset's cash flows are limited to payments of principal and interest.
- *Impairment:* The FASB proposed model is similar to the existing incurred loss model – no impairment until a loss is incurred. However, the IASB proposes using an expected cash flow model.

The above differences will significantly reduce the comparability of IFRS-based and US GAAP-based financial statements. The resulting confusion will clearly be at odds with the two Boards' stated intention of convergence. Therefore, we ask the boards to renew their efforts to develop a converged standard for financial instruments.

Specific Concerns about the FASB ED.

Classifying debt instruments for fair value through other comprehensive income. Accounting standards should reflect the business model of the reporting entity, rather than force the business entity to change the way it operates its business. Financial statements will be most useful if accounting standards are sufficiently flexible to reflect the business model of the reporting entity. Specifically, property-casualty insurers must be able to measure, classify and report their financial assets in a manner that is consistent with their business strategy for managing these assets.

From the perspective of an insurance company, we believe that the proposed guidance will be difficult to interpret and may raise questions as to its application. It is an appropriate business strategy to hold such assets in order to provide the necessary cash flows to fund the fortuitous claims that may arise, and we agree that in these instances, fair value should be reflected through other comprehensive income ("OCI"). However, we believe the ED's requirement that an entity's business strategy for the debt instrument must be to collect or pay the related contractual cash flows, rather than sell or settle the financial instrument with a third party, is too restrictive. For a property-casualty insurer, cash outflows resulting from catastrophes may necessitate the sales of individual debt instruments. Such sales are a necessary component of an insurer's business strategy and should not preclude an insurer's debt instruments from qualifying for FV-OCI treatment, provided the criteria under paragraphs 21a and 21c of the ED are met.

Impairments. We are also concerned that the proposed impairment guidance will be awkward and difficult to apply. Basing impairments on historical experience and current economic conditions without allowing consideration of future events or economic conditions will produce counter-intuitive results within economic cycles. For instance, at the end of a period of market growth, and even in the beginning of an economic slowdown, companies may expect impairment indicators to worsen over the short term; under the ED, however, impairment recognition would not result because of the ED's prohibition on the consideration of future events or economic conditions. Therefore, we expect the application of the proposed guidance will delay recognition of impairments during the aforementioned phases of economic cycles. Likewise, we believe the proposed guidance may cause companies to impair investments as

economic conditions improve. The application of this guidance to a group/pool of investments would further exacerbate our concerns.

Interest income yield adjustment. The exposure draft's proposed interest income recognition guidance appears to be rules-based and highly mechanical in nature. We do not agree with the recognition of changes in interest income via adjustments to the allowance for credit losses as a result of changes in cash flow expectations. First, we believe this approach will confuse users of financial statements as the allowance will not represent solely credit or impairment losses. Second, we believe this approach is too prescriptive, assuming there is an intent that accounting guidance should be principles-based. Third, massive and costly system and process changes would be required to accommodate this proposed interest income recognition methodology, with little perceived benefit gained from this highly prescriptive method of recognizing interest income. There appears to be a huge cost/benefit disconnect in the exposure draft as it relates to the recognition of interest income.

Valuing limited partnership interests. Another significant concern is the fair valuing of limited partnership interests that are not related to the entity's consolidated operations. The scope of the proposed ED is ambiguous and may cause comparability issues. If the ED requires application of fair value to these interests, the FASB must extend the practical expedient of using a net asset value ("NAV") methodology. NAV could apply the investor's proportionate ownership percentage to the underlying equity of these investments as a practical expedient because it would be the only realistic way to arrive at a "fair value" when no fair value information is available, given the following concerns:

- The receipt of the financial information about these interests generally lags behind the period for preparing the financial statements;
- Many partnerships do not carry assets at fair value, which means that insurers that invest in these partnerships would have to determine the fair value of the underlying investments before determining the overall fair value of their interest in the partnership. Such an approach involves a significant amount of work to achieve an extremely subjective number; and
- The proposed ED provides a four year deferral for non-public reporting companies. That deferral, however, effectively deprives public companies that invest in the non-public companies, such as partnerships, of relatively timely information that is needed to allow a determination of the fair value of the partnership interest.

We are concerned that if we are not allowed a practical expedient, investments in this asset class will become unattractive due to the significant valuation costs to comply. As we stated earlier, accounting standards should not drive business strategy.

Deferred tax assets. The proposed guidance indicates that the valuation allowance on a deferred tax asset related to a debt instrument measured at fair value with qualifying changes in fair value recognized in other comprehensive income should be evaluated in combination with other deferred tax assets of the entity. We disagree and believe such deferred tax assets must necessarily be segregated and analyzed separately.

We believe that an entity's intent and ability to hold debt instruments to recovery is a valid tax planning strategy as provided by ASC 740-10-30-19. This strategy can be used to overcome the need for a valuation allowance for the specific deferred tax assets on unrealized losses. The

positive intent to hold a debt security to maturity in an unrealized loss position is evidence of future taxable income. Where temporary unrealized losses on debt securities exist and the entity has the ability and intent to hold until recovery, the entity would not expect unrealized losses ever to be recognized in the entity's income statement or tax return. Thus, the unrealized losses would never require any source of future taxable income in order to realize the deferred tax assets.

The explicit requirement to combine the deferred tax asset related to a FV-OCI debt instrument with an entity's other deferred tax assets would prevent the consideration of tax planning strategies as provided by ASC 740. Thus, we believe such a deferred tax asset should be segregated and analyzed separately.

Recommended Accounting Approach.

As insurers, we see no rationale for introducing unnecessary volatility into the financial statements when there has been no change in the insurer's underlying business strategy. Thus, we ask the FASB to consider the following recommendation: modify the current accounting model to retain the Available For Sale ("AFS") and Trading classifications, but eliminate the Held To Maturity classification. We believe this recommended approach generally reflects the current business strategy of insurance companies.

The suggested presentation will include the fair value of the assets on the balance sheet with any market fluctuations recorded through OCI. A company that actively trades securities would record market fluctuations through the income statement; this approach seems appropriate if the insurer's intentions are to buy and sell securities to make money on spreads and small market movements. Our recommended approach is more straight-forward, provides clearer information to users, and avoids the complexities that different models for equities and fixed maturities would create.

Conclusion.

We support the FASB's efforts to provide more timely and useful information about an entity's portfolio of financial instruments. In fact, we specifically support the ED's guidance for hedge accounting. However, there are areas of the ED that add more complexity – such as the interest income yield adjustment – and require additional work in order to achieve the goal of less complexity. We also believe the guidance should be less prescriptive so that reporting entities can more accurately reflect their business strategy through the financial statements. With respect to this last point, we believe the business strategy of insurers is reflected in the current accounting model's treatment of AFS and Trading securities. We urge the FASB to retain those classifications and their related accounting and disclosures.

Thank you again for this opportunity to comment. As always, we are available to the FASB and its staff to address any questions you may have about our comments.

Sincerely,



Phillip L. Carson
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