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Technical Director
Financial Accounting Standards Board
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Submitted via: **director@fasb.org**

Re: ***File Reference No. 2012-260, Financial Instruments – Credit Losses***
AIA Comments in Response to Proposed Accounting Standards Update

The American Insurance Association (AIA) thanks the Financial Accounting Standards Board (FASB) for this opportunity to respond to the above referenced exposure document (ED). AIA represents approximately 300 major U.S. insurance companies that provide all lines of property-casualty insurance to U.S. consumers and businesses. AIA members write more than $117 billion annually in U.S. property-casualty premiums and approximately $225 billion annually in worldwide property-casualty premiums. As insurers, AIA member companies are major institutional investors in debt securities and therefore have a strong interest in the proposed guidance for the recognition of credit losses.

AIA appreciates the effort the FASB has expended in developing a new credit loss recognition model for financial instruments. The proposed ED moves away from the existing "incurred loss" model in favor of the new "current expected credit loss" (CECL) model. The CECL approach would require earlier recognition of credit losses, including potential losses for events that have not occurred, by requiring "day one" recognition of expected credit losses over the life of the financial asset – in other words, the reporting entity would set up an allowance account to reflect the amount of principal and interest that the holder of the financial asset instrument does not expect to collect, while the incurred loss model premises recognition upon the occurrence of a credit event. Though the incurred loss model has been criticized for not recognizing credit losses sooner, recognition is actually driven by the availability of information

indicating a credit event. Moving to the CECL approach does not change the real-world availability of information.

The overriding goal of the ED is to create one credit-loss recognition model that applies to every category of financial assets, such as loans, receivables and debt securities. However, the vastly different loss development characteristics among these categories of instruments, as well as differences in their respective risk profiles, may make that goal difficult to achieve. The proposed ED appears to be written to address concerns with loans, rather than for debt securities, of which AIA members are major institutional holders. The loan-centric nature of the ED does cause us concern since loans and debt securities have different risk profiles, performance metrics, and loss development histories. There was little discussion about debt securities as this ED was developed; thus, the ED guidance could have a distortive effect on the reporting insurer's investments in debt securities.

As a result of the financial crisis of 2008-2009, much was written about the current "incurred loss" accounting model as providing "too little, too late" – in other words, basing credit loss recognition on when a credit loss probably has been incurred was viewed as not providing enough information early enough to be decision useful. However, the issue with the impairment for debt securities during the financial crisis was that "too much" was written down for impaired assets due to the previous debt security guidance requiring impairment to fair value, even in dislocated markets. In addressing that concern, the FASB issued guidance in 2009 to specifically address investments in debt securities. Under FSP FAS 115-2, which has been codified into ASC 320, impairments of debt securities are separated into the amounts representing credit loss recognized through earnings and the amount relating to all other factors (non-credit loss) recognized in other comprehensive income (OCI). These two components of impairment are determined through a detailed analysis of expected cash flows. As a result of the existing guidance, the credit loss portion of debt securities is already being properly reported through earnings.

Since debt securities are acquired at fair value, and most often are carried at fair value, one can argue that the credit loss risk is already reflected in the carrying value of the securities. Since the business model for property & casualty (P&C) insurers often involves holding debt securities for future cash flows, with occasional sales, the vast majority of P&C investments in debt securities are currently classified and measured at fair value, with changes in fair value flowing through OCI. AIA members question the need for impairments for these debt securities when fair value is reported in the balance sheet, and believe that for debt securities reported at amortized cost, the proposed guidance in the ED is not an improvement over current guidance. We believe the existing Other-Than-Temporary Impairment (OTTI) guidance for debt securities is more appropriate than the proposed guidance in the ED, and accordingly, we recommend that the OTTI guidance of ASC 320 should be retained and that debt securities should be excluded from the proposed ED.

Nothing in the proposed ED suggests that the existing OTTI guidance has become unsuitable. The existing guidance specifically applies to debt securities and provides better decision-useful

information than a new framework that is clearly intended for bank loans, and thus should be retained. Thus, we believe the current guidance provides more useful information than the framework that is proposed in the ED.

Specific Concerns Presented by the ED.

- Applying the new CECL model would be difficult, especially for medium- to long-term debt instruments. Relying upon historical data and knowledge of current market conditions to develop forecasts of CECL presumes that the future would reflect the past. Forecasts of future events are inherently inaccurate because the forecasts pertain to the unknown. The incurred loss approach is based on actual information of a credit event, rather than economic forecasts; ironically, the use of actual loss information could become irrelevant under the proposed ED.

- The ED provides for "day one" recognition of credit losses, regardless of actual performance of the related debt securities. Without some linkage to observable economic activities, i.e., credit events, the amounts to be recorded in the financial statements under the proposed ED would seem to undermine the principle of faithful representation. There would be no objective evidence against which to verify the amounts recorded. This lack of empirical evidence would also create auditing challenges, essentially pitting the judgment of the company's management against the judgment of the outside auditor.

- Property & Casualty (P&C) insurers are significant investors in government debt securities, particularly U.S. government securities. The ED would require the recording of an allowance on U.S. government securities that, as a practical matter, will not default and thus provide little credit risk. Nevertheless, the ED could lead to an odd situation in which an allowance is recorded on the U.S. government securities, even when there is no impairment. In addition, the allowance account for U.S. government securities – generally considered the safest in the world – could, in effect, be over-reserved. This anomaly suggests that the CECL approach is not appropriate for debt securities and further highlights the need to provide a credit loss accounting approach that is better suited for debt securities.

- In the absence of empirical evidence from actual credit loss events, significant judgment would be required to provide forecasts of future credit losses. Undoubtedly, there would be differences in judgment from company to company in developing CECL. As a result of the disparity in judgment, there would also be diminished comparability. In an effort to provide credit loss recognition sooner, important characteristics, such as comparability and verifiability, may be sacrificed under this ED.

- Because the ED is written more from the perspective of loans, the proposed practical expedient would be operationally cumbersome to apply to a portfolio of

debt securities. Further, an interest rate environment in which rates often fluctuate may cause frequent changes in the fair value, so that in some periods the securities may qualify for the practical expedient while in other periods, they would not, regardless of the underlying credit risk. At a minimum, the criteria for using the practical expedient should be provided as a disjunction: *EITHER* (a) the fair value of the individual asset is greater than (or equal to) the amortized cost basis of the financial asset *OR* (b) the expected credit losses on the individual financial asset are insignificant.

The above issues would be avoided by retaining OTTI guidance of ASC 320 for debt securities.

Reinsurance.
As insurers, we are also interested in the ED's treatment of reinsurance receivables. Given that reinsurance accounting is already being considered within the insurance contracts project, AIA is uncomfortable with the notion that elements of reinsurance accounting framework – in this case, reinsurance credit loss – can be addressed in a piecemeal way. We believe a more holistic approach would be appropriate and encourage the FASB to address all reinsurance issues within the insurance contracts standard.

Non-accrual Accounting.
The ED would require the use of the nonaccrual principle, which is common in the banking industry, but would be a new GAAP principle. Though we accept the non-accrual principle in concept, the proposed guidance should not prescribe any method. Without further analysis and field testing, we do not yet see how nonaccrual income and cost recovery recognition rules would be applied to structured debt investments, the effective rates of which may change due to the variable amounts and timing of cash flows. We are also concerned that the nonaccrual income and cost recovery recognition rules could significantly distort interest income yields, create income volatility, and confuse investors. Under the proposal, reported interest income could decrease such that it no longer reflects expected yields. We believe the amortized cost basis of debt securities should continue to represent the present value of future cash flows and that the accretion between the present value and the future value should be recorded as interest income.

Conclusion
There is nothing inherently wrong with basing the recognition of a credit loss on the occurrence of a credit event. Nevertheless, the proposed ED would result in a model that recognizes credit losses sooner. AIA points out, however, that earlier recognition does not necessarily equate to better information. Without actual credit loss information for their debt investments, financial statement preparers would be forced to rely on other information sources, such as default studies and credit metrics, to substantiate the estimates and forecasts that the proposed ED requires. The relatively limited number of service providers means that preparers would be accessing the same information sources to

substantiate their financial reports. We challenge the FASB to consider whether such an environment would produce better information for the financial statement user.

We have also pointed out a number of weaknesses in the ED – the fact that it requires the recording of credit losses even when there is no evidence of impairment; that there is no flexibility for the preparer to demonstrate that certain investments may have little or no credit risk; that the practical expedient is not workable for debt securities - and that existing OTTI guidance is a better framework for analyzing and reporting credit losses for debt securities.

Finally, we encourage the FASB not to prescribe the nonaccrual principle for debt securities. Further, we ask the FASB to take a holistic approach in addressing credit risk of reinsurance receivables by including that topic in the pending insurance contracts proposal.

Thank you for this opportunity to comment on the credit loss ED. We look forward to further discussions with the FASB on this and all other matters relating to financial instruments. Please feel free to contact us with any questions.

Sincerely,

Phillip L. Carson
Associate General Counsel &
Director of Financial Regulatory Policy