



Michael Monahan
Senior Director, Accounting Policy

November 5, 2012

Ms. Leslie Seidman, Chairman
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

Re: Tentative Financial Instruments Classification & Measurement Model

Dear Ms. Seidman,

The American Council of Life Insurers (ACLI)¹ has been closely following the FASB Board (Board) deliberations on Financial Instruments. In the October 17 Board meeting on Classification & Measurement (C&M), the FASB tentatively adopted application guidance similar to IFRS 9, *Financial Instruments*, to determine if contractually linked instruments (i.e., structured securities) meet the cash flow characteristics of solely principal and interest. If certain conditions are not met, structured securities would be required to be reported at fair value with periodic changes in fair value recognized in net income (FV-NI). We are concerned about the Board's tentative decision as we believe reporting investments in structured securities at FV-NI could result in significant earnings volatility for insurers that would be viewed negatively by investors. As large investors in structured securities², it could also reduce our desire to invest in the impacted securities.

The FASB's tentative model contains three conditions which, if present, result in the cash flow characteristics being considered solely principal and interest. Depending on the business model, a financial asset that meets the solely principal and interest conditions may be reported at either fair value with periodic changes in fair value reported in other comprehensive income (FV-OCI) or amortized cost (AC). If the financial asset does not meet

¹ The American Council of Life Insurers (ACLI) is a Washington, D.C.-based trade association with more than 300 legal reserve life insurer and fraternal benefit society member companies operating in the United States. ACLI advocates in federal, state, and international forums. Its members represent more than 90 percent of the assets and premiums of the U.S. life insurance and annuity industry. In addition to life insurance, annuities and other workplace and individual retirement plans, ACLI members offer long-term care and disability income insurance, and reinsurance. Its public website can be accessed at www.acli.com.

² Based on recent information, insurers invest in excess of an estimated \$250 billion in the subordinated tranches of structured securities.

Circular 230 disclosure: This document was not intended or written to be used, and cannot be used, to: (1) avoid tax penalties, or (2) promote, market or recommend any tax plan or arrangement.

American Council of Life Insurers
101 Constitution Avenue, NW, Washington, DC 20001-2133
(202) 624-2324 t (866) 953-4097 f mikemonahan@acli.com
www.acli.com

the solely principal and interest conditions, it would be reported at FV-NI. Should structured securities meet the three conditions, and considering that most life insurers' business models employ asset-liability-management, we believe many structured securities would meet the business model criteria to be classified as FV-OCI under the FASB's tentative C&M model. Despite the preceding, we interpret one of the conditions in the FASB's tentative model³ to unjustly limit the securities that could be reported at other than FV-NI. Specifically, structured securities that are subordinate to the senior tranche could, after considering all possible scenarios, experience losses that are proportionately higher than the losses in the underlying collateral pool. As a result, FV-NI reporting would be required. For the reasons set forth in this letter, we believe subordinated tranches in our structured security portfolios should be considered to meet the solely principal and interest conditions in the tentative model and be allowed to be reported at either FV-OCI or AC based on an entity's business model and the characteristic of the instruments.

RECOMMENDATION AND REASONING

We recommend the FASB treat structured securities similar to other debt investments and consider them to meet the cash flow characteristics of solely principal and interest. The vast majority of the structured securities owned by ACLI members are comprised of underlying pools of collateral that would meet the solely principal and interest characteristics test because they primarily include bonds and/or loans. Although some structures contain derivatives, the derivatives are generally used to align the contractual interest cash flows of the collateral with the contractual interest cash flows of the structured securities issued. Because structured securities possess characteristics similar to other debt instruments, we do not believe a potential loss of principal and interest as a result of structured subordination should be a consideration when determining the proper classification and measurement of these investments; rather, credit exposure is more appropriately addressed in the financial instruments impairment model. We believe structured securities should be allowed to be evaluated for impairment by applying a similar impairment model as the model used for corporate bonds; otherwise, a corporate bond with the same credit rating and a similar level of exposure to credit risk as a structured security may be reported at FV-OCI and evaluated for impairment through the impairment model; yet the structured security would be required to be reported at FV-NI.

We have noted that the FASB's tentative model could result in the same tranche being reported inconsistently by one company versus another, depending on the time of purchase, given the tentative model requires the cash flow characteristics to be evaluated only upon purchase (i.e., generally not to be revisited if circumstances change after purchase). For example, if one company purchased a subordinate tranche at origination and another purchased the same tranche after the senior tranche was paid off (i.e., after receiving full payment of principal and interest), the first company (i.e., the company that purchased at origination) would likely be required to report the investment at FV-NI because the tranche could experience losses that are proportionately higher than the losses of the underlying collateral pool (i.e., it is a subordinated tranche); whereas, when the second company

³ One of the characteristics included is: The exposure to credit risk in the underlying pool of financial instruments inherent in the tranche is equal to or lower than the exposure to credit risk of the underlying pool of financial instruments (for example, this condition would be met if the underlying pool of instruments were to lose 50 percent as a result of credit losses and **under all circumstances** the tranche would lose 50 percent or less). (emphasis added)

purchased the same tranche after the senior tranche was paid off, it would be considered the senior tranche (no longer subordinate because the prior senior tranche was extinguished) and would be allowed to report the tranche as FV-OCI or AC, depending on its business model. Although the underlying characteristics of the tranche and the underlying pool are exactly the same (i.e., provide contractual principal and interest cash flows) and assuming the business model is the same for both companies, the investment could be reported inconsistently from company to company depending on the performance and expectations of the underlying collateral pool at the time of purchase. As mentioned before, we do not believe that credit exposure should drive the C&M conclusions.

Classifying structured securities as fair value through net income may create an accounting mismatch with related life insurance liabilities, which are generally measured at something other than fair value through net income (e.g., a measurement similar to AC or possibly in the future current measurement through OCI). As a result, structured securities should be permitted to be classified and measured based upon an entity's business model. We also do not agree that short-term volatility in the fair value of structured securities should be reflected in net income when the gains or losses have yet to be realized through the sale of the security or recognition of an other-than-temporary impairment (i.e., per Topic 320, when an other-than-temporary impairment occurs, credit-related losses are recognized in net income with the remaining non-credit portion of the fair value adjustment reported in OCI). In current U.S. GAAP, Topic 320 in conjunction with ASU 2010-11, *Derivatives and Hedging: Scope Exception Related to Embedded Credit Derivatives*, structured securities are typically reported as fixed income securities at fair value with periodic fair value changes reported in OCI (i.e., available-for-sale securities under Topic 320). We support the current classification and measurement that allows for recording structured securities at FV-OCI or AC, as it is consistent with the debt-like characteristics of structured securities and the business models generally employed by insurers. We recognize that the application guidance for contractually linked instruments in IFRS 9 was drafted when IFRS did not allow FV-OCI as a classification and measurement alternative. Given both the tentative FASB and IASB C&M models now provide for FV-OCI, we believe the model for structured securities should allow FV-OCI for all structured securities where the business model is to hold to collect contractual cash flows and sell. The securities would still be reported at fair value (rather than fair value changes being reported in net income, they would be reported in OCI). Should the FASB decide to retain the tentative conclusions regarding structured securities and given the potential significant volatility in net income, we believe it will reduce insurers' desire to invest in these securities and unfavorably impact the structured security market, which relies on the availability of investors in the subordinated tranches.

Our ACLI member companies would be happy to discuss this matter with you and/or provide you any additional information to evaluate this topic. Should you have any questions or wish to discuss any of our comments, please feel free to contact me.

Sincerely,



Michael Monahan
Senior Director, Accounting Policy

cc: Sue Cospers, Technical Director

