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Financial Accounting Standards Board Financial Accounting Foundation 401 Merritt 7 Norwalk, CT 06856-5116 International Accounting Standards Board IFRS Foundation Trustees 30 Cannon Street London EC4M 6XH, United Kingdom

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RE: FASB File Ref. No. 2013-290

Insurance Contracts

IASB <u>ED/2013/7</u> Insurance Contracts

Members of the Boards and Trustees of the Foundations:

On behalf of Sandler O'Neill + Partners, L.P., I am commenting on the FASB's Exposure Draft, *Insurance Contracts* (Topic 834), June 27, 2013 ("FASB ED"), and the IASB's Exposure Draft ED/2013/7, *Insurance Contracts*, June 2013 ("IASB ED"), each of which requests comment by October 25, 2013 on proposals published pursuant to a joint project of the Boards on revising accounting for insurance contracts.¹

Although we describe and discuss key features of these proposals in this letter, we do so primarily as a means of providing a broader conceptual critique of the Boards' stewardship of generally accepted accounting principles in the United States ("U.S. GAAP") and internationally ("IFRS"), which we regard as deficient by reason of its inconsistency with the Boards' own due process. In the absence of a return to first principles, in which the Foundations need to assist the Boards, we believe that investors and preparers will be ill served in the insurance contracts project.

We anticipate that this letter may strike some readers as blunt, but we are convinced that not to speak frankly but respectfully at this juncture would be a disservice to the Boards and their Foundations, as well as to the investors and preparers who are our

SANDLER O'NEILL + PARTNERS, L.P.

¹ The IASB supplemented its ED with two simultaneously published documents, *Basis for Conclusions* and *Illustrative Examples*, on which comments are also due by October 25, 2013. The FASB ED is a single, composite document including all elements of the IASB's three separate documents.

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clients. For reasons we explain herein, the clients on whose behalf we write include not only insurers but also banks and investment banks,² as well as investors in them.

Sandler O'Neill is a full-service investment banking firm and broker-dealer focused on the financial services sector. We address the Boards and the Foundations as a firm of financial professionals who work closely with a wide variety of financial companies. Our clients include some one thousand such companies, including insurers, banks, and investment banks, as well as investors in them.

Background

The Boards' proposals develop two prior documents published concurrently, the FASB's Discussion Paper, *Preliminary Views on Insurance Contracts*, September 17, 2010, and the IASB's Exposure Draft, *Insurance Contracts*, July 30, 2010.

In our December 15, 2010 letter commenting on the FASB's discussion paper,⁴ we urged the FASB to limit itself to what it termed "targeted improvements" to accounting for insurance contracts. We reasoned that to do otherwise and follow the IASB's lead would result in a radical, counterproductive revision to U.S. GAAP that would be at loggerheads with the business models of insurers. Even as modified in the FASB's preliminary views, we believed the IASB's proposal would:

- increase the volatility of insurers' equity and earnings dramatically, and often procyclically,
- degrade the granularity, transparency, and relevance of insurers' financial statements for investors and other users.
- · increase the cost and reduce the availability of capital to insurers, and
- distort business decisions by insurers, reducing the availability of long-term financing to a variety of entities.

² Bankers and investment bankers should preview the definition & scope discussion on page 3, the last paragraph of the key targeted improvement discussion on page 16, and the discussion of day-one losses on business combinations in footnote 23 before reading this letter in its entirety.

³ For further information on Sandler O'Neill + Partners, L.P., see http://www.sandleroneill.com/. Author contact information is jlongino@sandleroneill.com; 212-466-7936.

⁴ We copied the Chairman of the IASB, the Chairman and Chief Accountant of the SEC, and the Statutory Accounting Principles Working Group of the NAIC on that letter, which is available at http://www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175821905051&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs.

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Notwithstanding the Boards' "OCI solution" and other revisions in their current proposals, these concerns are no less true now than they were then. We have therefore chosen to make the focus of this letter the stewardship of the Boards and the consequent need for stronger governance by their Foundations.

Key Features of the Proposals

The key features of the proposals are their redefinition of the term *insurance contract* based on the characteristics of the instrument rather than the identity of the issuer; the consequent scope of the proposals, which would extend to issuers other than insurers, including banks; and the fair value measurement of insurance contracts, which would be recognized in a combination of net income or other comprehensive income ("OCI").⁶ In addition to the following description of these features, we include a more detailed summary of the Boards' measurement models in an appendix to this letter.

Definition of Insurance Contract; Scope

The FASB proposes to define the term *insurance contract* to be "a contract under which one party (the issuing entity) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder or its designated beneficiary if a specified uncertain future event (the insured event) adversely affects the policyholder." The definition would provide the basis for newly standardized accounting

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⁵ The "OCI solution" refers to the decision of the Boards to recognize changes in the fair value of insurance liabilities attributable to changes in the discount rate in other comprehensive income rather than net income to reduce, but not eliminate, the increased volatility of net income their proposals would cause. All other changes in the fair value of insurance liabilities would be recognized in net income.

⁶ We note that the Boards describe their proposals as measuring insurance contracts at a "present value" or "current value," terms not defined in the ED glossaries. In fact, the Boards propose to measure insurance contracts at fair value in that they apply a Level 3 derived "market" discount rate for insurance liabilities (not adjusted for own performance) to estimated future cash flows. Because we believe "fair value" to be the accurate, more forthcoming description of the proposals, we employ that term herein. Although the IASB glossary does not define the term *fair value*, the FASB glossary defines it as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." FASB ED, p. 28.

⁷ The IASB definition is substantially similar. The FASB ED defines *insurance risk* as the "risk arising from uncertainties about underwriting risk as opposed to financial risk. Insurance risk is fortuitous; the possibility of adverse events occurring is outside the control of the insured." *Financial risk* is the "risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable." Again, the IASB definitions are to the same effect.

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for insurance contracts, including reinsurance contracts, by reference to the characteristics of the instrument rather than the identity of the issuer.

As a result, banks and other non-insurance financial institutions would need to apply the proposed accounting to many guarantees and indemnities not now deemed to be insurance contracts. Financial, mortgage, and trade credit guarantees not subject to derivative accounting are within the scope of the FASB ED. Several other guarantee contracts currently accounted for under general guarantee guidance are within the scope of the proposals. These include auction-rate securities guarantees, guarantees on securitized assets, certain indemnities, liquidity facilities, minimum revenue guarantees, standby letters of credit, M&A guarantees, performance bonds, residual value guarantees, whole loan sale guarantees, and trust preferred repayment guarantees. Subject to certain conditions, the IASB would retain current guidance permitting such entities an election between insurance and financial instrument accounting for such instruments.

Measurement Models

The Boards propose two measurement models for insurance contracts within the scope of their proposals:

- The first, a building block approach ("BBA"), is a default model that would apply to most life, annuity, and long-term health contracts. Whereas the FASB model has two "building blocks" probability weighted discounted estimated cash flows and a margin representing unearned profit the IASB model has three because it bifurcates the margin into a contractual service margin representing unearned profit and an explicit risk adjustment reflecting compensation for the uncertainty that future cash outflows could be more than expected.
- The second, a premium allocation approach ("PAA"), would apply to contracts having (i) a coverage period of one year or less, or (ii) an estimated value of net fulfillment cash flows unlikely to change significantly before a claim is incurred. Such short-term contracts would include most property & casualty contracts and annual health contracts.

While the IASB views the PAA as a proxy for the BBA, the FASB views it as a separate measurement model. Suffice it to say that there are key similarities between the two approaches. Specifically, the unit of account under both approaches is a portfolio of insurance contracts having similar risks, pricing, duration, and cash flow patterns. Moreover, both approaches measure insurance contracts only after unbundling components not closely related to the insurance coverage specified in the contract.⁸

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⁸ Under the FASB ED, noninsurance cash flows subject to unbundling include those arising from embedded derivatives requiring bifurcation, distinct investment components containing financial risk but no significant insurance risk, and distinct performance obligations to provide

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Finally, the BBA requires the fair valuing of future cash flows and recognition in OCI of changes in fair value attributable to the discount rate, as does the PAA unless cash flows are estimated to occur within one year. As a practical matter, most short-term contracts would likely be fair valued under the PAA.

However one views the relationship between the BBA and the PAA, the more important point is that each approach to measuring insurance contracts would fundamentally alter how issuers of insurance contracts report their financial results.

The Nexus of Business Models, Accounting, & Investors

The fundamental flaw in the Boards' fair value approaches to measuring insurance contracts is that they are radically divorced from the business models of the firms to which they would apply, and therefore would not provide investors⁹ the financial information they need to reach investment conclusions.

Insurance Business Models

Both life insurers and P&C insurers collect and invest policy premiums to fund policy obligations, but while investment income primarily drives the profitability of long-duration products, premium income primarily drives the profitability of short-duration products. More specifically, investment results (return on assets less amounts credited to policyholders) drive the profitability of life insurers, while underwriting results (premiums less claim costs and expenses) drive the profitability of the shorter-duration product lines of P&C insurers.

Because the policy liabilities of life insurers consist largely of very long-term, illiquid contracts, balance sheet management consists of maintaining a portfolio of assets whose cash inflows match, as best as possible, the expected cash outflows of insurance contracts, increased by margins for adverse deviation. Projected asset cash flows are reduced for credit losses and other risks as a means of fine-tuning the cash-flow integration of assets and liabilities. Embedded asset-issuer options, such as prepayment options, are avoided or minimized to enhance the integration of cash flows. Investment in long-term, illiquid assets offers the advantages of better matching with policy liabilities

noninsurance goods and services. Unbundled components would be accounted for separately under other applicable U.S. GAAP.

⁹ Herein we use the term *investors* to include shareholders, lenders, and other creditors, consistent with the FASB's cohort of *primary users* to whom general-purpose financial reports are addressed. See FASB, Statement of Financial Accounting Concepts No. 8, *Conceptual Framework for Financial Reporting* (September 2010), ¶¶ OB5 & BC1.9. As discussed below, we believe the Boards' insurance contracts proposals violate their due-process commitment to financial accounting and reporting responsive to the needs of investors.

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as well as higher yields. Because the durations of assets seldom approach those of liabilities, reinvestment risk must also be managed, as must liquidity risk.

Investment income is more important to the profitability of life insurers because life insurance has a very long "tail" – the typical time elapsed between initial policy issuance and payment of the related claim. By contrast, property insurance is a short-tailed line of business in which claims are usually handled quickly. Casualty insurance is longer tailed than property insurance – because lawsuits can take years – but generally shorter tailed than life insurance.

In short, the relative importance of investment income to life, property, and casualty lines of business is a function of the length of time available to the insurer to invest cash received from the payment of premiums. ¹⁰ As the importance of investment income decreases for insurance lines of business, premiums become a more important source of profitability, including the ability to increase premiums promptly in response to unfavorable market or reserve development (the recognition of claims losses not previously assumed).

Valuation Metrics & Their Fate

The implications of these business models for what investors need to know and the information accounting principles should endeavor to provide are straightforward. Broadly, investors in life insurers tend to value these companies based on Price/Earnings multiples because of the relative stability of earnings compared to P&C insurers, whereas investors in P&C insurers tend to value them based on Price/Book Value multiples relative to Return On Equity. In assessing the quality of earnings, investors in both life and P&C insurers tend to look to operating earnings, or net income excluding realized (and unrealized) gains and losses on investments.

The common thread in what investors in insurers need to know is book value and current and expected future earnings, particularly operating earnings. Because of the earnings volatility of P&C insurers, investors pay attention to the relationship between ROE and P/BV multiples. Investors in P&C insurers consider the fair value of their investments because they are a source of liquidity, but investors are less interested in the fair value of the investments of life insurers because they understand that what drives their profitability is the managed spread relationships between policy obligations and investments funded by premiums.¹¹ The fair value of policy liabilities is of less concern to

¹⁰ Investment income is also more important to life insurers because life insurance is a lower margin line of business, reflecting the greater predictability of mortality compared to other insured risks.

¹¹ At this most general level of analysis, insurers and banks are alike in their dependence on fee and spread income and their integrated management of assets and liabilities. Their fundamental

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investors than the adequacy of claim reserves for P&C insurers and the credit quality of assets for life insurers.

Therefore, accounting principles applicable to insurance contracts and investments generally should not focus on their liquidation values (actual or speculative) but, rather, should enable an understanding of how fee and investment income is managed to fund the payout of policy obligations.¹² The Boards' proposals turn a blind eye to this goal.

In themselves and in tandem with the Boards' classification and measurement proposals, the insurance contracts proposals would nullify the valuation metrics so important to investors. Book value would no longer exist as a stabilizing, smoothing frame of reference for earnings because the "fair value" of insurance liabilities would become the engine of both book value and earnings volatility. Particularly for life insurers, the volatility of the insurance liabilities component of book value would overwhelm other sources of equity and earnings, and in a financial crisis book value would become the eye of the storm rather than a port in it – a problem the Boards' "OCI solution" fails to address. As well, because of the volatility of equity, return on equity would become an equally useless metric for investors.

difference is that the essence of banking is the lending and collection of capital, whereas the essence of insurance is the making and funding of promises.

¹² We note that the FASB's proposal is redundant for U.S. insurers because they are subject to a regime of statutory accounting designed to provide liquidation values to supervisors and other interested stakeholders, including investors. By contrast, current U.S. GAAP is reasonably calibrated to provide investors and other stakeholders with information useful to the analysis and valuation of insurers as going concerns, as we discuss more fully below. In addition to being redundant, the FASB ED would be inferior to statutory accounting, which rests upon the firm foundation of historically derived and time-tested actuarial concepts as opposed to the highly theoretical, nonoperational constructs of the Boards' proposals. In short, adoption of the FASB ED would do double damage to accounting principles applicable to U.S. insurers: it would impose a redundant, inferior regime of liquidation accounting, and it would deprive investors and other stakeholders of established GAAP reasonably calibrated to provide granular, transparent, and relevant financial information helpful to the assessment of insurers as going concerns.

While most insurance liabilities are not susceptible to run-on-the-bank risk, the Boards' proposals could easily cause the failure of insurers in the next financial crisis. If accounting were to paint an unrealistically negative portrait of insurers in a crisis, the rating agencies could downgrade them to the point that they would have to raise an inordinate amount of equity (if they could) or go into runoff. Similarly, large U.S. insurers newly under federal supervision would almost certainly be supervised based on results reported under U.S. GAAP regardless of the long-term economics, which could lead to unnecessary supervisory resolutions. See also the related discussion in footnote 26 below.

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Earnings would suffer the same fate as book value and equity, having largely become a derivative function of ephemeral, often speculative "fair values" of assets and liabilities. and operating earnings would be impossible to reverse-engineer or trend. Meaningful Earnings Per Share - the crowning achievement of accounting for investors - would cease to exist in the insurance sector. Decades of company and industry data would be lost because of the complete incompatibility of the Boards' models with everything that had gone before.

At sea and bereft of every guiding star, investors could easily conclude the insurance sector to be uninvestable. Such consequences for investors in the name of accountancy are unthinkable, unconscionable.

The Boards' Proposals in Context

The enormity of what the Boards have proposed for insurance contract accounting cannot be fully appreciated without the context of a short review of the history of financial accounting and reporting, 14 the due process that should govern their work, and the relative importance of due process and international accounting convergence.

Financial Accounting & Reporting

Accounting conventions evolved in a grass roots manner from bookkeeping practices. Whereas bookkeeping records financial transactions, accounting produces financial statements from the ledgers and trial balances produced by bookkeeping.

The balance sheet – also called the statement of financial position – displays a firm's assets and claims on those assets, reflecting the fundamental equation that assets must equal the sum of liabilities and shareholders' equity. The income statement – also called the statement of financial performance – displays revenues and expenses, reflecting increases and decreases in retained earnings within a reporting period.

The bedrock of the balance sheet is historical cost. Revised downward as appropriate to cover deterioration or impairment, historical cost came to determine asset valuation because it was grounded in the certainty of actual transactions that were easy to audit. As an alternative, financial assets held for sale began to be adjusted from acquisition cost to market quote.

The foundation of the income statement is matching. Matching of revenues and expenses through the use of accruals evolved to better align efforts and accomplishments within a reporting period than did inflows and outflows of cash.

¹⁴ See generally Thomas A. King's readable, worthwhile More Than a Numbers Game: A Brief History of Accounting (Hoboken: John Wiley & Sons, 2006), chapters 1 & 7 in particular.

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Resources consumed currently that would generate revenue in future periods came to be capitalized as an asset on the balance sheet, while those that would not were expensed through the income statement, reducing retained earnings.

The income statement upstaged the balance sheet as the primary financial statement in the 1920s as stock ownership became more widespread. Lenders want to know if they will get their money back and had focused on the balance sheet's inventory of potential collateral and other claims. Shareholders are focused on a firm's ability to pay future dividends through growth and improved margins as a means of valuing shares of common stock.

The introduction of the concept of *comprehensive income* in the FASB's Conceptual Framework represents an attempt to re-establish the primacy of the balance sheet, notwithstanding the FASB's commitment to accounting for investors, who continue to focus on net income based on realized transactions. This is so because investors need accounting principles helpful in estimating the future earnings power of a going concern rather than the fair value net worth of a firm in liquidation. In truth, both the balance sheet and income statement are important, but in the geography of financial accounting and reporting, performance drives position, not vice versa.

Viewed from the perspective of financial accounting, it becomes very clear that the Boards' proposals are not financial accounting at all but risk analysis masquerading as financial accounting, as a result of which they are incapable of producing anything even remotely resembling real financial reporting. The proposals stand financial accounting on its head, creating a dystopian reporting landscape where changes in the "fair value" marks of insurance liabilities drive earnings rather than earnings driving changes in the equity account, as they do in the recognizable landscape of real financial reporting.

What the Boards' proposals do is to treat portfolios of insurance contracts as miniature balance sheets reduced to the Level 3 fair values of mean estimates of netted premium revenues and claim expenses, not because this is a methodology productive of information appropriate for reporting on the face of the financial statements but, rather, because it is the keystone of the Boards' notion of risk measurement for insurance companies and the discipline of risk management it is intended to impose.

The netting and fair valuing of lifetime estimated premium revenues and claim expenses gets accounting for insurance contracts as far away as possible from the reporting of actual financial transactions and reveals itself to be the *reductio ad absurdum* of the accounting convention of matching. Little wonder that investors are alarmed at the

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¹⁵ Thoughtful creditors also value the perspective of the equity investor because – unlike agency credit ratings – equity research is a leading rather than lagging indicator of position and performance that is updated at least quarterly.

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aggregation of data and the weird effects of attempting to transpose the results of a balance-sheet-driven model of risk measurement to the income statement, including the odd redefinition of *earned premium* to be the sum of expected claims and benefits in a reporting period and the release of margin.¹⁶ In the world of real financial accounting and reporting, revenues are a function of sales and pricing, not the duration of liabilities, and profit is a function of changes in cash inflows and outflows, not release from risk evidenced by a reduction in the variability of cash outflows.

In the larger context of the Boards' recent financial instruments proposals, the insurance contracts proposals are part and parcel of extending the reach of fair value in the balance sheet, with the income statement an inconvenient complication. Taken together, the financial instruments and insurance contracts proposals are directionally akin to the fair value measurement of entire balance sheets that bankers perform to assess at periodic intervals the long-term embedded interest rate risk to which they are exposed. However, bankers use the results of this analysis as a backstop for their simulation analysis of nearer-term earnings at risk, to which they manage more actively, and would regard disclosure of the results of such fair value analysis in torturously fabricated financial statements as a poor excuse for financial reporting.

Of course, in order to propose their fair-value risk-assessment model for insurance contracts the Boards first had to exclude them from the scope of their financial instruments proposals, for which there is no principled basis in those proposals themselves. Under the financial instruments proposals, financial liabilities generally would be measured at amortized cost unless they were held with the objective to transact subsequently at fair value or they resulted from a short sale.

We can't imagine a class of liabilities more eligible for amortized-cost treatment than insurance contract liabilities. The insurance business model is to hold rather than extinguish these liabilities early, and to such an extent that there is no market value for insurance contracts other than private market value. As a result, discount rates for such liabilities are extremely speculative, and because they are material to the balance sheets of insurers and have durations of up to 40 years or more, small quarterly changes in these discount rates would create volatility that would overwhelm other sources of earnings and equity.

So at odds with the conceptual foundation of the financial instruments proposals is the exclusion of insurance contract liabilities from their scope that the conclusion of a supervisory rather than an accounting motive is unavoidable. Speculative information for investors about the volatility of insurance contract liabilities is not the goal, for it could be provided in the notes or MD&A. Rather, the goal is to coerce insurers to conform to the

¹⁶ See Example 20 (revenue recognition) beginning on page 140 of the FASB ED for the counterintuitive revenue pattern apparently caused by the disconnect between revenue recognition and margin release.

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Boards' supervisory vision of risk measurement and management, to which end the IASB has proposed amending IFRS 9 to include a FV/OCI category for certain fixed-income assets.

If there were any doubt that supervision rather than accountancy informs the Boards' financial instruments and insurance contracts projects, their contradictory treatment of liabilities dispels it utterly. The financial instruments proposals generally measure liabilities at historical cost because the liabilities of banks are of much shorter duration, hence much lower volatility. Insurance contract liabilities are an exception to this rule because they are often of much longer duration, hence much greater volatility. By contrast, the financial assets of both banks and insurers can be sources of significant volatility, so the Boards have proposed to extend the reach of fair value for such assets.

In short, the financial instruments and insurance contracts projects lack a principled foundation in accountancy, exposing for all to see the supervisory program of coercing financial firms to conform to the Boards' vision of risk measurement and management by requiring as much volatility as possible to be included in the financial statements rather than the notes, despite the fact that this volatility is often highly speculative as well as ephemeral, and unreflective of their business models.

Due Process

Like the Boards' recent financial instruments and credit impairment proposals, the insurance contracts proposals are symptomatic of a longstanding disregard of due process coincident with the unacknowledged mutation of accountancy into shadow supervision. As we have discussed more fully in our letter commenting on those proposals, *shadow supervision* is the use of fair-value measurement in the financial statements and audit of the statements and notes to impose the Boards' vision of risk measurement and management on financial firms rather than to provide investors with information helpful to them in reaching investment conclusions.¹⁷

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¹⁷ Our comment letter on the financial instruments and credit impairment proposals is available at http://www.fasb.org/cs/BlobServer?blobkey=id&blobtable=MungoBlobs.. It should be consulted for the conceptual predicate it provides for this letter, as should our letter commenting on the FASB's disclosure framework discussion paper. Our disclosure framework letter is available at http://www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175825209114&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs. As we remark in that letter, notable in the discussion paper is the identification of assets and liabilities – but not revenues and expenses – as establishing boundaries for information presented on the face of the financial statements. The paper confirms the extent to which OCI and AOCI have upstaged revenues and expenses in determining the presence and presentation of financial information on the face of the financial statements, particularly evident in the complete break with traditional accounting of the Boards' proposed fair value models for insurance contracts.

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As an exercise in shadow supervision, the insurance contracts proposals are fundamentally inconsistent with the Boards' core commitment to accounting for investors, upon which they converged in September 2010:

The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity.¹⁸

The FASB continues by clearly distinguishing between the information contained in financial reports and the use investors are expected to make of it:

General purpose financial reports are not designed to show the value of a reporting entity; but they provide information to help existing and potential investors, lenders, and other creditors to estimate the value of the reporting entity." ¹⁹

What is key here is that general purpose financial reports – and financial statements in particular – are to provide "information" rather than "estimates": in other words, factual financial data rather than speculation, on the basis of which investors are to form their own "estimates" of value as they see fit.

By both word and deed, investors have repeatedly rejected the Boards' supervisory agenda. Because actions speak louder than words,²⁰ we emphasize the undeniable facts of investor behavior that they consistently accord primacy to the income statement rather than the balance sheet, and that they routinely exclude the unrealized gains and losses of OCI from operating earnings. For investors, OCI and AOCI represent an unhelpful disconnect between performance and equity and an unwelcome distraction in the financial statements from what matters most to them.

¹⁸ FASB, Statement of Financial Accounting Concepts No. 8, *Conceptual Framework for Financial Reporting* (September 2010), ¶ OB2; IASB, *Conceptual Framework for Financial Reporting: Project Summary and Feedback Statement* (September 2010), p. 4. The due process to which the Boards have committed themselves has two dimensions: substantive and procedural. Of the two, substantive due process – *what* the Boards should be doing – is the more important because procedural safeguards derive from it, and without the Boards' unwavering, self-aware commitment to substantive due process, procedural due process – *how* the Boards conduct their business – will be for naught, as it has been in the insurance contracts project.

¹⁹ Concepts 8, ¶ OB7.

²⁰ Consistent with fair value orthodoxy, certain members of the Boards' staffs engaged insurance investors more as defenders of the faith than open-minded agents.

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What investors want in the financial statements themselves are good, clean numbers that do not require them to reverse-engineer ephemeral or speculative "fair values" before using the financial statements to reach an investment conclusion, and as certainly they do not want the issuers in which they are invested gratuitously put in harm's way by the volatility of such "fair values" in earnings or equity.²¹ Investors are not indifferent to the fair value information contained in OCI and AOCI, but it belongs in the notes, not on the face of the financial statements.

Like much fair value accounting, the insurance contracts proposals are inconsistent with the prime directive of accounting for investors. The Boards' risk measurement proposals for insurance contracts are not accounting principles, nor are they capable of producing financial statements worthy of the name, and the implication of the Boards that investors in insurers would wish upon themselves the nullification of each and every valuation metric important to them confounds belief, as does the implication that investors would wish upon insurers gratuitous volatility in their financial statements.

International Convergence

If the faith-based belief of both Boards in fair value as the accounting cure-all for otherwise deficient financial information largely explains the supervisory thrust of their proposals despite their due process commitment to the needs of investors, an additional explanation is the more understandable desire of both Boards for the international convergence of accounting standards.

Fix Due Process: Convergence Will Follow

We believe the more pressing task for the Boards is not the international convergence of accounting standards but, rather, better due process in the way the Boards develop and update accounting standards, including accounting for insurance contracts. We further believe that if the Boards were to commit themselves to responding more substantively

²¹ See generally "Accounting for Investors: The Fundamental Importance of Corporate Earning Power," Address of SEC Chairman Jerome N. Frank before the Eighth Annual Meeting of the Controllers' Institute of America, October 10, 1939, in which he remarked at page 8: "The accountant, that is, supplies *some* of the materials for, some of the ingredients of, the investor's judgment. The ingredients he supplies should, therefore, be as pure as possible; but the investor's judgment (or that of his advisers) cannot be compounded solely of those ingredients, nor can the accountant be asked to do the work of the investment analyst. It is, accordingly, essential to emphasize the importance of good accounting, but a mistake to over-emphasize it to the exclusion of many other factors. I distinctly do not mean that the accountant is to forecast future earnings. I do mean that he should give greater recognition to the fact that the principal interest of the investor and his advisers is future prospects – earnings [emphasis in original]."

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and consistently to investors, the international convergence of accounting standards would largely take care of itself.

Concerning the FASB as the steward of U.S. GAAP, we note that in contrast to the overriding principle of accounting for investors, there is but a single passing reference to convergence in its Concepts Statement No. 8. In that statement, convergence clearly is what it should be: a secondary, aspirational principle of action to be given effect *only* if consistent with the primary, mandatory desideratum of accounting for investors.

Stare Decisis: A Maxim to Converge By

There is a judicial maxim the Boards would do well to follow: *stare decisis*, "stand by things decided," the principle that past decisions should stand as guides for future decisions.

- In setting accounting standards, this maxim translates into a strong presumption that the Boards have largely "gotten it right" in existing guidance.
- Only compelling evidence developed through the application of dispassionate due process should be allowed to rebut the presumption that current guidance is generally serviceable for investors.
- A preference for targeted improvements rather than overreaching replacement should guide needed revision – gradualism rather than revolution should be the Boards' modus operandi.

The implications of *stare decisis* for responsibly updating accounting for insurance contracts do not lead to the conclusion that the liabilities for long-duration insurance contracts should be measured at historical cost, notwithstanding our discussion of them in the context of the Boards' financial instruments proposals. Rather, what is needed is respect for their settled and sensible treatment under current U.S. GAAP, coupled with the targeted improvement offered below to address the key concern underlying the Boards' unacceptable approaches to measuring long-duration insurance contracts.

Key Targeted Improvement to U.S. GAAP

U.S. GAAP measures long-duration insurance contracts in a manner very different from the Boards' proposals. Currently, the liability for future policy benefits is measured as the present value of estimated future policy benefits to be paid and related expenses less the present value of estimated future net premiums to be collected, and is recorded on the balance sheet when premium revenue is recognized. Premium revenue generally is recognized when due from policyholders, and claim costs are recognized when insured events occur.

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The discount rate is based on the estimated pre-tax investment yields (net of related investment expenses) expected at the contract issue date, adjusted for adverse deviation. By referring to expected investment yields to derive a discount rate at inception and generally not resetting that rate, U.S. GAAP reflects the integrated management of long-term asset and liability cash flows at the core of the life insurance business model and minimizes material accounting mismatches.²²

By contrast, the Boards' proposals would ignore the integrated relationship between assets and liabilities by using a Level 3 derived "market" rate that would attempt to reflect the liability characteristics, and then re-measure liabilities at each reporting period, with changes in value recorded in a combination of net income and OCI.

Putting aside the real-world challenges of identifying a "market" rate for liabilities whose only market value is private market value and whose cash flows can extend over 40 years or more, the quarterly extension of the current term structure of the yield curve decades into the future betrays misguided, impractical thinking.²³ Extreme volatility of equity and earnings arising from material accounting mismatches between assets and liabilities is a certainty, as is the fact that such accounting volatility would be devoid of economic or financial relevance – hence not only useless but also misleading for investors and other users.²⁴

For investors, the key shortcoming of U.S. GAAP is not its pragmatic manner of determining the discount rate but, rather, that assumptions for measuring traditional life insurance benefit liabilities are locked in at inception, to be revisited only in the event of a premium deficiency, a triggering event that may not be timely enough. Here, U.S. GAAP for interest-sensitive life products and investment contracts provides a useful

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²² If it be objected that using asset yields provides insurers the perverse incentive of reaching for yield or making duration bets, we answer that with good, consistent disclosure investors could easily identify aggressive investing. For example, it is well known that life companies generally invest in corporates rated BBB or A, while P&C companies invest in corporates rated A or AA.

²³ The treatment of business combinations under the Boards' proposals strikingly illustrates how deeply flawed is their use of "market" discount rates. As noted, the only real transactions available against which to benchmark discount rates are private transactions, yet because currently the "market" discount rate for the margin calculation under the proposals would likely be lower than a realistic rate used to decide what to pay in a deal, an acquirer would have a "loss" on the deal that would immediately be charged to net income under the FASB ED or adjust goodwill under the IASB ED. This nonsensical result contravenes the assumption under other U.S. GAAP that transactions executed at arm's length generally do not result in an immediate loss. Private market value is the only intellectually defensible determinant of discount rates for insurance liabilities, whether for purposes of acquiring a company or writing a single insurance contract.

As well, actuaries are generally better at distinguishing trends from noise, to which markets tend to overreact.

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alternative approach: management exercises quarterly judgment in determining whether there are significant, sustainable trends requiring an unlocking and resetting of assumptions before required annual unlocks.²⁵

Transposing this approach to traditional life insurance products would result in not reflecting in the financial statements changes in factors such as mortality or lapses with no apparent pattern, but moves that are materially off trend and sustained should be reflected currently in earnings. Similarly, the normal volatility of market interest rates would not be reflected in earnings, but if rates have materially moved off pricing assumptions and appear persistent at those new levels (as market interest rates have in the past 5 years), then an adjustment should be taken currently and recognized in net income, not consigned to OCI. If the discipline of a regularly required revisiting of assumptions were desired, it might be annual but certainly not quarterly.

Finally, we believe the proposed redefinition of *insurance contract* should not be pursued because of the term's operational integration into the manner in which U.S. GAAP reflects the business model of insurers. Absent the larger context of the Boards' proposals, its redefinition is unnecessary for insurers and would be extremely problematic for other financial firms such as banks, which should continue to account for instruments they issue under existing U.S. GAAP. We note that one disruptive consequence for the financial system would be the extension of supervision by state insurance commissioners to banks and other entities that issue "insurance contracts" as redefined unless they ceased issuing such instruments. In short, the redefinition of the term insurance contract is not a targeted improvement to U.S. GAAP.

Conclusion: First, Do No Harm

The insurance contracts project is a case study in how not to update an accounting standard. Begun by the IASB in 2002 and joined by the FASB in 2008, the project arose from the IASB's conceit that there is no global accounting standard for insurance contracts. In fact, U.S. GAAP is an international standard that comprehensively addresses accounting for insurance contracts. All major insurers - domestic and foreign - report pursuant to U.S. GAAP, and all local GAAP is based on the U.S. GAAP model for revenue and expense recognition. Even when spoken with a foreign accent, U.S. GAAP is recognizably the mother tongue.

By contrast, the BBA originated in European Embedded Value ("EEV"), developed by European life insurers to communicate to investors the present value of new long-tailed business at the time it was booked. Despite its origins in disclosure developed by life insurers for life insurers, the IASB became convinced that EEV could provide a basis for

²⁵ Investors analyze the performance of the P&C business on a nominal basis, and while discounting liabilities for longer-tailed incurred claims can provide useful information, it should be provided in the notes rather than the financial statements, where it would reduce their usability.

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accounting in the financial statements for all insurance contracts, in part because of its compatibility with the Solvency II supervisory regime for European insurers, sometimes called "Basel for insurers."

In the long and tangled history of the insurance contracts project, the important points are that the IASB dismissed out of hand where it should have started – U.S. GAAP – and jerry-built from EEV risk disclosure a theoretical accounting model with which European regulators are comfortable. However, it is diametrically opposed to the real-world needs and preferences of investors because it is ill suited to reporting on the face of the financial statements and so nullifies every valuation metric important to them. Although U.S. GAAP for insurance contracts is not perfect, replacing an imperfect standard needing only minor adjustment with a far less perfect one – because unreflective of insurance business models – is neither rational nor consistent with due process. In short, the Boards' implication that investors support their model over U.S. GAAP is not credible because of the model's unconscionable consequences for them.

It is ironic that the IASB chose to call its model the "building block" approach. The true building blocks of financial accounting and reporting worthy of the name are assets and liabilities and revenues and expenses, and the necessary relationship of the income statement to the balance sheet is that performance drives position, not vice versa. Supervision is not accountancy, and risk measurement is not performance measurement. Fair value has a rightful place in risk measurement and disclosure, but the Boards need to forswear its siren call in the financial statements as an instrument of coercing insurers and other financial firms to heel to the Boards' supervisory vision of risk measurement and management.

Quite simply, we have come to this pass in the insurance contracts project because the Boards have lost sight of their job description, with which their Foundations need to reacquaint them. It is deeply disheartening to contemplate the untold resources – both human and monetary – that the Boards have wasted on this project over the years, the IASB more so than the FASB. What is needed is not post-implementation review of accounting standards such as the FAF is conducting, but searching pre-agenda due

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²⁶ Notwithstanding European supervisory comfort, both the BBA and the PAA are so unreflective of the insurance business models in their speculative complexity that they strike us as vulnerable to management manipulation, particularly in the absence of a supervisor such as the Securities and Exchange Commission. U.S. GAAP has in the SEC an enforcement mechanism whose effectiveness is unequalled elsewhere in the world. For this reason, U.S. public companies and investors are canaries in the mineshaft that do not have the luxury of taking in stride adverse accounting developments, which will hit them first and foremost. See also the related discussion in footnote 13 above.

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diligence by the Boards²⁷ and vigilant oversight by their Foundations to help avoid bad ideas that gather momentum, heedless of the prime directive of accounting for investors.

Sincerely,

Joseph Longino Principal

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²⁷ We note that the FAF and FASB have recently taken procedural steps in this direction by subjecting changes to the FASB's agenda to a majority vote of the Board and refocusing its Financial Accounting Standards Advisory Council on future priorities. Whether substantive due process will improve remains to be seen. *See* footnote 18 above on the distinction between procedural and substantive due process.



APPENDIXSummary of Measurement Models

Building Block Approach

While some details of the FASB's and IASB's proposed building block measurement model for insurance contracts differ, both Boards contemplate using the fair value of unbiased, probability weighted fulfillment cash flows²⁸ to measure insurance contracts. Fulfillment cash flows would encompass expected inflows and outflows, including premiums and claims. Whereas the FASB would include in future cash outflows only "successful efforts" acquisition costs directly attributable to the issuance of specific insurance contracts, the IASB would permit deferral of all acquisition costs directly attributable to obtaining a portfolio of contracts. Other acquisition costs would be expensed as incurred.

Estimated future cash flows would be fair valued using a current discount rate that reflects the characteristics of the insurance liabilities. Both the estimated future cash flows and the discount rate applied to them would be updated at each reporting period, with two approaches for deriving the discount rate suggested but not required: a top-down approach that would adjust the rate of a reference portfolio of assets (not required to be physically held) to reflect the insurance liability characteristics, and a bottom-up approach that would adjust a risk-free rate to reflect the liability characteristics. Any changes in the fair value measurement of estimated insurance contract cash flows attributable to changes in the discount rate would be recognized in OCI, with all other changes recognized in net income.

The FASB's model uses a margin equal to the amount by which discounted cash inflows exceed outflows, preventing any day-one gains. If the margin were negative, the loss would be expensed immediately rather than deferred. The margin would be locked in at inception and released into earnings over the coverage and settlement periods as the issuer is released from exposure to risk pursuant to a method of amortization to be determined by the issuer, subject to reassessment and any necessary adjustment of the amortization pattern at each reporting period. Thus, at each reporting date, the carrying

²⁸ Although not required by the EDs, stochastic modeling would be one approach to estimating the future cash flows of long-duration insurance contracts, a method not currently common in the insurance industry.

²⁹ For participating policies the discount rate could reflect the return on the pool of assets that determines the rate paid to the policyholder.

³⁰ In the IASB model, if the discounted cash inflows were less than the sum of cash outflows plus the risk adjustment, the loss would be expensed immediately rather than deferred. The IASB

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amount of a portfolio of insurance contracts would be the sum of the fulfillment cash flows and the remaining margin.

Premium Allocation Approach

The premium-allocation approach to measuring short-term contracts would initially measure the pre-claim insurance liability as the fair value of expected contractual premiums less direct acquisition costs and any additional liability for an onerous (unprofitable) contract. Cash would be recognized for premiums received and a receivable would be recognized for expected future premiums. The liability for remaining coverage and any premiums receivable would be fair valued if the contract had a significant financing component, unless at contract inception payment of all or substantially all of the premium and provision of corresponding coverage were expected to occur within one year of each other. Subsequently, the liability for remaining coverage would be reduced in a manner reflecting the passage of time or the expected timing of incurred claims and benefits if that pattern differed significantly from the passage of time.

As insured events occur, the issuer would record in net income a liability for incurred claims, generally measured as the fair value of estimated fulfillment cash flows, without applying an explicit risk adjustment (unlike the IASB's model). As a practical expedient, the liability for incurred claims would not be fair valued if the effects of discounting were immaterial to the portfolio or incurred claims were expected to be paid within one year of the insured event. Changes in the fair value of a liability for incurred claims attributable to changes in the discount rate would be recognized in OCI, with other changes in fair value recognized in net income.

model would update estimates of fair valued fulfillment cash flows as well as the risk adjustment and contractual service margins at each reporting period. The significance of the separate contractual service margin for European insurers is that under Solvency II it would count as regulatory capital supporting new business writings.