



October 25, 2013

Mr. Russ Golden  
Chairman  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, CT 06856-05116

Re: File Reference No. 2013-290: Proposed Accounting Standards Update, Insurance Contracts (the "Proposal")

Dear Mr. Golden:

The Clearing House Association L.L.C. ("The Clearing House"),<sup>1</sup> an association of major commercial banks, appreciates the opportunity to comment on the above-referenced Proposal.

The Clearing House supports the efforts of the Financial Accounting Standards Board ("FASB") and the International Accounting Standards Board ("IASB") (collectively, the "Boards") to improve comparability, transparency, and consistency in financial statements with respect to the accounting for insurance.

However, we are concerned that the scope of the Proposal is overly broad, as it may extend to many contracts that are better accounted for under the FASB's existing guidance for guarantees. These contracts either consist of financial contracts that do not meet the definition of insurance risk, such as financial guarantees, standby letters of credit and liquidity facilities, or consist of indemnifications or guarantees that are incidental to a larger transaction and are intended merely to ensure that a seller satisfies its own performance obligation to a customer. The current accounting model for these types of contracts is both operational and well-understood, and we do not believe there is a demand from users of financial statements to change the current model. Furthermore, we believe the current framework is

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<sup>1</sup> Established in 1853, The Clearing House is the oldest banking association and payments company in the U.S. It is owned by the world's largest commercial banks, which collectively employ over 2 million people and hold more than half of all U.S. deposits. The Clearing House Association L.L.C. is a nonpartisan advocacy organization representing—through regulatory comment letters, amicus briefs and white papers—the interests of its owner banks on a variety of systemically important banking issues. Its affiliate, The Clearing House Payments Company L.L.C., provides payment, clearing, and settlement services to its member banks and other financial institutions, clearing almost \$2 trillion daily and representing nearly half of the automated-clearing-house, funds-transfer, and check-image payments made in the U.S. See The Clearing House's web page at [www.theclearinghouse.org](http://www.theclearinghouse.org).

more appropriate for financial contracts. Moreover, the proposed new model is operationally complex and does not provide more decision useful information, and may, in fact, prove confusing to investors.

In addition, where financial instruments such as catastrophe bonds are traded on an exchange or in a dealer market, such that quoted market prices are available, we believe the instrument should remain subject to fair value measurement, as we believe this results in a more objective and therefore more reliable value. At a minimum, the fair value option should be preserved for these instruments.

Accordingly, The Clearing House:

- *recommends* that the scope of the Proposal exclude financial contracts such as standby letters of credit, financial guarantees, and liquidity facilities, because they do not meet the definition of insurance, and changing to a new model would reduce comparability with similar products in the banking industry;
- *recommends* that other indemnifications that are incidental to a larger transaction should be excluded from the scope of the Proposal, because they are intended merely to ensure that a seller satisfies its own performance obligation to a customer; the current accounting model is operational and well-understood, and we are not aware of any demand for changes to the current model;
- *recommends* that instruments for which quoted market prices are available, such as catastrophe bonds, that are currently subject to fair value measurement should remain subject to that model;
- *recommends* that the fair value option be preserved for the contracts discussed herein if the Board does not specifically exclude them from the scope of the Proposal.

The remainder of our letter discusses these recommendations in greater detail.

***A. Financial contracts do not meet the definition of insurance risk.***

The Proposal applies to all entities that issue “insurance contracts.” An insurance contract is defined in the Proposal as one that transfers significant insurance risk to the entity from the policyholder. The Proposal further notes that the following products are potentially within the scope of the Proposal: standby letters of credit; financial guarantees; liquidity facilities; auction rate securities guarantees; and guarantees related to trust preferred securities. We are concerned that the examples provided that illustrate the application of the scope of the Proposal are unclear, inconsistent with the Proposal’s overall definition of insurance, and lack a clear conceptual basis. We believe this lack of clarity may lead to inconsistent application of the rules by preparers and confusion for financial statement users.

All of these products named above are based on financial risk, and specifically, credit risk. Essentially, they provide protection to the holder of a financial obligation from a financial loss in the event of a default – defined as nonpayment (when due) of contractual payments (generally principal and interest) by the issuer of the financial obligation.

Thus, credit risk (which includes default risk) is not included in the Board’s definition of insurance risk. This is because insurance risk is expressly defined in the Proposal as distinct from financial risk, which is defined as resulting from “a possible future change in... specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable”<sup>2</sup> (emphasis added).

We note that credit risk *per se* is not cited in the above definition of financial risk, and we are aware that there is a view that providing protection against the risk of default may be considered to be insurance risk because it represents the risk of nonperformance. We strongly disagree with this view because credit risk and default risk are inextricably linked and essentially synonymous: credit risk (as well as changes in a credit rating or a credit index) only exists because of the potential for default. The basic definition of credit risk as set forth by the Bank of International Settlements is, simply, the potential that a borrower or counterparty will fail to meet its obligations in accordance with agreed upon terms (i.e., default).<sup>3</sup> Further, we believe that credit risk is commonly understood to be within the fundamental meaning of financial risk. We do not believe that credit risk fits the definition of insurance risk, either as defined in the Proposal or as commonly understood in practice.

In sum, we believe that these contracts are primarily designed to provide protection to the holder from a financial loss in the event of a default or illiquidity. In addition, as discussed in more detail in section B. below, we believe there are additional features of certain of these contracts that distinguish them from insurance contracts. As such, we believe that the implementation guidance should make clear that these products are outside the scope of the Proposal as they do not meet the definition of insurance risk.

***B. Standby letters of credit and liquidity facilities are lending commitments and generally result in assets, not losses.***

A standby letter of credit is a type of financial guarantee defined as “[a]n irrevocable undertaking (typically by a financial institution) to guarantee payment of a specified financial obligation.”<sup>4</sup> It is significantly different from standard insurance contracts in that insurance claims normally result in a cash payment recorded as a loss or as a loss payment by the insurer. In contrast, the claim arising from the contingent event in a standby letter of credit may result in a loan by the bank to

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<sup>2</sup> Proposal Glossary, pp. 28-29.

<sup>3</sup> Principles for the Management of Credit Risk - Consultative Document, July 1999, Basel Committee on Banking Supervision, available at <http://www.bis.org/publ/bcbs54.htm>.

<sup>4</sup> Master Glossary, ASC.

the banking customer – that is, it may result in the bank recording an interest-bearing asset (as opposed to a loss).<sup>5</sup>

In other words, a standby letter of credit is effectively a loan commitment between a bank and its customer. As such, we believe it should be accounted for in the same manner as a loan commitment.

Liquidity facilities also have features that are significantly different from insurance products. As noted in the Proposal, with a liquidity facility, the financial institution providing the guarantee is required to make certain payments if losses or defaults occur. (Guarantees provided to auction rate security programs may include a similar type of guarantee.) In our experience, the losses triggering payment may be due either to a credit event, or in some cases, due to a market value change or illiquidity in a market that prevents the sale of an asset. In either instance, however, the risk is a financial risk.

As noted above, insurance claims normally result in a cash payment recorded as a loss by the insurer. In contrast, with a liquidity facility, the claim arising from the contingent event normally results in the bank purchasing a security from the insured party or providing a loan to the insured party. Thus, as with a standby letter of credit, an interest-earning asset is recorded on the balance sheet of the bank, rather than a loss. We believe this is a significant distinction from a traditional insurance contract, and provides further support for why these contracts should be considered outside the scope of the Proposal.

***C. Comparability of credit risk products will be reduced if these contracts are included in the Proposal.***

As proposed, the products listed above would be subject to either the “premium allocation approach” or the “building block approach”. Either approach represents a change from current U.S. generally accepted accounting principles (“U.S. GAAP”) for a number of common banking products. Most guarantee liabilities are currently accounted for pursuant to ASC Topic 460 (originally issued as FASB Interpretation No. 45, or “FIN 45”) at fair value at inception. Contingent losses under the guarantee are recognized and measured in accordance with ASC Topic 450, the same standard that governs the accounting for other bank credit exposures such as impairment on loans. Fees for loan commitments are currently accounted for under ASC 310.<sup>6</sup>

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<sup>5</sup> We note that if a letter of credit is drawn by the customer or beneficiary, the customer may reimburse the issuer of the letter of credit with available funds, such that a new borrowing would not be required. However, in the event of a credit downgrade, the customer may have less funds available, such that a new loan would result.

<sup>6</sup> It should be noted that in many cases, liquidity arrangements are accounted for as derivatives. If derivative accounting is not applicable, when contingent losses become probable, the accounting required by ASC 450 mirrors derivative accounting. Thus, applying an insurance model to these contracts is not a better alternative to the current approach.

Thus, whereas under current U.S. GAAP, contingent losses on these products are recognized and measured consistently with other credit products, they will be required to be accounted for under different, and more operationally complex, accounting methods. Requiring financial institutions to apply two different models for measuring credit risk may be confusing for financial statement users, because financial statement comparability for similar, related products will be reduced.

***D. Other indemnifications that are incidental to a larger transaction should be excluded from the scope of the Proposal.***

We understand that other indemnifications and guarantees such as securities lending indemnifications, guarantees related to representations and warranties on mortgage loan sales, merchant processing indemnifications in credit card arrangements, guarantees of a subsidiary's debt to a third party, and minimum revenue guarantees in business acquisitions may also be considered within the scope of the Proposal. These types of guarantees and indemnifications, many of which contain an element of credit risk, are typically incidental to a larger transaction and are accounted for in the transaction pricing at inception and subsequently measured under the existing guidance of ASC 450. We believe that these contracts do not meet the definition of an insurance contract because they are intended merely to ensure that the provider of the indemnification or guarantee has satisfied its performance obligation to its customer as part of the larger transaction.

We are not aware of any requests to change the current accounting, as it is operational and well-understood. As such, we believe that they should continue to be accounted for under current U.S. GAAP, as changing to a more complex insurance model would not provide significant benefits to users, and may in fact prove more confusing, given that these contracts do not meet the definition of insurance.

In addition, the Proposal excludes from its scope guarantees of an entity's own future performance, as does ASC 460 today.<sup>7</sup> Yet, the Proposal states that if a bank issues a guarantee of its subsidiary's debt, "that guarantee will most likely be within the scope of this Topic if that bank issues guarantees of the debt of third parties."<sup>8</sup> We believe this is inherently inconsistent. Moreover, we do not believe requiring the application of the Proposal's complex insurance accounting provisions to what we view as a fundamental assertion in consolidated financial statements (i.e., that an entity is liable for its own liabilities) will provide any useful information to financial statement users.<sup>9</sup>

***E. Changing the accounting model for guarantees runs counter to the objective of the proposal, and the costs are not justified by the benefits.***

Our understanding is that one of the overarching objectives of this proposal was to achieve convergence by developing insurance guidance for entities that follow International Financial Reporting

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<sup>7</sup> Proposal, 834-10-15-5k.2.

<sup>8</sup> Proposal, 834-10-55-4.

<sup>9</sup> This same concern applies to guarantees related to trust preferred securities.

Standards (“IFRS”), as IFRS do not contain a comprehensive standard for accounting for insurance contracts.<sup>10</sup>

Consistent with this, we note that financial guarantee contracts are explicitly excluded from the scope of the IASB proposal on insurance contracts,<sup>11</sup> unless the issuer has previously asserted explicitly that it regards those contracts as insurance contracts and has used accounting applicable to insurance contracts. We believe this scope exception is consistent with the fundamental objective of the project.

We further note that the Board stated that in instances in which other guidance provides better information to the users of financial statements for entities that issue such contracts and/or changing the existing accounting for those contracts would impose costs and disruption with insufficient benefit, a scope exception was provided.<sup>12</sup> We believe that an exception for the products discussed herein is warranted on both these grounds. We believe that the existing guidance of ASC 460 is operational, well understood, and not in need of change.<sup>13</sup> Changing to the much more complex model in the Proposal would provide little benefit to users of financial information.

***F. Financial instruments for which quoted market prices are available that are currently subject to fair value measurement should remain subject to that model.***

The Proposal applies to catastrophe bonds that provide for reduced payments of principal, interest, or both if a specified event adversely affects the issuer of the bond (unless the specified event does not create significant insurance risk).<sup>14</sup> However, we note that for many catastrophe bonds, quoted market prices are available on either an exchange or in a dealer market. Although the Proposal requires that such prices be used as an input to the valuation methodology, we believe that a better approach is to measure these instruments at fair value, as is currently required. We believe that fair value measurement provides more objective and, therefore, a more reliable value for investors for these types of instruments. At a minimum, we believe that fair value measurement should be available for certain financial instruments based upon the business model.

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<sup>10</sup> Proposal, paragraphs BC 4 and 5.

<sup>11</sup> IASB Exposure Draft ED/2013/7, Insurance Contracts, Paragraph 7(f).

<sup>12</sup> Proposal, paragraph BC39.

<sup>13</sup> FIN 45 did not address the subsequent accounting for guarantees. In the absence of specific guidance, industry practice has developed whereby an entity recognizes an undiscounted best estimate liability (or updates its initial estimate) when the specified event occurs. If the Board believes that an improvement is needed to current guidance, we would not object to a targeted project to codify this practice so that subsequent accounting for guarantees is explicitly provided for in the accounting literature.

<sup>14</sup> 834-10-55-25.

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***G. The fair value option should be preserved for credit and other financial products.***

The Proposal also eliminates the availability of the fair value option for products that are within the scope of the Proposal. If the Board does not specifically provide a scope exception for products discussed herein, we believe the fair value option should be preserved for financial contracts. We believe fair value should always be an option for financial instruments, and that new accounting guidance should not prohibit the use of fair value measurements.

***Conclusion***

In sum, we believe that the contracts and elements of larger transactions discussed herein should be excluded from the scope of the Proposal. We do not believe that a change to the current accounting model for these items is desired by investors, nor would it provide more decision-useful information. At the same time, we note that the Proposal may, in fact, prove confusing to users.

In addition, we believe that financial instruments for which quoted market prices are available that are currently subject to fair value measurement should continue to be measured at fair value, as we believe that this would produce a more objective value, and therefore more decision-useful information for investors for these types of instruments. Finally, we believe the fair value option should be preserved for financial contracts.

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Thank you for considering the comments provided in this letter. If you have any questions or are in need of any further information, please contact me at (212) 613-9883 (email: [david.wagner@theclearinghouse.org](mailto:david.wagner@theclearinghouse.org)) or Ryan Pozin at (212) 612-0135 (email: [ryan.pozin@theclearinghouse.org](mailto:ryan.pozin@theclearinghouse.org)).

Sincerely yours,



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