Letter of Comment No: 157
File Reference: EITF03-1A

October 29, 2004

Director, TA&I - FSB
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Dear Sir or Madam:

The American Council of Life Insurers (ACLI) would like to offer our comments on FSP EITF Issue 03-1-a (FSP) regarding the clarification of EITF Issue 03-1, The Meaning of Other-Than-Temporary Impairment (EITF). ACLI is the principal trade association of life insurance companies, representing 368 members that account for, in the aggregate, 71 percent of the assets of legal reserve life insurance companies in the United States.

As we stated in prior correspondence, we do not believe that impairments caused solely by interest rate and/or sector spread changes should result in other-than-temporary impairment write-downs unless the company has a current intent to sell the security or lacks the ability to hold that security until a forecasted recovery in value. The interpretations of the EITF would result in significant write-downs of securities impaired solely from interest rate and sector spread changes. Furthermore, we believe that the draft FSP provides insurers little relief from these interpretations.

Our concerns
Insurers hold the majority of their investments within the Available-for-Sale (AFS) category. Insurers require the flexibility offered by the AFS designation to sell securities to manage risk and match liability duration and target yield. The EITF and the draft FSP would significantly reduce the flexibility that insurers require to manage their portfolios. Insurers will have to either accept a modified lower of cost or market (LOCOM) accounting model reducing the usefulness of their financial statements or modify their investment strategies accepting additional risk in their investment portfolios.

The EITF has significantly changed the accounting for investment securities due to the introduction of tainting a company's assertion regarding its ability and intent to hold a security to recovery. While FAS 115 and SAB 59 both required the consideration of intent and ability in regards to holding an impaired security to recovery, they did not use intent and ability as the sole, determinative factor. Additionally, that guidance did not require a formal assertion of intent and did not dictate the strict interpretation of tainting that this EITF dictates. As market conditions changed, a company's decision to change its intent on holding a security did not call into question that company's ability to use the assertion of the intent and ability to hold for future impaired securities. SAB 59 was adopted as a clarification of FAS 12 and applied primarily to equity securities. Applying the tainting guidance introduced by the EITF would reduce the value of the information reported to the financial statement users.

Financial statement users currently see the mark-to-market changes of securities designated as AFS within other comprehensive income. Furthermore, the expanded disclosures required by the EITF for 2003 and beyond, coupled with the disclosure requirements of FAS 115, provide financial statement users with the market value changes and the impact from changing interest rates and sector spreads on the company's investment portfolio. Recording impairments from interest rate and sector spread changes in the income statement and then accreting those other-than-temporarily impaired securities back to par through net investment income does little to improve the quality of the financial statements. In fact, financial statements become more confusing for readers and more difficult to analyze by the investment community.

To understand the issues this guidance creates for insurance companies, it is important to understand the risk management methods used by most insurers, referred to as asset liability management (ALM). ALM is used by insurers to manage several risk elements of invested assets and long-duration liabilities. The key to a well-executed ALM strategy is a proactive management of the investment portfolio. ALM strategies will vary from company-to-company. Most basic ALM strategies, manage the following risks:

- Duration match and interest rate risk;
- Sector concentration/exposure;
- Sector spread;
- Credit risk; and
- Target yield.

In a rapidly changing market, a dynamic ALM model is required to maintain the proper mix of invested assets. Portfolio managers need more flexibility to trade their investment portfolios than that which is currently afforded by the EITF and draft FSP.

The draft FSP falls short of adequately addressing the concerns of insurers. It is lacking in three main areas:

1. The definition of minor impairments needs clarification to allow companies to set their definition of minor based on the security type and duration;
2. Paragraph 7 of the draft FSP does not allow for the proactive management of a portfolio used for ALM purposes without tainting; and
3. The draft FSP only covers paragraph 16 securities but should extend to paragraph 10 securities as well.

Prior to addressing these issues, we would request the FASB create a statement of principle for recording impairments in earnings. In determining this statement of principle, we believe that consideration needs to be given to FASB Concept Statement 2 as it relates to excessive conservatism and FASB Concept Statement 5 as it relates to recognition. In particular, the current approach offered in the EITF and draft FSP does not meet the loss recognition criteria described in that statement, because the EITF and draft FSP require loss recognition prior to there being adequate evidence of a reduction in the future economic benefit of an asset. Absent a probable default or a probable sale in advance of recovery, recording a loss in earnings fails to meet both the criteria of relevance, in that the loss recorded does not reflect an expected economic loss to the company, and reliability in that the timing of the loss is not aligned with the actual event. Therefore, we believe that a statement of principle should be that an impairment loss shall be recognized in earnings when it is probable a loss will be realized. We believe that this statement of principle should apply equally to all securities, including both debt and equity securities.

Following are two recommendations that we believe adequately address our concerns as it relates to debt securities. We ask the FASB to consider equity securities in their deliberations but we will not address them specifically in our recommendations.

Recommendation #1
We believe that the EITF framework for determining other-than-temporary impairments can be made workable with some clarification around the concept of minor impairments and the concept of tainting of the use of the intent to hold a security until it recovers assertion. We also believe that these clarifications are required for securities covered under both paragraph 10 and paragraph 16 of the EITF.

Minor impairments
We do not recommend a bright line for the definition of a minor impairment. In fact, we are concerned that the definition of minor impairments currently provided by the FASB in the draft FSP may lead to a bright line application by the auditing firms. Therefore, we are asking the FASB to provide additional guidance around the definition of minor impairments. We are not asking the FASB to produce a step-by-step manual for the definition of minor impairment, but rather to acknowledge that a company should consider the security type and duration and then determine a reasonable definition of minor based on a historical statistical analysis for each type and duration of security. We also believe that the FSP should remove the language "caused solely by changes in interest rates and/or sector spreads" from the definition of minor impairments. We believe that a security falling within the range of minor should not require a bifurcation to determine the cause of the impairment.

Tainting of Intent to Hold
The circumstances listed in paragraph 7 of the draft FSP that would not call into question an investor's intent should be expanded to include trades for risk management programs. The need to trade securities for ALM purposes is why most insurers designate the majority of their securities as AFS even though by doing so there is significant volatility in other comprehensive income. To avoid inappropriately shifting that volatility to the income statement, the FASB should add the following to the list of circumstances described in paragraph 7 of the draft FSP:

> *d. Trading needs arising from risk management programs, including but not limited to asset liability management.*

Insurers have the capability of identifying the purpose of trades. ALM programs tend to be well documented and could be reviewed by an auditor to determine if a trade is being made for purposes other than ALM. Also, auditors can review trades over a designated period and determine if general trading activity is consistent with the general market conditions and in compliance with the ALM process. In other words, we believe that

ALM contains very real parameters around trading and those parameters can be audited against. ALM is not an umbrella covering every trade an insurer makes.

We would look for this guidance from the draft FSP to apply to all debt securities, including securities covered by both paragraph 10 and paragraph 16 of the EITF. We would like to see a consistent definition of minor impairments and a consistent application of intent and ability to hold. Debt securities covered by paragraph 10 of the draft FSP are also subject to impairments caused solely by changes in interest rates and/or sector spreads. While securities purchased at a premium represent additional risk of loss in a declining interest rate environment, small shifts in interest rates do not always increase or decrease that risk materially. Additionally, the guidance provided by EITF 99-20 would apply to most of these securities and would adequately address the additional risk of prepayment by identifying adverse changes to cash flows.

We acknowledge that the FASB has expressed initial reservation about including risk management programs as non-tainting transactions. We also believe that the FASB is not looking for insurers to adopt a modified LOCOM accounting model. In considering how to scope out changes in interest rates and/or sector spreads from the guidance, we have concluded that it cannot be accomplished effectively while the current concept of intent and ability to hold remains. As an alternative to adding risk management programs to paragraph 7 of the FSP, we would ask the FASB to rework paragraph 16 of the EITF to remove the concept of tainting for all debt securities. To accomplish this, we believe that debt securities would need to be removed from paragraph 10 and revise paragraph 16 as follows:

> *For debt securities, an impairment should be deemed other-than-temporary if (a) the investor does not have the ability or does not have the current intent to hold an investment based on the facts and circumstances until a forecasted recovery of fair value up to (or beyond) the cost of the investment, which in certain cases may mean until maturity, or (b) it is probable that the investor will be unable to collect all amounts due according to the contractual terms of the debt security. In making the determination about collectibility, the investor should consider all information available, including evidence from rating agencies, about fair value fluctuations due to factors other than interest rates and credit sector spreads.*

We believe that these two alternatives would adequately address the concerns of insurers and allow for the continued use of the AFS designation without requiring modified LOCOM accounting. Absent these changes, companies will be required to write-down to the lower of cost or market all securities impaired for both interest rate and credit impairments. Subsequent to write-down, securities without issuer specific credit deterioration will likely be accreted back to par value through net investment income. As previously mentioned, this would significantly diminish the value of the financial statements for insurance companies.

Recommendation #2

As the FASB deliberates on alternatives to address the concerns from industry in implementing this EITF, we would encourage the FASB to consider scoping debt securities out of the EITF altogether and developing a new model for them, bearing in mind the aforementioned statement of principle. Debt securities, by having contractual cash flows, require a different perspective on write-downs than equities. Absent a probability of default, a holder of a debt security can expect to receive all of the contractual cash flows of that security unless it is sold in advance of recovery. Insurers purchase debt securities for those contractual cash flows and to produce a yield and duration match for their insurance liabilities. Insurers purchase securities with the intent to hold those securities until maturity. The sales of debt securities by insurers tend to be for the purpose of rebalancing the portfolio to adjust to changing market conditions. Therefore, we believe that a loss should only be recorded for a debt security in the event of a probable default or a probable sale in advance of recovery.

As such, in the event that the FASB looks to address debt securities with separate guidance, we provide the following list of considerations in creating that guidance:

- Most debt securities are held in the AFS category within FAS 115. We would expect the AFS category and the flexibility it affords to prevail in any new model that is developed;
- Securities in the AFS category are currently marked-to-market through other comprehensive income and shifting those amounts to the income statement absent a probable and/or expected future loss does not meet the criteria of recognition under FASB Concept Statement 5;
- Insurers and other financial institutions need to sell securities in both unrealized gain and loss positions without the fear of tainting to proactively manage risk in a rapidly changing environment;
- Changes in interest rates and/or sector spreads do not change the probability of receiving the contractual cash flows of a debt security and, therefore, without a *current* lack of intent to hold those securities, they do not present a probable future loss;
- Minor changes in credit of an issuer may change the market value of the security but not necessarily the risk of a probable default. For example, a security rated AA by S&P that is downgraded to A would cause a decrease in the price of that security but not necessarily cause a significant increase in the risk of a probable default and would result in a loss only if the company does not have the current intent to hold that security until it recovers or matures; and
- Recovery periods for debt securities are more difficult to forecast given their reliance on general market conditions in addition to issuer specific conditions. For this reason, it is more difficult to assess intent and ability to hold until a recovery due to the number of factors outside of the control of the issuer.

Effective date

Requiring the adoption of the EITF and the FSP by year end will present significant challenges to insurers in the following areas:

- SOP 03-3 requires the accretion of the security for GAAP purposes creating system issues that most investment accounting software programs are ill-equipped to handle;
- The EITF and FSP, unless modified, will represent a sea of change in investment management strategies that will require time to implement;
- Portfolio allocations will likely change and companies will change the designation of a portion of their portfolios under FAS 115 (we believe that the condition of

"rare" for moving securities into the trading category will be met, given the significance of the change in accounting, if not, a one-time exception should be granted);

- Given the consequences of sales of securities with unrealized losses as a result of the tainting concept, companies would request additional time to manage their portfolios into a buy-and-hold portfolio which may require the sale of some impaired securities; and
- The documentation burden of the guidance is substantial and companies will need time to develop and implement internal processes to capture the required documentation for audit purposes.

We believe that these significant considerations make a fourth quarter 2004 effective date unworkable for insurers and we would urge the FASB to delay the effective date by one year to allow these implementation issues to be resolved.

Conclusion
The concerns raised in this comment letter represent significant issues for insurance companies and other financial institutions. If these issues are not appropriately addressed, insurers will be forced to either adopt a modified LOCOM accounting model that will significantly deteriorate the value of the financial statements or change their trading behavior, taking significant risk by not having the flexibility to trade many securities in their portfolios. We believe that the ALM process is a well-defined and documented model that provides a basis for trading and should be a permitted practice for securities designated as AFS. We further believe that auditors have the expertise and knowledge to review ALM processes to determine that trades comply with the model and determine on a judgmental basis if a company is abusing the intent and ability to hold assertion.

Given the aforementioned, the issues broached on this topic relating to debt securities have highlighted some flaws in the impairment model for them. We believe that a statement of principle should be created and implementing it may require that debt securities be scoped out of the guidance for the EITF and FSP and addressed separately. We believe that current guidance and disclosure requirements are sufficient to provide information to financial statement users in the interim while the FASB deliberates on the creation of a new model for debt securities.

We appreciate this opportunity to provide this feedback and offer our support to respond to questions that you may have on these most important matters.

Sincerely,

James F. Renz

James F. Renz
Director, Accounting Policy