AMERICAN ACADEMY *of* ACTUARIES

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Re: FASB—File Reference No. 2013-220 - Proposed Accounting Standards Update, *Financial Instruments-Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*;
IASB—Exposure Draft 2012/4, *Classification and Measurement: Limited Amendments to IFRS 9*

On behalf of the American Academy of Actuaries'[1] Financial Reporting Committee, I am pleased to provide comments to the Financial Accounting Standards Board (FASB) on File Reference No. 2013-220—Proposed Accounting Standards Update, *Financial Instruments-Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities* and to the International Accounting Standards Board (IASB) on Exposure Draft 2012/4, *Classification and Measurement: Limited Amendments to IFRS 9*, with respect to the boards' joint project on classification and measurement of financial instruments. In particular, we are concerned that certain proposals contained within the exposure drafts, taken in conjunction with decisions in the insurance contracts project, will result in accounting mismatches that will reduce the relevance and representational faithfulness of the financial statements.

The interaction between assets and liabilities is a critical component in the management and performance of long duration insurance contracts. Thus, avoiding mismatches between accounting for liabilities and associated assets is critical to producing relevant financial statement information for insurance contracts.

1. We recommend retention of a category for financial instrument assets of fair value, with certain changes in fair value reported in other comprehensive income (FV-OCI). As discussed in our comment letters responding to the insurance contracts exposure drafts, [2,3] it is generally appropriate for the effect of changes in discount rates on certain insurance contract liability values to be reported in OCI. However, if insurance contracts are

[1] The American Academy of Actuaries ("Academy") is a 17,500-member professional association whose mission is to serve the public on behalf of the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.
[2] http://www.actuary.org/files/Academy_%20Response_to_IASB.pdf, http://www.actuary.org/files/Academy_Response_to_FASB.pdf
[3] Response to question 16 of our comment letter on the FASB exposure draft and response to question 4 of our comment letter on the IASB exposure draft.

reported at current fulfillment value, with changes in discount rates reported in OCI, but the financial instrument assets backing the insurance contract liabilities are reported at fair value, with all changes in fair value reported in net income, there will be an accounting mismatch in net income. This is because net income will include the effect of changes in interest rates on the assets but not the liabilities. Conversely, if the financial instrument assets backing the insurance contract liabilities are reported at amortized cost, there will be an accounting mismatch in equity since equity will include the effect of changes in interest rates on the liabilities but not the assets.

These accounting mismatches can be resolved by permitting a FV-OCI category for financial instrument assets. Note that the qualifications for assets to be reported at FV-OCI should not be so stringent that a significant portion of assets backing insurance contracts, which are often subject to regulatory constraints to avoid excessive risk, would be disqualified from using FV-OCI.

2. A fair value option (FVO) should be retained for insurance contracts because, unless all assets that back insurance contracts (including equities and derivatives) are eligible for FV-OCI, there could still be situations in which accounting mismatches occur because the liabilities are backed by assets that are not eligible for FV-OCI.

   As discussed in our insurance contracts comment letters, these situations can be mitigated if OCI for insurance contracts is optional (subject to appropriate criteria) and if an effective hedge accounting mechanism is adopted for hedged risks within insurance contracts. However, there may still be situations in which a full FVO would be more effective in eliminating or mitigating accounting mismatches. In particular, this would be the case if an unlocked margin or contractual service margin creates an accounting mismatch between the insurance contract liability and the assets at fair value backing the liability.

   An additional situation in which FVO would be appropriate for insurance contracts would be on reinsurance assets and liabilities under a modified coinsurance, or coinsurance with funds withheld, contract. Such reinsurance contracts often contain a significant embedded derivative since the cedant pays the reinsurer cash flows that are based on the returns on assets held by the cedant.[4] It can be costly to perform the required bifurcation. Also, especially for reinsurers, it can be difficult to avoid accounting mismatches when some of the reinsurance cash flows are embedded derivatives reported at fair value through net income while the remainder are reported under the insurance contracts accounting model. Thus a FVO would be beneficial for these contracts, both to avoid accounting mismatches and to avoid the cost of bifurcation.

   We acknowledge that fair value may not be the most relevant measure of insurance contract assets and liabilities when those assets and liabilities are considered individually. However, to the extent a FVO would mitigate or eliminate accounting mismatches, any

[4] Paragraphs 815-15-55-107 through 815-15-55-109 under FASB Accounting Standards Codification and paragraph B4.3.5(f) in IFRS 9

reduction in relevance of the insurance contract measurement itself would be more than offset by the increased relevance of the overall financial statements.

Thank you again for this opportunity to provide input. If you have any questions, please contact Tina Getachew, Senior Policy Analyst, Risk Management and Financial Reporting Council, by phone (+1 202/223/8196) or email (getachew@actuary.org).

Sincerely,

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