AMERICAN ACADEMY of ACTUARIES

Financial Accounting Standards Board
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Attn: Technical Director – File Reference No. 1201-100

The American Academy of Actuaries'[1] Financial Reporting Committee appreciates the opportunity to comment on the Financial Accounting Standards Board's exposure draft "Proposed Statement of Financial Accounting Standards: Fair Value Measurements." Below, we offer general commentary on the draft, followed by commentary on several of the specific issues raised in the exposure draft.

Members of the Financial Reporting Committee include: Ralph S. Blanchard, FCAS, MAAA, Chairperson; Henry W. Siegel, FSA, MAAA, Vice-Chairperson; Mark G. Beilke, ASA, MAAA; Rowen B. Bell, FSA, MAAA; Errol Cramer, FSA, MAAA; William C. Hines, FSA, MAAA; Darrell D. Knapp, FSA, MAAA; Ken A. LaSorella, FSA, MAAA; Jinn-Feng Lin, FSA, MCA, MAAA; Mary D. Miller, FCAS, MAAA; Mark F. Oberholtzer, FSA, MAAA; William J. Sohn, FCA, FSA, MAAA; Stephen J. Strommen, FSA, MAAA; Andrea M. Sweeny, FCA, FCAS, MAAA; Nancy P. Watkins, FCAS, MAAA; James F. Verlautz, FCA, FSA, MAAA.

General Comments

Lack of guidance for most liability valuations

A major area of our expertise is the valuation of liabilities resulting from insurance contracts, and from other similar liabilities resulting from other than insurance contracts. Given this expertise in liability valuation, much of our focus when reviewing this exposure draft was on the guidance for the fair value measurement of liabilities. We found this guidance sparse and in most cases of minimum relevance.

The liabilities we are involved with are not traded, and the corresponding asset (for the party to whom the obligation is owed) is also not traded (other than public debt). Hence, guidance focused on the valuation of publicly traded debt is of minimal relevance.

Assuming that the FASB is interested in including liabilities under a fair value measurement model, we recommend that the FASB work off of the liability valuation developments of the IASB insurance project. At a minimum, we recommend that insurance liabilities be scoped out of this fair value measurement standard, pending developments in the anticipated IASB/FASB joint insurance project.

[1] The Academy is the public policy organization for actuaries of all specialties within the United States. In addition to setting qualification and practice standards, a major purpose of the Academy is to act as the public information organization for the profession. The Academy is nonpartisan and assists the public policy process through the presentation of objective analysis. The Academy regularly prepares comments on proposed federal regulations, and works closely with state officials on issues related to insurance. The Academy also develops and upholds actuarial standards of conduct, qualification and practice, and the Code of Professional Conduct for all actuaries practicing in the United States.

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Usefulness of credit standing adjustment

The FASB Concept Statement 7 (paragraph 78) states that "(t)he most relevant measure of a liability always reflects the credit standing of the entity obligated to pay." We find this statement in direct conflict with the definition of fair value, if fair value is defined based on the willingness and ability of the obligor to "exchange" the liability.

The Exposure Draft (paragraph 4) defines fair value as "the price at which an asset or liability could be exchanged in a current transaction between knowledgeable, unrelated willing parties." Willing parties are described as (in paragraph 5) as being "(a) knowledgeable, …and (b) willing and able to transact in the same market(s), having the legal and financial ability to do so. Fair value presumes the absence of compulsion (duress)."

In a regulated market, the ability to acquire such liabilities will likely be restricted to those of acceptable credit quality. Hence, the "seller" of such liabilities (assuming that the sale of liabilities is even legally possible) would likely be restricted from the sale of such liabilities to an entity of equivalent credit standing, whenever the "seller" is below a certain credit quality. Hence, the guidance in footnote 4 is inoperative for regulated markets.

We believe the guidance would more likely be operative if it made the following delineation with regard to liabilities:

- Liabilities subject to direct trading
- Liabilities not subject to direct trading (i.e. cannot be traded due to legal constraints or subject to approval of the insured and or regulators)

With regard to liabilities subject to direct trading, the guidance provided may be operative. We find it difficult to test this assumption, however, due to the scarcity of such situations.

For liabilities not subject to direct trading, there are frequently only two ways an obligor can relieve themselves of their obligation – through settlement with the obligee or through sale of the legal entity with the direct obligation. The former (liability settlement) may be subject to legal restrictions such as fair trade laws that would eliminate the ability to settle at a level reflecting credit standing. There may also be other restrictions, such as the risk to franchise value (i.e., reputational risk) that would make such a reflection unlikely for a "willing" party.

As to the latter option mentioned (i.e., the sale of the legal entity with the obligation), the more operative credit standing for the transaction is the credit standing of the acquirer, not the seller. In a regulated market, such an acquirer would also be restricted to those with acceptable credit standings.

In summary, the reflection of credit standing in transactions that would permit derecognition of a liability is much more restricted than that implied by the exposure draft. The exposure draft should be adjusted to note that such reflection is a function of the willingness and ability of the entity to enter into transactions that reflect its credit standing.

Comment on Specific Issues

The following comments address issues delineated in the FASB exposure draft and are not necessarily organized in order of priority or as they appear in the actual exposure draft. The wording of each issue may be paraphrased from that found in the exposure draft.

Issue 1: Definition of Fair Value

Will entities be able to consistently apply the fair value measurement objective using the guidance provided by this proposed Statement together with other applicable valuation standards and generally accepted valuation practices? If not, what additional guidance is needed?

Academy response: As mentioned in our second general comment regarding credit standing, we find the definition of fair value exchange based on willing and able parties to be inconsistent with the stance taken on credit standing. We also believe that the guidance for such valuation is lacking with regard to more practical issues such as the credit standing of the corporate whole versus that of a reporting segment or separate legal subsidiary of the reporting entity.

With regard to insurance liabilities, we believe the application of fair value to insurance, if ever appropriate, should be addressed as part of the anticipated IASB/FASB joint project on insurance liabilities and should therefore be eliminated from the scope of this paper.

Issue 2: Valuation Techniques

Is the guidance incorporated from *FASB Concepts Statement No. 7, Using Cash Flow Information and Present Value in Accounting Measurements* sufficient? If not, what additional guidance is needed?

Academy response: The guidance is largely non-existent with regard to non-traded liabilities. Paragraph 7 lists three techniques that "shall" be applied to level 3 valuations. However, with regard to non-traded liabilities, the first technique is inoperative and the last technique does not apply (as it relates only to assets). As mentioned in our first general comment section, we recommend that any standard on liability measurement be based on developments from the anticipated joint IASB/FASB insurance project, and that in particular, insurance liabilities be eliminated from the scope of this standard until FASB and the IASB have completed that anticipated joint project.

We note that the major difficulty in such valuations arise when the asset corresponding to such a liability is not traded. The approach in the exposure draft breaks down when the corresponding asset is not traded. (This also may impair the relevance of liability fair value financial measures to users of financial statements when neither the liability nor the corresponding asset is traded.)

We also have a concern with the statement in Paragraph 8 that restricts a change in the valuation technique to only those circumstances where the change results in a more reliable estimate. Such a restriction is unnecessary where the change in techniques is not material to the financial statements. The restriction might also impair the future development of new techniques and the market for providers of such estimates.

With regard to the new techniques, such techniques are frequently developed due to issues such as data (and maintenance) cost, future responsiveness to issues that may not currently exist, or a change in the available resources. Such a change may not immediately result in a more reliable estimate, but

may be made with a view of what the future may bring. The proposed Paragraph 8 guidance would preclude such changes, implying a lock-in of methods and their accompanying requirements (as to data and expertise).

As to the market for providers of fair value estimates, some liabilities are subject to multiple valuation approaches, with no clear and consistent advantage of one technique over another. The Paragraph 8 guidance would require a lock-in of the technique originally used, in the absence of a clearly more reliable alternative. This would limit the competitive marketplace for such estimates to only those comfortable with the technique used for the prior estimate. We see no benefit to such a restriction. The focus should be on restricting the change in methods where such a change materially impacts the financial statements without any expected improvement in reliability. Even then, it may be necessary to allow such changes provided adequate disclosure exists, due to the need to adjust to changes in available data or resources.

Issue 3: Active Markets

Is the guidance provided concerning active markets sufficient? If not, what additional guidance is needed?

Academy response: No comment, except to note, again, that there is no active market for insurance liabilities.

Issue 4: Valuation Premise

Is the guidance in the proposed statement, including that contained in Appendix B (Example 3) sufficient with regard to selecting the valuation premise that should be used for estimates of fair value? If not, what additional guidance is needed?

Academy response: No comment, given that this issue focuses exclusively on physical assets, and the focus of our commentary is on liabilities (and to a lesser extent on financial assets).

Issue 5: Fair Value Hierarchy

Is the guidance contained in the proposed statement, including Appendix B (Example 4) sufficient for the hierarchy to be used in selecting valuation technique inputs? If not, what additional guidance is needed?

Academy response: We find this guidance sufficient, subject to our commentary on Issue 6 regarding transaction costs.

Issue 6: Level 1 Reference Market

Is the guidance concerning the determination of the appropriate reference market sufficient? If not, what additional guidance is needed?

Academy response: Given the absence of any reference market for insurance liabilities, this guidance is not helpful to us. We are, however, concerned that a measurement focusing on exchange value that does not reflect the associated transaction costs of such exchange may not be totally relevant.

Issue 7: Pricing in Active Dealer Markets

This proposed Statement would require that the fair value of financial instruments traded in active dealer markets where bid and asked prices are more readily and regularly available than closing prices be estimated using bid prices for long positions (assets) and asked prices for short positions (liabilities), except as otherwise specified for offsetting positions. Do you agree? If not, what alternative approaches should the Board consider?

Academy response: We believe that such short positions should be used for liability valuation only if the liability obligor is legally able to sell such liabilities in that market. The difference in market access for the asset versus liability "holder" is a major issue affecting the relevance and implementation ability of such guidance.

Issue 9: Level 3 Estimates

Issue 9: This proposed Statement would require that in the absence of quoted prices for identical or similar assets or liabilities in active markets, fair value be estimated using multiple valuation techniques consistent with the market approach, income approach, and cost approach whenever the information necessary to apply those techniques is available without undue cost and effort (Level 3 estimates). Appendix B provides general guidance for applying multiple valuation techniques (Examples 6−8). Is that guidance sufficient? If not, what additional guidance is needed?

Academy response: As mentioned in our general comments, such guidance has no relevance to many liability valuation situations we are involved in. The focus on market inputs is of little aid where significant information asymmetry exists between the general market and the particular holder of a liability. In such a case, the general market's estimates, if they exist, are likely to be unreliable and unlikely to result in a "willing" seller.

Paragraph 24 considers such a situation, but labels the use of entity-specific assumptions in such a situation as a "practical expedient" that "may" be used. We believe the existing wording is likely to result in undue pressure on statement preparers to use unreliable market inputs in place of more reliable entity specific assumptions. As such, we recommend that alternative language be developed that clarifies that entity-specific assumptions are to be used where the market inputs are deemed to be less reliable (due to information asymmetry), subject to suitable disclosure.

The Financial Reporting Committee appreciates the opportunity to comment on the "Fair Value Measurements" exposure draft. We would stress again that in general, we believe this standard should exclude from its scope all insurance liabilities pending development of a revised insurance standard. If you have any questions about the reasoning behind our comments, please direct them to Ethan Sonnichsen, the Academy's staff liaison for the Financial Reporting Committee, at (202) 223-8196 or sonnichsen@actuary.org.