AMERICAN ACADEMY *of* ACTUARIES

May 31, 2000

Mr. Timothy S. Lucas
Director of Research and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856–5116

Re: File Reference No. 204–B

Dear Mr. Lucas:

We are writing on behalf of the American Academy of Actuaries (the Academy) to provide comments on Financial Accounting Series Document No. 204–B, *Preliminary Views on major issues related to Reporting Financial Instruments and Certain Related Assets and Liabilities at Fair Value* (the Document).

We will respond first to the issues raised by the Financial Accounting Standards Board and then summarize our views on the key concerns raised by these issues. Most of our comments deal with the definition of a financial instrument and the use of estimation methods and models when items are not actively traded.

Issue 1: What Should Be Reported at Fair Value

Definition of a financial instrument.

Many life, annuity, health and property and casualty insurance products meet the Document's definition of a financial instrument, found in paragraph 14. The Document definition is clear and operational for these products.

However, there are categories of insurance product liabilities where it may be difficult to apply the definition. In these cases, some policy features would be characterized as financial instruments and other policy features would be characterized as non–financial instruments. Some examples of insurance products with a mixture of financial and service features include:

Workers' Compensation:

- Wage replacement benefits for injured workers (paid in cash directly to the injured workers).

- Medical benefits for injured workers (generally provided by direct payment to a third party provider with no cash payment to the injured worker).

Health Plans:

- If treatment is requested through the approved health provider network then medical services are provided.
- If treatment is requested outside the approved network then indemnification is provided.

From our point of view it is important that these policy features be treated consistently. If fair value is the overall objective and some policy features are measured as financial instruments, then the entire insurance contract should be measured as a financial instrument. Many of these products are priced and administered on a combined basis so we suggest that the policies not be bifurcated. Also, entities should not be able to elect the accounting treatment — there would be increased risk of accounting arbitrage if this were permitted.

Financial instruments excluded from the scope.

Paragraph 4 states:

> *"... it often will be necessary to use valuation models* [to determine fair values], *some of which will have to be developed internally. The application of some of those models is likely to be complex and will require internally developed information and assumptions, which are, by their nature, subjective."*

Paragraph 5 states:

> *"Those issues are neither new nor unique to fair value information. It is not certain that, on balance, fair value information would be more complex and subjective and more difficult to audit than some of the information reported today..."*

Paragraph 41 states:

> *"Employers' and plans' obligations for pension benefits, other postretirement benefits, and certain other employee benefits are excluded for practical reasons. Some of those obligations can be especially complex, and accounting literature already requires periodic remeasurement of those obligations (albeit not at fair value)."*

We feel that the exclusion of some financial instruments from the scope of the Document for "practical reasons" in paragraph 41 needs to be clarified. We agree that complexity by itself is not sufficient to exclude some financial instruments from fair value measurement. We note, however, that paragraph 41 excludes certain financial instruments for reasons that are not entirely clear. We suggest that you provide additional guidance as to when the paragraph 41 threshold is crossed because there may be some insurance liabilities (e.g., hazardous waste or asbestos liabilities)

included in the scope of this paragraph.

We believe pension benefits sold by insurance companies should be treated consistently with pension liabilities of all companies. Many life companies sell products that fund pension liabilities but under the proposal they would be accounted for differently than self-funded plans. Therefore, we do not believe the exclusion of pension benefits in Paragraph 41 is appropriate.

We also suggest that you address the issues associated with financial instruments excluded from fair value measurement (such as the exclusion mentioned in paragraph 41) at the same time or before fair value measurement is adopted.

Related assets and liabilities included in the scope.

Paragraph 157 implies that self-insured liabilities are not subject to fair value measurement. We do not understand why this is the case. Some entities choose to self-insure their risk exposures (for example, auto liability exposure). Had the liabilities been transferred to an insurer, they would be subject to fair value measurement and this seems inconsistent. In general, we recommend consistent treatment for all insurance or self-insured liabilities, whether or not they meet the strict definition of financial instrument. In addition, to the extent real estate assets support fair value policy liabilities, they too should be valued at fair value.

Issue 2: What Does Fair Value Mean

Definition of fair value.

Paragraph 47 defines Fair Value to be an estimate of an exit price determined by market conditions. The definition of fair value is clear and operational for items that trade in an active market. However, in practice it may be difficult to estimate an exit price for items not actively traded. We believe insurance contracts fall into this category.

Measuring items not actively traded.

For items not actively traded, paragraphs 60 through 82 of the Document provide general guidelines to estimate exit price. Estimates based on market price or reasonably connected to a market price are preferred over those estimates based on internal models or general economic factors. The estimate should also include adjustments for risk premium or other factors (i.e., liquidity, market imperfections, etc.) (Paragraph 78).

Beginning with paragraph 73, the Document describes how to estimate prices where little or no market price information exists. In this event, an exit price must be estimated based primarily on general market information and internally developed estimates and assumptions. The paragraph continues by stating that discounted cash flows should form the basis for the estimate.

Footnote 10 (paragraph 57) raises the possibility of using information from contemporaneous reinsurance transactions as a starting point to determine exit price estimates. This may work for some insurance liabilities, but not for most insurance liabilities. In many cases, contract terms and

conditions, valuation models, and pricing are generally known only to the contracting entities and apply solely to the facts and circumstances of a specific transaction between the contracting entities. The number of reinsurance transactions for certain liabilities are also relatively low, such that even if all the underlying reinsurance pricing information was publicly available, the market would not be considered "active" enough for determination of a reliable price. (For example, the reinsurance market for existing claim liabilities can be considered to be relatively inactive.)

Since there is no active market for most insurance liabilities, we believe that exit prices for insurance liabilities must be computed using discounted cashflows. Discounting insurance liability cashflows is a process already in use today. Virtually every calculation of actuarial values in life insurance and annuities uses discounted cash flows. Other lines of insurance also use actuarial pricing models based on estimates of discounted cash flows. These models include assumptions such as interest rates, expenses, mortality and morbidity costs, policyholder behavior, and taxes. Other assumptions related to risk may also be included.

For the purposes of computing fair values of insurance liabilities, we believe that some assumptions can be based on market observations but many assumptions must be entity-specific because there is no observable market price which can be used to derive a market based assumption. The following are just a few examples of entity specific assumptions:

- Assumptions for mortality and policyholder behavior must be specific to the individual insurance entity. Many factors influence the results one company will experience relative to another. For example, some life insurance liabilities are established only after the insured's health status is extensively evaluated. The establishment of other life insurance liabilities may only require the insured to have a regular pulse. Mortality assumptions must necessarily reflect the underwriting standards employed by the company and many other factors.

- A portion of the insurance expenses represent compensation to the sales organization. These expenses must reflect the contractual obligations between the company and the sales structure. The remaining expenses should reflect the company specific cost structure and business practices. It would be difficult to determine a market level for expense assumptions from observed transactions.

The assumptions for risk premiums and the interest rate for discounting cash flows will present interesting challenges. Interest rate assumptions and provisions for risk must be considered together. The choice of interest rate depends on the method chosen for the provision for risk. It is possible to allow for risk through the selection of scenarios, through the interest discount rate or through explicit risk charges added to the cash flows that are to be discounted or through some combination of these methods. At one extreme, the entire provision for risk could be reflected in the cash flows. Another extreme puts the entire provision for risk in the interest rate. Or, for example, the yield rate on the insurer's own asset portfolio can be the appropriate discount rate if the correct adjustments are made to the cash flows being discounted.

In this context, we are particularly concerned about the discussion of the use of a "risk free" rate. If the Treasury rate forms the basis for the discount rate, the use of a current market spread will

be required if the exit value is to be consistent with market prices. This is particularly visible with guaranteed investment contracts (GICs). A simple GIC requires the insurer to return the deposit plus a guaranteed amount of interest at some specified point in the future. If this contract is valued using the Treasury rate, a liability value that is greater than the deposit will result because the guaranteed rate will always exceed the Treasury rate. Clearly, this result is inconsistent with the exit value objective. Adding a risk adjustment to the cash flows will not help unless that risk premium is negative. Any positive risk premium will only increase the value. In order to evaluate such liabilities in a manner consistent with market prices, a risk-adjusted corporate debt rate is required. Although this might be characterized as a "risk free rate," it is normally quite different from Treasury rates and the term "risk free rate" is often considered to mean Treasury rates.

We believe that actuaries will be able to produce the models and estimates required under any clear and operational fair value standard. Actuaries are already involved in many different types of cash flow analyses involving many diverse products. Actuarial Standards of Practice already cover validation of models and processes for setting and reviewing the appropriateness of assumptions, including cash flow assumptions, and will continue to evolve to reflect practice as it emerges. Measurement of items not actively traded will continue to be a subject of continued actuarial research and development.

Insurance Liabilities and Credit Risk

Consistent with Statement of Financial Accounting Concepts No. 7, the Document suggests that an entity's own credit risk be considered in the exit price estimate of the entity's liabilities. We believe it would be inappropriate to adopt this requirement for most insurance liabilities. We discuss this issue in detail in our comments at the end of this letter.

Additional Issues - Non-guaranteed Cash Flows

We are also concerned with the handling of non-guaranteed elements included in insurance contracts. We agree with the statement in paragraph 189 that dividends should be included in calculating fair value as they are related to contractual rights. In addition, insurance liabilities may include provision for other non-guaranteed elements provided by contract. Examples are excess interest credits, reductions in the cost of benefits, and contingent refunds at termination. While benefit payments under non-guaranteed elements are contingent on some future event or action of the insured, the risk is identifiable and measurable. Accordingly, we believe they should be included with other projected cash flows in estimating the fair value of policy liabilities.

Additional Issues - Use of Risk Premiums

We found the guidance on the use of risk premiums (in paragraph 82 of the document and paragraph 62 of Concept Statement Number 7) to be unclear and non-operational.

Paragraph 82 of the document says that, when using internally developed models in the absence of market prices:

> "*the information necessary to estimate the adjustments referred to in paragraphs 78c* [the risk premium] *and 78d* [other factors including illiquidity, market imperfections, and anticipated profit margins] *may not be available. In that circumstance, it will be necessary to estimate cash flows without adjustment for risk premiums, illiquidity, market imperfections, and anticipated profit margins*."

Paragraph 62 of Concept Statement Number 7 says:

> "*An arbitrary adjustment for risk, or one that cannot be evaluated by comparison to marketplace information, introduces an unjustified bias into the measurement. ... in many cases a reliable estimate of the market risk premium may not be obtainable... . In such situations, the present value of expected cash flows, discounted at a risk-free rate of interest, may be the best available estimate of fair value in the circumstances*."

Given that there is no active market for many insurance liabilities, there is no readily available, direct information on the market risk premium associated with their fair value. The market risk premium would have to be estimated. It is unclear as to what marketplace information would be required under the above guidance for an acceptable estimate of the risk premium. Would the information have to be insurance specific, or even insurance product specific, or could it be based on overall market pricing for risk in general financial markets? It is also unclear how much judgement may be used to produce an acceptable "estimate" of this risk premium.

Our operational concern is that an accounting standard (that addresses estimation of market risk premiums) might be developed that would be practically impossible to apply for many insurance liabilities. In such a case, these liabilities would appear to have the same risk characteristics as U.S. government obligations, due to the absence of any risk margin in their reported fair value. This is especially troubling, in that those insurance liabilities with the greatest risk can frequently be the most sparsely traded (e.g., liabilities for mass torts such as asbestos or hazardous waste cleanups). Therefore, liabilities with the greatest risk are more likely to be reported as if no risk exists at all. We believe that this situation should be avoided in any fair value standard.

For liabilities subject to fair value measurement, an internal calculation of the risk premium should be allowed in the exit price estimate, with sufficient allowance for judgement for the risk premium guidance to be operational. If this is not possible in the fair value framework, special rules may be necessary such as mentioned in paragraph 41. In both cases we suggest additional disclosure requirements.

<u>Issue 3: How Should Changes in Fair Value Be Reported</u>

Recognition of gains and losses immediately in earnings

Paragraph 85 states, in part:

> *If fair values of securities, other financial instruments, and other items within the scope of this Preliminary Views are reported in financial statements, changes in fair value would be reported in earnings when they occur whether or not they are realized.*

Our principal concern in this area is consistency in the application of fair value accounting. Otherwise, the implementation of fair value could carry the same shortcomings of a mixed attribute system that are shared by the current insurance framework. We believe the following five principles are important and will be discussed in our comments at the end of this letter:

1. If assets are valued at fair value, liabilities should be valued at fair value.
2. Similar products should be treated in similar fashion.
3. Different features of the same contract should receive similar treatment.
4. Similar products offered by dissimilar institutions should receive similar treatment.
5. Assumptions used in establishing fair values should be internally consistent.

Issue 4: Implementation

Complexity, subjectivity, and auditability

We agree that some fair value measurement methods will be complex and will utilize subjective assumptions. In fact, there may be a significant increase in complexity for some fair value measurement methods. However, many current insurance liability measurement methods are already complex, so fair value measurement may not add significant additional complexity.

We believe that current liability estimates in some insurance lines already contain subjectivity. For estimated cash flows where the flows farthest in the future reflect the greatest subjectivity, and where those estimated obligations do not currently reflect the time value of money, we believe the movement to fair value may cause a net reduction in the subjectivity of the estimate. We also prefer allowing a subjective adjustment for risk, with adequate disclosure, where the alternative would be a requirement to use present value without reflecting risk. An educated estimate of a quantity or assumption that is not directly observable is far better than a precise calculation of a quantity known to be wrong.

Concerns about the use of subjective assumptions can also be addressed in appropriate disclosure. If the user has sufficient information on assumptions including the historical track record for previous estimates, then the subjectivity is much more disciplined. In addition, there should be disclosure of the effect on earnings of changes in assumptions and modeling methods.

Finally, implementation of fair value accounting will increase the time needed for insurance companies to prepare financial statements and for auditors to review the additional complexity. For example, book based liabilities for life insurance products can often be generated through the application of factors to individual policies, requiring simple checks of arithmetic for audit

purposes. Many fair value based insurance liabilities will require increased use of the skill sets needed to review the representation/modeling of the business and the underlying model assumptions and parameters.

Issue 5: Customer Relationships

We have no comment on this issue.

Issue 6: Items Similar to Financial Instruments

We believe that all insurance contract liabilities should be subject to the same accounting treatment. Otherwise, it would be easy to manipulate contract language or reinsurance arrangements to convert an insurance contract from a financial instrument to a non-financial instrument, and vice versa. If insurance contracts are included in a fair value standard, including all insurance contract liabilities in that standard would remove this incentive for accounting arbitrage.

We also recommend that servicing contracts or servicing obligations normally associated with insurance contracts, but which have been contractually isolated from normal insurance obligations, be included in the same accounting standard as insurance obligations. Examples include claim servicing obligations for "third party administrators," commonly used in the workers' compensation market.

Issue 7: The Next Phase

We recommend that a phase-in period be used if a fair value standard is implemented for insurance liabilities, due to the lack of previous reporting experience with such a standard. As outlined, a fair value standard has the potential to create significant disruptions in the financial markets as they relate to insurance. As a result, it will take time for practitioners, analysts and investors to become comfortable with the new system. A phased introduction will help provide the needed time. One approach would be to limit the disclosure of fair value results to footnotes for a reasonable period of time.

Finally, there is the need to clarify the application of fair value principles to purchase accounting. How should goodwill be treated under a fair value accounting system?

Other Comments

The Academy believes that the most challenging concepts brought out in the Document concern the following topics:

1. Method of determining risk premium
2. Use of risk premiums
3. Consistency
4. Credit Standing

Item 1 concerns the relationship between the discount rate and the risk adjustments in the cash flows. These two items must be considered together. This issue has already been addressed in our earlier comments (see the discussion near the end of the *Measuring items not actively traded* section).

Item 2 was addressed under *Additional Issues – Use of Risk Premium*.

Item 3 (Consistency) will need to be maintained in the following ways for the appropriate application of fair value accounting:

- *If assets are valued at fair value, liabilities should be valued at fair value.* Within a properly defined fair value system, changes in interest rates will often have similar effects on both sides of the balance sheet for a well matched company. If assets are at fair value while liabilities are at book, the volatility of surplus will make the financial statement less meaningful.

- *Similar products should be treated in similar fashion.* This is of particular concern with both service contracts and other contracts that are excluded by the scope statement. If the same coverage can be done either as a service contract or an indemnity contract, and the accounting is different between the two, the most favorable accounting treatment will determine which way the business is booked.

- *Different features of the same contract should receive similar treatment.* Some contracts have features that are slated to receive fair value treatment along with features that will be excluded. We believe it is inappropriate to value different portions of a combined contract on different bases. We feel that the same valuation method should be used for parts of a contract rather than splitting the contract and using different methods for different features.

- *Similar products offered by dissimilar institutions should receive similar treatment.* Of concern here are financial instruments that can be written by different financial institutions such as brokerage houses, banks and insurance companies. If treatment differs, accounting arbitrage will result.

- *Assumptions used in establishing fair values should be internally consistent.* For example, it would usually be inappropriate to use a 14% inflation rate with a 1% interest rate. Likewise it would usually be inappropriate to use one set of expense factors for determining cash flows and a totally unrelated set for setting dividends.

Item 4 (Credit Standing). We agree that an insurer's financial assets are normally saleable in the capital markets, and that the fair value of such assets normally reflects the credit standing of the issuer. We do believe that there are financial characteristics unique to the insurance liability market which limit credit standing's applicability to insurance and lead us to believe that an insurer's credit standing should not be reflected in the estimated fair value of insurance contract liabilities for the following reasons:

- We believe that an insurer's financial liabilities under its insurance contracts represent obligations to its policyholders which generally cannot be sold without the permission of the policyholder. Reinsuring an

insurer's obligation typically hedges the insurer's financial risk associated with that obligation, but does not relieve the insurer of its obligation to satisfy that liability. Accordingly, it is generally not possible for an insurer to dispose of its liabilities in a manner that allows it to capture the hypothetical reduction in their value associated with its less than pristine credit standing.

- For creditors, and for the insurance regulators charged with aiding policyholders, reducing an insurer's insurance liabilities to reflect a reduction in the insurer's credit standing will present a misleading picture of the insurer's ability to meet its obligations. In an extreme case, an insurer with substantial uncertainty as to its ability to satisfy its obligations may still have positive capital and thus apparently enough assets to satisfy its liabilities. However, the credit adjustment reflected in its liabilities could cause the implicit liability discount rate to far exceed the investment returns available to the insurer, causing the apparently solvent company to fall far short of paying its obligations as they come due.

- We are concerned that reflecting an insurer's credit standing in the fair value of its liabilities could be misleading to equity investors. A deterioration in an insurer's credit standing would cause a decrease in its liabilities and thus an increase in its earnings. Conversely, an insurer with an improving credit standing would find its earnings penalised. Since it is likely that in these cases investment analysts would reverse these effects, financial statement users would be better served if the adjustments of liabilities for credit standing were not made in the first place.

- Shareholders require information on a going-concern basis. Insurance companies are a viable going-concern only if the market values their promise to pay in the future. (The principal product insurers provide is the promise to pay a future benefit, in return for cash paid to them up-front.) An insurer that tries to leverage its weakened credit standing to reduce its insurance liability payments is effectively abandoning its going-concern franchise. In fact, a troubled insurer that is interested in protecting its going-concern franchise will need to do all it can to show that its reduced credit standing does not impair its ability to fully pay its claims. Therefore, reflection of credit standing in the fair value of insurance liabilities is an example of liquidation accounting, not going-concern accounting, hence not relevant to shareholders.

In summary, the inability of an insurer to realize the "benefit" of its unfavorable credit standing, combined with the confusion for many financial statement users that would be caused by recognizing this impact and the mixing of going concern vs. liquidation accounting views, lead us to recommend that the insurer's credit standing not be reflected in the estimated fair value of the liabilities associated with insurance contracts.

Thank you for the opportunity to comment on the Document. We look forward to our continued discussion on fair value concepts and other topics of mutual interest. The American Academy of Actuaries will provide whatever assistance we can to members and staff of the Financial Accounting Standards Board. Please feel free to contact us through Sam Dillard, Financial Reporting Policy Analyst at (202) 785-7866 or at Dillard@actuary.org.

Sincerely,

Burton D. Jay

Donna C. Novak

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American Academy of Actuaries

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