



ASSOCIATION ACTUARIELLE INTERNATIONALE  
INTERNATIONAL ACTUARIAL ASSOCIATION

August 12, 2003

Mr. Peter Clark  
International Accounting Standards Board  
30 Cannon Street, London EC4M 6XH,  
United Kingdom

Re: July 25<sup>th</sup> meeting

Dear Peter:

Thank you for the opportunity to meet and discuss the findings of the ACLI/IAA Joint Research Report and Supplement. Your insightful comments and questions provide us with additional issues that we will incorporate into our next research project especially within the context of a fair value model.

While our Report was primarily intended to focus on the measurement of insurance contracts, we believe the Board will find the information useful when addressing EU concerns about the relevance of IAS 32/39 for financial intermediaries. We continue to believe that an accounting standard for insurance contracts should reflect the "business reality" of the entity. Hence, the emphasis, in the Report, was on the financial impact when assets and liabilities are measured consistently or inconsistently.

The second point of the Report focused upon constraints imposed upon any measurement technique. Constraints may be introduced for practical or other reasons. Any constraint should be evaluated with regard to its impact on the usefulness of the resulting financial information provided. The discussions about the appropriate discount rate and the no gain at issue were two examples.

We took note of the request to distribute these reports to other accounting standard setters, especially the FASB. We plan to send out the Report and the final version of the Supplement shortly. We also plan to discuss our findings with other national standard setters as their schedules permit. One opportunity that we plan to pursue is the possibility of a joint meeting with the Canadian and US Boards along with the IASB in October.

Finally, we have attached a Revised Version of the Supplement that will serve as the "official" version that can be shared with others interested in this material. We look forward to our next meeting when we plan to present the findings of our work focusing on a universal life insurance contract with emphasis on renewal premiums and non-guaranteed elements.

Sincerely,

Alan Close, Sam Gutterman, William Hines, Dave Sandberg



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August 11, 2003

Sir David Tweedie  
Chair  
International Accounting Standards Board  
30 Cannon Street, London EC4M 6XH,  
United Kingdom

Re: Insurance Contracts Project

Dear Sir David:

The accompanying final version of the Supplement to our Second Report is submitted on behalf of the American Council of Life Insurers (ACLI) and the International Actuarial Association (IAA).

In the Supplement, we raise concerns about whether the net income or the equity presented under the insurance contract accounting project would properly reflect “business reality” when assets and liabilities are measured inconsistently. In particular, we express concerns when a significant proportion of insurer assets are designated as “available-for-sale” (AFS) under IAS 39 (or SFAS 115 in the case of US GAAP). US insurers typically designate their assets as AFS to avoid the penalties imposed upon a “tainted” portfolio created with the sale of even a single Held-to-Maturity asset.

We note that the recently released IASB insurance contract accounting exposure draft (ED 5) reflects some of our concerns in paragraphs BC 110 and BC 111 of ED 5. However, BC 110 and BC 111 suggest that reported income is not distorted by changes in the value of AFS assets, while we have demonstrated that such distortion does occur and is material for financial intermediaries. The primary basis for our concern is *to give the opportunity to insurers to have internally consistent reporting that reflects “business reality”*, both in terms of reported equity and reported profit or loss.

We feel it is important that the IASB address the principal finding of the Supplement, namely enhancing the coordination among the three financial reporting projects concerning financial instruments, insurance contracts and performance reporting for financial intermediaries. By giving priority to this coordination to reflect “business reality”, the IASB should be better positioned to enhance the meaningful and relevant nature of the financial information of financial intermediaries that will be provided to the users of the financial statements.

We thank you for the opportunity to meet with members of your staff and Board to discuss both our Second Report and this Supplement. We agreed at that meeting to submit both our Second Report and this Supplement to the FASB in view of the observations made in the Supplement.

American Council of Life Insurers

International Actuarial Association



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## **Supplement to the Second Joint Report of the ACLI – IAA Research Project**

### **1. Executive Summary**

This Supplement to the Second Report of the Joint Research Project of the ACLI –IAA (*the Supplement*) further investigates certain key issues raised in the Second Report. These include certain of the major consequences of inconsistent asset / liability measurement for financial intermediaries and the potential bias in the amount of reported equity (and income) that can result from the selection of asset category. Underlying this analysis is a search for enhanced measures of business reality.

Due to the effects of inconsistent asset/liability measurement and the resultant cumulative effect on comprehensive income since SFAS 115 was adopted in 1993, taken at face value, both GAAP equity and GAAP earnings of US life insurers may have been higher than justified by business reality, with similar effects had IAS 32/39 been used. Under other interest rate circumstances, both equity and earnings would have been understated. With US life insurers having chosen to designate up to half of their investment assets as available-for-sale (AFS), the Supplement also suggests that the financial results in respect of contracts measured on the amortized cost (AC) basis (or any basis conceptually similar to SFAS 60) would have been unrepresentative of business reality because life insurers' financial assets were inconsistently measured as a mixture of held-to-maturity (HTM), AFS or trading. This inconsistency is the result of accounting requirements that can impact major portions of the balance sheet when selling an asset designated as HTM, even when there is no change in the underlying business reality of the company.

Through the use of an annuity certain that has the characteristics of a 20-year bond as a simple example, this Supplement illustrates the sizable differences in earnings and comprehensive income that would emerge if US interest rates remain at or increase from June 2003 levels.

*Note that the ACLI and IAA have not examined the impact on equity and earnings from any factor other than inconsistent asset/liability measurement (such as taxation) since that is beyond the scope of our research to date. Specifically, the ACLI and IAA have only investigated amortized cost liability methods and have not yet investigated the use of other methods, such as the deposit type approach required under SFAS 97. The latter, while having some characteristics similar to those in amortized cost methods, allows unlocking of*



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*DAC amortization assumptions to affect income over the life of the DAC amortization stream. Possible approaches similar to that described in EITF 82-9 (shadow accounting) might be appropriate.*

This Supplement also examines how the current restrictions on the choice of asset designation under SFAS 115 and IAS 32/39 make it unlikely that life insurers could make elections that would enable them to produce meaningful financial statements for contract liabilities measured under amortized cost type regimes – and suggests an alternative HTM restriction.

The principal finding of the ACLI and IAA is a recommendation that the IASB should enhance its coordination of three related financial reporting projects to develop:

- measurement bases for financial assets held by financial intermediaries and financial liabilities written by financial intermediaries;
- measurement bases for insurance contract liabilities written by insurers or other financial intermediary allowed to underwrite insurance; and
- performance reporting bases for financial intermediaries

Developing these should ensure that meaningful and relevant financial information reflecting “business reality” will be provided to users of the financial statements of financial intermediaries. *The ACLI and IAA would be willing to help to test the implications from any such coordinated effort.*



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## 2. Introduction

In the Second Report of the Joint ACLI – IAA Research Project (*the Second Report*), there was a very short comment on Chart 5c as follows:

*“It should be noted that **differences** similar to those illustrated in Charts 5a – 5c **would arise in the accounting value of the bond assets alone, even if no change in the level or slope of the yield curve took place after the purchase of the bond.**”*

This Supplement to the Second Report (*the Supplement*):

- illustrates the differences that can arise due to the selection of asset category (*held-to-maturity* or *available-for-sale*) and shows that the accounting differences from asset category selection can be sizable whether or not interest rates change;
- extends the analysis in the Second Report to examine the consequences of inconsistent asset/liability measurement for a financial intermediary offering investment contracts (and, by extension, insurance contracts) under both US GAAP and proposed IFRS using interest rate scenarios based on historical experience; and
- discusses the business of financial intermediation and suggests an alternative IASB asset measurement treatment that could be considered to provide financial information about the operations of a financial intermediary that better reflects business reality.

The following describes how the findings from the Second Report led to this Supplement.

- The Second Report examined the effect of changes in interest rates on earnings from an annuity contract, based on whether assets and liabilities were measured consistently.
- The first two research findings (illustrated in Charts 5a to 5c) were surprising in the following ways:
  - If actual experience was the initial best estimate pricing expectation, the pattern of earnings was similar when assets and liabilities were measured consistently (whether assets and liabilities were measured at HTM/AC or FV/FV). This also occurs *regardless of how interest rates changed subsequent to the contract initiation*.
  - The relative slope of the pattern of annual earnings expected under the HTM/AC and FV/FV methods was a function *only* of the slope of the yield curve *at the date of contract initiation*. The pattern of income under the FV/FV regime depended only on the pricing of the product when actual experience matched pricing.

- This led to the realization that “earnings” resulting even from an unchanged yield curve would be materially different if a sizable percentage of assets were measured under HTM rather than AFS.
- This led to a realization that insurers that had designated a considerable portion of invested assets as AFS may have reported significantly higher equity than otherwise identical insurers that had designated assets as HTM under the conditions that prevailed in the US since SFAS 115 and IAS 32/39 were adopted. *For a well matched insurer with liabilities measured under an amortized cost (or conceptually consistent) method, the elevated equity (and in some cases elevated earnings) was not due to business reality, but solely reflected “financial noise” from interest declines.*
- This led in turn to the realization that the opposite would be true (i.e., depressed equity and, in some cases, depressed earnings) if a secular rise in interest rates were to occur.

***The ACLI and the IAA feel a responsibility to bring these findings to the attention of the IASB (and to the FASB) to avoid financial statements produced under the first standard developed from basic principles by the IASB being seen as unrepresentative of the underlying business reality of the business subject to the financial reporting.***

### **3. Financial intermediation and inconsistent A / L measurement**

Financial intermediaries accept money from customers and invest that money. The financial intermediary’s profit is made by managing the “spreads” between the actual experience on the contract and what is credited to (or charged to) the customer. In the case of an investment product, the “spread” can be as “simple” as an “investment spread”. In the case of an insurance contract, the “spreads” can also include a “mortality spread”, a “morbidity spread”, an “expense spread”, etc. In order to analyze the operations of a financial intermediary, the emergence of the actual spreads earned must be closely monitored. ***Practically, this means that to provide meaningful financial information the measurement of the outcomes on the asset and liability sides of the balance sheet should be made in a consistent manner.***

The Second Report demonstrated that the use of inconsistent measurement bases for assets and liabilities could produce “financial noise” in the determination either of earnings or of comprehensive income. The magnitude of the “financial noise” was examined using the volatile period 1972 – 2002 as an example. In this Supplement, illustrations using interest rate patterns observed



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from subsets of that data are examined (including subsets obtained by “running the data backwards” to illustrate what would happen in periods of increasing interest rates). These additional illustrations show a high likelihood that “financial noise” was introduced into US GAAP as applied to life insurers following the adoption of SFAS 115 in 1993 in respect of contracts measured under amortized cost (or conceptually closely related) methods when assets were measured on a AFS basis.

This Supplement shows how the AFS measurement method is inconsistent with the amortized cost method of measuring financial liabilities. This is particularly important for life insurers because most of the national insurance accounting methods allowable under Phase 1 of the IASB insurance accounting project use insurance contract liability measurement methods that are conceptually close to amortized cost methods. It may also be important for life insurers because the tentative direction for Phase 2 of the insurance accounting project is to require fair value liability measurement methods for insurance contracts that are also inconsistent with AFS asset measurement methods. Section 14 of this Supplement suggests one way in which this inconsistency might be eliminated through a change in the HTM rules.

Current US GAAP relies on insurance contract liability methods that are inconsistent with the AFS asset measurement method. The ACLI/IAA’s research to date suggests that, with typical US life insurers designating up to half of their assets as AFS, life insurer GAAP equity may have been higher than justified by business reality since 1996. While the evidence is harder to document, the ACLI and the IAA believe that that life insurer GAAP earnings may have also been higher than justified by business reality since 1996 as a result of the normal trading of debt securities in a declining interest rate market. While in the US, the reporting requirements for this “extra” income enables analysts to back out the effects of this trading, those for IFRSs may not.



#### 4. A June 2003 purchase of 20-year US Treasury Bond - interest unchanged

Chart S-1 shows the interest rate curve that existed at June 27, 2003. The chart shows both the level of spot interest rates each year for 20 years for a 20-year Treasury bond. *Note that the yield to maturity is above the spot rate until duration 17. This reflects the large weighting of the final principal repayment.*

Chart S-1 - US Treasury Yield Curve at June 27, 2003

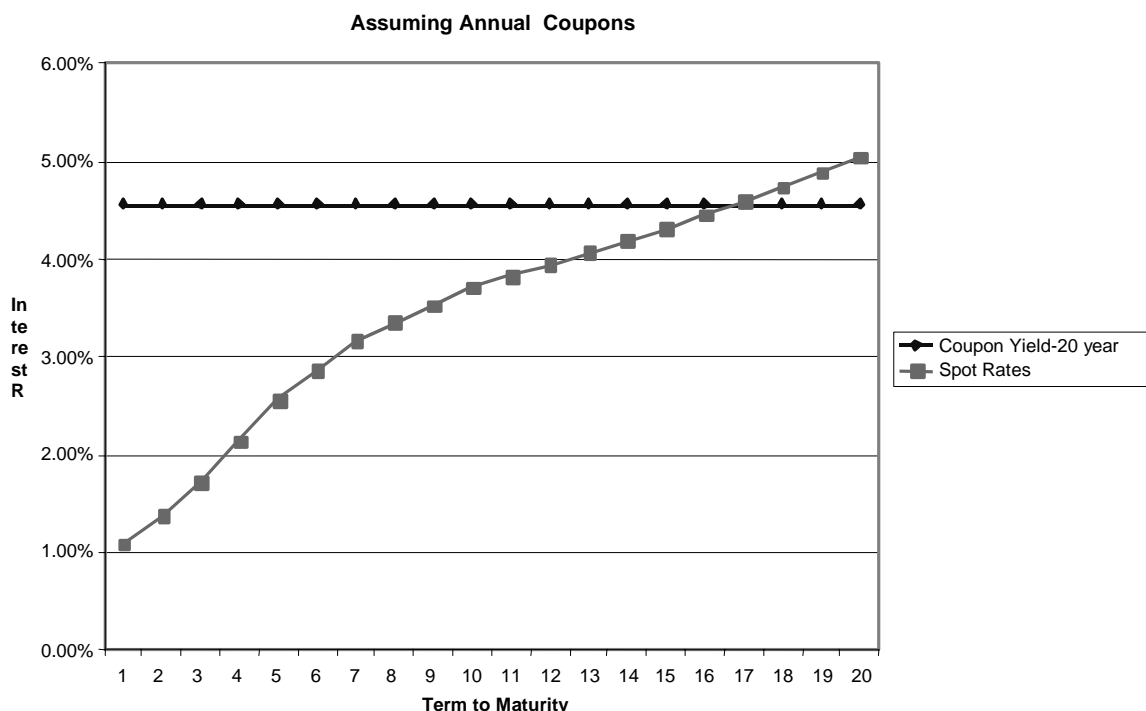
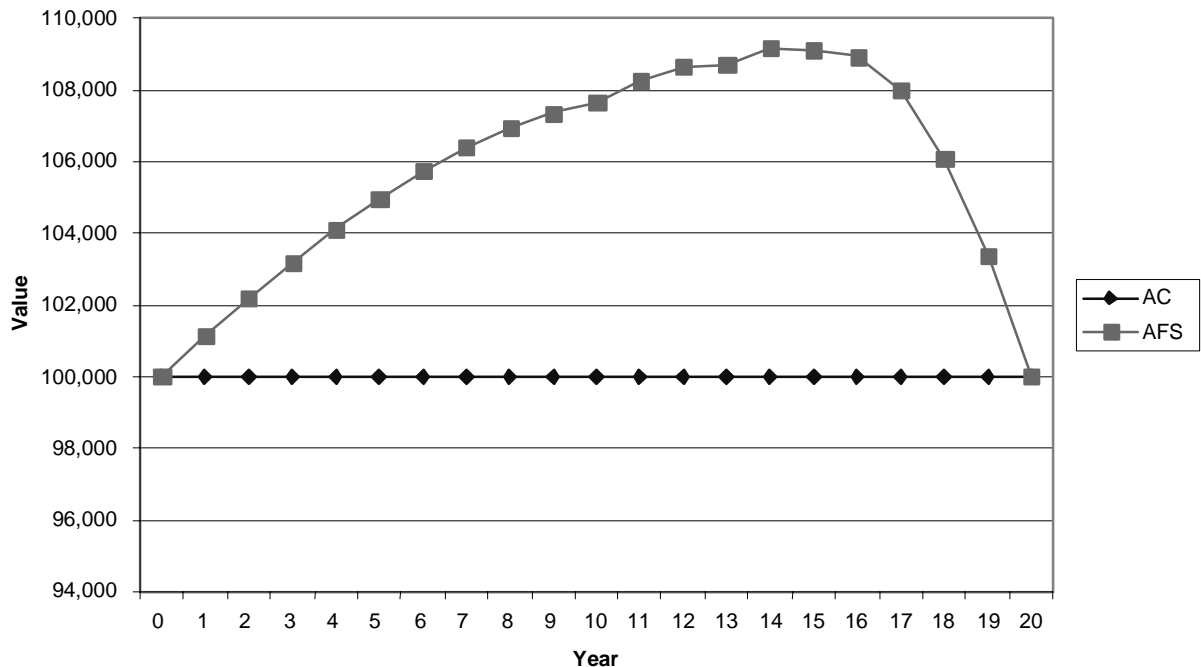


Chart S-2 shows the asset value of a \$100,000 20 year Treasury bond purchased at par in June 2003 when measured at each successive year end as an HTM asset (i.e. using amortized cost under the effective interest method) compared to the asset value measured for the same asset if it had been designated as an available for sale (AFS) asset for measurement purposes *assuming interest rates remain fixed at June 2003 levels forever.*

The value of the bond under the HTM basis is always its par value. The value of the bond under the AFS basis is the market value of the bond at the various durations after purchase. The market value of the bond initially increases with time *even when the underlying interest rate curve remains unchanged.* This is because the effective interest rate determined under the amortized cost basis lies in between the spot rates for short-term payments (such as the interest payments due in the early years) and the spot rate used for the final principal repayment.

Thus, as time passes in the early years, the near term interest payments are discounted at lower rates than at issue (due to the steepness of the yield curve in June 2003) and the market value of the bond rises above \$100,000.

**Chart S-2 - 20-YEAR BOND Purchased in June 2003  
AC vs. AFS Measurement**



There is another way to look at this information. Consider a financial institution that issues a financial instrument that has the identical characteristics to a 20-year Treasury bond and that also buys a 20-year Treasury bond at issue to hedge the effects of future interest rate changes. For purposes of this simple illustration, it is assumed that there is no “own credit rating” and that “hedge accounting” does not apply since the “hedge” is a cash instrument “hedge”. Now, consider if the financial institution measures the liability on an amortized cost basis (i.e., assuming the effective interest method) and if it measures the “immunizing asset” on the AFS basis.

The “business reality” is that, since the financial intermediary has completely immunized itself against any change in interest rate level or slope, no earnings or comprehensive income should arise with the passage of time. The accounting reality is that, while the financial institution would not show any earnings, **it would show significant temporary comprehensive income through increases in the amount of equity, reflecting the unrealized capital gain on the AFS measured bond.** This amount of increased equity is completely illusory since at all time periods, the entire asset is required to be held to *fully discharge*

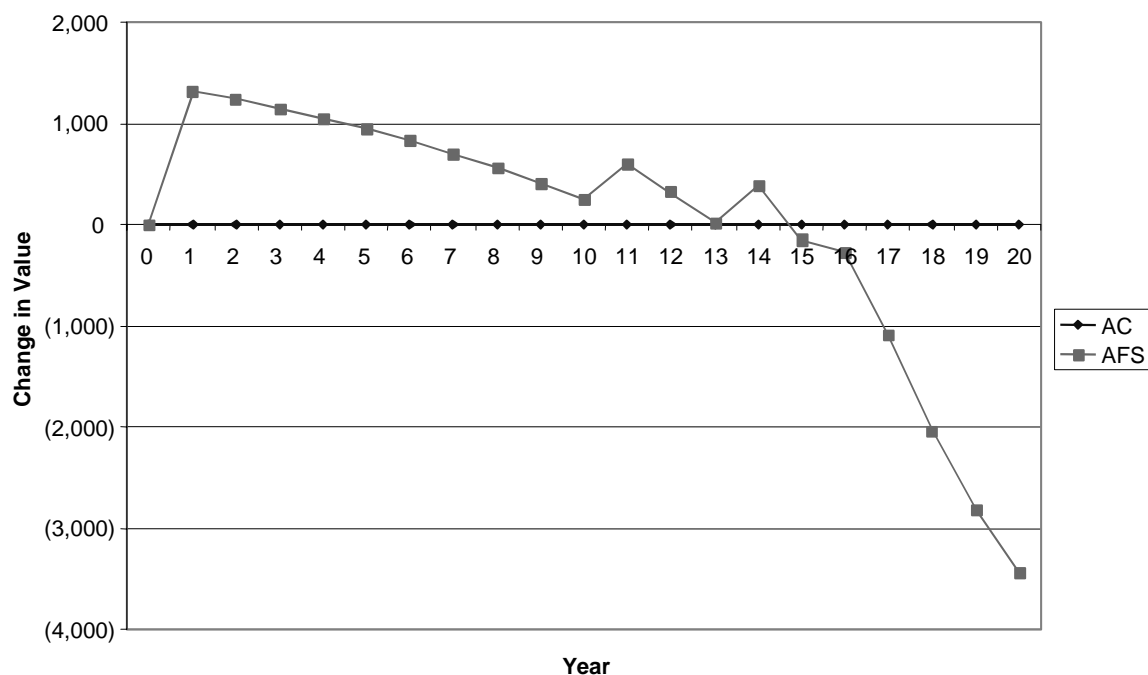
the value of the matching liability and to offset the liability assumed. **The amount of equity shown in the balance sheet is due entirely to “financial noise” from the inconsistent methods used to measure the assets and the liabilities.**

### **5. Reported equity from a 2003 US Treasury Bond purchase – interest unchanged**

Chart S-3 shows the annual change in the amount of equity reported by a financial institution that both measures the “20-year bond” liability using the amortized cost method and measures the immunizing 20-year bond asset using the AFS method assuming interest rates remained unchanged after the transaction date. As can be seen, since the amortized cost based liability value does not change, equity would increase materially, but slowly, each year for the first 14 years and decrease materially, but rapidly, in the last 5 years.

***While it may be relatively easy for insurers to tell analysts to “ignore the good news in equity” due to interest rates, it might be far more problematic to tell the analysts to “ignore the bad news” should the interest rate curve change its slope or begin to increase. In any case, it is not good financial reporting policy to generate comprehensive income amounts that are unrepresentative of “business reality”.***

**Chart S-3 - Change in Value, 20-Year Bond Purchased June, 2003  
Asset Measured at AC vs. AFS**



*The same debt but different measurement basis* - Another example with results similar to those illustrated in Charts S-2 and S-3 further demonstrates the mismatch in financial reporting. Assume that a “AAA” company issues debt securities of \$1,000,000 maturing in 20 years, no call provision, at a fixed rate of 100 basis points over the Treasury rate. The company measures and reports the value of the debt instrument at amortized cost with fair value disclosures. Based upon the June 2003 yield curve, the following table reflects the measurement of the instrument using amortized cost and fair value.

**Table S-1 - Comparison of HTM & FV for "AAA" 20-Year Bond**

<u>Year</u>	<u>HTM</u>	<u>Fair Value</u>	<u>Change in FV</u>	<u>Cumulative Change</u>
0	1,000,000.00	1,000,000.00		
1	1,000,000.00	1,012,123.05	12,123.05	12,123.05
2	1,000,000.00	1,023,592.59	11,469.55	23,592.59
3	1,000,000.00	1,034,319.98	10,727.39	34,319.98
4	1,000,000.00	1,044,212.90	9,892.92	44,212.90
5	1,000,000.00	1,053,175.60	8,962.69	53,175.60
6	1,000,000.00	1,061,109.11	7,933.51	61,109.11
7	1,000,000.00	1,067,911.55	6,802.44	67,911.55
8	1,000,000.00	1,073,478.39	5,566.85	73,478.39
9	1,000,000.00	1,077,702.84	4,224.45	77,702.84
10	1,000,000.00	1,080,476.17	2,773.33	80,476.17
11	1,000,000.00	1,086,513.96	6,037.79	86,513.96
12	1,000,000.00	1,089,961.43	3,447.47	89,961.43
13	1,000,000.00	1,090,622.23	660.79	90,622.23
14	1,000,000.00	1,094,843.32	4,221.09	94,843.32
15	1,000,000.00	1,093,849.48	(993.85)	93,849.48
16	1,000,000.00	1,091,609.66	(2,239.82)	91,609.66
17	1,000,000.00	1,081,391.20	(10,218.45)	81,391.20
18	1,000,000.00	1,061,678.98	(19,712.22)	61,678.98
19	1,000,000.00	1,034,087.57	(27,591.41)	34,087.57
20	1,000,000.00	1,000,000.00	(34,087.57)	-

Under IAS 39, the holder may classify the debt instrument as a HTM investment if it has the intent and ability to hold the instrument to maturity. Alternatively, it could designate the instrument as HFT or AFS, both measured at fair value. The limitations placed on the HTM classification tend to cause most financial institutions to designate debt instruments that it holds as AFS.

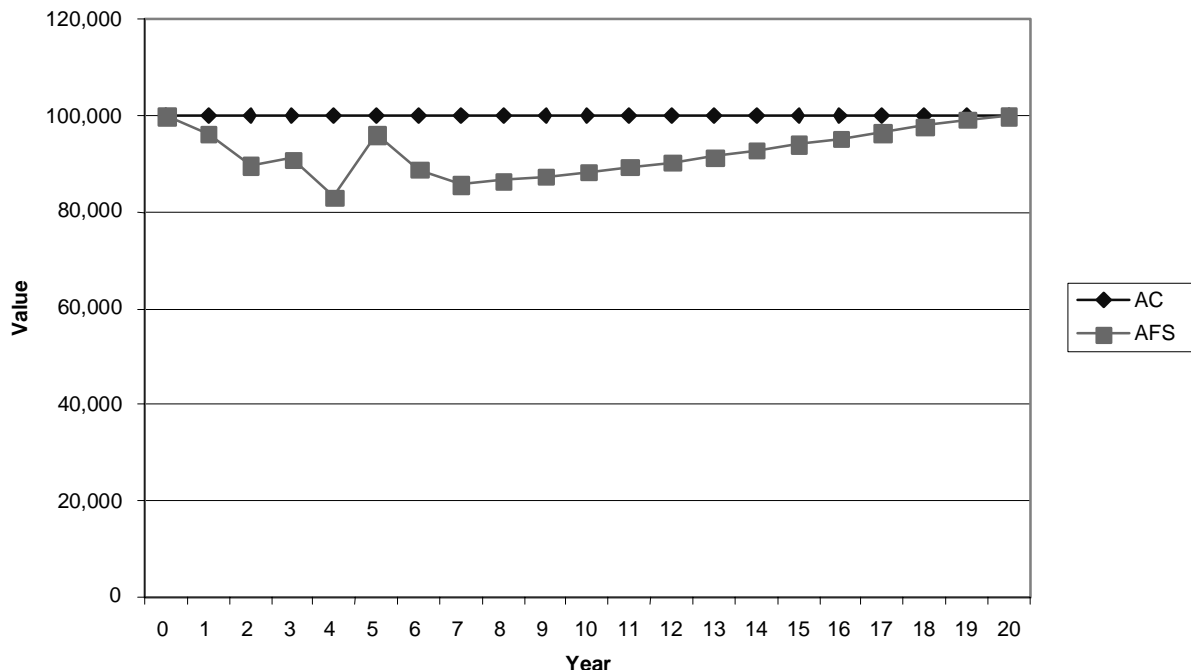
The debtor would report the debt instrument as a liability at \$ 1,000,000. The holder of the instrument would report an asset at fair value. In year 14, it would show a gain of almost \$95,000 only to unwind it over the subsequent six-year period.

## **6. A June 2003 purchase of a 20-year US Treasury Bond – when interest rates increase to a sustained intermediately higher level**

Interest rates have generally experienced a secular decline since the first Asian financial crisis in 1997. To illustrate the effect of interest rate increases, an example was created under which the bond was assumed to be purchased in June 2003 (as before), but where the interest rate curve at each year end was the curve determined by “running the interest rate curve backwards,” i.e., the assumed interest rate curve at the end of the first year was the 2002 year end curve, the interest rate curve at the end of the second year was the 2001 year end interest rate curve etc., until in 1996 interest rates were assumed to be stable thereafter. This is shown in Chart S-4.

In this case, the market value of the bond used for AFS purposes would always be less than the amortized cost of the liability. The amount by which the asset is less than the liability is reflected by a reduction in equity – ***even though at all times the liability can be fully discharged by the value of the matching asset. Once again, the decrease in the financial institution’s equity is entirely “financial noise” due to the inconsistent bases of measurement of the financial intermediary’s assets and liabilities.***

**Chart S-4 - 20-YEAR BOND Purchased in June 2003  
AC vs. AFS, Yields from 2003 to 1996**

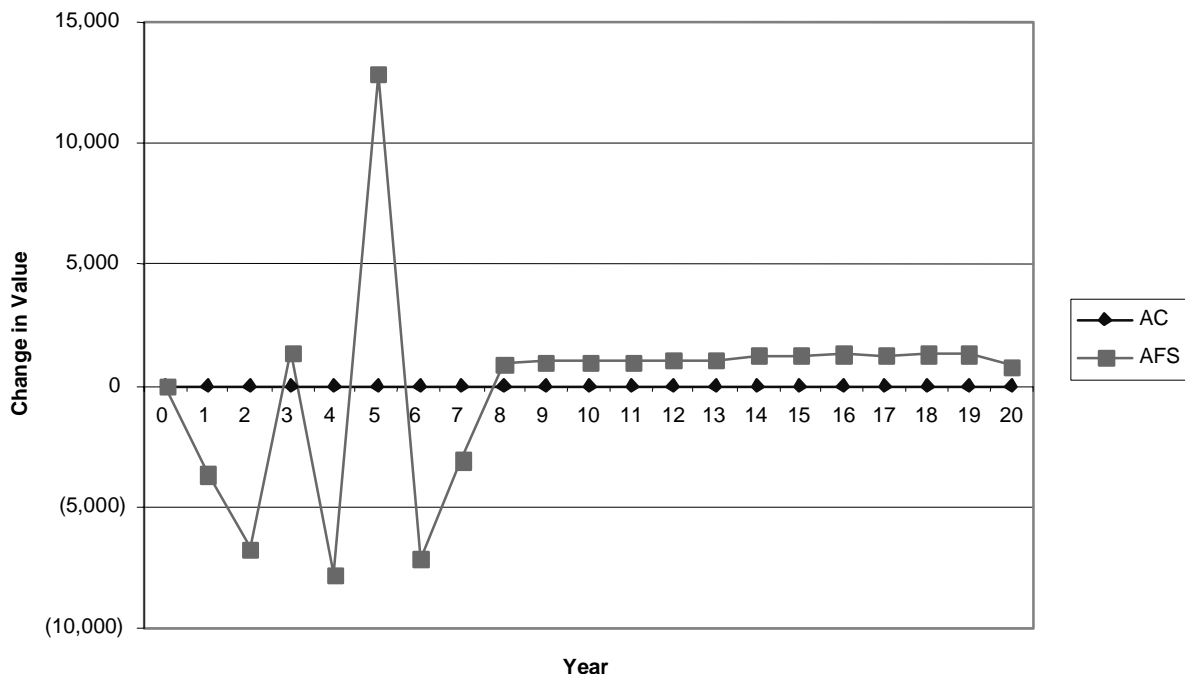


## **7. Reported equity from a 2003 US Treasury Bond purchase – when interest rates increase to a sustained intermediately higher level**

Chart S-5 shows the annual changes in equity that would have arisen had interest rates followed the pattern suggested by “running the interest rate history backwards from 2003 to 1996 and fixing the interest rate curve at the 1996 level thereafter.” As can be seen, there would have been volatile comprehensive income in the first seven years. Since at all times the financial institution could have discharged the liability for the value of the asset, the changes in annual comprehensive income can be regarded entirely as accounting “financial noise” due to inconsistent measurement methods for assets and liabilities.

Note that the relatively stable series of increases to equity that would be expected to emerge once the interest rate curve was “frozen” at the 1996 year-end level in effect reverses the accounting “financial noise”.

**Chart S-5 - Change in 20-Year Bond Value  
AC vs. AFS, Yields from 2003 to 1996**



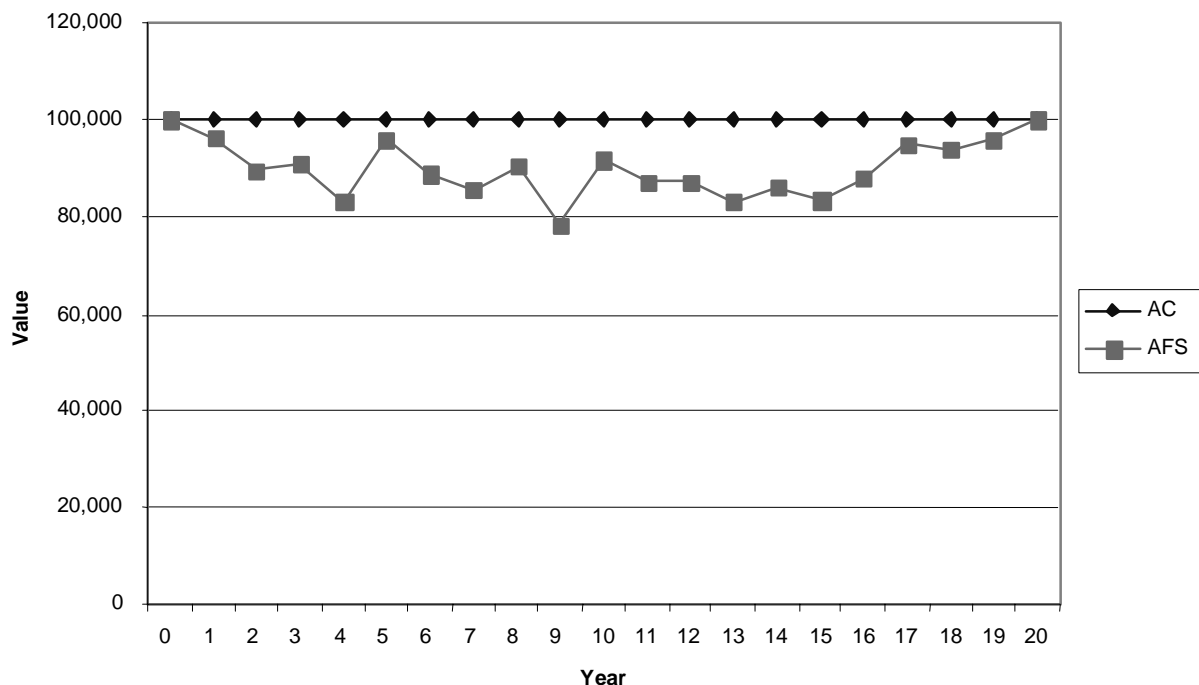
## 8. Situation where interest rate “experience” reflects the past 20 years

Chart S-6 illustrates the value of the liability and the asset when the interest rate curve is that determined by “running interest rates backwards” for the entire 20 years of the liability (from 2003 to 1984).

As can be seen, the asset would have been below par value during the entire 20-year period. Yet equity would have been volatile and would always have been less than the equity at issue of the liability in spite of the fact that, at all points in time, the liability could have been fully discharged by the value of the immunizing asset.

The reductions in equity and the volatility in comprehensive income can be regarded as accounting “financial noise” entirely due to the inconsistent measurement bases used for assets and liabilities and not reflective of “business reality”.

**Chart S-6 - 20-YEAR BOND Purchased June 2003  
AC vs. AFS, Yields from 2003 to 1984**



## 9. Annual changes in comprehensive income (interest history reversed)

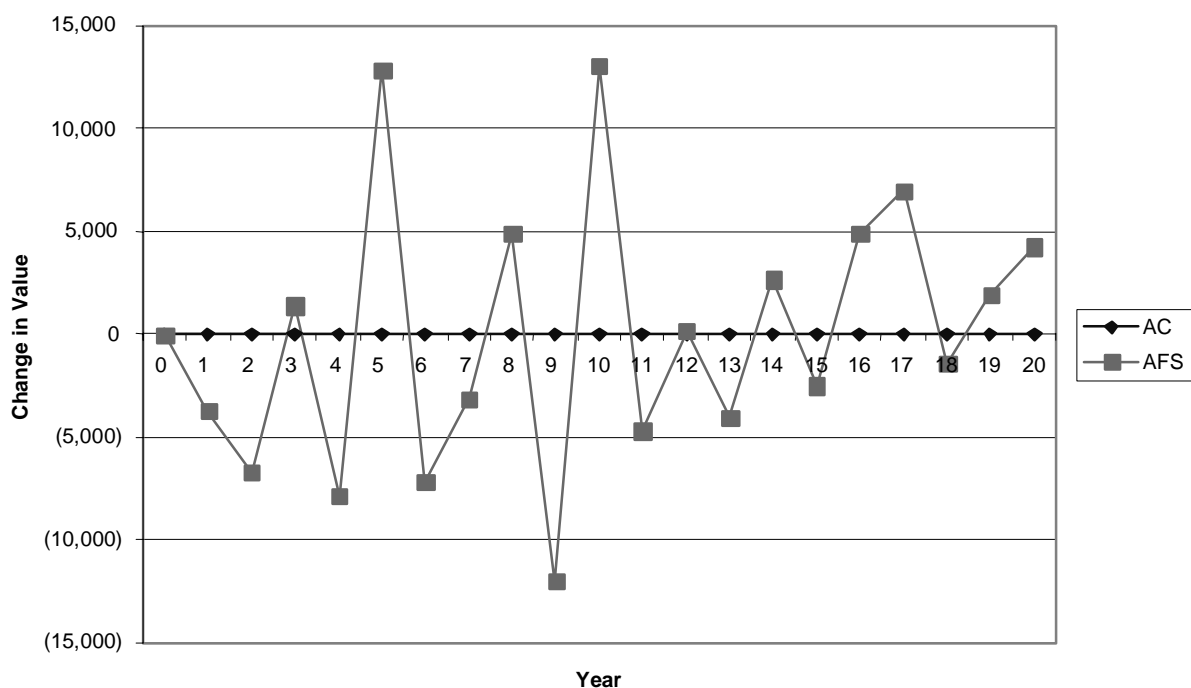
Chart S-7 shows the annual change in reported comprehensive income had the interest rate experience been the same as if the interest rate series had been run backwards.

Note the extreme volatility in comprehensive income reflecting the dramatic swings in interest rate curve levels and slopes during the past 20 years.

While it is true that earnings would have been stable had the financial institution adopted a “buy and hold” strategy for the immunizing bond asset, the changes in equity would have been both illusory and potentially misleading for users of the financial statements of a financial institution that had arranged its affairs to have no net exposure to shifts in interest rate curve levels or slopes.

The only way to show the underlying “business reality” would be to ignore the changes in equity.

**Chart S-7 - Change in 20-Year Bond Value  
AC vs. AFS, Yields from 2003 to 1984**





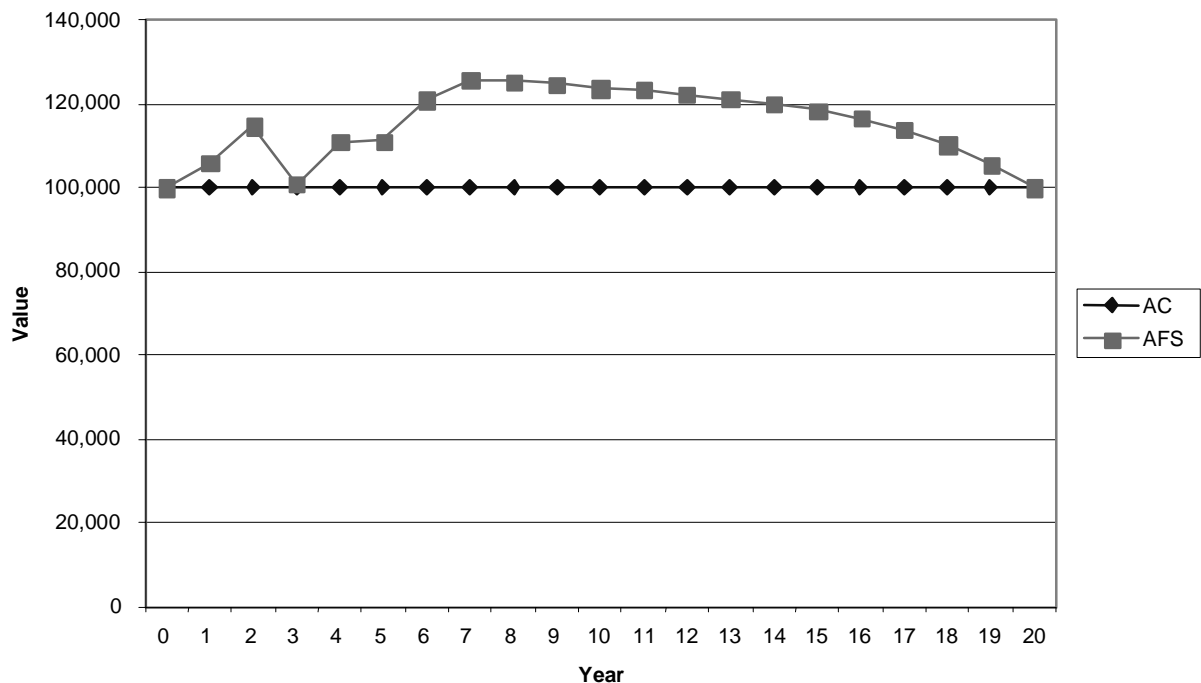
# **10. Effect of declining interest rates (1996 – 2003 and level thereafter)**

The effect of the secular decrease in US interest rate levels since the first Asian financial crisis in 1997 can be explored by examining what would have happened as interest rates have fallen (and the yield curve has become steeper) since 1996.

Chart S-8 illustrates the value of the amortized cost liability and the matching AFS asset had they been originated at year-end 1996 and exposed to interest rate history thereafter (with the yield curve at the end of June 2003 assumed to be constant thereafter).

As can be seen, the market value of the bond would have exceeded the value of the liability by up to almost 125%. This amount would have been reflected in the equity of the hypothetical financial institution.

**Chart S-8 - 20-YEAR BOND Purchased 1996  
AC vs. AFS, Yields 1996 to 2003**

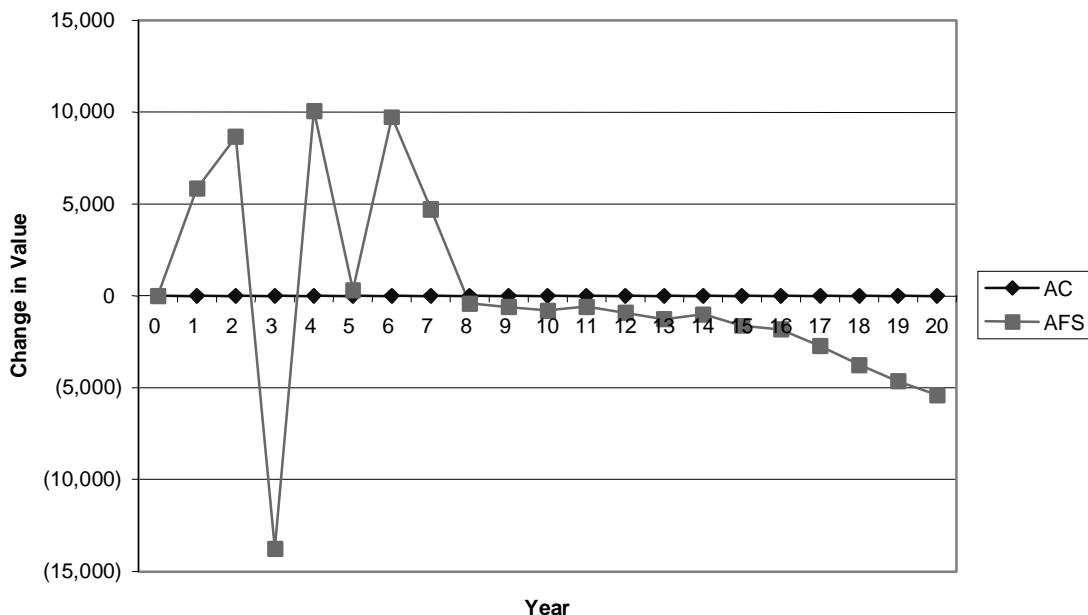


# **11. Effect on comprehensive income when interest rates fall**

Chart S-9 shows the volatile pattern of changes in comprehensive income that would have arisen from the accounting “financial noise” due to the inconsistent measurement of assets and liabilities over the last seven years. Of course, since the liability could always be discharged by the value of the asset, the cumulative increase in equity does not reflect “business reality”. The increased equity disappears over the remaining lifetime of the liability after 2003, even if the yield curve does not change thereafter, due to future negative comprehensive income in the remaining time periods (Of course, even if the yield curve does change, the equity disappears over the remaining contract period.)

Put another way, the readers of financial statements need to be aware that for a well matched financial intermediary, the equity amounts shown as a result of the secular decrease in interest rates since the first Asian financial crisis can be illusory and materially overstated.

**Chart S-9 - Change in Value - 20-Year Bond Purchase in 1996  
AC vs. AFS, Yields from 1996 to 2003**





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***Both the ACLI and the IAA believe this reported equity beyond the level justified by “business reality” might be the case for many well-matched insurers currently reporting under US GAAP.***

***This is because many of the insurance liabilities measured under US GAAP are based on an amortized cost methodology while a very high proportion of the assets measured under US GAAP are designated as AFS.***

*The potential overstatement in life insurer equity can, in part, be evaluated by the amount of accumulated comprehensive income reported in the SEC filings of large US insurers.*

The “in part” qualification is important because it would only be true for a life insurer that had:

- a very “tight” match between expected liability and expected asset cash flows;
- 100% fixed income investments to back its fixed income liabilities; and
- a “buy and hold” investment strategy.

While the first two conditions may not be far from business reality, the third qualification is certainly not representative of the practices of most life insurers reporting under US GAAP. The rigid asset classification rules of SFAS 115 result in an accounting policy that dictates business practice for life insurers if they wish to avoid reporting volatility not representative of the underlying business reality.

## **12. Data from 2002 SEC filings of listed US life insurers (form 10-k)**

The tables in this section illustrate:

- the percentage of corporate assets designated as AFS;
- the magnitude of the accumulated comprehensive income reported by large American financial intermediaries in their most recent SEC filings; and
- the relative size of the change in unrealized gains/losses in accumulated comprehensive income to net income.



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Based on information obtained from the 2002 10-Ks of six large US life insurers, the percentage of AFS assets ranges from just over a quarter to just about a half.

Table S-2	
Company	AFS % of Total Assets
A	47.5%
B	35.5%
C	51.2%
D	38.5%
E	43.8%
F	29.2%

Note that accumulated comprehensive income straddles 10% of equity.

Table S-3		
Company	ACI as % of Total Equity	Gain/Loss as % of ACI
A	8.4%	224.77%
B	13.9%	103.47%
C	11.5%	113.70%
D	9.6%	123.89%
E	12.1%	109.63%
F	9.0%	100.35%

Note also that a change in unrealized gains and losses would be a material proportion of net income.

Table S-4	
Company	Change in gains/losses as % of Net Income
A	57.4%
B	616.2%
C	25.1%
D	282.3%
E	827.8%
F	137.2%

### **13. Potential effect on US life insurer GAAP net income from trading**

Consider the case of an insurer that sold a 20-year bond liability (measured at amortized cost) and simultaneously purchased an exactly matching 20-year bond asset at the end of 1996. Now, consider the effect if the insurer sold the \$100,000 bond at fair value for \$112,337 at year end 2000 and purchased a new \$112,337 bond at par maturing in 2016 (i.e., for the remaining term of the original bond). In this case, because an AFS measured bond had been sold, a capital gain of \$12,337 would have been realized and the \$12,337 would have been reported as income.

Each year after the sale and purchase, the insurer would have to pay the policyholder the equivalent of \$6,650 of interest (reflecting the original interest rate). But during this period the insurer would only receive interest income on the new \$112,337 bond of \$6,158, leaving a cash flow gap of \$492. In year 20, the insurer would still pay the policyholder a final payment of \$106,650, but the insurer's cash flow in year 20 would be  $\$112,337 - 492 = \$111,845$ .

It can be shown (based on using spot rates from the year end 2000 yield curve, or the equivalent level interest rate of 5.76%) that the 16 years of cash flow shortfall of \$492 (due to less interest income) has the same present value as the 20<sup>th</sup> year excess maturity value "gain" of \$12,337.

**That is, the \$12,337 "gain" from the sale of the bond is not really of the nature of earnings but is really of the nature of a timing difference due to the purchase of a lower interest rate bond for a higher capital amount.**

Put another way, reflecting the realized capital in the earnings of the insurer ignores the expectation of future "earnings drag" in each of the remaining 16 years.

Note that normal trading of AFS measured bonds in the decreasing interest rate environment over the last six years would have had the effect of increasing earnings (and hence equity), as realized capital gains arising from the increased market value of the bonds due to falling interest rates were reflected in income.

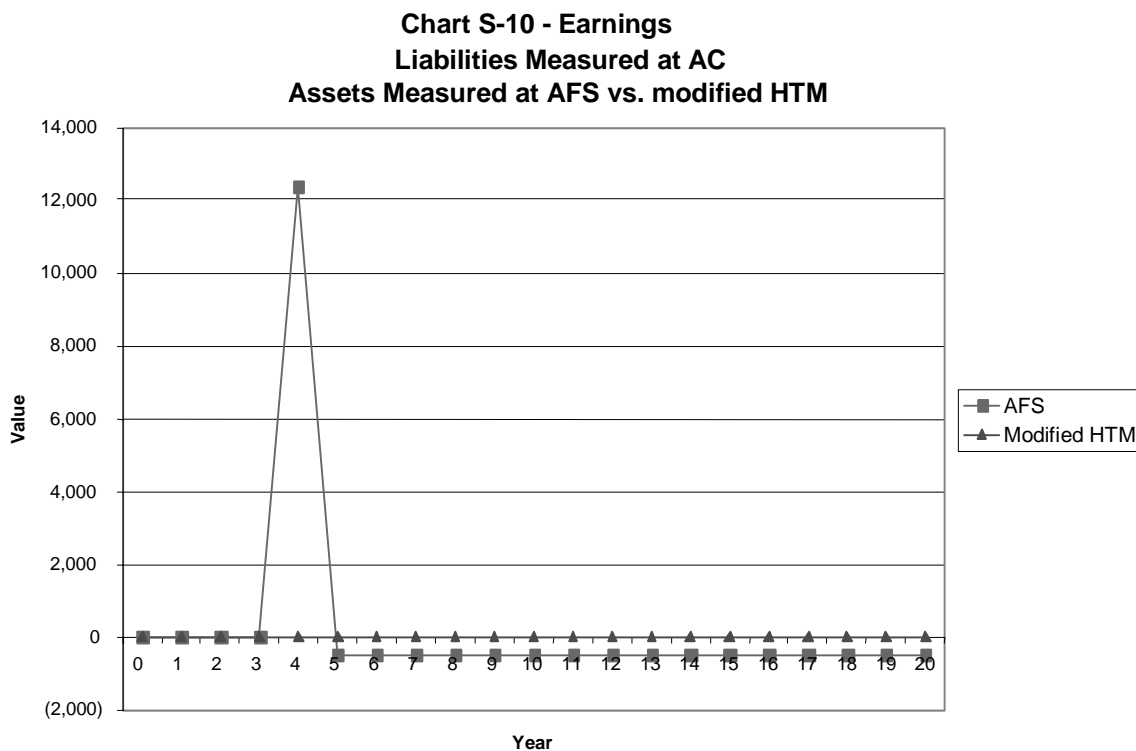
Given the proportion of equity that accumulated comprehensive income on AFS securities currently represents in the US as shown in Table S-3, it is important to recognize that the amount of realized capital gains due to trading of bonds in a decreasing interest rate environment can materially overstate "business reality" since, as noted above, the "business reality" from trading a higher interest payment bond for a lower interest rate paying bond of the same maturity is to create a future "earnings drag".

***Therefore, treating the realization of the capital gain as income represents another accounting measurement inconsistency between assets and liabilities when liabilities are measured using the amortized cost (or conceptually consistent) basis.***

**14. A “modified HTM” could align net income with business reality**

If the capital gains referred to in Section 13 were not included in revenue but rather were amortized into revenue at the equivalent level interest rate of 5.76% (resulting in making up the “shortfall of \$492 noted above), no such measurement inconsistency would arise. In such a case, the earnings in years 5 – 20 would again be returned to 0 (as if the sale and purchase had not taken place).

In Chart S-10, the “modified HTM” line represents what would happen if the liability continued to be measured under the amortized cost method and if the “shortfall” in interest income during the last 16 years from the asset trade were “augmented” by adding the level amortized gain from the sale of the asset.





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The ACLI and IAA are not clear what is the policy purpose of the restrictions that currently apply to the designation of an asset as “HTM”. The current restrictions are that the purchaser must have the intention and the ability to hold an asset to maturity in order to designate it as an HTM asset. Given that designation, the asset is always reported at amortized cost. There is a heavy penalty imposed if the purchaser sells an HTM asset, since such a sale can “taint” the purchaser’s asset portfolio.

Viewed in this way, the HTM restrictions are “barriers to access” to the HTM designation.

The ACLI and the IAA wonder if the financial reporting policy purpose that lies behind the HTM restrictions could not be accomplished by “control of result” of the accounting of HTM assets rather than “barriers to access” to the HTM asset designation.

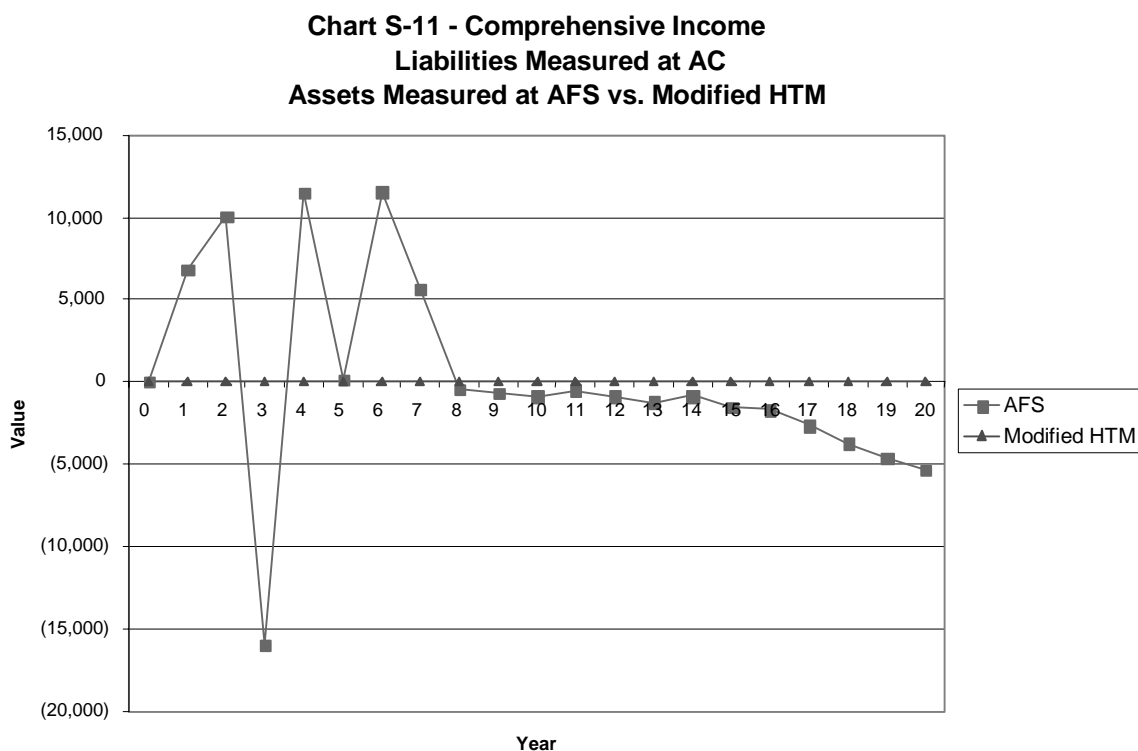
*This could be accomplished by a change in the HTM rules for any HTM designated asset involving the payment of interest or its equivalent, such as bonds and mortgages (but excluding any asset with equity participation features). This could possibly be available to financial intermediaries only. This change would have income (or loss) for the asset be reported on an amortized cost basis. This amortization would occur **even if the asset were sold**, irrespective of the type or designation of the subsequent asset.*

Under such a regime, any gain or loss due solely to a change in interest rates (i.e., not due to an impairment) would be amortized to the maturity of the asset using the interest rate curve applicable at the time of the asset sale. While this may seem onerous, the calculations involved would be similar to the calculations (and record keeping) involved to amortize a premium or a discount when any fixed income security is purchased at a price other than par value.

The ACLI and IAA note that access to such a changed HTM environment would meet a large number of the objections raised in the many submissions to the IAS 32/39 Roundtable. Such a change would enable insurers to “hedge” their interest rate risk based on best estimated cash flows without running the risk of “tainting” their HTM asset portfolio. Such a change in HTM rules would enable assets and liabilities to be measured on a consistent basis during the period when the predominant method of liability measurement of financial liabilities and insurance liabilities is amortized cost (or methods closely related conceptually to the amortized cost method).

Chart S-11 illustrates that, under the proposed modified HTM system, the comprehensive income is zero (i.e. it reflects “business reality” in the example

created both to illustrate the effects of inconsistent asset / liability measurement and to illustrate how a relatively simple change in HTM restrictions could remove the inconsistencies).



Until such time as the IASB requires all financial instrument assets and liabilities including those for insurance contracts to be measured using fair value, such a change would allow for a robust “HTM” insurance liability measurement basis to be developed as the ACLI suggested in its November 2002 brief.

The lack of an interim stage to determine income and equity of financial intermediaries measuring assets and liabilities on consistent bases could lead to intense resistance to the adoption of fair value techniques, no matter how well conceived.

In addition, if and when a comprehensive fair value requirement was to be adopted (thus having consistent asset and liability measurement bases for financial intermediaries), the elimination of the HTM asset designation option would not cause major discontinuities in earnings and equity. Greater confidence in such a new FV system would therefore result.





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## **15. Participants to the Supplement**

This Supplement to the Second Report was prepared by the participants listed below to further investigate certain issues raised by the Research Project. Before publication, the Supplement was also made available to all members of the drafting group of the Actuarial Standards Subcommittee of the IAA. While there was widespread review by certain members of the IAA active in its consideration of IASB insurance accounting and related actuarial standards issues, this review does not constitute the necessary due process for this Supplement to be considered a Public Statement of the IAA, that can only be made after a formal vote of the members of the IAA. Therefore, all statements in this Supplement concerning the opinions of the IAA should be read only as the opinions of those members of the IAA committee who have participated in its preparation.

At the date of publication, this Supplement had also not completed the process required for it to be considered an official public statement of the ACLI.

### **Participants from the American Council of Life Insurance**

Alan Close	Chairman, Accounting Committee
Jim Renz	
Dave Sandberg, FSA, MAAA	
Henry Siegel, FSA, MAAA	
Steve Strommen, FSA, MAAA	

### **Participants from the International Actuarial Association**

Sam Gutterman, FSA, FCAS, MAAA	Chairman, Insurance Accounting Committee
William Hines, FSA, MAAA	
Paul McCrossan, FSA, FCIA, MAAA	Co-Chairman Actuarial Standards Sub-Committee
Francis Ruijgt	Co-Chairman, Actuarial Standards Sub-Committee