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The Accounting Industry's Reaction to the Financial Crisis

– OR –

-How I Learned to Stop Worrying,

-and Love the Bomb

AGENDA

- Fair Value Accounting's Unexpected Consequences
- FASB's Reaction
- FASB's Fair Value Project and Convergence
- NAIC's Reaction

Evolution of Fair Value Accounting

- Insurance companies are no strangers to fair value (FV) accounting
  - Marketable equity securities at FV (SFAS 60)
  - Available-for-sale securities at FV (SFAS 115)
- Both statements included the concept of "other than temporary impairment" (OTTI)

Fair Value Accounting

- OTTI historically applied to individual poorly performing securities
  - Rules of thumb were fairly reliable in identifying OTTI issues (e.g., 20% impaired for > six months)
  - Concept had never been applied to entire markets or portfolios

Fair Value Accounting

- SFAS No. 157 became effective for financial assets in 2007/2008, "*to provide more transparency in financial statements regarding fair value*"
  - Defines fair value for all GAAP
  - Approach for measuring fair value
  - Establishes new disclosure requirements meant to enhance the users' understanding of fair value measurements

Timing Was Unfortunate

- Dow falls 34% during 2008, ending near the low for the year
- By Mar 9, down and additional 25% (6,547)
- Unprecedented market disruption for debt securities other than issues explicitly backed by the Treasury
  - Virtually no market for mortgage-backed and auction rate securities or anything below investment grade

2008 OTTI Horror Stories

- Bifurcate mutual funds
  - Recognize OTTI related to holdings within a mutual fund, with offsetting unrealized gain back to fair value
- Impair S&P 500 spider fund
  - Hypothesizing that U.S. equity markets will not recover is not supported by 150 years of data
- "Intent and ability to hold" is tainted if any security has ever been sold below cost

Congress Threatens FASB

- In March, Rep. Paul Kanjorski, chair of the Capital Markets Subcommittee, threatens a "legislative solution" if the FASB/SEC do not act to change the current fair value accounting rules

FASB'S RESPONSE

FASB Response

- FASB responds with two Staff Position Papers to reduce the diversity in application of OTTI
  - FASB Staff Position FAS 115-2
  - FASB Staff Position FAS 157-4
- Note that these papers did not change the requirements that financial assets and liabilities be carried at fair value (exit price)

FASB Response

- FASB Staff Position FAS 115-2
  - Assumption that there exists a difference between the present value of cash flows and the market price of debt securities
  - Bifurcate credit loss from market disruption component
    - Credit loss reported as a realized loss
    - Market disruption loss treated as an unrealized loss
  - Clarifies "intent and ability to hold"
    - Does management intend to sell the security?
    - Will management be forced to sell the security?

FSP FAS 115-2

- Lehman Bonds were a good example
  - Cost basis = $1000
  - Trading value = $120 (exit value)
  - Risk-weighted cash flows based on current assumptions = $320
  - Impairment = $880 ($1000 - $120)
  - Realized loss = $680 ($1000 - $320)
  - Other comprehensive loss = $200 ($320 - $120)

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FASB Response

- FASB Staff Position FAS157-4
  - Clarifies situations evidencing a market disruption
  - Allows management to use alternative valuation methods upon decrease in market activity from historic levels (i.e., Level 3)
    - Still fair value – just not derived from observable market transactions

FAIR VALUE CONVERGENCE – FASB'S FINANCIAL INSTRUMENTS PROJECT

Fair Value Goes Global

- As if this wern't enough, the FASB and IASB agree to create converged financial instrument accounting guidance
  - Expected to result in a replacement of current FASB and IASB standards with a common standard
  - FASB's exposure draft expected during 2010
  - Current decisions to date at www.fasb.org under "Projects"

Financial Instruments Project

- Financial assets and liabilities should be measured at fair value on the balance sheet with changes in fair value recognized through either net income (FVNI) or other comprehensive income (FVOCI)
  - Separately present two portfolios on the balance sheet
  - Elimination of amortized cost classification for financial assets
  - Financial assets include policy loans

Financial Instruments Project

- FVOCI may be elected if the company's business strategy is to hold debt instruments for collection of contractual cash flows
  - Financial instruments in this portfolio must:
    - Have a stated maturity date
    - Holder must expect to recover 100% of par value
    - Not be a derivative or hybrid instrument

Financial Instruments Project

- Balance sheet presentation
  - FVNI requires only presentation of fair value
  - FVOCI requires separate balance sheet presentation of

    Amortized cost
    \- Cumulative credit losses
    <u>+/- Adjustments to arrive at fair value</u>
    Fair value

Financial Instruments Project

- Balance sheet presentation
  - FASB tentatively decided not to exempt non-marketable securities from FV accounting
    - Apply fair value measurement guidance
  - Reclassifications between FVNI and FVOCI are not permitted

Financial Instruments Project

- Income statement presentation
  - FVNI requires separate presentation of net realized and net unrealized gain/loss
  - FVOCI requires separate presentation of interest income, interest expense, net realized gain/loss and credit-related impairments

Financial Instruments Project

- Credit impairments (OTTI) should be recognized in net income for FVOCI assets in a two-step process:
  1. Individual security basis
     - Recognize impairment through net income based on NPV of individual security versus amortized cost
     - Elimination of "probable" standard
     - Changes in expected cash flows result in recoveries or losses

Financial Instruments Project

- Credit impairments (continued)
  2. Pooled security basis
     - Segregate securities into pools having similar risk categories
     - Calculate and apply an historical loss rate to each pool, and recognize the impairment in net income
     - Changes in loss rate will result in additional or reversal of previously recognized impairment

NAIC'S REACTION

Statutory Reaction

- Regulators become concerned about reduced surplus on their domestics
  - Leverage ratios
  - Impact on ratings
  - Risk-based capital
- Explore ways to use statutory accounting to address the problem
- Regulators resurrect codifications "plug"

Statutory Reaction

- SSAP No. 10R, *Income Taxes – A Temporary Replacement of SSAP No. 10*, passes in Dec 2010 by a 3-2 vote
  - Applicable for 2009 and 2010 at the election of the company
    - Must not be in any RBC action level
  - Sunsets on Jan 1, 2011 as written
    - Some talk of "going to GAAP"
  - The resultant increase is reported as "special surplus"

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Statutory Reaction

- SSAP No. 10R (continued)
  - Admissibility formula changed to allow DTAs reversing within three years (previously one)
    - Reserves (especially long-tailed lines)
    - Depreciation
    - Nonadmitted assets
    - NOL carryforward
  - Par. 10 (b) limitation increased to 15% from 10%
  - Significant increase in footnote disclosures

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Statutory Reaction

- SSAP 43R – Loan backed and structured securities (adoption of 115-2)
  - Effective for 2009 year-end
  - Requires bifurcation of investment impairments
    - PV of future expected cash flows
    - Credit loss v. unrealized loss
  - Allows a cumulative effect adjustment for previously impaired securities

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Thank You !