

October 1, 2013

Russell G. Golden
Chairman
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Via email: director@fasb.org

File Reference: FASB No. 2013-290 *Insurance Contracts*

Dear Chairman Golden:

The American Bankers Association¹ (ABA) appreciates the opportunity to comment on the exposure draft, *Insurance Contracts* (ED). The ED redefines an insurance contract and requires new methodologies for measuring insurance liabilities. Both the new definition and the measurement differ from those that are commonly in use today among insurance companies as well as other companies, including banking institutions whose products would now fall within the scope of the ED. Wherein current insurance GAAP is generally based on industry practice, the ED prescribes guidance based on a product-by-product basis. As noted in more detail below, we disagree that certain common banking products are, under the ED, defined as insurance contracts and would require accounting procedures that are significantly different from other similar debt instruments. These products do not contain the risk of an insurance contract and requiring insurance accounting will not only confuse investors, but also needlessly require more operationally complex systems to administer them.

The ED defines an insurance contract as one that transfers significant insurance risk to the entity from the policyholder. Insurance risk is “fortuitous, the possibility of adverse events occurring is outside the control of the insured” and is distinguished from financial risk, which results from possible future changes in interest rates, financial instrument prices, commodity prices, foreign exchange rates, index of prices or rates, credit rating or credit index, or other variable.

With this in mind, the ED notes that various products and services commonly offered by banking institutions are considered by the FASB to be insurance products. Among them:

- Financial guarantees
- Standby letters of credit
- Liquidity facilities

¹ The American Bankers Association represents banks of all sizes and charters and is the voice for the nation’s \$14 trillion banking industry and its two million employees.

- Auction rate securities guarantees
- Guarantees related to trust preferred securities

Further, transactions involving recourse and indemnifications, certain guarantees related to representations and warranties on mortgage loan sales and regarding mergers and acquisitions (affecting not only those in the banking industry but all companies) are also included and appear to be considered insurance products.

Most guarantee (non-contingent) liabilities are currently accounted for in conformity with Accounting Standards Codification (ASC) Topic 460² (also widely known as “FIN 45”). They are measured at fair value at inception and subsequently adjusted to recognize the release of risk over the period of the guarantee. Contingent losses under the guarantee are recognized and measured in accordance with ASC Topic 450 (also known as “FAS 5”), the same standard that guides the accounting for losses for most other bank products (including impairment on loans). As proposed in the ED, the banking and guarantee products listed above appear to generally be subject to the “premium allocation approach”, whereby the present value of net cash flows related to the guarantee would be maintained as a liability, calculated by a probability-weighted method. Changes to the liability based on a change in discount rate would be recorded to Other Comprehensive Income, whereas all other changes in the liability would be recorded to net income.

The ED also eliminates the availability of the Fair Value Option for products that are within the scope of the ED.

The Scope of the ED Must Exclude Credit Risk-Related Banking Products and Transactions

The ED states that comparability will be enhanced by requiring contracts that transfer significant insurance risk to be accounted for in a similar manner. We support the notion that comparable insurance products should be accounted for consistently. However, as we noted above, the ED includes many common banking products and transactions within the definition of insurance contracts that are not, in fact, insurance products or transactions – they are credit products and transactions. Including these products as insurance is not only inappropriate because of the nature of these products, it will also reduce comparability of credit risk-related products within the banking industry. Currently, contingent losses (and related administrative costs) on these products are recognized and measured consistently with other banking assets, but will be required to be accounted for under arbitrarily different, yet more operationally complex, accounting methods.³

² ASC Topic 460 applies to those guarantees not accounted for under the Fair Value Option.

³ Under the ED, the liability would be measured at the net present value of the probability-weighted mean of the future net cash flows expected to fulfill the contract, plus a margin representing the profit at risk. Included in the net cash flows would be certain ongoing administrative costs that are currently not tracked for any accounting purposes at banking institutions (such as costs to handle “claims”).

As a result, ABA recommends that credit risk be wholly included within the definition of financial risk (we note that changes in credit ratings or a credit index are already within the definition), thus excluding the vast majority of banking products from the scope of the ED. Overall, credit risk does not represent an insurance risk, which is defined in the ED as being “fortuitous...” with “the possibility of adverse events occurring being outside the control of the insured.”⁴ In the vast majority of cases in which performance on a financial guarantee is required, there are systematic – not fortuitous -- events that occur over a period of time that contribute to the “adverse event”.⁵ Further, in many of these cases, if not indemnified, the insured is able to avoid the “adverse event” by merely selling the financial instrument that contains the credit risk.⁶

We believe banking products based predominately on credit risk do not fit into the Board’s *overall* definition of insurance risk. We note that financial guarantee contracts are excluded from the scope of the IASB exposure draft on insurance contracts, unless the issuer has previously asserted explicitly that it regards those contracts as insurance contracts and has used accounting applicable to insurance contracts. While we believe that banking products should not be included within the scope of the ED because credit risk is a financial (and not insurance) risk, the IASB’s explicit scope exception is acceptable. Our detailed conceptual reasons are discussed below.

The Decision Framework to Determine Product Scope Must be Refined

The ED lays out a framework in evaluating whether there is sufficient insurance risk in a product or instrument to determine whether insurance contract accounting is appropriate. However, the guidance (mainly that included in the table on pages 76 through 88 of the ED) is insufficiently clear and often seemingly contradictory, due to apparent inconsistencies in descriptions of specific terms and of instruments. Clear descriptions would allow for a more deliberate analysis of insurance risk. For example, the distinction between the insurer, the insured, the policyholder, and the beneficiary of a product is often vague. We believe these relationships are important within such an analysis. Further, more guidance is needed in distinguishing financial risk from insurance risk.

⁴ The ED also notes that insurance risk arises from the uncertainties about underwriting risk, which arises from uncertainties about the amount of net cash flows from premiums, commissions, claims and claim settlement expenses paid under a contract. Credit risk-related products may technically contain insurance risk as defined. However, “fortuitous” normally refers to events happening by chance or luck, such as a car accident, an injury, or untimely death of a business owner. Such risks are not characteristic of the risks arising from credit risk-related products.

⁵ A key distinction of credit risk is that it is actively manageable by the bank throughout the contractual life of the instrument. For all intents and purposes, insurance risk is not. For example, upon identifying potential specific impairment on an individual contract, the credit officer may restructure the terms of the agreement, including changes in payment terms and/or requiring additional collateral from the borrower/guaranteed party. In contrast, outside of fraud detection (including whether prescribed loss control programs are being executed by the insured), there is generally little an insurer can do to avoid the adverse event once the contract is executed.

⁶ Of course, if the financial instrument is indeed sold, the holder would often realize losses from declines in fair value – risks that are specifically noted as “financial risks.”

The following examples will assist the Board in understanding these comments, as banking products that appear to be captured in the scope of the ED are significantly different from other insurance products.

Standby letter of credit (SBLOC)

An SBLOC is significantly different from standard insurance contracts that are described in the ED.

- The typical insurance agreement has two parties: the insured (with a related beneficiary) and the insurer. The insured/beneficiary have a common insurable interest in the insured item/person (and, thus, should be considered as related parties) and pay insurance premiums to the insurer. An SBLOC is an instrument created in a transaction among three unrelated parties: a bank, a bank customer, and an investor. In contrast to the insurance product, in an SBLOC, the party with the ultimate insurable interest (the investor) does not pay an insurance premium (in this case, the premium would be the loan commitment fee). It is the bank customer that pays a commitment fee, and the presence of an SBLOC normally results in a lower credit spread in the bond issued to the investor. The “insurance transaction” is basically a private transaction between the bank and the bank customer and can be thought of as collateral by the bond investor. The “policyholder” is the bank customer, not the investor.
- Insurance claims normally result in a cash payment recorded as a loss (or loss payment) by the insurer with no required continuing involvement by the insurer. In contrast, the claim arising from the contingent event in an SBLOC results in a loan by the bank to the banking customer – an asset by which the bank earns interest.
- Insurance losses (or loss payments) are typically the cash used to settle a claim and are contractually defined. An SBLOC is often fully collateralized, with no expected loss to be realized.

In other words, the SBLOC is effectively a loan commitment between a bank and its customer. Draws on an SBLOC result in recording an asset (and not in recording a loss).⁷ While the table on page 85-86 notes instances in which an SBLOC may be considered outside the definition of an insurance contract, the distinction between what is in scope and out of scope is very confusing.

Liquidity facilities (and auction rate securities guarantees, where applicable⁸)

Liquidity facilities also have features significantly different from insurance products.

⁷ A contingent loss is currently provided for under ASC 450 prior to funding the SBLOC.

⁸ Auction rate security programs normally did not include contractual guarantees at the outset of the program, though certain dealers eventually bought back certain securities upon failed auctions and have bought back securities as part of legal settlements. However, a guarantee that would apply to such program would follow the same general principles as with a liquidity facility.

- Insurance claims normally result in a cash payment recorded as a loss by the insurer. In contrast, within a liquidity facility, the claim arising from the contingent event normally results in the bank purchasing a security from the insured party. As with an SBLOC, an asset is recorded on the balance sheet of the bank (which earns interest), rather than a loss.⁹
- Settlement on many liquidity facilities can be based on financial risks, such as the decline in market price due to market illiquidity. While defaults experienced within the underlying assets of the security may have occurred, the payment waterfall structure of the security may prevent actual security-based defaults. Nonetheless, market liquidity can still cause the facility guarantees to require execution. In other words, it is a market value change (and not necessarily the credit guarantee) that appears to be the insurable event.

Despite the fact that the settlement of the claim results in an asset on the bank's balance sheet, within the table on page 79 of the ED, it is the sale of a beneficial interest at a loss that is stated to represent the triggering event. It is unclear why such a sale, which results from the change in a financial instrument price, does not represent financial risk and is, thus, considered an insurance contract.

Guarantees related to trust preferred securities (TPS)

Guarantees made by bank holding companies related to TPS are normally to ensure that the available amounts that have been placed into the related trust for the payment of dividends are, in fact, actually paid to shareholders. Such guarantees of the TPS structure are necessary from a tax and regulatory aspect, and connect the bank holding company to the TPS holder. In practice, however, they amount to the standard guarantee that a company makes when issuing debt or preferred stock. If it is the intent that such guarantees are to be considered insurance contracts, we recommend that this issue be addressed comprehensively within a separate project on promises to pay made within debt and equity instruments.

Loans sold with recourse or indemnification provisions

It is common for financial institutions to sell loans with a recourse or indemnification provision in the sales agreement. If specific loans experience default or other adverse events, recourse provisions require the loans to be purchased back by the seller, while indemnification typically requires certain payments to be made. Though not included in the table on page 76-88, under the guidelines of the ED, it appears that within these transactions, a third-party (the seller) is making a guarantee to the policyholder (the buyer) on the credit of the borrower.¹⁰ Therefore, such sales would apparently qualify as insurance contracts.

⁹ Since liquidity facilities normally purchase the securities at above-market prices, a realized loss is also recorded at the time of purchase. This loss, under current accounting standards, is estimated and accrued prior to acquisition.

¹⁰ Under the ED, a guarantee of an entity's own performance does not qualify as insurance risk. The risk arising from sales with recourse or indemnification, however, does not include the failure of the entity to perform prescribed underwriting procedures (as in the representation and warranty clause included in many loan sales), but typically includes only whether the sold loan defaults or not.

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To include recourse and indemnification provisions within the definition of an insurance contract would require changes to Topic 860-20 (Sales of financial assets) and we do not believe that it is the intent of the Board to make such changes.¹¹ Consistent with our discussion above, these provisions are credit risk-related and, thus, more appropriately considered to be financial risks.

Merger and acquisition guarantees

The majority of merger and acquisition transactions have some kind of contingency in which future payments are required by either of the parties. As described in the ED, it is not clear that such guarantees are sometimes provided by the acquirer or a third-party, and are not limited to sellers. In the event the guarantee is provided by the acquirer, such a guarantee would appear to be out of the scope of insurance risk, as it relates to “own performance.” In the event this represents a third-party guarantee, it appears to be equivalent to a standby letter of credit, which (as noted above) does not transfer “fortuitous risk”, does not transfer risk between the policyholder to the guarantee provider, and merely represents a loan between the acquirer and the guarantor.

In summary, we strongly recommend that credit risk, which does not result in fortuitous events, be considered a financial risk within the ED, disqualifying most banking products from the definition of insurance contract.

Thank you for your attention to these matters and for considering our views. Please feel free to contact me (mgullette@aba.com; 202-663-4986) if you would like to discuss our views.

Sincerely,



Michael L. Gullette

¹¹ Currently, the recourse liability assumed during a sale of a financial asset is recorded at fair value (as opposed to the net present value of cash flows). Therefore, at a minimum, the measurement basis of such liabilities will require change.