WELLS FARGO

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Via email

Russell G. Golden, Chairman
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, Connecticut 06856-5116

Re: File Reference No. 2013-290, *Insurance Contracts (Topic 834)*

Dear Mr. Golden:

Wells Fargo & Company (Wells Fargo) is a $1.5 trillion diversified financial services company providing banking, insurance, investments, mortgage, and consumer and commercial finance. We appreciate the opportunity to comment on the FASB's Proposed Accounting Standards Update, *Insurance Contracts (Topic 834)* ("the proposed guidance") as we are engaged in many business activities which include instruments that are accounted for as insurance under existing U.S. GAAP standards and instruments that are financial-type products that may be included in the scope of the proposed guidance.

<u>Executive Summary:</u>

We appreciate that the FASB has worked with the IASB to develop a standard for insurance contract accounting and hope that the two Boards continue to work together to produce high quality accounting standards in each of their joint projects. We acknowledge that the IASB does not have a comprehensive insurance standard and even though the Boards have jointly deliberated the standards, the proposed guidance from each respective Board is not converged and would result in significant changes to existing U.S. GAAP. This lack of convergence is most apparent in that financial guarantees are excluded from the IASB's insurance exposure draft but included in the FASB's exposure draft. In addition, differences in revenue recognition exist for similar instruments scoped into each Board's proposal. For example, the margin is arbitrarily fixed and amortized into income under the FASB approach but continuously updated under the IASB proposal. While we understand the IASB's urgency to issue a standard for insurance contracts, we urge the FASB to fully consider the implications of changing the long-standing guidance for insurance and financial contracts scoped into the proposed guidance, especially when convergence is not achieved as proposed. Given the fundamental changes in accounting for financial contracts proposed by the FASB, we have focused our comments on the scope and potential implications to such instruments.

We are not convinced that the current U.S GAAP accounting framework for traditional banking products requires the significant changes the FASB is proposing. These instruments, largely consisting of financial guarantees, are initially accounted for at fair value and updated over time as the risk profile changes, in accordance with ASC 460, *Guarantees*, and ASC 450, *Contingencies*. We believe the existing accounting framework provides an effective and well-understood model for measuring and reporting the nature and risks inherent in such instruments. While we acknowledge the subsequent measurement guidance under ASC 460 is less prescribed than the initial measurement guidance, we believe practice has developed to provide a consistent reporting and accurate reflection of risk. This practice is supported by the long-standing acceptance of such disclosures by the investment community evidenced by the lack of investor feedback or outreach efforts indicating dissatisfaction or misunderstanding of such disclosures.

We understand the proposed guidance will require entities to measure and characterize as insurance, many traditional banking products such as standby letters of credit and other similar obligations consisting of liquidity facilities, guarantees, representations and warranties, indemnifications, and other similar arrangements. The proposed guidance will unnecessarily change the complexion of the financial statements through the creation of new accounts, changes in geography, as well as grossing up the balance sheet. These financial arrangements have significant differences in risk exposure, cash flow characteristics, risk management, and business rationale compared to traditional insurance products. For this reason, in part, is why the IASB scoped financial guarantees out of their proposed insurance contracts guidance[1]. Given it is anticipated that the measurement of the earnings impact for these instruments under the proposed guidance will largely be consistent with the current accounting framework, we do not believe it is necessary to fully replace the existing accounting framework with a significantly more complex and opaque accounting model.

The proposed definition of insurance risk is too broad as the scope of the proposed guidance includes financial instruments and contracts that are not subject to insurance risk or where insurance risk is only incidental. For example, we believe credit risk is a form of financial risk rather than insurance risk. We encourage the FASB to consider whether instruments primarily underwritten based on the credit-worthiness of a customer or guaranteed party should be insurance as credit underwriting is a distinguishing feature of a lending relationship. Accordingly, we believe all forms of credit risk should be included in financial risk and excluded from the insurance accounting framework. Credit risk is best reflected within the financial statements along with other financial instruments that have a similar risk profile. While the proposed guidance attempts to differentiate between these types of contracts by separately defining insurance risk from financial risk, we believe the delineation is not clear and does not fully contemplate the features necessary to differentiate these products. For example, a credit rating down grade which is clearly financial risk and scoped out of insurance accounting is not significantly different from other forms of credit risk and related default risk which are included within the scope of the proposed guidance. Credit risk is generally considered the likelihood of a borrower or counterparty failing to meet its contractual obligations. This risk is not fortuitous as it can be actively managed over time by restructuring exposures, adjusting collateral maintenance requirements, and other similar actions. As such, credit risk should be scoped out of insurance accounting.

Performance under an insurance contract typically results in the recognition of a loss by the insurer equal to or close to the amount paid to the insured party, even if the insurer is able to recoup some value from an insured asset[2]. Traditional banking products typically provide recourse or an expectation of repayment from the customer or guaranteed party that has significant value. For example, performance under these contracts typically result in an immediate reimbursement to the lender/ guarantor, an origination of a loan, a right to liquidate collateral, the acquisition of an asset, or other means to recover amounts from the customer or guaranteed party. These recourse provisions are generally not present within insurance products and significantly alter the risk profile of traditional banking products compared to insurance contracts. Under the proposal, instruments with these recourse provisions are measured on a net basis[3], which may result in inappropriately expensing certain cash outflows prior

[1] Basis for conclusions of IASB insurance exposure draft, paragraph BCA 185
[2] For example, an auto insurer may recover the salvage value of an automobile that has been damaged beyond repair.
[3] Contracts under insurance guidance will be measured based on all expected cash inflows and outflows which would include payments made to acquire or originate an asset, even if that asset survives the contractual arrangement subject to insurance accounting and held as an investment.

to funding the origination or acquisition of an asset. For example, if performance under a contract results in the origination of a loan, it is unclear if estimated cash outflows should be limited to expected credit or market value losses related to the potential future asset or the principal amount of the loan. We believe the cash outflows should be limited to the expected credit or market value losses; however, this exposure is already adequately and timely accounted for under ASC 450 or other applicable literature. We believe this complex measurement model misstates the risk profile of such instruments and encourage the FASB to reconsider whether such instruments should be included in the scope of the proposed guidance.

The proposed guidance also significantly complicates the recognition and measurement of these instruments as future cash inflows and outflows must be determined on a probability-weighted basis. This method is significantly more complex than the current accounting model as traditional banking products and similar obligations are typically entered at or near market terms resulting in little or no initial value of the instruments and obligations. Estimating future cash inflows and outflows will require considerable effort that will largely result in a similar measurement amount achieved within the current accounting model. We believe this complexity is unwarranted.

For these reasons, we do not understand why the FASB has chosen to replace the existing accounting framework with a more complex accounting and reporting model that is so distinctly disconnected from the underlying risks of these financial products. We encourage the FASB to retain the current framework and address any deficiencies through targeted improvements or inclusion in the financial instruments project. If the FASB continues to include these instruments within the scope of the proposed guidance, we believe further evaluation of the fundamental differences in instrument level characteristics should be addressed within the accounting framework along with the incorporation of a business model concept, similar to that within the proposed guidance for financial instruments. We believe a business model concept supplemented with a clear definition of insurance risk and financial risk would provide a better means of differentiation between financial contracts and insurance contracts.

Our specific comments and additional suggestions for improvement to the proposed framework are expressed more fully below.

Concerns with the Proposed Guidance:

Our concerns with the proposed guidance are as follows:

- **Definition of insurance risk is too expansive:** The proposed guidance includes financial instruments that have a much different risk profile compared to traditional insurance contracts. While many financial instruments have features similar to insurance risk, they primarily involve elements of credit risk. These contracts are underwritten and issued at terms that reflect the credit standing of the customer or quality of collateral posted, if any. It is misleading to characterize credit risk as insurance risk as the financial instruments scoped into the proposed guidance differ significantly in their risk management and form taken in the marketplace. This is evidenced by the various credit-related instruments and obligations available in the marketplace, which are currently disclosed in a consistent manner reflective of their risk profile. Moreover, we believe the Board's definition of financial risk is incomplete as it considers only certain elements of credit risk, e.g., changes in credit ratings or indices. Market participants consider credit risk as a financial risk and believe that a fundamental element of credit risk includes the "risk that an entity will suffer a financial loss if its customers, clients or market counterparties fail to meet a payment obligation under a contract", which is the risk of credit default[4]. We believe classifying such credit-related instruments as insurance contracts contradicts the nature of the instruments and misaligns the accounting model from well-established risk management practices. Moreover, accounting for credit risk within insurance accounting and separately in

[4] "Enhancing the Risk Disclosures of Banks, a report of the Enhanced Disclosure Task Force" dated October 29, 2012

credit loss guidance is unclear and confusing to apply. If the Board does not want to undertake targeted improvements to the existing accounting guidance, we recommend that the Board include such instruments in the credit losses component of the financial instruments project.

- **<u>Instruments with recourse provisions should not be insurance:</u>** One of the principles inherent in insurance is the transfer of risk from one party to another without expectation of substantial recovery. This generally manifests itself in the form of an insurance contract between a policyholder and an insurer whereby a payment is made by the insurer in the event a specified future event ("claim event") occurs. These arrangements transfer the risk of loss due to an occurrence of a claim event from the policyholder or its beneficiary to the insurer. For traditional insurance contracts, the insurer typically would not obtain collateral and the insurer would not recognize an asset of substantial value upon the occurrence of a claim event, resulting in a potentially significant loss experienced by the insurer. However, many financial instruments do not result in a total or near total loss to the insurer as they often require direct reimbursement or receipt of an asset, which significantly mitigates any potential future losses, if any. For example, certain liquidity facilities provide protection from loss in the event of a failed remarketing of an issuer's debt or a debt instrument is downgraded beyond a specified level. The provider of the liquidity facility does not incur an insurance loss under these types of arrangements. Even though a loss may be incurred the risk of loss is assessed in context of the credit quality or market value of the underlying asset received and the quality of the issuer. We believe any anticipated loss is appropriately and timely accounted for under existing GAAP, whether the facility is accounted for at fair value or as a loss contingency in accordance with ASC 450. We believe replacing existing well-understood and guidance with the proposed guidance will create an unnecessary and confusing dichotomy for financial instruments.

- **<u>Arrangements uncharacteristic of insurance:</u>** To further illustrate our concerns, we have provided the following examples of instruments and obligations that have conceptual inconsistencies with insurance. We believe financial instruments that are largely dependent on credit or market events should not be classified and disclosed as insurance contracts due, in part, to the significant differences in risk and economics of these financial products. Additionally, certain indemnifications and representations and warranties should not be subject to insurance accounting as they are often incidental to other transactions but provided to facilitate common marketplace trading. We have addressed the following specific arrangements described in the proposed guidance in ASC 834-10-55-40:

  - <u>Standby letters of credit:</u> These contracts are issued by financial institutions on behalf of a customer to a third party (known as the beneficiary), which allows the instrument to be drawn by the beneficiary based on specified terms and conditions (e.g. nonperformance by a customer or credit ratings changes of a customer). These agreements are underwritten, originated and monitored using our credit standards in the same manner as our loan receivables. These lending-related commitments expose the issuer to credit risk as any amount drawn must be immediately reimbursed by the customer, or if remaining outstanding, there would be a loan receivable from the customer. Standby letters of credit generally expire unused. Standby letters of credit are accounted for as guarantees in accordance with ASC 460, but the contingent portion of the guarantees is accounted for under ASC 450, which results in an allowance for unfunded commitments. Under current accounting, the allowance for unfunded commitments includes an estimate for credit loss that may be incurred from the open lending availability on revolving facilities, standby letters of credit and commercial letters of credit. We do not believe it is appropriate to account for the credit risk associated with these commitments under the proposed insurance framework as we believe stand-by letters of credit are most akin to lending commitments. We strongly encourage the Board to include standby letters of credit within the definition of loan commitments subject to the recent proposal on credit losses.

  - <u>Indemnifications</u>**:** We generally provide indemnifications to counterparties as part of larger business transactions. These indemnifications are typically incidental elements of a transaction in which certain assurances are provided the counterparty to execute many transactions and are often standard terms not specific to a particular counterparty. These indemnifications are pervasive throughout a multitude of our contractual arrangements to third parties, but rarely result in a loss. These types of indemnifications range from providing remedies in the event of tax law changes or changes in interpretation to supporting the on-going solvency of the seller. These indemnifications will be difficult to assess as they are often combined with other standard representation and warranties which would be scoped out of insurance accounting if considered an indemnification of one's own performance. The inclusion in the proposed guidance would require review of thousands of contracts to identify and differentiate such provisions. Additionally, we do not believe the earnings impact from application of the proposed guidance would be significantly different than the current accounting. Accordingly, an accounting change for indemnifications is not necessary.

- Representations and warranties**:** Most financial instruments require representations and warranties to be provided by the seller to the buyer for many types of financial assets. For example, representations and warranties are provided from the initial originator of a mortgage loan to the buyer, often times a securitization trust, and then those same representations and warranties are provided to buyers of the securities issued by the securitization trust. It is unclear whether these representations and warranties would be considered insurance if the sponsor of the securitization was the same as the loan originator. These representations and warranties are assessed at the time of sale, reserved for at fair value upon transfer, and subsequently updated for credit events over time as events and expectations change. In the event these types of arrangements are considered insurance, different accounting and presentation would result for similar arrangements depending upon which party provided the representation and warranty.

  We also offer guarantees on securitized assets and whole loan sales through our normal business activities. These guarantees often take the form of recourse provisions provided to buyers protecting them from credit events, such as default or that certain underwriting procedures were performed. To the extent these provisions relate to own performance risk, they should be scoped out of the proposed guidance. We are concerned about the inherent conflict with the initial recognition and measurement guidance in ASC 860[5] which requires initial measurement of these provisions at fair value. Subsequent measurement is appropriately and timely accounted for based on ASC 450. As a related matter, if such provisions are included in a transfer of financial assets that do not qualify for derecognition, does the Board intend for such provisions to be separately accounted for under the proposed guidance? We believe existing GAAP is a superior measurement model to the proposed guidance for these provisions.

- Auction rate securities guarantees: These arrangements often require the guarantor to purchase specified assets upon certain events occurring, such as a failed remarketing. This often results in the receipt of an asset that has significant value which may be used to fully recover any loss temporarily incurred by the guarantor. This is vastly different from an insurance contract where any asset obtained has value that is severely impaired and unlikely to meaningfully mitigate losses. Additionally, we are not clear on whether the example is meant to address explicit remarketing obligations made in contractual arrangements or possible implicit support made to retail customers in the event of a market event. If the implicit support is the primary concern, even more arrangements than originally anticipated may be within scope of the proposed guidance given various implicit, uncommitted obligations. These, along with other types of liquidity facilities sometimes require fair value accounting which we believe is a superior measurement for such arrangements.

- Trust preferred securities: These securities are issued from off-balance sheet trusts generally backed solely by subordinated debt issued by the sponsor. The sponsor reflects this subordinated debt as a liability on its balance sheet and often provides a guarantee to the holders of the preferred securities specifying that the

[5] FASB Codification on Transfers and Servicing

contractual payments will be paid to the holders of the securities. We believe such guarantees are "in-substance" indemnifications of the sponsor's own performance should qualify for the scope exception for own performance risk. Moreover, the value that could be ascribed to this guarantee is embedded in the debt obligation recognized on the sponsor's balance sheet. Accordingly, it is unclear if the Board intended the embedded performance guarantee to be bifurcated and accounted for separately from the debt obligation.

While we appreciate the guarantees information provided in the proposed guidance, we request that the Board provide further explanation of the guarantee scope conclusions offering a clear understanding of the circumstances and logic used in reaching the conclusions

- **The use of inconsistent measurement methods for similar contracts is confusing:** The FASB's proposed guidance requires different measurement depending on the length of the coverage period. The Premium Allocation Approach ("PAA") is required for instruments one year or less but requires the Building Block Approach ("BBA") for instruments with longer tenors. We are concerned that this will create disparate treatment for similar contracts. While we appreciate the FASB providing an operationally less burdensome approach (the PAA), we think the same model should be applied to similar contracts regardless of tenor. As a financial institution, an instrument or obligation may have a term of more or less than one year. We do not believe that it is an improvement to financial reporting to have different accounting methods for similar contracts based solely on the term of the instrument while there is no difference in the underlying economics. While the FASB has allowed for the use of the PAA if significant variability in expected cash flows is unlikely, it is unclear how to apply this "significant variability" criterion. We request that the FASB clarify the requirements for usage of each of the proposed models.

- **Measurement method is not improved under proposed guidance:** The proposed guidance casts aside well-established, supportable valuation of financial instruments that would now be insurance contracts. We do not believe that the measurement method in the proposed guidance, which is based on probability-weighted discounted cash flows, is always necessary or results in better measurement than current practice. Financial instruments are typically issued at market terms at inception of the contract, which results in minimal to no estimated fair value to the instruments. Industry practice has developed for the subsequent measurement of such instruments, which largely consists of releasing the liability over the life of the instrument as the risk declines. We do not believe that we should record the instrument at a value other than fair value when it is readily determinable based on market and industry standards. In addition, many financial instruments (e.g. liquidity facilities, financial guarantees) may be accounted for as derivatives because the institution is required to purchase an asset at a price that exceeds the fair value. If derivative accounting is not applicable, then the institution would recognize a contingent loss when probable[6], which mirrors the derivative accounting at fair value. We believe the current measurement approach reflects losses timely and accurately and is superior to the proposed guidance.

- **The proposed guidance would result in a gross up of the balance sheet:** If we are required to apply the proposed guidance to many of our financial instruments, we would expect to use the PAA for a significant portion of our portfolio. This method requires the lifetime of expected premiums (e.g., fees for certain financial instruments) to be included in the value of the insurance liability at the inception of the arrangement. The calculation of PAA results in a higher value than fair value. We believe a similar result would occur for contracts under the BBA, except it may be to a lesser extent as expected cash inflows are offset by expected cash outflows. Accordingly, under both measurement models, we believe this increased value of the contract would inappropriately gross up the balance sheet and create a misleading value for the contracts. We believe

[6] In accordance with FASB ASC 450

these amounts are not a reflection of the true value or risk inherent in such financial contracts and we request the Board to reconsider whether this measurement model is relevant.

- **Bifurcation process for non-insurance components is complex:** The proposed guidance requires the bifurcation of certain derivatives, distinct investment components, and distinct performance obligations from the insurance contract. While there is considerable existing guidance for bifurcating derivatives that are not clearly and closely related to their host instrument, there is little guidance provided on the mechanics of how to perform such an accounting analysis for these other components. The proposed guidance indicates when to bifurcate and what characteristics should be present, but we believe further implementation guidance is necessary. For example, it is unclear how to adjust fulfillment cash flows of the insurance contract for the bifurcated component(s).

- **Presentation and disclosure will be misleading:** It appears the disclosure requirements were clearly written for insurance companies with large portfolios of homogeneous instruments. However, for non-insurance companies, the proposed guidance will result in a gross up of the balance sheet for many instruments and reflect contracts in a manner inconsistent with the risk management and business practices of financial institutions. This will likely confuse users of the financial statements and misrepresent the nature of our arrangements. We are also concerned about the inconsistency created between our Management Discussion and Analysis and our footnotes as the proposed guidance will require non-insurance companies to have substantial footnote disclosures related to insurance contracts.

- **Implementation and transition costs will be substantial:** Considerable effort will be required to evaluate many of our financial instruments under the complex measurement models outlined in the proposed guidance. As a result of the broad definition of insurance risk, it will be necessary to evaluate a significant number of instruments. As one example, we have approximately 20,000 separate standby letter of credit contracts across several lines of business. These contracts are not homogeneous in nature as they are highly customized based on specific terms and conditions unique to each customer and their particular financial or performance risk. Given the expanded scope of insurance contracts, the initial evaluation of our contracts and whether they are insurance-related will be both costly and challenging. The Board has increased the complexity by requiring retrospective application. We encourage the Board to consider ways to simplify the transition process, including consideration for a practical expedient or a modified retrospective application as proposed in the Board’s Proposed ASU on Leases (Topic 842).

Conclusion:

While we support the FASB’s work with the IASB on the joint projects, we are concerned that the expansion of the scope of the insurance project to non-traditional insurance arrangements will result in an inferior and more complex accounting model. We do not believe the proposed guidance achieves a better accounting framework for financial products agreements as such instruments are underwritten, entered into, and managed differently than insurance contracts resulting in misleading disclosure. The proposed changes will be widespread and will not be beneficial to either users or preparers, especially due to the dramatic increase in the number of well-understood traditional banking products and customary contractual arrangements that will be subject to insurance accounting under the proposed guidance.

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We appreciate the opportunity to comment on the issues contained in the Boards' invitation. If you have any questions, please contact me at 415-222-3119.

Sincerely,

/s/ Richard D. Levy

Richard D. Levy
Executive Vice President & Controller

cc: Hans Hoogervorst – International Accounting Standards Board
Kathy Murphy - Office of the Comptroller of the Currency
Robert Storch - Federal Deposit Insurance Corporation
Steven Merriett - Federal Reserve Board
Donna Fisher - American Bankers Association
David Wagner – The Clearing House Association