

Memorandum to Wayne Upton and Peter Clark from Paul McCrossan
Concerning the Supplement to the Second Joint Report of the ACLI – IAA
Research Project

In the Supplement to the Second Joint Report of the ACLI – IAA Research Project that was discussed with IASB staff and selected Board members in London, the ACLI and IAA representatives demonstrated the potential bias in reported earnings and equity when assets and liabilities are measured inconsistently. In the Supplement, a simple amortization method was proposed to deal with illusory earnings from asset sales that did not reflect the underlying “business reality”. *This memorandum shows that the amortization adjustment has a strong theoretical underpinning rather than being created as an earnings smoothing device or an earnings deferral device.*

While I was unable to attend, in person, the educational session held with the IASB’s staff and selected Board members, I did hear that comments had been made to the effect that it did not make good accounting sense to keep track of an asset that had been sold. (In fact, I was told that the comment was more to the effect that “Hell would freeze over” before accounting would be sanctioned to keep track of an asset that had been sold.)

In my role in the ACLI – IAA project, I may have inadvertently contributed to the consternation expressed by IASB staff. This is because, as explained below, I suggested we choose to illustrate the results for a financial intermediary that tightly manages its exposure to interest rate risks by investing its moneys in a security that exactly replicates the cash flows of the underlying financial liability i.e. for a company that fully hedged its potential interest rate risk. There were several reasons for making this assumption – the most important of which was to avoid “contamination” of the accounting illustrations by gains or losses from asset / liability term mismatch in a changing interest environment.

Thus, the use of the 20-year Treasury bond asset served several different purposes in the Supplement.

1. In the falling interest rate environment since 1996, for a company that had fully hedged its interest rate risk, it demonstrated that the equity that would have been reported (had the asset not been traded) would have been “illusory” and would have solely been the product of inconsistent asset and liability measurement.
2. It also showed that even when the original matching asset was sold at a gain and replaced by a new bond purchased at par (with an interest rate reflecting the new interest rate environment) of the same term as the remaining term of the bond sold, both the “profit” and the “equity” that would have been reported would not have reflected “business reality” and would also have solely been the product of inconsistent asset and liability measurement.

Note that, in the case of an asset sale at MV, the inconsistency still arises from the way the assets and liabilities are measured – but in a slightly different manner than it arises when the asset is not sold. On sale, the asset is measured at market for earnings purposes as well as for equity purposes (i.e. at the sale price). However, the liability is still measured at amortized cost. What is missing in order to make the asset and liability measurements consistent at the point of sale is the value of the underlying interest rate guarantee for the financial liability measured on the same market basis.

*How should the value of the underlying interest rate guarantee be measured to ensure consistency? Since the 20 year Treasury bond is the asset that replicates the liability cash flows exactly at all times during the life of the liability, **the MV of the underlying interest rate guarantee always has to be measured with reference to the replicating asset whether or not it is held.** Once this is recognized, the fundamental reason for the “illusory” equity and profits can be seen to be that the value of the interest rate guarantee underlying the hypothetical contract illustrated in the Supplement is not recorded in the balance sheet.*

This issue is not new to the Board. In its February and March Board meeting discussions, the IASB Board recognized that, in phase 1, the liabilities associated with embedded options and guarantees such as guaranteed annuity options, guaranteed minimum death benefits and minimum interest rate guarantees would not be reported on the balance sheet. Because of concerns that the readers of financial statements needed to be aware of the magnitude of these items, the Board decided to require these amounts to be disclosed on the Notes to the financial statements. These discussions are reflected in paragraphs 29 and 30 of ED 5.

What may be new to the Board (and certainly was to me as we developed the case study used in the Supplement) was the linkage between the “cost” of these guarantees and the unrealized or realized gains on AFS assets. It was through the analysis of the case study that we recognized that there could be an alternative approach to the HTM asset category that would bring the accounting results into sync with the “business reality”.

Consider the following example (drawn from table S –1 of the Supplement) showing the balance sheet at duration 14 when the asset is recorded as AFS and the liability is recorded at AC (the asset is not sold).

Asset		Liability	
Bond (BV)	1,000,000.00	Financial Instrument (AC)	1,000,000.00
Excess MV (AFS)	94,843.32	Equity	94,843.32

Contrast this with a balance sheet that records the market value of the interest rate guarantee as a liability.

Asset		Liability	
Bond (BV)	1,000,000.00	Financial liability (AC)	1,000,000.00
Excess MV (AFS)	94,843.32	Interest rate guarantee MV	94,843.32
		Equity	0.00

This simple example shows that, consistently measured, the equity would always be zero. The reason that the AFS method generates illusory equity in effect is that it “takes credit” for the increase in market value of bonds due to falling interest rates – while failing to recognize the offsetting liability for the interest rate guarantee that has increased due to the very same fall in interest rates.

i.e., the “illusory” equity that emerges on the balance sheet when a liability is held at AC and the (matching) asset is held as AFS is solely due to the non-symmetrical (i.e. inconsistent) measurement of assets and liabilities.

Consider, now, sections 13 and 14 of the Supplement that illustrate the effect of an AFS bond sale at duration 3. It can be seen that, just before the bond is sold, the MV of the \$100,000 par bond was \$112,337. It can also readily be seen that the increase in the MV of the interest rate guarantee was also \$12,337.

This leads to the following balance sheet **just before sale of the bond** under phase 1 as proposed (when asset and liabilities are inconsistently measured).

Asset		Liability	
Bond (BV)	100,000	Financial liability (AC)	100,000
Bond (excess MV)	12,337	Equity	12,337

Now, consider the case **immediately after the bond** is sold at duration 3 (at a gain) and the proceeds are reinvested in a lower coupon bond for a higher principal amount. In this case, under proposed phase 1 accounting, the financial intermediary would have shown capital gain income of \$12,337.

Asset		Liability	
Bond (BV)	112,337	Financial liability (AC)	100,000
Bond (excess MV)	0	Equity	12,337

However, note that, if the MV of the interest rate guarantee were recorded as a liability, the balance sheet would have been as follows.

Asset		Liability	
Bond (BV)	112,337	Financial Liability (AC)	100,000
Bond (Excess MV)	0	Interest rate guarantee	12,337
		Equity	0

*When the liability is measured at amortized cost, the unrecorded value of the interest rate guarantee is always the difference between the financial liability recorded (in this case 100,000) and the market cost of purchasing an asset that perfectly replicates the cash flow characteristics of the financial liability (in this case 112,337). **Note that, since liability measurement is independent of the assets actually held, the MV of the interest rate guarantee does not change because of the sale of the replicating asset.***

Viewed in this way, when we pointed out that the financial results would always reflect “business reality” if the difference in cash flows between the asset sold and the asset purchased were to be amortized over the remaining lifetime, **we engaged in a netting process that may not have been obvious to the IASB.**

Here is my explanation of the netting process. The unrecorded liability for the interest rate guarantee should always be measured with reference to the MV of the replicating asset (with interest rate payments of \$6,650 per annum). The MV of the replacement asset should always be measured with respect to its interest payments of \$6,158 per annum.

Since each of the annual interest payments is always subject to the same discounting factor at each duration, we amortized the net difference in interest payments of \$492 to reflect the “business reality” that no income and no equity should be recorded. [I note (for completeness) that we used the equivalent level interest rate in our example rather than the theoretically more correct spot rates to discount at each duration since there was no material difference in the calculation from the use of the much simpler level interest rate factor.]

If it makes it easier to look at the balance sheet with the netting unwound, this could easily be illustrated by generating the income statements and the balance sheet for each of the remaining years.

In summary, the illusory earnings that emerge on the balance sheet when a liability is held at AC and a (matching) asset held as AFS is sold and replaced by another security with the same term is entirely due to the non-symmetrical (i.e. inconsistent) measurement of assets and liabilities.

Conclusion

In our Second Report, we demonstrated that inconsistent measurement of assets and liabilities could lead to “financial noise” being introduced into the financial statements of financial intermediaries. In our Supplement to the Second Report, we demonstrated that, even under a stable interest rate scenario, inconsistent measurement of assets and liabilities could lead to financial noise being introduced into both the reported equity and profit and loss numbers if a significant proportion of a financial intermediary’s assets were designated as AFS. In this memorandum, I have tried to demonstrate that the nature of the inconsistency in using AFS assets combined with AC (or logically consistent) liabilities is the inconsistency involved from recognition of FV changes in the asset side combined with ignoring the FV changes in the underlying interest rate guarantee on liability side of the balance sheet ***whether or not the asset is sold.***

I know that the IASB has been aware of the problems from inconsistent measurements of assets and liabilities since I was present when the Board twice discussed the impact of not recording major sets of financial liabilities (e.g. guaranteed annuity options, guaranteed minimum death benefits and minimum interest rate guarantees) on an AC basis in Board meetings this year. The Board tentatively decided to deal with the lack of recording of these financial liabilities solely through the mechanism of balance sheet disclosure rather than alternative profit and loss calculations.

In view of the “illusory” earnings and equity that could be recorded during phase 1, I question whether this is an adequate response. In a declining interest rate environment, illusory increases in equity and earnings will be shown in the main financials. The offsetting items not reported on the balance sheet will only be shown in the Notes to the financial statements. In a rising interest rate environment, falling (or negative) equity could undermine confidence in a sound financial intermediary.

I believe that our research has demonstrated that assets designated as AFS, even if not traded, **cannot** produce equity that reflects reality when liabilities are designated as AC. Nor, can they produce earnings that reflect reality if the liabilities are designated as FV. Finally, I believe we have demonstrated for a company that chooses not to expose itself to interest rate mismatch risk that, when assets designated as AFS are traded, **neither earnings nor equity reflect “business reality”** when liabilities are measured using AC (or logically consistent) methods.

In phase 1, most national insurance accounting standards will use liability measurement methods logically consistent with AC methods. The ACLI and the IAA do not understand the accounting policy reasons that led the FASB and

IASB to impose barriers to the designation of non-equity assets as HTM for a financial institution i.e. the requirement of the intention to hold to maturity and the ability to hold to maturity combined with a “tainting” of the HTM portfolio if an HTM asset is sold. Neither do I – especially when most of the liabilities of financial intermediaries can be (and are) still measured on bases logically similar to amortized cost.

Proposed Solution

Our work suggests that allowing financial intermediaries to have easier access to a slightly modified HTM asset category can result in assets and liabilities that are more consistently measured. For financial intermediaries that are well matched, the amortization of the gain on sale of an asset over its remaining term to maturity is a, simple, practical solution to mitigate against the illusory earnings and equity that would otherwise result if insurers designate major proportions of their assets as AFS during phase 1 (or beyond).

As demonstrated (I hope) above, the purpose of the amortization is neither to “smooth” income nor to “defer” income. Rather, it is to have earnings and equity reflect the “business reality” that would occur if assets and liabilities were measured on consistent bases.

Finally, there is an issue of how to properly reflect the interest rate risks taken when insurers’ assets expose the insurers to significant interest rate risk. I would be happy to discuss this issue with you in the future. However, as I indicated to Peter when I was last in London, I feel that disclosure of sensitivities to interest rate movements (and to continuation of current interest rates) may be the best way to produce meaningful financial statements to serve the needs of the stakeholders given the Board’s decision to have assets measured on three different (and mutually inconsistent) bases for the indefinite future.