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CAN ACCOUNTING KEEP UP?

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Recorder: PAUL H. LEFEVRE

- Collateralized mortgage obligation (CMO) structures
  - Changes in prepayment speeds
  - Interest-only (IO's) and principal-only (PO's) – *Statement of Financial Accounting Standards (SFAS) 91* and Emerging Issues Tax Force (EITF) 89-4
- Derivatives
  - Interest rate caps/floors
  - Off-balance-sheet items/*SFAS 105*
  - Accounting for interest rate swaps
- Hybrid bonds
  - Commodity or index-related coupons or principal
- Federal income taxes – *SFAS 109*
- Fair-value disclosures – *SGAS 107*

MR. PAUL H. LEFEVRE: This session was conceived about a year ago, in response to the changes that had especially occurred on the investment side and the frustrations some of us felt in investing in instruments with unclear accounting. Since then, another part of this title should have been added: Can We Keep Up With The Accountants? FASB recently came out with *Financial Accounting Standard (FAS) 115* and I think that should go in the second title.

Peter Minton, a principal at Morgan Stanley, is an accountant. He'll talk a little bit about hedge accounting and accounting for swaps and some derivatives. John Nigh, a principal at Tillinghast in Atlanta and Mexico City, will talk about tax accounting. Bob Wilkins is the project manager on *FAS 115* at the FASB. Bob was basically responsible for the 115 project, and he's going to try to give us some history and some background, so that we can appreciate where it came from, what kind of compromises occurred, etc.

I'm from Keyport Life. I'll make a few introductory remarks as well as cover accounting for mortgage-backed securities. I think that we all realize that we're going through a time of very, very fast change. Insurance company products are changing very rapidly. Investment vehicles are changing very rapidly. I remember there was a discussion of collaterized mortgage obligations (CMO's) five or six years ago at a Society meeting. They were very simple instruments with only three tranches. They are now very complex structures with dozens of tranches.

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Derivatives have come out of their infancy. You can swap anything to anything now. There have been concerns about the various audiences for financial statements. There have been concerns about companies and their solvency. There certainly are concerns about off-balance-sheet types of instruments and how to recognize them. So, a lot is going on, and I believe it puts an awful lot of pressure on the accounting profession to keep up with. There have been some significant GAAP accounting changes: *FAS 97* for amortization of deferred acquisition costs and *FAS 96* on accounting for income taxes. We were probably the only company that went on *FAS 96* because it never really happened. It was replaced by *FAS 109*. *FAS 91* basically covers the accounting for mortgage-backed and other types of securities. And then we had *FAS 107*, which was on fair-value disclosure. Well, we now have 115, which is on fair-value reporting for the assets side.

What does all this mean? We need to understand all these accounting changes and methods because we are the people in insurance companies who are pricing products and dealing with the earnings and the emergence of earnings. The effect of these changes could be much different than what you might have projected when you priced a product or when you projected earnings. Many surprises can occur, and if management isn't tuned into some of the things, that can happen. In this session, the focus will be on GAAP accounting. I think it's very important to really understand that it is important to educate management and not have it surprised. One of the things that I have noticed at our company is that when the investment committee meets to discuss a new class of investments, the first question is, what is the accounting for? You find that if you're not careful, you end up making many decisions on the investment side, based on accounting implications. You need to be aware of some anomalies. There are different ways of doing the same thing that result in very different accounting. The example that surprised some companies was that there were companies that bought IO and PO separate trading of registered interest and principal of securities (STRIPS) that were from the same collateral and behaved, in total, the same way as Ginnie Mae's, yet the emergence of investment income on the combinations of IOs and POs as compared with the identical Ginnie Maes was very different.

You also need to be aware of the audience, and the audience for financial statements is the investing public, the Wall Street analysts, etc. Many of us are wondering how this audience is going to deal with market-value accounting on some assets and not others, and on only half of the balance sheet. I'm sure Bob will give us a little insight into that.

Mortgage-backed securities, and I include many of the derivative mortgage-backed securities in this, include instruments that can be very volatile in volatile interest rate environments. Many CMOs, such as PAC bonds, don't have a lot of volatility, and are designed to provide a fairly predictable cash-flow stream. But even those are starting to break their bands in the dramatic drop in interest rates that we've had. When you account for a CMO or a mortgage back that is bought at a discount or a premium, the approach is very similar to *FAS 97*. You calculate the expected cash flows at the time of purchase. You discount those cash flows and determine an internal rate of return that gives you the price, and then you report investment income forward by using that internal rate of return as the yield. For example, if you're reporting monthly, when you get to the end of the month, you book the principal payments and take your internal rate of return times the beginning balance and compare that to the investment income you actually collected. You either have a positive or a negative, which would be your amortization or accretion. Then, just like under *FAS 97*, you have a periodic unlocking, so to speak. You compare the actual cash flows to the expected.

Let's take a quarterly example. You get to the end of the quarter. You say that this amount is the expected principal cash flows. This is what they actually were. And then you reestimate the future expected cash flows, based on what has happened to interest rates. So now you have a new set of cash flows. So you go back to your initial calculation and you recalculate your internal rate of return and make a positive or negative adjustment to the book value of your security. Again, this is very similar to a *FAS 97* unlocking adjustment. And then you go forward at the new internal rate of return.

Now, in something like a PAC bond, that adjustment might not be very large. It might not happen at all. And in those cases, you don't have to do it very often. But in some of the more volatile types of instruments, such as support bonds, these adjustments can get very large and are very material to your bottom line, if you don't do this very often. The Emerging Issues Tax Force (EITF) 89-4 is sort of a subset of this. It really deals with IOs and high-risk CMOs. Under this approach, it's pretty much what I just described, but you don't go back to the beginning. When you calculate your new internal rate of return, you do it prospectively. So, instead of going back and having an adjustment at that point, an *FAS 91* adjustment, you calculate prospectively. Only you get a new internal rate of return and go forward. Now, with interest-only STRIPS, the catch there is that you can get a negative adjustment if you get to the point in which the internal rate of return on the remaining cash flows is negative, and that's not impossible. And so if that happens, then you do adjust your book value down until you get a zero internal rate of return.

The process of doing this is not easy. Most of you know this. It takes a significant investment in systems and in sources of information. If you have a large mortgage-backed or CMO block, you need to have a method to get your expected cash flows. Certainly, there are many ways to do this. There are systems. There are data sources. A very widely used one is Bloomberg, in which you can get consensus cash flows. You can get them from Wall Street because they are pricing CMOs. You really have to understand the CMO structures. It's very difficult to just look at the single tranche that you bought and fully understand the cash-flow implications. So, companies that are really heavy in CMOs should have the software and the data to look at the entire deal and be able to monitor what's happening to the cash flows in their part of the deal.

The typical investment accounting, the old-fashioned investment accounting tools that served our industry so well until recently, are way out of date for this. You need good tools and good accounting systems to do this. You have to decide how often you're going to do this. When you get into the CMO structures that do have a lot of volatility, you really have to do it security by security. I'm aware of some companies that attempt to model an entire CMO block with a proxy for a single bond. You can really get way off on that.

MR. PETER A. MINTON: I'm going to discuss the treatment of interest rate swaps, interest caps, and touch very briefly on hedge accounting.

Just by way of a primer, an interest rate swap is an agreement between two parties in which, in essence, what we've agreed to do is swap payments based upon some index. The most common type of a swap is when one party pays the fixed rate under this agreement and the other party pays a floating rate, again, most commonly, at this point, it probably is a London Interbank Offered Rate (LIBOR) floating rate leg. This is clearly the most simple form of the swap. Now that we've gotten into much more sophisticated option-pricing models, tax-dependent types of models, we can pretty much pick our own poison in this industry. We can do swaps on currencies, swaps on different parts of foreign-yield curves, and different parts of different foreign-yield curves. Entering into these swap agreements can get very elaborate but, in essence, it all does come down to. We're agreeing to do. We're agreeing to exchange payments based upon an index. An interest rate cap is basically an agreement, again, to swap payments. In this case, however, it is a cap or a floor. In the case of a cap, for example, we've agreed to exchange payments if, in fact, the floating-rate leg is above a specified strike level. So, it, in essence, is almost a cap. It is almost an option; a call-like or a footlike type of instrument.

The accounting for these types of instruments, in the case of swaps, is relatively straightforward, with only a few wrinkles, as usual. The basic idea of accounting for the swaps is, that they're, in general, off-balance-sheet items, at this point. There is disclosure of the items. But they are off-balance-sheet hems and, frankly, for statutory purposes, things like risk capital, potentially for the market-value accounting regulations that we're going to talk about, are also, at the moment, off the balance sheet. The accounting treatment for the most simple form of swap is, in fact, reasonably simple. You will recognize income or loss based upon the payments that are made at the time the payment is made. For example, I enter into a swap in which I agree to pay 6% as a fixed rate and I am going to receive the LIBOR. My first payment of rates doesn't move right at this point. In essence, I'm going to be a net payer on that swap. I'm going to pay 6%. I'm going to receive a net payment for the difference between the 6% leg and what's called a 350, for ease of math here. And, in essence, I'll recognize a loss through the income statement for the differential, based upon that interest rate differential and the notional amount of the swap. And that's another important distinction to make here: these are notional contracts. Therefore, no principal is involved. In essence, you're agreeing on a notional or a fictitious amount upon which all payments will be based. And so you are just simply receiving and recognizing as income or expense the net payment that flows between the two parties.

Interest rate caps and floors have become a little bit more complicated, and there is some divergence at times in how people account for these types of instruments. Again, there can potentially be some diversions between GAAP and statutory accounting practices (SAP), depending upon how your internal and external accountants decide to treat these. One of the things that has, in fact, put a question mark over the idea of a clear treatment of caps is that there is a New York State private letter ruling, and the key here is *private*. And it's been very difficult to actually get either New York or the party whom this private letter ruling was released to actually release it to anybody else. That, in essence, says, despite how you treat the up-front payment of a put or a call option, if you're doing it for hedging purposes be held at a cost basis, if it is cost basis type of instrument.

In the case of caps and this private letter ruling, you write the price that was paid for that cap off, over the useful life of the cap. So, if I bought a five-year cap that cost me five points up front, I would be writing off against income one point per year on that cap.

Regarding hedge accounting, check with your local regulators as to what qualifies as a hedge. In some states, interestingly enough, a cash hedge is not a hedge. It has to be futures, and that's primarily New York. You need to scrutinize fairly carefully to see what your belief system is there. But if I've entered into a hedging, a hedge against some assets, then when I unwind the hedge, I will basically bring the gain or loss on the hedged instrument to adjust the basis of the assets that were hedged. So, for example, I basically short some futures. I did the right thing because I saw rates rise, I've lost value in my underlying cash instruments, but I've actually gained value in my futures contracts. In essence, I'm going to end up taking what's called a million dollar gain or a loss that I've gotten on my hedge. If it is a loss, I am basically going to increase the basis of the assets that I was hedging. One of the nuances here is it's clear that there is some ability to fudge, as there always is. So, for example, the question immediately comes up, "Gee, if I'm hedging a basket of assets or I'm hedging my portfolio, what basis do I actually adjust?" If it's a loss, one could, for example, actually adjust the basis of all 30-year bonds and leave all short assets untouched. Some people may do that, but that's clearly not the intent of the hedging regulations. You actually want to identify the basket that you're hedging, without forcing your accounting people to write a $1 cost-basis adjustment to ten thousand different assets. You want to be fair about this and actually identify that basket and write it off over what seems to be a good average life based upon what you actually hedged.

I'm going to go a little bit away from my scope here. For statutory purposes, some debate is going on within some of the groups working on CMO regulation at the moment as to the treatment of the write-down of an IO position. If you read the IMR and AVR provisions, one would assume, because there has been no credit deterioration in the IO position, that any actual write-down of that IO would, in essence, be an IMR type of provision. There's debate going on as to whether it should flow through IMR, be captured in the IMR, or whether the write-down on an IO should flow directly through the surplus accounts of the company. For those who own IO's, that is an important thing to keep apprised of, and that is going on at the moment within the CMO working committee.

MR. JOHN O. NIGH: I'm speaking on FASB's Statement 109, otherwise known as Accounting for Income Taxes.

FAS 96 replaced Actuarial Practice Bulletin (APB) Opinion 11 and *FAS 109* replaced *96*. All of these have been titled Accounting for Income Taxes. APB Opinion 11 was adopted in 1967. Of course, that was pre-*FAS 60* and, over the years, it had been adjusted on a piecemeal basis, and it was felt that it was time, past time, to replace it, and that was the intent of *FAS 96*. *FAS 96* encountered several objections, and I have found one company that did adopt *FAS 96*, through Paul's admission earlier. For only two basic reasons, even though there were several objections to *FAS 96*, FASB decided to adopt *FAS 109*. FASB did respond and promulgate Statement 109.

FAS 96 fundamentally changed the approach to accounting for income taxes, and that fundamental change was from a deferred method to a liability method. Some of my colleagues refer to it as an asset/liability method. I think the accountants just refer to it as a liability method. What that means is that we change from an emphasis on the income statement to an emphasis on the balance sheet. Again, this is *FAS 96*. Balances were intended to be adjusted currently to reflect changes in the tax law, including changes in the tax rates. When we have changes in the tax law, including changes in the tax rates, those changes are not only reflected to the balance sheet, but the effect is shown through the income statement. So, if we do, in fact, have an increase in our corporate federal income tax rate, the effect of that will be felt through the income statement. The asset/liability method under Statement 96 precluded considering future transactions, primarily future income, regardless of how likely they were to occur. Future reversals of current temporary differences (primarily reserve differences), however, were allowed to be offset against net operating losses (NOLs). As I alluded to earlier, Statement 109 addressed two principal objections to 96. There were other objections, but FASB felt that they had been adequately aired in promulgating 96. Those two principal objections were the restricted criteria for recognizing deferred tax assets and the complexities of implementation. And I will not get into the complexities of the implemention. I will simply get into the ease with which *FAS 109* can be implemented.

Under 109, deferred tax assets can be recognized from deductible temporary differences, operating loss carry-forwards and tax-credit carry-forwards. A deferred tax asset is required to be reduced by valuation allowance if it is more likely than not that some portion will not be realized. More likely than not is defined to mean greater than 50%. I think this is one area in which you will likely get into a significant number of debates with your accounting firms, because once you get away from 100%, and only in very rare cases can you argue 100% certainty, then you need to try to develop this valuation percentage. Keep in mind that when you look at future events and, in particular, future income, a going-concern analysis requires you to look at all elements of the income, including the losses, albeit minor probably, associated with first-year or new business. Many companies still realize losses on a GAAP basis from new issues, but certainly not to the extent that we see it on a statutory basis.

The valuation allowances focus on all dollar-deferred tax assets, not merely the net of the assets over the liabilities. An example might be when an NOL is expiring, say within five years, and the future taxable income is emerging over a ten-year period, which is otherwise sufficient to exhaust the NOL. But because it is emerging over a ten-year period, it's difficult to argue that 100% of that asset should be recognized. Sources of taxable income that may be considered include temporary differences that will be reversed in future periods, taxable income in carry-back years, strategies to prevent NOLs or credits from expiring unused and, as I've already referred to, future taxable income.

I'm going to comment on a few other aspects of *FAS 109*. For those of you who have foreign interest, for example, I'm not covering every aspect here. I'm not going to comment on the effect of *FAS 52*. On business combinations, *FAS 109* does retain the *FAS 96*, gross-up approach. In other words, it eliminates the net of tax approach, and any differences of GAAP basis over tax basis must be recorded as a temporary difference. Now, however, in contrast to 96, on date of implementation or date of restatement, any assets/liabilities associated with prior business combinations need to be grossed up, and any benefits that result from that grossing up process are first used to reduce any existing goodwill to zero. Second, "used to reduce any intangible assets to zero" can be read as present-value future profit assets. To the extent that any credits remain after that, they're required to the be applied to the cumulative effect of the accounting change.

Statement 109 eliminated APB Opinion 23, indefinite reversal exceptions on a prospective basis. So, to the extent that anything existed, or indefinite reversals existed as of December 15, 1992, no liability needs to be recognized. By and large, I think the insurance community (although I may be misstating its concern), had a very real concern about its possibly needing to recognize its phase-III tax liability as, in some cases, companies would become bankrupt if they had to recognize their liability for this.

The statement is effective for fiscal years beginning after December 15, 1992, but earlier adoption is permitted. You can restate as many previously issued financial statements as desired, but they need to be restated consecutively. The effect of the change of *FAS 109* is to be reported in the year of adoption or the earlier restated year. Because of the flexible rules here, I think we will encounter some difficulties in comparing not only present and future income statements, but also in comparing one company's financial statements with another company's financial statements.

MR. BOB WILKINS: I want to give some background to the project to help you understand why it was that the board decided to address this topic at all. It really goes back to some inconsistencies that existed in the accounting literature. That was the principal factor that caused us to get involved. We weren't the first organization to look at this, however. I'm sure you're aware of the fact that legally, the SEC is the organization that has the right to set accounting rules for registrants. But it has deferred to the private sector and has identified the FASB as being the organization that should set accounting standards. On industry matters, FASB also defers to the AICPA and its top technical body, the Accounting Standards Executive Committee, also referred to as AcSEC. And because of inconsistencies that existed in AcSEC's literature and our literature when it talked about different industries, the AICPA undertook a project to conform to literature, to eliminate the inconsistencies that existed. And so it proposed a statement of position in May 1990, and the responses it received were overwhelmingly against its proposal. And so in September, it was starting to backtrack. It was about that same time that SEC Chairman Breeden emphasized that for depository institutions – not for insurance companies, but for depository institutions – marketable securities ought to be reported at their fair value or their market value. That led to AcSEC dropping the ball and deciding not to address the inconsistencies, and its proposal would have swept in insurance companies. And so, Breeden called representatives of both FASB and the AICPA to Washington and said he proposed to do it here at the federal level if the private sector could not respond by correcting the problems that he saw. And so, AcSEC Chairman Jack Kreicher indicated that it would take a look at it. Well, by Halloween of 1990, he sent a letter to the FASB indicating that the AICPA would not do it, but recommended that the FASB should look into this area.

We also, in a very unusual move, received a letter that was signed by all six of the major CPA firms, endorsing AcSEC's recommendation to the FASB to look at this problem. We did not, though, want to immediately just undertake whatever Chairman Breeden wanted to do. The board members wanted to take a thorough look and try to decide if it made sense to try to just go at the inconsistencies that existed.

To use amortized cost, it had to be based on the intent and the ability to hold for a certain period. For insurance companies, as you know, Statement 60 says that you need to have the intent to hold to maturity. The literature for savings and loan associations and for credit unions use the same terminology. But for banks, it says you need to have the intent to hold on a long-term basis. And our Statement 65, which talks about mortgage banking activities, says you have to have the intent to hold for the foreseeable future or until maturity, which is almost a contradiction in terms. And so, this inconsistent literature was where the problem really started as far back as 1988. It took AcSEC until 1990 to go ahead and actually undertake a project. But now, at the end of 1990, the AICPA is not going to do anything. It is telling FASB to look at it. So, FASB then had to decide whether to simply address the inconsistencies in a very narrow scope project or to really try to accelerate its own existing project on financial instruments. We recognize that there are different ways to accomplish the very same thing. Back in 1986, we had begun, very slowly, to look at the area of accounting for financial instruments and the fact that there are inconsistencies. No official literature on swap accounting is issued by the FASB. Certain aspects address for hedge accounting, but it's not as robust as it should be and it needs to be looked at. And so the FASB also thought it should go ahead and accelerate a portion of its own project on financial instruments. It actually addressed the accounting for all investments in debt and equity securities rather than just have this narrow scope focusing on the inconsistencies, which was what the AICPA was doing at the time.

So, the board required us to talk to many people to try to understand how they used the investments and securities. The board didn't want to get into a project without really understanding how these particular assets were being used by the reporting entities. And it took until June 1991 before the board was in a position to make a decision about the scope of a project.

The board members have equal votes and a two-thirds majority is needed to reach any agreement, any ruling. So, that requires five of seven to agree. And the Board did not want to undertake a project unless there was agreement among the five about the direction of the project, because you could go many different ways. One would be to eliminate the consistencies. You could say if the real problem or concern is gains trading, we could just simply defer gains much like an IMR approach. We don't need to address the accounting for all securities. So, we took the Board through a wide range of different scope options, and ultimately it decided to undertake a project that would have required fair-value accounting for investments and marketable securities. And we got it to say, "and perhaps related liabilities." And you know why we're looking at related liabilities. Because financial institutions, including insurance companies, manage or expose earned interest rate risk by correlating the repricing of maturity characteristics of their assets and their liabilities.

And so the staff was emphasizing to the board that it needed to look again at both sides. If we're going to do something significant for the whole group of investments and securities, then we need to consider the related liabilities, or at least give the option. And we were doing it in the context of an option, not a requirement, because this standard was going to apply to all industries. We didn't want to make a manufacturing company start fair valuing its long-term debt if, in fact, it really didn't have financial assets. So, there were different approaches about how to implement this. We were thinking of it in terms of an option. The board members agreed that would be part of the original scope of the projects. So, this was somewhat of a major undertaking.

We're going to look at a broad reconsideration of the accounting for debt and equity securities and related liabilities. We had a problem on related liabilities. Obviously, what we had in mind was that related liabilities would also be at fair value, but we're only looking at part of the balance sheet. If you look at the right hand side of the balance sheet, securities are only part of the assets. Loans are another source of receivables or investments. And loans were not part of the scope of this project. So it didn't make sense to require all the liabilities to be reported at fair value when only some of the assets are reported at fair value, or would be under this proposal that we were working on. And so, the question came up of how to decide which liabilities should be reported at fair value. When we went and met with companies, for the most part they said they do not link specific assets/liabilities. They generally approach their interest rate management on an overall or macro basis. And so we don't make these associations. We might say we've got GIC liabilities, and a certain pool of assets support that. Maybe the same thing is true of structured settlements. But, for the most part, we do not identify specific assets as being linked to specific liabilities.

And so, the way we manage will not give us this association. So the staff tried to develop various approaches in which you could construct pools of liabilities with certain constraints. So, it wasn't just free choice, so to speak, without any rationality at all. We even talked about a pro rata approach, which to me makes no sense at all, but someone raised that possibility. We just simply worked with numbers. Take a proportion of the unrealized gain or loss and run that through the income statement or through the balance sheet. No matter what approach we came up with, the Board said, it was just not workable. It either didn't accomplish what it had in mind, or it was too complex. And so, we ran into a stone wall there.

When we were talking about the valuation of liabilities, we also had a dispute over the valuation. How do you determine the fair value of such things as core-deposit intangibles for a depository institution, as well as the various reserves of insurance companies? When we talked about insurance companies, a key question was whether the fair value of an insurer's liabilities should depend on what assets that insurer owns. We heard that from the AAA representatives when they appeared at our public hearing in January. That's understandable because actuaries focus on the adequacy of the reserves, and they have to look at the composition of the assets as part of their overall analysis. But some board members said they didn't understand that. It seems to me that the fair value of an obligation for future outflows should not depend on what assets the entity owns. If two entities have the same obligations but they own different assets, then the fair value of their assets should be different, but the fair value of their liabilities should be the same. But the actuaries said the fair value of the liability should be affected by the assets that you own. And so, that is a point in which we did not have agreement.

A second key question was, should there be a bit of a floor on the valuation of liabilities? Is it appropriate to say that the fair value of the liability is something less than what the policyholder can demand by surrendering his or her policy? It's very similar to what you have with the depository institution, in which a bank would like to assert that the fair value of its obligation for your passbook account is not the $100 that it shows in your passbook that you could withdraw, but it is something less because it is planning on your forbearance in withdrawing that amount. You're willing to accept a rate of interest, or perhaps no interest on your checking accounts and, therefore, it's a cheap source of funds for the bank. It should be able to recognize that benefit by saying the fair value of the liability is something less. On the life insurance side, it's the same notion. Should there be a floor? Some thought yes, some thought no. Those who said yes say that after all, most life insurance policies result in cash outflows due to cash surrender value, not from the payment of death benefits. So, how can I ignore cash surrender value, even though it's not expected that everybody's going to surrender his or her policy tomorrow? But these are questions that came up about the valuation of liabilities, and it ultimately left us with an impasse.

And, as I said, five votes are needed to reach agreement to move forward with an answer, and that wasn't happening. The board was split. Several different camps had different ideas about what should be done on this. We were basically unable to achieve our objection, and we acknowledged that in July 1992. We could not reach agreement with respect to the valuation of liabilities. Furthermore, some board members said that we even had a split on this. Some said to go ahead on the asset side and require fair-value accounting for all investments and debt and equity securities and even though we couldn't reach agreement on the liability side, liabilities wouldn't be brought up. Therefore, liabilities would not be permitted to be at fair value, but market-value accounting would be required for all debt and equity securities. Other board members said they thought it should go in tandem. The board should look at both sides or neither. And again, because of that split, we did not make any progress. And then the question really came down to the board. What should be done? Do we just want to drop the project and give up on it? And that certainly was a very definite possibility. But the board finally said that the situation was a matter of credibility. This inconsistent literature is a problem. It was also causing a problem because the literature, even though it was inconsistent, was also really being ignored. Mark Weston acknowledged that. It was also acknowledged in our public hearings. People were not looking at an intent to hold to maturity, but rather were saying, "As long as I have the absence of a current intent to sell, I can use the amortized cost accounting." Or perhaps thinking way back, "Well, that's just the automatic accounting for debt securities."

And so, we had a situation of what should we do? Now, we did ultimately decide that we would give up on some of the concerns that we had. We would give up on our view of broadly expanding use of fair-value accounting by requiring it for all debt and equity securities. We would give up on gains-trading concerns. The board decided to not simply require the deferral of gains, much like IMR. It decided that it would continue to permit accounting based on intent, which is what the current system is. What your intent is with respect to that security influences the accounting. Some board members said that doesn't make any sense at all. The nature of the asset ought to determine its accounting, not what management asserts that it intends to do with that asset. Some said Statement 107 is going to require the disclosure of fair values. They didn't think anything had to be done at all and that disclosure is sufficient. Now, the board did not accept that. Actually, I ran across a cartoon that I thought illustrated the problem in that people really don't focus enough on the information in the footnotes. This also reinforces a notion, in the board's view, that disclosure is never an adequate substitute for recognition of the basic financial statements, because that's really the true measure of one's performance. This cartoon showed two gentlemen sitting on a park bench. One's a bum and the other is an executive who's reading *The Wall Street Journal*. And the bum looks over to the executive and says, "Take my advice; be sure to read the notes to the financial statements, because you never know what truths you'll find there."

But the board decided that disclosure's not an adequate substitute. We did two things. First, we decided to eliminate the inconsistencies that existed, and we decided to basically use the language in Statement 60 as it applies to insurance companies. We wanted to require all companies, not just insurance companies and S&Ls, to use the amortized cost method only when there is a positive intent and ability to hold the security to maturity. The board members' notion on that is that if you're not going to be holding it to maturity, then you're going to be liquidating it in the marketplace, and then the most relevant piece of information is not its cost. The most relevant piece of information is its current market value, because that will more closely approximate the cash flows that you will receive on liquidation whenever you choose to sell it.

Second, the board decided to do away with the lower-of-cost-of-market (LOCOM) accounting, because it thought that was one-sided. This is what really has led people to still call this the market-value project or the mark-to-market project, which it really isn't so much in terms of contrasting what we did versus what we had planned on doing originally. The board was not evenhanded. It believes users of financial statements are interested in the net good news as well as the net bad news. And so you shouldn't be reporting securities at market value only when it's less than cost, but to be evenhanded about it, you ought to report it at fair-value even when it's above cost. And so we said that those securities that are not being held to maturity, for which you do not have this positive intent and ability to hold to maturity, should not be reported at LOCOM, which is what the SEC is requiring, because that's what the overall current literature across all spectrums says. I recognize Statement 60 doesn't refer to LOCOM. It talks about trading and held for investment, and it's got this big empty vacuum in between. So, the SEC is requiring LOCOM accounting. The Board said to replace that with fair-value reporting for just the securities that are available for sale.

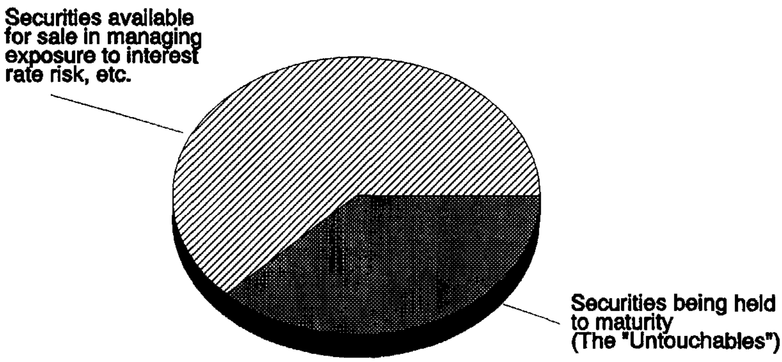
The real thing the board wanted to emphasize though is that the use of amortized cost for bonds is not an automatic. It is conditional. You have to meet certain conditions to use amortized costs. If we go back 40-50 years, of course, everybody used the cost method for bonds, because nobody actively managed their portfolio of investments. You bought a bond and you held it until it matured. You clipped the coupons, got your interest, and so forth. People were not actively managing their portfolios. And so amortized cost accounting for all bonds was, of course, the appropriate accounting, but as people's behavior changed, as entities' behavior changed, different accounting became more appropriate.

I will very briefly summarize trading securities. There's no change for most people. For insurance companies, yes, there is the change, because under current practice, when we say trading securities at fair value, the changes in that fair value are not currently included in earnings. Under Statement 115 they will be, although insurance companies' real trading activities are pretty small, if existent at all. Many of the securities that they currently show as trading will perhaps be available for sale under Statement 115, and so that would get the very same accounting as it is currently getting. But we did make the change in the held-for-sale category. Of course, we did use different descripters. We said that rather than use held for investment, we would call that the held-to-maturity category to emphasize the criteria being used for using amortized cost. Held for sale is now being referred to as available for sale and, of course, that will be, as I said, at fair value rather than at LOCOM.

Because the board realized that it was not doing anything on liabilities, rather than have the LOCOM adjustment in earnings, it made the change in fair value -- the unrealized holding gain or loss -- in shareholders' equity. Therefore, this standard should not be accused of causing volatility in earnings, because it doesn't cause volatility in earnings. We're not changing how the income statement is prepared. You still keep recognizing interest income the way you would have otherwise. Now, clearly to the extent that people had been using a different criteria for determining what would be carried in amortized costs and what would not be, yes, it's going to have an impact, but, in this sense, this is what we have.

Chart 1 is just a demonstration to tell you what we've got in mind, and we have talked to people who have done this. Some people were victims of the SEC's enforcement actions, in which they had demonstrated or had reported a rather high security portfolio turnover and the SEC came along. What we have heard from people was that to appropriately manage their exposure to interest rate risk, they do not need to be able to sell all securities in their portfolios. Now, if they had that ability, that option, that flexibility, yes, would be easier. But when they look at it, they say, "Do I need to be able to sell each and every security?" No. The kinds of adjustments needed to manage exposure to interest rate risk can be accomplished really by being able to sell just a portion of the security portfolio. And so, what we're really envisioning in Statement 115's application is that most entities, and I think *most* is an appropriate term if you look at the whole range of entities, will decide to keep some securities available for sale to accomplish the necessary adjustments as they manage their exposure interest rate risk. And it can be any size. It doesn't have to be as large as shown on Chart 1, but it can be any size. And, of course, that would be reported as a fair value; the changes being in shareholders' equity.

CHART 1



But those that they would choose to not have available to their portfolio managers would be untouchable. These are the ones they will hold to maturity and would be amortized at cost. And it's up to management to decide just what it wants. When they were prompted by the SEC to make changes, very few insurance companies went entirely to LOCOM. Many did make an allocation. That's really what we anticipate; however, if an entity wants total flexibility, fine. It can say it's all available for sale and nothing is hold to maturity. If it is having accounting based on intent, management can decide what intent, what degree of flexibility, it wants to have. And so, this is really the notion that we had when we went ahead and set up our standard.

Now, I will not get into all the details that Mark Weston did about our standard, but I did want to bring out a few things. We do identify a variety of changes in circumstances that would, in essence, justify the disposition of a held-to-maturity security without calling in the question of classification of the rest. In the document, we talked about changes in statutory or regulatory requirements. The first one included significant changes regarding permissible investments. If a change by the NAIC that talks about the amount of securities, of certain ratings that you can hold, is narrowed or reduced, and you have too many securities in that category, you can sell held-to-maturity securities to make the necessary changes in response to the change in regulation. The second one is a significant increase in risk rates of securities used for capital or for risk-based capital purposes. We know that's coming down the pipe for property & casualty (P&C) companies. If 115 is adopted and certain securities that are held to maturity are set up because of the change in risk rates, once it comes out, some changes, some restructurings, need to be made. Sales of held-to-maturity securities in response to those kinds of changes are acceptable.

The question was brought up about the sale of a held-to-maturity security to meet liquidity needs for unusual claims. And I just want to convey to you that, in the discussions that I had with board members, they felt that to the extent that you, as an insurance company, have claims, I mean this is part of your business, you need to maintain enough securities as available for sale to meet the needs, if, indeed, you're going to obtain the cash through the sale of securities. Now, I know there are a variety of ways you can obtain cash to pay claims. Even through reinsurance you can obtain cash, but there are various techniques you have. When we did the exposure draft, I thought maybe something like Hurricane Andrew, being as extraordinary and unusual as it was, would be the kind of thing that would maybe be beyond the scope of what they had in mind. But I learned subsequently in discussions with board members that, no, for a P&C company, they felt that the losses on Hurricane Andrew might not be the things that ought to cause sales from the held-to-maturity securities. I think there's a consequence. I think it's probably going to be the case. The P&C companies will probably have a smaller percentage of their securities as held to maturity than would life insurance companies.

Because we talked about liabilities and the question of what will happen about the liability side has come up, we now have a standard out. I don't like to call it a mark-to-market standard, because it's not the mark-to-market project we had in the beginning. All it really does is say that this is the rule that existed before. You have to follow it with some implementation guidance to emphasize that. What's going to happen on liabilities? I don't know, but we have received some requests that we add a separate project to take a look at permitting the reporting of liabilities at fair value. In the third quarter, I suspect we will be bringing this back to the board for discussion.

We're in an unusual situation. At the end of this month, two of our board members leave us. They are permitted to serve two five-year terms. One board member has reached the end of his second five-year term, so he must leave. The second board member is concluding his first five-year term and he plans to retire to Virginia. We're getting two new members on the board, and so we are going to wait until they're up to speed. Then we will bring back to the board the issue of whether we should be doing something further on liabilities right away and not just simply awaiting the normal evolution of the financial instruments project, which could take a good number of years. I know that some of your organizations are looking at this. The ACLI is looking at it. Clearly, the AAA has already given us a report, a letter that talks about perhaps a general approach on liabilities. Yes, it hasn't been fleshed out, but the board will be looking at this issue. Obviously, the sooner we get information that would be useful to the board in deciding this, the better. I'm not sure what the timing will be. I don't think it will be in the first half of July, but beyond that, I really couldn't say, but we will be bringing this back to the board to decide probably sometime in the third quarter. But we still have all these same problems with us. We're only doing a portion of the assets under 115. So, then, are we only talking about a portion of liabilities and, if so, what portions? How do you determine which liabilities? And if we're going to do all liabilities, then you're almost suggesting we need to make major changes on the rest of the assets and do away with this accounting based on management's intent. So, I'm not sure what will happen, but I wanted to let you know we are going to be doing that.

I want to make a few other comments. John talked about Statement 109. Remember, when we talked about the unrealized holding gains and losses on the available-for-sale securities that are reported at fair value, the unrealized gains and losses are not in the earnings. They're in that separate component of shareholders' equity.

That is net of tax. Statement 109 does tell you to go ahead and apply its revisions. It's net of tax and, therefore, the tax effect never goes through earnings. But if President Clinton comes along with a change in tax rates, under Statement 109, the entire effect of the change in tax rates, including the effect on those unrealized holding gains and losses would go right through earnings. That's the way 109 is written. It was done that way because people complained about the complexity that was in Statement 96, although that was also part of 96, but there was a lot of complexity if you started trying to decide to split out the change in rates on all the temporary differences. But we do plan to bring that issue back to the board in the third quarter. Should we readdress that, because obviously many companies will have these kinds of temporary differences that relate to items that have not gone through earnings at all – that are simply in a separate component of shareholders' equity. So, we will, at least, bring it back to the board to decide whether it plans to do something further.

There is one thing that I guess was not mentioned on swap accounting. Typically there is this assertion that you do need to say that swap is a hedge of some other instrument. Some believe that speculative swap contracts ought to be reported at fair value. And to avoid that accounting, you should be designating that swap as a hedge of something. But there could be a consequence, because if the hedged item is an available-for-sale security reported in the fair value, then our paragraph 115 of the standard does point out that the accounting for the hedging instrument, the swap contract, could be affected because you would have to report the gains and losses on that also in a separate component of equity. So, there are some complications when we get to hedge accounting. By the way, we also have a hedging project, but that's making slow progress. We're hoping to come out with a document sometime next month that would at least lay out some of the board's considerations to date. This is not an exposure draft. We don't have any preliminary views, or true board views, but it's a discussion of various aspects of hedge accounting that may be of interest to those of you who have more of a technical accounting interest as well.

MR. LEFEVRE: There has been a lot of emotional response to *FAS 115*. There are many predictions. It's going to change the way companies invest. It's a great opportunity for Peter and his people to push swaps, to put everybody in short-term investments and do everything in the swap market, etc. I think from your explanation, if I picked it up right, Bob, it puts a lot of onus on management and it puts a lot of onus on the accounting firms to come into an agreement as to how this is going to be handled.

MR. MINTON: I think one of the things which we've heard throughout the industry is an assumption that low turnover will, in fact, be a determinant of how much is set aside for held to maturity versus what has to go into available for sale. Is that a correct statement, or is it really not a proof of ability and, therefore, not really a determinant?

MR. WILKINS: The board members had been given a suggestion that they ought to grant a safe-harbor provision for some diminimous amount of annual turnover in a portfolio. The board members rejected that, aside from the fact that some people alluded to 15-25% annual turnover, which I think fails the diminimous test. But apart from that, the board members thought that the volume of turnover really wasn't the criteria. The circumstances that give rise to the decision to sell something that you had initially said you had the intent to hold to maturity are important. So you need to focus on the circumstances. Now, the board members also rejected having some automatic consequence. Some people told us the standard has no teeth, because if you do sell a held-to-maturity security for an unjustified reason, it doesn't say what happens. We had talked about putting some provision in the document that would specify an accounting consequence, but all board members rejected doing so. One board member referred to that as a guillotine provision, and he thought that was totally inappropriate. But the notion is, a single sale probably will not cause any problem. But clearly, if you do sell, if there's any kind of pattern at all, then that really calls in the question of your credibility. And that's really the problem that led to us to do something. People were saying that current financial statements aren't credible because there are record amounts of sales that, by some companies, had large volumes of turnover and yet they were using amortized costs, which is conditional. It's supposed to be only when you have the intent to hold to maturity; therefore, the credibility of financial statements was undermined. But to get to your question, again, no.

MR. MINTON: I guess the next question really relates to, again, another provision, which I'm not sure the people have focused on. Can you touch a little bit on the ability to sell out of the held-to-maturity account for credit reasons?

MR. WILKINS: As Mark explained, that is one of the things that is permitted. If you have evidence that the creditworthiness of the issue or the security has deteriorated, the sale of the security, even though it's classified as held to maturity, certainly would not call into question the classification of the other held-to-maturity securities. That's a legitimate reason for getting out, but you need to have some evidence. You just can't say, "Well, I'm worried what might happen in the next five years." There must be some evidence of some deterioration. But we make it explicit in the background, in the basis for conclusion, that you do not have to wait for this entity to show up on a credit watch list. You don't have to wait for the credit rating to actually drop. It's not after the fact in that sense.

MR. MINTON: What if the credit improved?

MR. WILKINS: If the credit improved, then that would not be a reason for unloading the security that you originally said you were going to hold to maturity.

MR. LARRY H. RUBIN: I have a few questions on statutory accounting. One is on the statutory accounting for interest-only STRIPS. You said that there is currently a debate as to whether the losses should be reporting the IMR or they should flow directly to surplus. When would you recognize the loss on an IO? Would it be at the time an interest rate dropped, caused you to expect a negative investment income, or at the time it actually disappeared off your balance sheet and got prepaid?

MR. WILKINS: If you actually reanalyze that the expected internal rate of return (IRR) is based upon some change in the prepay speed of the underlying collateral, then at some point you will get fast enough. That's what we've actually seen of late. The underlying collateral speeds have been fast enough and all of a sudden there has been something that some people call permanent impairment. Others said they would adjust their IRR assumption going forward. But, in any event, if there is a write-down of that for any of these reasons, whether it be an outright sale because you've disposed of the asset, or if it is simply a write-down because of the adjustment of what you now prospectively believe to be the proper IRR on it, then you really will not get all of your money back. But there is now a debate as to whether that goes into the IMR and is written off over the half-life or wherever that fits into the particular regulations, or whether that's directed to surplus.

MR. RUBIN: Can you talk about statutory, looking at intent as well as for any of these instruments that are bought for the purpose of hedging interest rate risks?

MR. WILKINS: There is presently the beginnings of an NAIC working group that wants to look at derivative products. So, from that point of view, yes, some people are going to be working on how we actually deal with swaps, futures, and options from all points of view. It's going to be a fairly broad-scoped kind of project, as we understand it, which would be looking at the accounting, looking at what is permissible and what is not permissible. As you know, there are considered to be loose regulations or easy regulations as to what you can use futures and options or swaps for in the model investment law, which we don't think will go through as proposed. But a working group is looking at that. What was the first part of the question?

MR. RUBIN: If you're buying a security and its purpose is either to sell in a rising rate environment or to sell in a declining rate environment and not hold to maturity, under Statutory Accounting, I really thought you should be marking that to market.

MR. WILKINS: At that moment, and this may change, I believe, from our understanding from the people we've spoken to, the NAIC wants to stay with what it has which is more of the AVR/IMR provisions. If you look to the banking side, however, you've actually seen much more of a willingness by the regulatory boards to go along with what GAAP is doing here, or else look to be behind the times. That's not the thinking of the NAIC at this point. At one point, there were some proposals to use an IMR/AVR concept for GAAP purposes, and I think it was determined that the scope was simply much too limited.

MR. R. THOMAS HERGET: Bob, if you do look at the project of marking liabilities to market this summer like you said you might, would any principals or pronouncements coming from that endeavor apply to other financial institutions, such as banks or savings and loans? Or would this just be for insurance companies?

MR. WILKINS: I would expect it will be broadly applied. The board members are reluctant to establish accounting principals when they really believe that the transactions are common to a broad range of industries, and so I would think it would be a broad application. It's not something that would result in an exposure draft by October. It would broadly apply to all and it would probably be in an optional context. I don't believe it would be required.

MR. HERGET: Does anybody on the panel think there exists the remotest possibility that the statutory blue blank might some day be allowed to carry a deferred tax asset? I've heard the NAIC had been discussing that.

MR. LEFEVRE: We're of no opinion. We're no help on this one.