



September 1, 2009

Sir David Tweedie
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Sent via Comment Letters page at www.iasb.org

Dear Sir David:

The following are comments from the Group of North American Insurance Enterprises (GNAIE) on Discussion Paper DP/2009/2: "Credit Risk in Liability Measurement". These comments relate entirely to measurement of insurance liabilities. As described below, some of these comments relate to all insurance liabilities, while others apply only to life insurance liabilities. We expect that these issues will also be addressed in the IASB/FASB joint project on accounting for insurance liabilities.

Q1. When a liability is first recognized, should its measurement (a) always, (b) sometime, or (c) never incorporate the price of credit risk inherent in the liability? Why?

For insurance contracts, GNAIE supports the contract fulfillment value measurement attribute which calibrates the initial liability to the premium the customer pays for the insurance contract, which would result in no gain (and generally no loss) at inception. There is no separate measurement or identification of credit risk in insurance contracts. This result is consistent with the tentative conclusions reached by both the IASB and the FASB in their joint project on insurance contracts. For short duration insurance contracts, including many property-casualty personal lines products, an unearned premium reserve can be an acceptable proxy for the liability at inception, also with no separate measurement or identification of credit risk and also with no gain (and generally no loss) at inception.

Assuming that the IASB and FASB maintain their current positions that the initial insurance liability should be calibrated to no gain (and generally no loss) at inception, it appears that Q1 will not be relevant to insurance liabilities.

Jerry M. de St. Paer
Executive Chair

Douglas Wm. Barnert
Executive Director

Group of North American Insurance Enterprises
40 Exchange Place, Suite 1707
New York, NY 10005
UNITED STATES

++1-212-480-0808
info@gnaie.net
www.gnaie.net

- Q2. Should current measurements following initial recognition (a) always, (b) sometime, or (c) never incorporate the price of credit risk inherent in the liability? Why?

GNAIE believes that a change in credit standing of an insurance liability following initial measurement of the liability should *never* be incorporated in the liability. If the credit standing of the liability deteriorates after the contract is issued, the insurer will not be able to realize a gain from that deterioration and remain a going concern. In virtually all jurisdictions, the insurer will not be able to continue in business if it is unable to pay liabilities according to all of its insurance contracts as they come due. The insurer will also not be able to get regulatory approval to transfer the obligations under such contracts to another entity with a reduced expectation that the liability will be paid. Therefore, if the change in the credit standing of the liability were to be incorporated in measurement of the liability following initial recognition, the insurer would recognize a gain it could never realize when the credit standing of the liability deteriorates, and would recognize a loss it would never realize when the credit standing of the liability improves.

Incorporating a change in credit standing of an insurance liability after initial measurement is also unnecessary from the perspective of the informational value it would provide to a policyholder. In the event the credit standing improves after inception, the policyholder would nevertheless be unable to realize the gain as insurance contracts are generally not transferable. Furthermore, for any particular insurance contract, the liability value for the insurer need not be the same value that the policyholder would have as an asset.

We do not believe that a risk free rate is appropriate for discounting (life) insurance contracts. In particular, a liquidity spread will often be needed since the liquidity characteristics of an insurance liability are generally different from those of risk free instruments. An additional spread may also be needed to avoid artificial accounting mismatches between assets and liabilities when market spreads change, as discussed further in the response to Q3 below. One solution is to include asset pricing changes in the liability (but only for pure pricing changes that do not reflect changes in credit standing or probability of payment). This view leads to the use of a funding spread, as described in the attached paper, which we understand has been sent by Matthew Modisett to the IASB in response to its request for comments on the Discussion Paper.

In the case of non-life insurance contracts, GNAIE does not support discounting. As such, there would be no separate identification of the impact of the credit standing of the liability at inception, or of the impact of any subsequent changes in the credit standing of the liability.

- Q3. How should the amount of a change in market interest rates attributable to the price of the credit risk inherent in the liability be determined?

As described in our comments on Q1 and Q2 above, we believe there should not be changes in interest rates attributable to changes in credit risk inherent in insurance liabilities. For life insurance liabilities, we believe that the cash flows associated with insurance contracts should be discounted. We prefer discounting these liabilities at an asset earned rate for the insurer. If the insurer's assets are perfectly matched to its liabilities, the asset earned rate would reflect all relevant characteristics of the liabilities. However, the insurer may not have such a perfect match,

either intentionally or unintentionally. There are various other choices for a discount rate (for life insurance liabilities) which could be appropriate. The attached paper (which was sent to the IASB by Matthew Modisett, as noted above) describes one possible approach (called “funding spread”), which is based on a liquidity premium over a risk free rate. We believe that the IASB and the FASB should consider such alternatives for life insurance liabilities in the discount rate “building block” in its insurance contracts project.

We note that the IASB is discussing different approaches for determining discount rates in several of its currently active projects. For example, the pensions project is using a high grade corporate bond rate. A discount rate based on financing transactions between the parties is under consideration in the leases project and the revenue recognition project. And the rates discussed in the project on rate regulated activities include a contractually defined rate or a rate based on experience. The Board may conclude that the same rate basis should not be used in all of these projects, because of differences in the contracts or markets, such as regulatory restrictions on settlement and transfer in the case of insurance liabilities.

- Q4. The paper describes three categories of approaches to liability measurement and credit standing. Which of the approaches do you prefer, and why? Are there other alternatives that have not been identified?

For life insurance at inception, GNAIE supports the general approach described in paragraph 62(c) of the staff paper accompanying Discussion Paper DP/2009/2. “Measure borrowings and other liabilities that result from an exchange for cash at the amount of the cash proceeds. Measure liabilities that do not have a cash exchange at the present value of expected future cash flows, discounted at market rates that exclude the effect of credit risk. Subsequent current measurements should incorporate changes in market interest rates.” For the reasons described above, GNAIE is opposed to the approaches described in paragraphs 62(a) and 62(b) of the staff paper, which are based on the risk-free rate of interest. However, as described in the comments on Q3 above and in the attached paper, adjustments to the risk-free rate (e.g., for liquidity and to insure consistency between asset and liability valuation) may be appropriate. GNAIE continues to believe that it is not appropriate to discount non-life insurance liabilities.

Sincerely,

A handwritten signature in black ink that reads "Kevin Spataro". The signature is written in a cursive, slightly slanted style.

Kevin Spataro
Chair, GNAIE Accounting Convergence Committee

KAS:KK:c11

Enc.

September 1, 2009

TO: IASC Foundation Publications Department,
1st Floor, 30 Cannon Street,
London EC4M 6XH,
United Kingdom.
Tel: +44 (0)20 7332 2730 Fax: +44 (0)20 7332 2749
Email: publications@iasb.org Web: www.iasb.org

RE: Credit Risk in Liability Measurement, And
An alternate method: the Funding Spread

From: Dr. Matthew c. Modisett, PhD, ASA, MMA

Summary of Position:

The negative consequences of both the “own spread” and of the “risk-free rate only” methodologies are severe enough to warrant discarding both. It is further felt that the use of the entity’s own asset spread has similar undesirable consequences to warrant it to be discarded.¹ In their place recommendation is made for the use of a corporate spread, the **Funding Spread**.

The funding spread is a current performance measure. Using the entity’s own assumptions for liability cash flows, the discount rate at time t would be calculated as follows:

Liability Discount Rate = Risk-Free rate (Level 1 est.)

+ Average credit spreads as of time t, (Level 1 est.)
for a “target portfolio of credit ratings”
originally determined at time 0,²

- Default charge rate as viewed at time t, (Level 3 est.)

+/- A fixed spread calculated to make (Level 2, est.)
Day-1 value equal zero.

¹ Detailed drawbacks re presented later in this paper under the sections Concise Statements against Own Credit Spread and Own Asset Spread and Salient attractive features of Funding spread.

² The credit index is referenced, for example A-rated corporate, rather than particular assets, for example XYZ Company. The spread at time t is for assets that at time t have the rating originally targeted at time 0.

This methodology essentially uses the current liquidity premium over risk-free.

The remainder of this note details and justifies this calculation and discusses its requirements for disclosure and on-going management.

In this note are presented:

- The Concept of the Funding Spread,
- Whether and how Funding Spread is useful to analysts,
- The Funding Spread's salient attractive features,
- The relationship with other accounting concepts,
- Answers to the 4 Questions for Respondents,
- Comments on Day-1 gain-loss and P&L vs. OCI,
- Additional Discussion of Funding Spread,
- Concise Statements against Own Credit Spread and Own Asset Spread, and
- Reactions to 2 specific paragraphs in the staff paper.

Concept of Funding Spread

A corporate spread over risk-free is necessary for discounting liabilities, but not that according to the entity's own credit. The appropriate spread is the spread appropriate for funding the liability in accordance with prudent industry standards. This has two main components:

- 1) The current market nominal spread (a Level 1 input), and
- 2) A default charge for future defaults (a Level 3 input),

There could be a third component, depending on the Day-1 treatment:

- 3) A Spread to zero-out Day-1 gain/loss.

The funding spread's main component is the difference between nominal and default charge, and represents the liquidity premium available in the market.

Primary motivating Example (Life Insurance):

Life insurance liabilities are essentially financial and the assets to fund the obligations are generally financial as well.

Suppose the *generally accepted portfolio* of assets to back life insurance assets under industry best practices were to have a portfolio of investment grade bonds with average rating A.³

In this case, the nominal market spread to use would be the spread consistent with this portfolio's market value at the measurement date. Conceptually, it is the yield given current price and *promised* cash flows.

However, this nominal spread will not be realized in practice since there will be (at least potentially) defaults. So, this nominal spread must be adjusted downward to estimate the spread that could be realized.

Accordingly, the rate used to discount a liability is either:

Liability Discount rate = risk-free + Nominal corporate spread – default charge

Or

Liability Discount rate = risk-free + Nominal corporate spread – default charge + Spread-to-zero-out-Day-1-gain-loss

The first formula is used if the accounting standard allows a non-zero value at inception. The second formula is used if the accounting standard requires a zero value at inception. In the later case, the Spread-to-zero-out-Initial-Value is appropriately calculated to zero out the initial value and is fixed over the life of the liability. (See the answer to Question 1, for further discussion of the Spread-to-zero-out-Initial-Value.)

Emphasis is made that the spread is an asset spread. It is NOT calculated from any cost-of-capital argument.

Emphasis is made that the reference portfolio is NOT the entity's own portfolio, rather an industry standard best-practice portfolio. (It could be that no particular industry player uses the exact best-practices portfolio.) To the extent that an entity's own portfolio varies from the industry standard, differences in asset and liability movements would affect the entity's financials.

³ For illustration, the prudent portfolio is made simple. In practice, it could have more finely defined allocation across asset classes, industry sectors, maturities, etc.

Further emphasis is made that only the credit spread is used from industry standards. The timing and distribution of liability cash flows arise from the specifics of the obligation itself. (The reference to “maturities” in the second indented paragraph above recognizes that spread may vary by maturity.)

Clarification is made that the default charge is not an absolute concept. It is a Level 3, not-directly-observable parameter. The nature of the estimate depends on the level of conservatism required from the calculation. It could be “Best estimate” (using, say, historical averages of default) or very conservative (say at the 99.5% confidence level given historic defaults). As with any other Level 3 parameter, appropriate diligence and disclosure is necessary.

Additional clarification can be made that the nominal market spread itself (the spread before default charge) has Level 1 and level 3 components: deciding the best practices benchmark portfolio is a Level 3 input, while the actual market spreads from this portfolio are Level 1.

Whether and How Funding Spread is useful to Analysts

The funding spread concept appeals to an asset portfolio to be used as a basis for determining a liability spread. The “prudent industry standard” asset portfolio would potentially vary from company to company but would be subject to auditor and regulatory review. It would also be required to be disclosed in the financial statements.

Envisioned is sufficient disclosure such that an analyst would have available:

1. The distribution of the actual asset.
2. The distribution of assets net of any hedges, and
3. The distribution used for determining the liability spread.

With 2 and 3, an analyst would be able to estimate the variation of the company’s assets and liabilities relative to market indices. This would be valuable analytic information for seeing market exposures, making comparisons between companies, and for making portfolio of investments across companies with the desired market sensitivities. Depending on other liability information available, this could also allow for estimating the extent of an asset-liability matching/mismatch.

Notice that this use of the financial information does not require that each company use the same “prudent industry standard” asset portfolio for liability spread determination; it only requires that each company disclose the assumption used.

Salient attractive features of Funding Spread

- A. If a company’s own credit standing deteriorates or improves, this has no effect on the liability valuation using funding spread.
 - a. This avoids the well-discussed issue of the counter intuitive effects arising from using a company’s own spread.

- B. A completely asset-liability-matched company would have no change in equity for changes in market conditions. This statement is worth elaboration.
 - a. Consider the case of a completely asset-liability matched company, using the credit portfolio representative of the industry. (This is an idealized case which is appropriate for doing a thought experiment to test the proposed accounting.) Assume that asset spreads change but there is consensus that this indicates no change in default estimates. (This is also an idealized assumption. In practice, such consensus is difficult to imagine.) In this case, the total effect on the company makes sense:
 - i. If there is a change in corporate spreads then the asset and liability sides of the balance sheet would be equally affected, causing no net change in equity. This is the correct and desired accounting result since the on-going prospects of the company have not changed. (There is consensus that the risk of the assets has not changed, only the pricing.)
 - ii. Note that the use of only a risk-free rate with no spread for discounting liabilities would fail this test. Assets would deteriorate/improve with no offset from liabilities. Since the assumption is that this asset change is only a pricing change and has no component of change in asset risk, the net effect on

equity in the risk-free (no spread) model represents spurious volatility in earnings.

- b. Consider the case as in a, except now assume that the change in corporate spread is *entirely due to changes in default assumptions*, and that there is consensus in the market that this is the reason. (Again, an idealized example.)
 - i. In this case, when spreads change for reason of changing default expectations, the funding spread method would have assets deteriorate (improve) but liabilities not. This is a desirable result reflecting the changing prospects of the company.
 - ii. This is the case most proponents of the no-spread methodology envision. In the risk-free discounting model, all changes due to changing default assumptions run through assets with no effect on liabilities. Deteriorating (improving) asset values have the effect of deteriorating (improving) entity's owner's equity. If it were true that changes in asset spreads were 100% indicative of changes in default expectations, then the risk-free model would be correct. However, it is not true so the risk-free model is incorrect. (See 2b, above). The risk-free discounting model does not provide a clean reflection of changing default chances, rather also includes market noise around this.
 1. For example, one rule of thumb provided by the Bank of England states 1/3 of the nominal spread is due to default expectations. Using this as an estimate, it indicates that the movement in fair value due to the risk-free model is roughly 3x the effect it should be.
- c. By separately treating the default assumptions, the funding spread achieves the effects desired by the risk-free model, but without the undesirable noise.

- C. To the extent that an entity is not perfectly matched, in a classic ALM sense, differences would be reflected in the financial statements. This again is the desired result.
- a. The exposure of the asset-liability mismatches and deviations from industry standard is viewed by the author to be the entire motivation for implementing Fair Value accounting in the first place. As such, this realization of ALM implications is more than a desirable result; it is the goal to which Fair Value accounting strives. Accordingly, the funding spread method realizes the goals originally envisioned by Fair Value accounting.
- D. What if the portfolio of the entity is downgraded?
- a. This would reduce the asset values, all other things equal. However the liability value would be unaffected since the industry best-practices portfolio would still be the same. (It is set at inception of the liability and *does not* change with the actual backing assets.) Accordingly, the equity of the entity would fall. This is the correct accounting result reflecting the company's underperformance on asset.
- E. What if all portfolios of all players in the industry were downgraded. For example, if the entire insurance industry saw its average portfolio fall from average A to average BB (a frightening example made extreme for illustrative purposes), then what would the effect be?
- a. The recommendation is that the best-practices portfolio would not change. It would have been decided earlier, and if the industry as a whole for whatever reason could not follow (or exceeded) its own declared standard, then (for better or worse) the effect would flow through the financials.⁴

⁴ And alternate accounting standard is conceivable, but NOT recommended in this note: have the best-practices portfolio track the actual portfolio of the industry as a whole.

- A. So, in the example, even though the target had been to maintain an A-rated portfolio, the actual portfolio at the measurement date was BB for the industry and so this is de facto the industry practice.
- B. This method is not favored by the author (though conceivable) for all the same reasons that the standard setters do not want to use the entity's specific assets to determine the entity's liability discount rate. Essentially, the industry would be using its own assets, a concept that was rejected at the company level and should also be rejected at the industry level.

- b. This underscores the need for disclosure of the Level 3 assumptions used in setting the defaults. The explicit detail of the original best-practices asset portfolio constitutes a necessary ingredient for later use by analysts.

Relationship to other Accounting Concepts

Exit value and Going-concern:

Debate has centered on the chosen concept of Exit Value as a transaction price between willing parties, and repeatedly it has been emphasized that the standard is not a liquidation price. The funding spread appeals to industry practices of going-concerns, and clearly is not focused on liquidation values, rather values associated with going-concerns. Thus, the possible confusion with liquidation value is avoided.

Furthermore, the use of industry standard for assets to back the liability automatically incorporates the “transaction by willing parties” since it appeals to the standards of the very willing parties already engaged in similar activities. These are the potential market participants that could take over the liability in an exit transaction.

Reliability of Measure:

The appeal to an industry portfolio representing best practice includes the notion of reliable market information. For example, the concept of the “A-corporate spread” includes within itself a self-correcting process in which unreliable (illiquid) issues are relegated and emerging acceptable issues are included. By definition/design, the market information would conform to any reasonable requirement for reliability and measurability.

C. Furthermore, simply because the current obligations of the industry are funded with a different credit rating than planned, this does not mean that new obligations of the entity would employ the realized credit rating. More likely the original plan best-practice’s portfolio would be the target for any new obligations.

Entity-specific:

Some debate has centered on the “own credit spread” as an entity-specific item used to value the liability. In this sense, the “own credit spread” needed to be an exception to the general rule of not using entity-specific parameters. The funding spread avoids this conflict by appealing to an industry spread. Funding spread, though determined at inception of a liability, is not entity specific in any undesirable manner.

Fulfillment value:

Potential confusion arises around the concept of fulfillment value since the concept apparently refers to the entity’s own ability to fulfill the liability. The confusion seems to arise through logic similar to the following: if the entity is not fulfilling the obligation, does this not imply a liquidation price, at least as a possibility, and how does this relate to the going-concern assumption.

By contrast, the funding spread appeals to the industry practice of other providers of similar obligations. As such, the fulfillment concept applies, not to the entity itself, but rather to what a best-practice market participant would need to fulfill the obligation. Under this line of reasoning, the concept of spread necessary for fulfillment is not entity-specific and does not lead to a liquidation assumption, but rather refers to an orderly transfer from the entity to another market player already engaged in similar obligations.

A clarification is made that this use of a funding spread, which is not entity-specific, is independent of other liability specific assumptions which may or may not be entity specific. For example, when a funding spread could be used to determine the discounting rate, this is independent of any company-specific assumptions used to project liability cash flows. The liability cash flows may or may not be entity-specific without impacting the use of the funding spread.

Answers to the Questions for Respondents in IAS DP/2009/2

The answer presented below. These may be clearer after reading the discussion on the funding spread model above.

Question 1

When a liability is first recognized, should its measurement (a) always, (b) sometimes or (c) never incorporate the price of credit risk inherent in the liability? Why?

- a. If the answer is ‘sometimes’, in what cases should the initial measurement exclude the price of the credit risk inherent in the liability?
- b. If the answer is ‘never’:
 - (i) What interest rate should be used in the measurement?
 - (ii) What should be done with the difference between the computed amount and cash proceeds (if any)?

Answer 1

“Zero spread”: Never
“Own spread”: Never
Funding Spread: Always

The funding spread has been described at length above, and this description answers b(i).

Question b(ii) appears to be addressing the Day-1 gain/loss issue, and the question is addressed under this assumption. This paper submits that the funding spread can be implemented with or without a zero-inception assumption. No direct statement is made in this note concerning the issue of Day-1 value except to state how the Day-1 treatment would impact the use of a funding spread. The funding spread accommodates either a forced day-1 value of zero, or a day-1 value allowed to be different from zero.

As mentioned earlier:

Liability Discount rate = risk-free + Nominal corporate spread – default charge

Or

Liability Discount rate = risk-free + Nominal corporate spread – default charge + Spread-to-zero-out-Day-1-gain-loss

The first formula is used if the accounting standard allows a non-zero Day-1 value. The second formula is used if the accounting standard requires a zero Day-1 value. In

the later case, the Spread-to-zero-out-Day-1-gain-loss is appropriately calculated to zero out the initial value and is fixed over the life of the liability.

Emphasis is made that:

- The Spread-to-zero-out-Day-1-gain-loss is fixed over the liability's life.⁵
- Nominal corporate spread varies with market prices (Level 1 input)
- Default charge is periodically re-estimated. (Level 3 input)

Question 2

Should current measurements following initial recognition (a) always, (b) sometimes or (c) never incorporate the price of credit risk inherent in the liability? Why? If the answer is 'sometimes', in what cases should subsequent current measurements exclude the price of the credit risk inherent in the liability?

Answer 2

“Zero spread”: Never
“Own spread”: Never
Funding Spread: Always

This question is worded with the Own credit spread in mind. The funding spread was not considered when formulating this question, and is not “the credit risk inherent in the liability” but should always be used.

Question 3

How should the amount of a change in market interest rates attributable to the price of the credit risk inherent in the liability be determined?

Answer 3

The “Own Credit” model runs the risk that the underlying entity may not have identifiable market spreads.

⁵ Other amortization methodologies, than a fixed spread, could likely be used to force a zero Day-1 value without impacting the positive aspects of the Funding spread. See Point 2 of Additional Discussion of Funding Spread, below.

However, the funding spread method appeals to measurable (e.g. liquid) spreads, and this question is rendered moot. (See Reliability of Measure, above.) The proposed method of funding spread does not use the entity's own credit spread, rather external market credit spreads appropriate for funding a liability. Accordingly, the definition of "market credit spreads" will rely on measurable spreads, and so the question of how to measure the change is not difficult, or more accurately is by design not an issue.

Question 4

The paper describes three categories of approaches to liability measurement and credit standing. Which of the approaches do you prefer, and why? Are there other alternatives that have not been identified?

Answer 4

No method presented in DP/2009/2 for the fair value is preferred to the funding spread method.

Comments on Day-1 gain-loss and P&L vs. OCI:

As already mentioned, the funding spread can be used whether or not there is a requirement to zero-out the Day-1 gain-loss. The proposed funding spread is independent of the Day-1 issue.

A comment specific to only the Day-1 issue follows.

On the issue of Day-1-gain-loss and whether changes in value flow through P&L or only equity, there seems that specific rules applicable in all situations are difficult to make and justify. An example illustrates the thinking:

Case A: A company issues a bullet bond. This is a one-off issue and the company envisions no further issuance.

In this case, it seems warranted (intuitive) that there be a zero day-1 assumption and also that any later changes in fair value would flow through equity and not P&L. The bond might be illiquid or might have an active

secondary market. The liquidity is not relevant; rather it is the management's planned on-going management of this obligation that motivates the treatment.

Case B: A large global company is constantly issuing new debt of all maturities timing issuance according to market possibilities, and regularly buys back its own debt when financially attractive.

In this case, the trading in its own debt (both issuing new and buying back) is credibly viewed as an additional on-going entity activity, and as such Day-1 gains or losses could be justified: arguably, since this is an on-going trading activity, Day-1 gains/losses are part of the on-going operations of the company and should flow through P&L; independent of the Day-1 issue, it would seem justified that any changes in Fair Value of debts flow through P&L as well because of the active management of these liabilities.

Both these cases use the same instruments. However, the differences in the use and management of the instruments dictates whether or not gains/losses flow should through P&L. These considerations may also affect the view as to whether or not day-1 gains/losses are appropriate.

Additional Discussion of Funding Spread

- 1) The selection of an acceptable industry portfolio for the funding spread calculation is an issue of judgment.
 - a) Clearly this would require judgment and disclosure.
- 2) When zero Day-1 gain/loss is necessary the gain/loss can be amortized
 - a) Consistent with the overall methodology, one can introduce a fixed spread modifier (fixed over the life of the liability) as done above. An adjustment spread could be positive or negative, calculated to insure a "zero initial" result.
 - b) Other amortization methods of course could be used. The fixed spread method seemed convenient consistent with the funding spread, but not a necessary method for amortization.

Lessons from the current crisis:

It is now accepted that the market credit spread contains a liquidity premium and/or alternate factors other than expected defaults. It is now natural that accounting should reflect this market practice.

While there is no science to decide the split between default and other portions of the spread using only market prices, this does not negate that this is the market practice to estimate and use this concept.

Concise Statements against Own Credit Spread and Own Asset Spread:

- 1) The use of own spread for discounting one's own liability is NOT market consistent.
 - a) Reason: When A lends to B, A gets a discount on the price for the risk of B's potential default. There is no market transaction in which B gets a discount for its own chance of default. The superficial similarity of the own spread methodology for calculating price does not change the economics of the situation: by getting a discount on its own liability via the "own spread" methodology, B's accounting "mimics" a transaction that does not exist in any financial market. Accordingly, the "own spread" methodology is not in any manner market consistent.

- 2) By the going-concern assumption, the change in the company's own spread does not affect its financials.
 - a) Going-concern assumption: no default of the entity.
 - b) Own credit spread: measures potential of default.
 - c) To use both assumptions concurrently is essentially a logical contradiction; not merely comparing apples to oranges, this is more like considering that moment in time when it is both night and day.

- 3) The use of own asset spread for discounting one's own liability has undesirable (counter intuitive) consequences.
 - a) Suppose a company mismanages its assets. This would cause asset spreads to widen, perhaps severely. If the accounting treatment were to use the entity's

own assets for determination of the proper liability discount rate (either using the yield directly or via a spread consideration), then the company would receive a break on the liability side. This is not the desired result from an account standard. Under the assumption of mismanaging assets, accounting should display the effect on equity.

- b) Similarly, good management of assets should not be penalized through the liability calculation, rather should increase the value of the company.

Emphasis is made that none of these arguments against own credit spread or own asset spread applies to the funding spread methodology presented in this paper.

Reactions to Specific Paragraphs in the Staff paper:

Realization argument with respect to using Overall Market Corporate Spread for discounting liabilities. (Reference is made to Staff Paper Paragraphs 58 to 61.)

While it is arguable that companies can not take advantage of some moves in their own credit spread, they clearly are able to take advantage of changes in prices for assets used for funding a liability. Thus, the use of the funding spread directly satisfies any question of being able to realize the Fair Value change.⁶ Changes in the overall market cost of credit will affect a company's yield on assets used to fund an obligation, and this change flows through the liability valuation.

Accordingly, this paper submits that the realizations arguments against "own spread" do not apply to the funding spread.

Staff Paper Paragraph 37 can be cast in the light of ALM thinking.

⁶ This assumes that the industry standard portfolio is indeed transact-able, which is a reasonable condition to place on the portfolio in order to get a reliable measure.

37 It is now 31 December 20X2. The value of the entity's asset has not changed, but market interest rates have increased. Neither the entity's credit quality nor the credit spread on similar liabilities has changed. Now the entity's fair value statements of financial position look like this:

	31 December 20X1	31 December 20X2
Asset	1,000	1,000
Liability	(900)	(850)
Equity, beginning	(100)	(100)
Gain from remeasuring liability	—	(50)
Equity, ending	(100)	(150)

In the staff example, while interest rates have increased, there has been no change to assets. This change in interest rates caused a change in liabilities but not assets. However, assume that the above financial were calculated using a funding spread methodology for the liabilities, what would be the interpretation?

The paragraph does not state the assumption of spread less defaults for the best-practices asset portfolio for the stated liability, since this was not under consideration when the staff published its paper. Accordingly, we will consider 2 cases are considered:

- A) Assuming the best-practice portfolio spreads did not change from 20X1 to 20X2 then the above situation must represent a company with an asset-liability mismatch: the liabilities changed for spread rate changes but not the assets. In this case, it is completely appropriate that the equity take the gain for this mismatch. The increase in equity reflects the company's realized over-performance in comparison with the best practice industry portfolio. This AL mismatch is positive in this case, but in general represents volatility vs. the benchmark.

- B) If the funding spread also changed, then the interest rate change effect canceled the funding spread effect for the assets. Since this is not the case for the liabilities, we are still left with the conclusion that the above entity has an Asset-Liability mismatch, and accordingly, the increase in equity reflects the mismatch, appropriately.

As a general rule, in this case of no ALM, it is appropriate that the entirety of the change flow through equity. Further, **by having ALM effects flow through equity, proper ALM is encouraged, which is a desirable result from an accounting standard.**

This paper represents solely the personal views of Dr. Matthew C Modisett, PhD., ASA, MMA: matthew.modisett@alico.com. No endorsement from any institution to which Dr. Modisett is associated is implied nor should be inferred from this presentation.