

Isis Financial Systems's White Paper on FASB Reporting Requirements - FSP AAG INV-1 and SOP 94-4-1

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Most investors invest in only what they understand. Unfortunately many investors do not understand the Stable Value industry, perhaps because its guarantee is unclear. As a result, the Stable Value industry suffers from identity crisis, which translates into regulatory concerns and lost marketing opportunities.

Recent turmoil in the investment and the pension fund industries has caused industry leaders to question Stable Value's book value accounting standard, and whether Stable Value commingled funds provide any actual guarantees. In particular, the SEC, the Securities and Exchange Commission, questioned FASB, the Financial Accounting Standards Board, why shouldn't Stable Value funds report at fair market value⁹. For the SEC to boldly show concerns that Stable Value's benefits and guarantees are unclear defines the gross significance of the industry's identity crisis, a crisis that can result in lost marketing opportunities.

FASB responded to this questioning with FASB Staff Position AAG INV-1 and Statement of Position 94-4¹ (FSP AAG INV-1 and SOP 94-4-1). FASB indicates Stable Value positions should be reported in book value, with fair value disclosure. FASB made clear that commingled funds, also known as Collective Trust Funds, must be guaranteed by a Wrap. And FASB also laid forth new, significant financial reporting requirements: the value of the Wrap guarantee must exist and also be clearly disclosed in the financial statements.

FASB's requirements not only address the SEC's concerns, but they also educate sophisticated investors who read the financial statements, as illustrated below. Reaching and educating the broader market remains a burden of the Stable Value industry. Better communication will benefit not only sophisticated investors but the broader market place as well.

Financial statement disclosures are intended to help readers understand key differences between alternatives. One key difference for Stable Value is the level of participation: most GICs are non-participating, while commingled funds and synthetics are usually participating. When market valuations change, perhaps through a yield shift, non-participating rates remain unaltered. In the same circumstance, participating rates will reflect the amortization of the underlying portfolio's gains and losses.

To some extent, this difference in the degree of interest-rate risk is considered additional guarantee. Participation does not constitute a lack of guarantee - only a limitation on the guarantee. FSP AAG INV-1 and SOP 94-4¹ uphold that benefit responsiveness guarantees principal and accrued interest risk. FASB also says that adequate disclosure of participation levels is sufficient. This limit of guarantee is commonly called the degree of benefit responsiveness.

Crediting rates are the result of a selected crediting method. Reporting should communicate the implications of this method. For example, a geometric rate will amortize quicker than either an IRR or amortization method. Variables that affect crediting rates should also be disclosed, such as the book-to-market variance (the interest-rate risk), Wrap flows, withdrawal risk, and the Wrap contract's duration and yield.

FASB's scenario analysis enables readers to more easily compare the impact of one alternative's methods and variables to another's. For example, readers can examine the impact of participation levels by comparing the amortization of the book-to-market variance in a commingled fund's crediting rate with that fund's underlying current yield. Readers may also assess the impact of variables like Wrap cash flows and participant withdrawals. In short, scenario analysis educates the readers and presents the industry in a better-understood and more-credible manner.

FASB stresses the importance of Wrap reporting in many ways. They have said: "The only reason that the fund can report contract value is because it is a certain, guaranteed transaction value. If this guarantee is no longer certain, fair value should be required"². Another FASB member went so far as to say: "If guarantee is not certain, fair value

should be required”³. The guarantee requirement subsequently became more practical: If benefit responsiveness becomes improbable, contracts must be carried at fair market value.

FASB requires the Wrap to have value and provide benefits. That is to say, the Wrap must provide beneficial cash flows under limited guaranteed scenarios. Such benefit responsiveness may be limited to disastrous levels of defaults or large withdrawals attributed to catastrophes. Alternatively, Wraps may provide beneficial responsiveness guaranteed in circumstances that are less severe. Reporters must disclose these guarantee limitations in their financial statements.

Regardless of the type of guarantee, guarantors must maintain a high-credit quality. Without Wrap benefit and without a properly rated guarantor, the Wrap is deemed not benefit responsive and must be reported at a fair market value.

FASB believes that appropriate Wrap reporting is essential for better reader understanding. Financial statements must provide prominent Wrap valuation disclosure, along with any impact that the Wrap has on the crediting rates.

Unfortunately FASB also states that the Stable Value industry itself should define how to value Wraps, without clearly indicating how to do so. Without direction, the industry has had difficulty in consistently defining a method that fairly values the Wrap.

One proposed method to price Wraps treats them like Credit Default Swaps, which are priced at zero at inception and are usually maintain a value close to zero through their lifetimes. Other research comes up with valuations at, or close to, zero, for the same reasons. The Wrap is a defined cash outflow for an undefined cash inflow. Because value needs to be reported, efforts to attribute a single zero valuation cause dissention. The only way for a Wrap to be deemed benefit responsive is to define and report a positive value.

The FASB Staff Position AAG INV-1 gives the following disclosure example:⁴

Investments (at fair value)	\$8,800,000
Wrapper contracts (at fair value)	<u>100,000</u>
Total assets	8,900,000
Total liabilities	<u>200,000</u>
Net assets reflecting all investments at fair value	8,700,000
Adjustment from fair value to contract value for fully benefit-responsive investment contracts	<u>1,100,000</u>
Net assets	\$9,800,000

Above, FASB reports the Wrap as both an asset and a liability—a dual disclosure. This makes sense since the Wrap is essentially an ongoing fee for a payoff that occurs in only rare circumstances. In other words, the Wrap has an ongoing cost—a liability—and, at the same time, an indefinite benefit of Wrap flows—an asset.

Remember that FASB is the board that frames GAAP, the Generally Accepted Accounting Principals. We should consider GAAP when interpreting FASB’s requirements. GAAP looks at Wrap-type contracts as long-term service contracts—in particular, as installment contracts⁵. Installment contracts must recognize both the revenues and costs associated with a sale. This means financial statements should report a Wrap’s total expected benefit and total expected cost. Early in the life of contracts, Wraps are reported as large assets and liabilities. As contracts mature, their valuations are reduced because costs become recognized and the benefiting guarantee matures. Expense, and perhaps gains are recognized in the applicable periods.

Note that in the example above FASB suggests a smaller asset than a liability. This is consistent with installment contract accounting. As the contract matures, beneficiaries expense the cost, which is excess liability. Such recognition parallels an issuer's profit recognition and adheres to GAAP's matching principle.

Dual reporting is the only means to report the correct asset value of the Wrap. In atypical situations, where the Wrap is likely to provide beneficial flows, the expected benefit is represented by a larger asset valuation.

So let's report a Wrap as how FASB suggests.

We already know the Wrap's cost. This is the present value of the outflows, using an appropriate yield curve. That cost, a liability, is reported under "Total liabilities".

Valuing the Wrap benefit requires determining the Expected Value of possible Wrap inflows. To reach this value, one must first define the possibilities. Catastrophes, as we know, cause significant withdrawals. Disastrous levels of defaults cause large swings in market value. These scenarios are what the Wrap guarantees against. Because such scenarios define beneficial Wrap flows, they also define Wrap valuation. By applying probability weightings to the Wrap's expected beneficial flows, you derive the Expected Value of the Wrap, which is reported under "Wrapper contracts (at fair value)".

FASB provides scenario analysis as a means to determine Wrap valuation, and not simply as a means to better communicate to readers. This becomes clear when studying FASB's efforts to prevent arbitrary Wrap valuations:

During FASB's March 2, 2005 meeting, board members push for scenario analysis: "Mr. Young would support Alternative B if it can be tested to see if these stable value investment vehicles can truly support heavy market strains and still guarantee contract value. If he could be more comfortable with the guaranteed nature of these investments, he would fully support Alternative B."⁶ This push for scenario analysis clearly shows its importance for proving the existence and value of the wrap.

FASB goes on to say: "Investment companies subject to this FSP should disclose...any limitations on guarantees (for example, premature termination of the contracts by the plan, plant closings, layoffs, plan termination, bankruptcy, mergers, and early retirement incentives)."⁷ FASB defines the variables that come into play in assessing those risks and in valuing the Wrap asset as much as they define the requisite disclosures.

Scenario analysis lays forth two important variables in assessing Wrap valuation: yield-shift scenarios and participant-withdrawal scenarios. Yield-shift shock assesses the Wrap in the case of bankruptcy and merger, instances that are probable, though not disastrous. Withdrawal scenarios assess the risks one participant might suffer from another's significant withdrawals, including plant closings and other examples cited above. Such scenarios are probable though are not catastrophic. By implementing both of these tests, scenarios analysis effectively assesses the risk coverage that Wraps are supposed to guarantee.

Wrap value, by definition, does not come from probable scenarios, but from only improbable scenarios, since realistic scenarios do not exercise the Wrap. This means that the scenario analysis required for disclosure must be expanded to enable the valuation of the improbable scenarios that cause Wraps to have actual value.

As some may recall, in 2005, the SVIA, the Stable Value Investment Association, successfully lobbied FASB to reduce the withdrawal parameters in scenario analysis. This was deemed appropriate at the time because, they argued, less severe analysis provides more realistic reporting. However, this watered-down version of scenario analysis stepped away from FASB's guideline to value the Wrap's benefit, a benefit whose definition is based solely on the improbable.

FASB's deliberations say: "Mr. Young agreed with Mr. Trott and stated that in working with simulations it became clear that the duration of the portfolio makes a major difference in yields. If the duration is increased, the wrapper becomes increasingly valuable because of the risk of default."⁸ These arguments led FASB to impose a no-duration-impact limitation to their proposed scenario analysis. Unfortunately this limitation is unrealistic. Deposit and withdrawal schedules impact durations, as do contract-driven and company-policy-driven withdrawals. FASB required this restriction to avoid any improper distortion of Wrap valuation through participant withdrawals by

controlling duration in a desirable fashion. This makes FASB's guidelines clear: They want scenario analysis to be performed in a manner that provides appropriate and accurate Wrap valuation.

Again, valuation should use a scenario analysis that includes the improbable and that exposes the benefit of the Wrap. If a wrap is guaranteed, scenario analysis should include a shift in yield to mirror the worst recorded shift in history (20%), regardless of how improbable such an event may be. The analysis should even include a complete withdrawal (100%), should the Wrap guarantee such a scenario.

While these scenarios are rather unrealistic, their probabilities are reflected in their weighting. So, eventhough these scenarios might define large beneficial Wrap inflows, the expected value remains low. The Wrap's rate indicates the low valuation to those unlikely benefits. If no wrap benefit exists under any scenario, then there is no guarantee, there is no benefit responsiveness, and the stable value option must be valued at fair market value.

When performing scenario analysis, one should apply yield shifts first and withdraw scenarios second, as FASB presents. This causes a larger impact to the Wrap's valuation, which is desired.

In order for a Wrap to maintain value, beneficial cash flows must be possible under at least certain scenarios. These scenarios must be defined. Valuation scenario analysis should first document any beneficial flows. These flows must then be probability-weighted in order to derive the Wrap's expected Benefit. FASB seems to prefer that those scenarios provide some depth to the guarantee. For example, FASB wants financial reports to disclose the limitations to the guarantee, and not the cases that the guarantee applies to.

Auditors also will see the value in implementing scenario analysis: to disclosure any probable failure of benefit responsiveness. In probable scenarios, failure of beneficial responsiveness is indicated by a lack of beneficial wrap flows to support participant withdrawals as contract value. To do this, auditors must test yield shift and withdrawal scenarios to define those probabilities where there is no guarantee, and ensure those guarantee limitations are properly noted in the financial statements.

Consistent application of both scenario analysis disclosures and Wrap-reporting requirements secure book value accounting. This model is consistent with both the objectives of FASB and the capabilities of the marketplace.

This method also educates the Stable Value industry's customers, and provides a clearer understanding to and faith in the financial information they read. This reporting even helps expose Stable Value's credible benefits to the broader investing public. They are worth the effort.

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Notes:

1. AAG INV-1 and SOP 94-4-1: Reporting of Fully Benefit-Responsive Investment Contracts Held by Certain Investment Companies Subject to the AICPA Investment Company Guide and Defined-Contribution Health and Welfare and Pension Plans.
2. FASB Minutes of the March 23, 2005 Board Meeting (Stable Value Investments), April 6, 2005, Page 5.
3. FASB Minutes of the February 9, 2004 Board Meeting (Stable Value Investments), March 2, 2005, Page 5.
4. FASB Staff Position: FSP AAG INV-1, December 29, 2005, Page 9.
5. See Accounting Research Bulletin (APB), Page 10.
6. FASB Minutes of the February 9, 2004 Board Meeting (Stable Value Investments), March 2, 2005, Page 5.
7. FASB Minutes of the March 23, 2005 Board Meeting (Stable Value Investments), April 6, 2005, Page 8.
8. Ibid, Page 5.
9. Minutes of the March 23, 2005 Board Meeting (Stable Value Investments), March 23, 2005, Page 4:
"Mr. Herz mentioned a concern raised by the SEC that the wrapper agreement is actually of little substance within the stable value arrangement because the investment limitations and strategy are really what ensure the stability of the fund. There is some concern that this project and SOP 94-4 are putting too much emphasis on the wrapper rather than the structure of the arrangement. The insurance companies that write these wrappers often carry them on their books at zero or negligible value. "
10. Added Note 9.