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INVESTMENT MANAGEMENT

Wider Adoption of New Impairment Guidelines Projected, As Well as Significant Changes in Insurer Portfolio Strategy

BY ERIKA MORPHY

Insurance companies and other financial firms have already come to grips with the idea that the US Financial Accounting Standards Board (FASB) will soon be requiring a charge to earnings in GAAP financial statements when a security has been impaired by an interest rate decline.

But as the industry awaits the final and formal shape of these regulations, insiders are drawing anticipatory conclusions about the effect of this new definition - as well as forecasting that further regulatory actions may be in store.

Alton Cogert, CFA, CPA, president of Strategic Asset Alliance, tells *IFI*, for example, that he believes the same rules will eventually be applicable to insurance companies that use statutory accounting. "Now, firms that use statutory accounting think this debate doesn't touch them. But we have heard through the grapevine - and confirmed from auditors - that if FASB finalizes its rules by year-end, the NAIC will use them as well and apply them to statutory accounting."

The interest rate definition will be embodied in EITF 03-1 which applies strictly to the available-for-sale (AFS) category in Financial Accounting Standard No. 115 (SFAS 115), and not to the trading or held-to-maturity categories. All securities, including mortgage-backed, agency, and Treasury will be subject to the new rules. A complete operational definition of "impairment" has yet to be determined.

Changing Investment Behavior Anticipated

In the longer term, Cogert also foresees a change among many firms in investment behavior once the new rules are made clear. To escape AFS impairments, some firms -- depending on their situation - will be inclined to place more securities in the held-to-maturity category, and adopt a passive portfolio management approach. Others will opt to place more securities in the trading category and take an active management approach.

Both choices will affect third-party insurance asset managers, Cogert observes. "Fees should decline with passively managed portfolios as they are easier to maintain, obviously, and require fewer people." As trading is given more emphasis in other portfolios, however, asset managers should pick up new business stemming from this increased activity.

In a new report, Moody's speculates on other possible changes in investment behavior under EITF, including changes in the types of assets in which companies invest; scenarios in which companies sell higher-yielding securities to offset earnings charges from the impairment of lower-yielding securities, thereby forgoing future investment income needed to cover future product benefits and crediting rates; and the possibility that these decisions might affect profitability and capital ratios.

The Importance of Match-Funding

Moody's adds that the potential ramification on credit ratings from any effect on earnings will depend upon whether a firm has match-funded its investment portfolio.

"If the investment portfolio is match-funded, Moody's does not anticipate that any impact on earnings will affect the financial institution's credit rating," it said in the report, *New Accounting Guidance May Result in Significant Charges To Earnings of Financial Institutions If Interest Rates Rise; No Direct Effect On Credit Ratings For Institutions That Match-Fund Their Investment Portfolios.*

This is because, Moody's says, any decline in the fair value of a debt security from interest rate change is offset by a change in the fair value of the liability.But on the other hand, "if an entity has not match-funded its investment portfolio, the decrease in the fair value of debt securities from changes in interest rates could have credit rating ramifications," Moody's adds.

Some institutions - namely P&C insurers - cannot or do not match-fund their investment portfolios. "Generally, for these types of entities, changes in the fair value of investments are not economically offset by changes in the fair value of their liabilities." There could be possible credit ramifications for these firms if there is a steady increase in interest rates, the agency warned.

Aside from insurers, institutions likely to be affected by EITF 03-1 include banks, and agencies like Freddie Mac and Fannie Mae. ■