The Financial Valuation Group®

Forensic Accounting, Business Valuation and Consulting

In This Issue:

Spotlight: Insurance Industry
Fair Value: Friend or Foe?

Michael J Mard, CPA/ABV, CPCU

Greater financial system regulation arising from the Dodd-Frank Act (the Act) has been in the headlines for several years now since the financial crisis. As the U.S. Financial System Oversight Council continues to exert powers granted to it by the Act, the economic question is simple: is more financial safety worth the higher cost of regulation? The taxpayers will ultimately bear the added cost. But it gets a bit more complicated. Most writings discuss this question on the banking industry with little said about the insurance industry. This article, Fair Value: Friend or Foe?, reviews this complication as it applies to the insurance industry and shows how the election of Generally Accepted Accounting Principles can enhance solvency and minimize the cost to the public.

This article addresses three questions regarding regulation of insurance companies (acronyms are defined in the body of this piece):

1. Will the FSOC's power to designate SIFI reach property casualty insurance carriers?
2. Will the NAIC and state regulators react to the FSOC pressure by expanding their regulatory tools?
3. Can the fair value of liabilities in a rising interest rate market improve carrier capital surplus?

The answers to all three questions are "yes."

The Financial Stability Oversight Council

The Financial Stability Oversight Council (FSOC or Council) was established under the Dodd-Frank Wall Street Reform and Consumer Protection Act and is charged with identifying risks to the financial stability of the United States, promoting market discipline and responding to emerging risks to the stability of the U.S. financial system. The Council consists of ten voting members and five nonvoting members and brings together the expertise of federal financial regulators, state regulators, and an independent insurance expert appointed by the President.[1]

The FSOC is the "college of regulators" charged with monitoring, preventing and ultimately resolving broad systemic risks to the U.S. economy. Under the FSOC process, certain non-bank financial institutions designated as SIFIs (Systemically Important Financial Institutions) may be subject to heightened scrutiny and capital standards, both by the Council and by the Federal Reserve Board.[2]

Using AIG as an example, Fortune Magazine summarizes the impact of the FSOC thusly, "International regulators have deemed AIG a 'systemically important financial institution' – that is, big enough that its failure could trigger another (economic) crisis. That designation will require it to keep an as-yet-undetermined amount of cash on its books…"[3]

This movement is not limited to the U.S., but is in fact worldwide. As stated by the Financial Stability Board of the FSOC:

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Fair Value: Friend or Foe (Continued from page 1)

Systemically important financial institutions…are financial institutions whose distress or disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity.

At the Pittsburgh Summit in 2009, G20 Leaders called on the FSB to propose possible measures to address too-big-to-fail (TBTF) problems associated with SIFIs. In 2010 at the Seoul Summit the G20 Leaders endorsed the FSB framework for reducing the moral hazard of SIFIs (the SIFI Framework).

The objective of the SIFI Framework is to address the systemic risks and the associated moral hazard problem for institutions that are seen by markets as TBTF. It does so by reducing the probability of SIFIs failing through implementation of a multipronged and integrated set of policy measures to address systemically important financial institutions…[4]

Importantly, there are approximately 40 institutions worldwide that have been designated systemically important by regulators. These break out into approximately 30 banks and nine non-banks (insurance companies).[5]

Designation of MetLife

Companies earning the SIFI classification include most recently MetLife, Inc. which has been fighting the designation tooth and nail in the courts. It is instructive for purposes of this article to review the reasons for the FSOC's determination and the MetLife position as it sues the FSOC. As stated in the FSOC response to the claims by MetLife[6] (emphasis added):

The Council explained that no single statutory factor was dispositive in its determination, and it also identified two separate grounds for its designation under Section 113(a)(1): first, MetLife's distress could pose a threat to U.S. financial stability through the "exposures channel," based on market participants' exposures to MetLife, AR 368; and second, MetLife's distress could pose a threat to U.S. financial stability through the "asset liquidation channel," based on the potential for asset liquidations by MetLife…

MetLife's argument against being designated a SIFI is simple: It is already tightly regulated inside out by fifty states, the SEC and many other bodies. Perhaps more elegantly stated is the dissenting vote on the Council's SIFI designation by Roy Woodall[7] (citations omitted):

The Resolution presented for the vote today by the Council points only to the First Determination Standard as the sole justification for the Council's determination – that material financial distress at the nonbank financial company could pose a threat to the financial stability of the United States…

I believe that there could be some findings within the Council's Notice of Final Determination and Statement of the Basis for the Financial Stability Oversight Council's Final Determination Regarding MetLife, Inc., (Notice of Final Determination) that would be useful in considering the designation of MetLife under the Second Determination Standard – that the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the nonbank financial company could pose a threat to the financial stability of the United States, regardless of whether the company were experiencing material financial distress…

The analysis (by the FSOC) relies on implausible, contrived scenarios as well as failures to appreciate fundamental aspects of insurance and annuity products, and, importantly, State insurance regulation and the framework of the McCarran-Ferguson Act. It presumes that all current operations and activities are static without consideration of any dynamics or responses occurring before a presumed insolvency. The analysis discusses in detail, and is dismissive of, the U.S. State insurance regulatory framework, the panoply of State regulatory authorities, and the willingness of State regulators to act, thereby overstating shortcomings and uncertainties that are inherent in all regulatory frameworks, State or Federal.

Writing for A.M. Best, Frank Klimko concludes, "MetLife mistakenly asserts that the council 'assumed the utter ineffectiveness of state regulators…MetLife's existing (state) regulation(s) principally address policyholder protection and not threats to financial stability."[8] (emphasis added).

State Regulators

Both make compelling points. State regulators protect policyholders; the FSOC protects an entire financial system. As stated by the National Association of Insurance Commissioners (NAIC)[9]

State insurance regulators created the NAIC in 1871 to address the need to coordinate regulation of multistate insurers. The first major step in that process was the development of uniform financial reporting by insurance companies. Since then, new legislative concepts, new levels of expertise in data collection and delivery, and a commitment to even greater technological capability have moved the NAIC forward into its role as a multidimensional, regulatory support organization.

The mission of the NAIC is to assist state insurance

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regulators, individually and collectively, in serving the public interest and achieving the following fundamental insurance regulatory goals in a responsive, efficient and cost effective manner, consistent with the wishes of its members:

- *Protect the public interest;*
- *Promote competitive markets;*
- *Facilitate the fair and equitable treatment of insurance consumers;*
- *Promote the reliability, solvency and financial solidity of insurance institutions; and*
- *Support and improve state regulation of insurance*

In short, in order to protect the public interest, specifically policyholders of a particular insurance company, the state regulators and the NAIC created a significant tool with the development of uniform financial reporting by insurance companies, namely Statutory Accounting Principles (SAP) which significantly differ from Generally Accepted Accounting Principles (GAAP) required to be used by all publicly traded companies. As stated by NAIC[10]:

> *Statutory Accounting Principles are designed to assist state insurance departments in the regulation of the solvency of insurance companies. The ultimate objective of solvency regulation is to ensure that policyholder, contract holder and other legal obligations are met when they come due and that companies maintain capital and surplus at all times and in such forms as required by statute to provide a margin of safety*

In contrast, the Financial Accounting Standards Board promulgates GAAP[11]:

> *The mission of the FASB is to establish and improve standards of financial accounting and reporting that foster financial reporting by nongovernmental entities that provides decision-useful information to investors and other users of financial reports.*

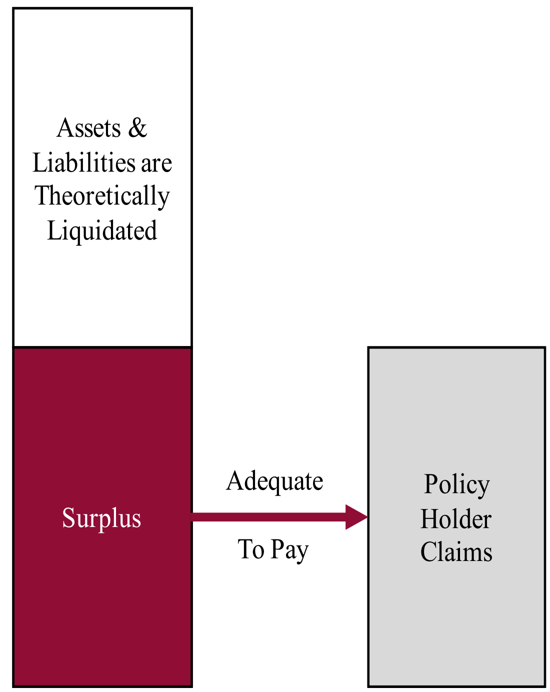
The differences between SAP and GAAP accounting are significant. SAP is an orderly liquidation methodology dictated by the regulatory bodies to protect policyholders from insurance company insolvency. GAAP is a series of going concern based and generally industry specific standards which recognize and match transaction timing differences as well as the fair value of assets and liabilities. For example, SAP and GAAP differ in their treatment of areas such as:

- Deferred acquisition costs
- Deferred tax assets
- Non-admitted assets
- Invested assets
- Loss reserves
  - Retroactive reinsurance
  - Structured settlements

ILLUSTRATION 1

State Regulators

Statutory Accounting Principles



- Ceded reinsurance
- Acquisition accounting
- Fair value of certain assets and liabilities

SAP in essence uses a hypothetical orderly liquidation computation of an insurance company's balance sheet to determine whether there is enough solvency (in the regulator's mind) to supply protection for potential claims of the company's policyholders, assuming instant insolvency contemporaneous with instant filing of policyholder claims. See Illustration 1.

In contrast, GAAP applies to all industries in a manner to aid users/investors. As stated recently by Edward W. Trott, a former FASB member[12]:

> *Financial statements that comply with generally accepted accounting principles also provide users with what they expect, even if there are some differences based on accounting policy options. The consistency of financial information provided by GAAP helps to reduce the cost of capital for companies (both public*

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Valuing Stock Issued as Compensation – Fair Value vs. Fair Market Value

By: Donald P. Wisehart, CPA/ABV, CVA, MST

In valuing stock issued as compensation, it is necessary to comply with Internal Revenue Service code section 409(A) as well as complying with Generally Accepted Accounting Principles (GAAP). The key is to "balance" 409(A)'s fair market value requirements for "reasonable valuation methods" with the fair value requirements under the Financial Accounting Standards Board (FASB) Accounting Standard Codification ASC 718, Compensation – Stock Compensation (formerly Statement of Financial Accounting Standards 123R). Furthermore, fair value assignments will follow the approaches found in the AICPA[1] Practice Aid, which stipulates a specified hierarchy of assumptions and inputs while fair market value has no stated hierarchy of preference.[2]

The definitions of fair market value and fair value are, indeed, different. Fair market value is defined as "the price, expressed in terms of cash equivalents, at which such property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, when neither is under compulsion to buy or to sell, and both have reasonable knowledge of relevant facts." (Revenue Ruling 59-60). Fair value is defined as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."

As you can see, the two standards are not identical. But are the standards really compatible and would they, nonetheless, produce the same value? For the most part, the short answer is yes, the two standards are compatible and would likely produce the same value. In May 2013, the FASB stated the "fair value, as refined, is consistent with the definition of fair market value in IRS Rev Rul. 59-60."[3]

The longer answer is that there are

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Announcements:

Education:

- Dr. Michael Crain taught corporate finance to global MBA students for Manchester Business School, University of Manchester, UK.
- Dr. Michael Crain taught two courses on valuation to graduate students in the School of Accounting at Florida Atlantic University.
- Mr. Michael Mard and Mr. Donald P. Wisehart are presenting The Knowledge Group National Webinar January 28, 2016. https://theknowledgegroup.org/mobile/event.php?event_id=1303

Achievements:

- Mr. Michael Mard obtained his Charted Property Casualty Underwriter (CPCU) designation.
- Mr. Michael Mard became a member of the Society of Insurance Research (SIR).
- Mr. Michael Mard became a member of CPCU Society.

Upcoming Events/Appearances:

- The SIR 45th Annual Conference will be attended by Mr. Michael Mard.
- The 2015 Insurance Conference on Financial Reporting will be attended by Mr. Michael Mard.
- Dr. Michael Crain will be speaking at the American Institute of CPAs annual Forensic & Valuation Services Conference in Las Vegas on damage measurements using statistical analysis.

differences. For starters, the definitions are viewed from different perspectives. Noncompliance with §409A can result in taxes and penalties paid by the individual. Accordingly, the standard of value taxes on an individual perspective[4]. On the other hand, option valuations for financial reporting purposes are a corporate issue whereby the results are measured from the perspective of the company.[5] "Due to differences in the applicable standards and the factors that can be considered for a specific individual interest compared with an aggregation of generic interests, it is possible to have a different value for tax purposes compared with financial reporting purposes. Representatives from the Securities and Exchange Commission (SEC) and the IRS have been questioned on this topic and they agreed that different standards may produce different value conclusions for the same stock option grant. They went on to say, however, that their opinions are in no way binding, but represent a consensus of thought related to the poised questions."[6]

Although in most cases, the application of the two different standards will result in similar conclusions of value, neither the SEC nor the IRS has stated, with definitiveness, that the two standards of value would result in the same valuation conclusion. ~

Endnotes:

1. American Institute of Certified Public Accountants.
2. 409A Compliance – Issues, Approaches and Mistakes Not to Make, A teleconference from Business Valuation Resources, May 2, 2007.
3. Ibid.
4. BVR's Guide to Valuations for IRC 409A Compliance, Neil J. Beaton, page 1-19.
5. Ibid.
6. Ibid., page 1-19.

Retaining An IRS Qualified Appraiser

By: Steven D. Hyden, CPA/ABV

It is no secret that taxpayers and the IRS are in a constant state of conflict over a number of issues, and one of them is value. Value has traditionally been a subject of much disagreement in the arenas of charitable donations and estate and gift taxes.

When the subject is an interest in a closely held business, the fair market value of the interest is the critical element in the determination of the gift or estate tax liability. The appraisal of the interest is not an objective calculation but rather an empirical analysis. Although the foundation of any business appraisal is the proper application of generally accepted valuation techniques, the utilization of judgment is critical in applying the empirical process. Because judgment plays such an important role in the determination of the value of a closely held business interest, the IRS has sought to bring some order to historic chaos, both by the recognition of certain standards and by establishing accepted qualifications for appraisers.

At the sole discretion of the IRS, values of gifts for gift tax purposes and non-gift completed transfers to family members may require a "qualified appraisal", as defined by Treas. Reg. § 301.6501(c)-1(f)(3).[1] The IRS's guidance includes the following requirements related to the "qualified appraiser" preparing the "qualified appraisal":

- The appraiser holds him/herself out to the public as an appraiser or performs appraisals on a regular basis.
- The appraiser is qualified to make appraisals of the type of property being valued, as evidenced by background, experience, education and membership in professional appraisal organizations.
- The appraiser is neither the donor nor donee of the property nor a family member.
- The appraisal documentation (read: report) must contain all of the following[2]:
  - ♦ Date of appraisal, date of transfer and purpose of the appraisal
  - ♦ A description of the property
  - ♦ A description of the appraisal process employed
  - ♦ A description of hypothetical and limiting conditions, assumptions used, and restrictions on the property that would affect the conclusion
  - ♦ Disclosure of information considered, including, in the case of a business interest, all financial data used in determining value, such that another person can replicate the work and arrive at the appraised value
  - ♦ Description of procedures and reasoning supporting the analysis and conclusion(s)
  - ♦ The valuation method(s) utilized, the rationale for selecting the method(s) and procedure used in determining value
  - ♦ The specific basis for the valuation, that is, discussion of the methods relied upon.

Much of this guidance has been supported in various court decisions. For example, courts have accepted as "expert appraisers" those who represent business valuation firms or consulting firms providing business valuation

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and private) by reducing uncertainties. It also reduces the cost incurred by financial statement users, who have access to information that helps them compare the financials of different companies. Both those elements help make the GAAP brand valuable.

Critically, the FSOC utilizes GAAP in its determinations of which companies, namely banks and non-banks, are SIFI. The FSOC performs additional analyses in order to conclude comprehensive capital analysis and review (CCAR) and Dodd Frank Annual Stress Testing (DFAST) via complex mathematical models (see for instance http://financialresearch.gov/working-papers/). But the starting point is GAAP. See Illustration 2.

Last December, Congress passed and the President signed Public Law 113-279 "to clarify the application of certain leverage and risk-based requirements under the Dodd-Frank Wall Street Reform and Consumer Protection Act" which stated[13] (emphasis added):

"(3) RULE OF CONSTRUCTION ON ACCOUNTING PRINCIPLES.—

"(A) IN GENERAL.—A depository institution holding company or nonbank financial company supervised by the Board of Governors of the Federal Reserve that is also a person regulated by a State insurance regulator that is engaged in the business of insurance that files financial statements with a State insurance regulator or the National Association of Insurance Commissioners utilizing only Statutory Accounting Principles in accordance with State law, shall not be required by the Board under the authority of this section or the authority of the Home Owners' Loan Act to prepare such financial statements in accordance with Generally Accepted Accounting Principles.

Different Tape Measures

For the FSOC to begin its analysis of different companies using either SAP or GAAP is akin to a tailor using two tape measures, one with imperial measurements and the other with metric. Although the FSOC shall not require GAAP for a company that is following SAP, to do so might eliminate a company's recognition of the fair value of perfectly valid intangible assets. Further, under GAAP and assuming that fair value measurement is triggered, liabilities might be restated at a lower amount in a rising interest rate market, as we have now. Specifically[14],

Fair value is a market-based measurement, not an entity-specific measurement. For some assets and liabilities, observable market transactions or market information might be available. For other assets and liabilities, observable market transactions and market information might not be available. However, the objective of a fair value measurement in both cases is the same—to estimate the price at which an orderly transaction to

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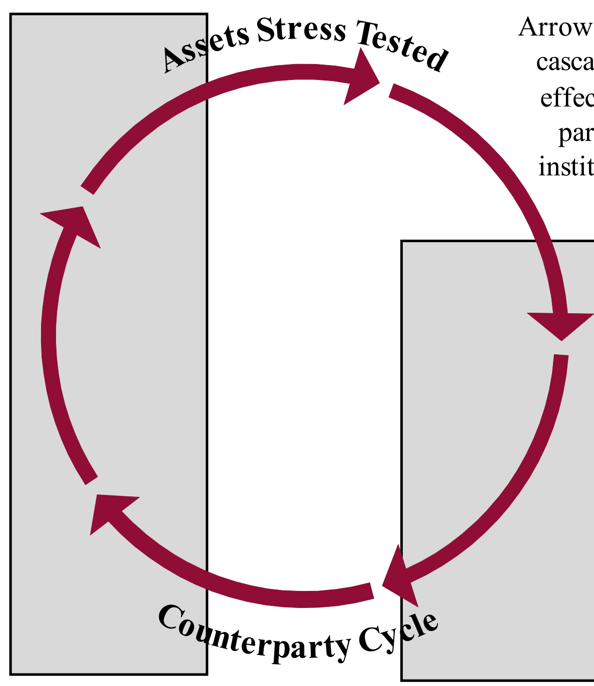
ILLUSTRATION 2

FSOC's SIFIs

GAAP assets being stress tested should result in an adequate cash flow to satisfy the counterparties and keep the exposures channel fluid.



Arrows represent the cascading domino effect to counterparties' (other institutions') cash flows.

sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions (that is, an exit price at the measurement date from the perspective of a market participant that holds the asset or owes the liability).

Fair value is not computed automatically at each issuance of GAAP statements but rather upon the occurrence of certain triggering events. Triggering events requiring the application of fair value under GAAP include business combinations such as mergers or acquisitions as well as certain other events. But if so triggered, the impact to an insurance carrier's equity in a rising interest rate market can be material. For instance, assume a ten year liability of $1,000,000 whose interest rate increases by some 125 basis points. The decrease of the present value of the liability can approach $100,000 or more, depending on the existing rate. The adjustment to reduce the liability correspondingly increases equity by that amount! This increase of equity due to the reduction of the fair value of a liability in a rising interest rate market could provide a material enhancement to an insurance carrier's surplus.

Conclusion

While the benefit of any specific regulation could be argued good or bad (anyone want to sleep in an asbestos filled hotel?) the nature of a governmental regulatory power frequently is thought to grow with upward pressure to expand powers. As we monitor the FSOC's activities (both domestically and in collaboration with international bodies such as the Bank of England), we see a worldwide designation of some forty entities systemically important (banks and non-banks) and more to come. The insurance industry and the nature of the public's dependency on it have resulted in many national and state level regulatory monitors. Until the recent Great Recession, the state insurance regulators and the NAIC have, by and large, achieved policyholder protection by determining a theoretical surplus using a hypothetical orderly liquidation process by applying SAP. However, this emphasis on a carrier's asset liquidation channel ignores that carrier's exposures channel, based on market participants' exposures. As such, continuing to ignore the implications of any insurance carrier's exposures channel is to invite FSOC oversight to all insurance companies. A strong beginning step at the state regulatory and NAIC level to correcting this omission and fully retaining its authority is the application of GAAP, and specifically fair value, to address market participants' exposures. A next step, of course, will be to adopt CCAR and DFAST stress testing specific to the insurance industry's exposures channels. We will address this in our next newsletter. ~

Endnotes:

1. http://www.treasury.gov/initiatives/fsoc/Pages/home.aspx
2. Insurance Journal, http://www.insurancejournal.com/, December 21, 2014, by Ray Lehmann, "Big SIFI News: MetLife is Designated, Obama Signs Insurance Capital Standards Bill".
3. Fortune magazine, issue August 1, 2015, page 66, "A Second Look at AIG: Investors Who Avoid The Insurer Because of Its Past Mistakes Are Missing Out, Says Fidelity's John Roth" by Lauren Silva Laughlin.
4. http://www.financialstabilityboard.org/what-we-do/policy-development/systematically-important-financial-institutions-sifis/
5. Ibid.
6. Case 1:15-cv-00045-RMC Document 60-1 Filed August 4, 2015, In the United States District Court for the District of Columbia, Metlife, Inc., Plaintiff, v. Financial Stability Oversight Council, Defendant. Redacted Brief Civil Action No. 15-45 (RMC), Page 22 of 88.
7. http://www.treasury.gov/initiatives/fsoc/designations/documents/dissenting%20and%20minority%20views.pdf Views of Roy Woodall, former Kentucky Insurance Commissioner and the Financial Stability Oversight Council's (the Council) Independent Member.
8. "FSOC: State Regulation Won't prevent a Future Financial Meltdown," Best's Insurance News & Analysis, by Frank Klimko, August 5, 2015.
9. http://www.naic.org/index_about.htm
10. http://www.naic.org/cipr_topics/topic_statutory_accounting_principles.htm
11. http://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1176154526495
12. http://ww2.cfo.com/gaap-ifrs/2015/05/exceptions-private-companies-damaging-gaap-brand/
13. http://www.gpo.gov/fdsys/pkg/PLAW-113publ279/pdf/PLAW-113publ279.pdf
14. https://asc.fasb.org/section&trid=2155944, 820-10-05-1B

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- FVG is sponsoring the Thomson Howell Ferguson, PA 2015 Insurance Conference on Financial Reporting in October.

Ft. Lauderdale, FL **Tampa, FL**

Kingston, RI

Return address:

The Financial Valuation Group
201 N Franklin Street
Suite 3150
Tampa, FL 33602

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Qualified Appraiser ***(Continued from page 5)***

services and look favorably on accreditations and credentials such as the AICPA's Accredited in Business Valuation (ABV).

In a future article we will examine in greater detail what certain court decisions have had to say about appraiser qualifications. However, of one thing there is no doubt – ignoring the guidance and retaining an unqualified appraiser, or not retaining an appraiser at all, is an invitation to disaster. Values so determined will most certainly be disallowed, and at a minimum the taxpayer will have to commission a proper valuation, but at that point the taxpayer will be in the unenviable position of developing both a proactive empirical analysis consistent with accepted standards as well as a reactive counterargument to the IRS's initial challenge. Do it right the first time. ~

Endnotes:

1. Treas. Reg. § 301.6501(c)-1(f)(3).
2. Ibid.