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AMERICAN COUNCIL OF LIFE INSURERS
FINANCIAL SECURITY FOR LIFE

Letter of Comment No: 2
File Reference: FSPFAS133A

November 21, 2005

Mr. Robert H. Herz
Chairman
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: Proposed FASB Staff Position No. 133-a, "Accounting for Unrealized Gains (Losses) Relating to Derivative Instruments Measured at Fair Value under Statement 133"

Dear Mr. Herz:

The American Council of Life Insurers (ACLI) appreciates the opportunity to comment on the proposed FASB Staff Position No. 133-A, "Accounting for Unrealized Gains (Losses) Relating to Derivative Instruments Measured at Fair Value under Statement 133" (FSP). ACLI is the principal trade association of life insurance companies, representing 356 member companies that account for 80 percent of total assets, 78 percent of the life insurance premiums and 84 percent of annuity considerations, in the United States.

The ACLI has specific comments related to the potential inadvertent effects the FSP may have on the accounting for certain contracts accounted for under FASB Statement 97 - *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments* (FAS 97) as a result of the FSP's proposed changes to Derivatives Implementation Group Issue B6, *Embedded Derivatives: Allocating the Basis of a Hybrid Instrument to the Host Contract and the Embedded Derivative* ("Issue B6").

Specifically, certain variable annuity contracts (classified as separate accounts in accordance with Statement of Position 03-1) with guarantees and equity indexed life and annuity contracts contain embedded derivatives under Statement 133. The ACLI has two significant concerns regarding the hybrid instrument accounting described in the proposed FSP (for more information concerning the details of our concerns, please refer to the attachment where we describe the application of the FSP to a hybrid variable annuity contract):

1. Paragraph 8 of the FSP, within the proposed amended response to Statement 133 Issue B6, states, "Once the carrying value of the host contract is established, it would be accounted for under generally accepted accounting principles applicable to instruments of that type that do not contain embedded derivatives." We believe that, after application of the FSP as it relates to derivatives embedded in traditional variable annuity and investment contracts, the resulting

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accounting for the host contracts could be significantly different from that prescribed in FAS 97 and do not believe the intent of the FSP was to modify the accounting for contracts under FAS 97. In addition, accounting for variable annuity contracts in the separate accounts as provided in SOP 03-1 could be significantly modified by the application of the FSP. In summary, we believe the FSP would require issuers of contracts under FAS 97, with an embedded derivative guarantee to defer, on their balance sheet, certain profits expected to be earned on the host contract. This is significantly different from the profit recognition model prescribed by FAS 97.

2. Paragraph 19 of the FSP states, "The Board observed that at initial recognition of a hybrid instrument, the unrealized gain (loss) related to the host contract is *generally* inseparable from an unrealized gain (loss) related to the embedded derivative, considering the existence of a single observable transaction price for the hybrid instrument. Largely for that reason, this FSP requires that the unrealized gain (loss) be determined based on the fair value of the hybrid instrument, rather than the fair value of the embedded derivative instrument." In the case of guarantees embedded in variable annuity contracts and equity indexed options embedded in life and annuity contracts which are subject to Statement 133, the embedded derivative can be separated from the host contract and any unrealized gain or loss on the embedded derivative can be separated from, and measured more reliably than, any unrealized gain or loss on the hybrid instrument. The guarantee is priced separately from the host contract (for variable annuities it is usually explicit in the contract), and the reference market for the guarantee is often times a different market from the hybrid contract's reference market or the host contract's reference market. The equity-indexed options can be valued by reference to the equity index upon which they are based, and therefore can be more reliably measured at fair value than the debt host or the hybrid instrument. Continuing to separate the embedded derivative and determining the unrealized gain or loss applicable to the embedded derivative portion of the contract only, as currently prescribed by Issue B6, the accounting for the host contract under FAS 97 and SOP 03-1 is not affected. If the value of the embedded derivative and host contract were determined by valuing the hybrid instrument based on entity inputs (Level 5), as is often, if not always, the case for annuity contracts with embedded guarantees, the subsequent accounting for the host contract and the unrealized portion would be inconsistent with FAS 97 and SOP 03-1. Separate account assets would not be equal to separate account liabilities, separate account liabilities would not equal the contract holder's account value and the accretion of the amount attributable to the host contract would change the earnings attributable to the host contract from that prescribed by FAS 97.

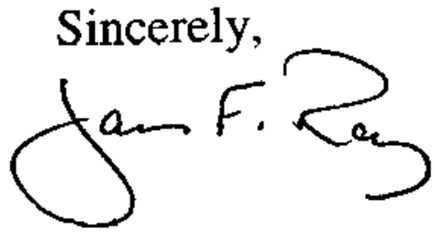
Due to conflicts between the FSP and FAS 97, as well as SOP 03-1, we therefore recommend that the FSP provide scope exclusion for host contracts that are accounted for under FAS 97. We would also recommend that embedded derivatives in hybrid instruments for which the host contract is accounted for under FAS 97 should be accounted for in a manner consistent with the current accounting prescribed in Issue B6. While we are not aware of significant concerns as it relates to host contracts accounted for under Statements 60, 113 or 120, we do not believe the revenue and/or profit recognition models prescribed by those standards for the host contract should be impacted by the FSP. We, therefore, would also recommend the same exclusion for host contracts that are accounted for under Statements 60, 113 and 120.

In addition, under response 2a, Statement 133 Issue Paper B29 requires bifurcation of an additional compound embedded derivative contained in certain equity-indexed investment contracts. We would suggest that the accounting "interplay" of Statement 133 (including B29), FAS 97 and this FSP would require further study and clarification.

The ACLI also has a general comment related to the potential widespread application and/or precedent-setting nature of this proposed FSP with only a 30-day comment period. ACLI members are concerned that providing this special accounting (deferral of profit or loss recognition) for fair value measurements of derivatives under Level 5, as defined in Statement 15X, may later be applicable to all Level 5 measurements under Statement 15X. We are concerned that the assessment of the potential impacts this guidance may have if extended to Level 5 measurements for other than derivatives has not been adequately addressed nor have the concepts been exposed on a widespread basis.

It would be our pleasure to further discuss our comments in greater detail with the Board or Staff.

Sincerely,



James F. Renz
Director, Accounting Policy

ATTACHMENT
Implementing the FSP

As an example, assume an insurance enterprise issues a variable annuity contract with an embedded derivative guarantee. Similar accounting would exist for an insurance enterprise that issued an equity indexed annuity or life insurance contract.

In this example, the guarantee is an embedded derivative in the traditional variable annuity host contract issued in the retail market and the ACLI believes the retail market is not the reference market.

Assume a contract holder deposits $50,000 into a variable annuity contract with an embedded derivative guarantee. The fair value of the hybrid instrument is determined to be $3,000 (the amount the insurance enterprise would be paid upon reinsuring or selling the contract). We believe the transaction price upon contract holder deposit into an annuity contract is $0. Therefore, the unrealized gain is $3,000. $3,000 represents a significant component of the profit to be earned on the variable annuity contract.

For purposes of this example, assume the calculation of the embedded derivative is an asset (present value of fees exceeds present value of benefits, or "lay-off" price) equal to $200.

We believe the following journal entry would be recorded at inception:

Dr. Separate Account Assets	$50,000	
Dr. Embedded Derivative	200	
Cr. Unrealized Gain		3,000
Cr. Separate Account Liabilities		47,200

As can be seen by this example, separate account assets do not equal separate account liabilities, separate account liabilities do not equal account value and, as a result, the accounting prescribed by the FSP has changed the accounting for the traditional variable annuity host contract at inception.

Day two accounting will result in:

1. separate account assets and liabilities changing in value based upon the performance of the underlying funds
2. changes in fair value of the embedded derivative recorded in earnings
3. profits would be limited to the discounting effect used in determining the fair value of the hybrid instrument
4. the unrealized gain would likely not be recognized until contract surrender or when the last benefit payment was made

The FSP would therefore result in a profit recognition model partially contingent upon contract termination. This profit recognition model is inconsistent with the profit recognition model for the traditional variable annuity host contract in Statement 97.