



November 15, 2007

LETTER OF COMMENT NO. 7

Ms. Suzanne Q. Bielstein
Technical Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Sent via email to: director@fasb.org

Re: Preliminary Views on Insurance Contracts, File Reference 1540-100

Dear Ms. Bielstein:

On behalf of The Northwestern Mutual Life Insurance Company, we are pleased to respond to the Board's Invitation to Comment ("the ITC") regarding the International Accounting Standards Board's recent Discussion Paper entitled *Preliminary Views on Insurance Contracts* ("the DP") and the potential for adding a joint IASB/FASB project on insurance contracts to the FASB's agenda.

Northwestern Mutual, headquartered in Milwaukee, Wisconsin, is the 11th largest life insurance group in the U.S. based on total assets. Our company has earned the highest available ratings for financial strength from each of Standard & Poor's, Moody's Investor Services, Fitch Ratings and A.M. Best. We offer our clients a full array of life insurance products, including permanent whole life, term and universal life products. In addition, we offer annuities, disability income and long-term care insurance. As a mutual insurance company, virtually all of our insurance contracts are participating. During 2006, Northwestern Mutual paid over \$4.6 billion in participating dividends to our policyholders, representing over 25% of all participating dividends paid by U.S. domiciled life insurers.

Our responses to the specific questions raised in the ITC are provided beginning on page 2. In summary, we offer the following introductory comments:

- We believe there is a significant opportunity to comprehensively address and improve current U.S. GAAP for insurance contracts. While we recognize the potential benefits of international convergence of accounting and financial reporting standards, we believe that convergence should be pursued only with full regard for the challenge and cost to insurers.

- We have serious concerns about the preliminary views expressed in the DP and do not believe it is the optimal starting point for a joint IASB/FASB project. Given our conceptual and practical concerns, we believe that current U.S. GAAP would be a more appropriate starting point, especially for participating life insurance contracts.
- We ask that the FASB challenge and validate the assertion that a “mark-to-model” accounting framework, as advocated in the DP, better meets the needs and expectations of insurance financial statement users. This conclusion is presented as foregone in the DP, but our own experience as an investor and our discussions with other investors and financial statement users suggests otherwise.
- We believe that the current FASB agenda includes a number of fundamental conceptual projects that should be completed prior to the initiation of a new project regarding the specifics of insurance accounting and reporting.

Responses to Specific Questions

The Board’s specific questions are repeated below, along with Northwestern Mutual’s responses.

Question 1

Is there a need for the FASB to comprehensively address the accounting for insurance contracts? Why or Why not?

- 1a. What aspects of existing U.S. GAAP accounting for insurance contracts could be improved or simplified and how pervasive are these issues?
- 1b. How important is the development of common, high-quality standard used in both the U.S. and IFRS jurisdictions?

Response

Yes, we believe there is a need for the FASB to comprehensively address accounting for insurance contracts. As noted in the ITC, the current U.S. GAAP framework for insurance accounting has evolved gradually and over many years through the development of standards focused on specific categories of products (e.g., SFAS #60, #97, #113, #120) and has never been subject to comprehensive consideration by the FASB.

Existing U.S. GAAP accounting for insurance contracts should be improved or simplified in each of the following areas:

- A need for clear definition for the scope of insurance contract accounting and a requirement that those accepting similar risk transfer apply the same accounting and reporting principles even if not “insurers” in a conventional or legal sense.
- Resolution of the current “mixed attribute” accounting model that invites accounting mismatches without real economic substance (i.e., mark-to-market valuation of most investment assets while many insurance liabilities are based largely on assumptions “locked-in” at issuance). This is especially true for

participating insurance contracts, where the ultimate insurance contract benefits are integral to and dependent upon actual investment returns.

- Embedded option accounting (e.g., SFAS #133/149) invites accounting mismatches that are not consistent with overall economic substance and inconsistent accounting results among substantially similar insurance products.
- The current accounting framework for deferred acquisition costs, especially retrospective adjustments and internal replacement requirements, is burdensome, unnecessarily complex and creates confusion for users of insurer financial statements.

Given the increasingly global nature of our industry and the capital markets, the development of common, high-quality standard used commonly in the U.S. and internationally is a worthwhile objective. However, we suggest that the potential benefits of convergence not create a mandate or urgency that underestimates the challenges and costs for preparers, users and auditors. We recommend an approach that first validates, through field testing or other means, the perceived benefits of a new comprehensive standard as exceeding these substantial costs.

Question 2

Are the preliminary views expressed in the IASB's Discussion Paper a suitable starting point for a project to improve, simplify, and converge U.S. financial reporting for insurance contracts? Why or why not?

2a. Do you believe the preliminary views would be feasible to implement? If not what aspects of the preliminary views do you believe could be difficult to apply and why?

2b. Are there other alternatives to improve or simplify U.S. financial reporting for insurance contracts that you would recommend? What would be the benefits of those alternatives to users of the financial statements?

Response

We have serious concerns about the DP as an appropriate starting point for U.S. insurance accounting and reporting standards. Our concerns are detailed in our response to the IASB, which is attached for your reference.

A fundamental concern regards the apparent mandate for a "fair value" measurement framework by the IASB, which requires "market-observable" inputs to the measurement of insurance liabilities in absence of a relevant and reliable marketplace for transfer of such liabilities. It is well understood, and acknowledged in the DP, that many of these market inputs do not exist. Such a "mark-to-model" accounting framework would likely result in less reliable, less relevant financial information for users and a lack of consistency and comparability between companies. It also faces serious challenges in terms of its auditability, particularly in a "principles-based" context.

The recent, collective difficulties experienced by financial statement preparers, auditors, regulators and other users regarding the implementation of SFAS #157 (especially “level 3” assets for which valuation is primarily model-dependent) illustrates the disconnect between the legitimate conceptual objective of “fair” valuation and its practical implications. While these difficulties were aggravated by the volatile credit environment, at least some “market-observable” inputs were available. There is no such reference market for insurance contracts, and we are concerned that application of a similar valuation requirement for insurance contract liabilities will be counterproductive.

We also suggest that any joint project include a reconsideration of the general assertion made in the DP that users of insurance company financial statements favor a “fair value” financial statement framework versus one based on historical cost with appropriate fair value disclosures. That assertion is not supported in the DP and our discussions with investors (our own and others) did not find unanimity on this point.

Question 3

Is there a need to address accounting by policyholders in an insurance contracts project? Why? If yes, should accounting by policyholders be addressed at the same time as the accounting by insurers? Can or should that wait until after the accounting by insurers is completed?

Response

There is a need to ultimately address accounting by policyholders, as existing guidance is sparse and incomplete. We view this need as secondary in importance to the need for a comprehensive review of accounting by those entities issuing insurance contracts and see limited synergy in addressing them together, as there is no necessary relationship between accounting by insurance companies and accounting by their policyholders. For these reasons, it should be deferred until after the standards for accounting by insurers is complete.

Question 4

How would you address the interaction between the accounting for insurance contracts and the FASB’s other projects on the conceptual framework, revenue recognition, liabilities and equity, financial instruments, and financial statement presentation? Are certain projects precedential?

Response

Because they would provide important foundations for the purpose and practice of general purpose financial reporting, we believe the FASB should complete its work on the conceptual framework and financial statement presentation projects prior to initiating a project regarding the narrower issue of accounting for insurance contracts. Further, the projects currently on the FASB agenda regarding revenue recognition and financial instruments generally would also provide broad conceptual guidance for the related

issues that will be encountered in any comprehensive review of U.S. GAAP for insurance contracts. These projects should also take precedence.

We appreciate the opportunity to provide input to the Board's deliberations on accounting for insurance contracts.

Please contact Mr. Walter Givler (wallygivler@northwesternmutual.com) if you desire clarification or expansion of our comments, or if we can be of further service to the Board during future deliberations on this topic.

Sincerely,



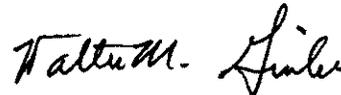
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November 15, 2007

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

Sent via email to: commentletters@iasb.org

Re: Discussion Paper on Preliminary Views on Insurance Contracts

Dear Sir David:

On behalf of The Northwestern Mutual Life Insurance Company, we are pleased to offer our comments on the International Accounting Standards Board's Discussion Paper entitled *Preliminary Views on Insurance Contracts* ("the DP").

Northwestern Mutual, headquartered in Milwaukee, Wisconsin U.S.A., is our country's 11th largest life insurance group based on total assets. Our company has earned the highest available ratings for financial strength from each of Standard & Poor's, Moody's Investor Services, Fitch Ratings and A.M. Best. We offer our clients a full array of life insurance products, including permanent whole life, term and universal life products. In addition, we offer annuities, disability income and long-term care insurance. As a mutual insurance company, virtually all of our insurance contracts are participating. During 2006, Northwestern Mutual paid over \$4.6 billion in participating dividends to our policyholders, representing over 25% of all participating dividends paid by U.S. domiciled life insurers.

Our responses to the specific questions raised in the DP are provided beginning on page 2. In summary, we offer the following introductory comments:

- We are concerned that some of the preliminary views and alternatives outlined in the DP would be inappropriate and misleading if applied to participating insurance contracts. Specifically, failure to include all expected future cash flows (e.g., policy dividends and renewal premiums) in the basis for liability measurement, or use of discount rates that ignore the integral relationship between an insurer's expected investment returns and related contract benefits, would be inconsistent with the real world economics of these products and produce financial statements that are fundamentally misleading to users.

- We suggest that the Board challenge the presumption that a “mark-to-market” accounting framework for insurance contract liabilities provides more relevant and useful information for users of insurers’ financial statements, especially in the absence of an active and transparent secondary market for insurance obligations. In practice, the model-based valuation of insurance liabilities proposed in the DP would likely be viewed by financial statement users as less reliable (as underlying model assumptions and techniques could not be readily validated and audited) than a valuation based on an insurer’s own actual experience and reasonable future expectations based on this experience. Further, a lack of common, market observable model inputs would likely result in a greater lack of comparability of financial results among different insurers.
- We ask that the Board recognize the significant challenge and cost to insurers to implement a new insurance accounting framework, and plan for extensive due diligence as the project moves forward. This due diligence should include a continued receptivity to opinions that differ from the Board’s current majority view, development of accompanying actuarial standards and implementation guidance, and extensive field testing to assure that any new framework is workable in practice and offers real value to financial statement users in excess of the substantial cost to insurers.

Responses to DP Specific Questions

The Board’s specific questions are repeated below, along with Northwestern Mutual’s responses. Note that responses to question 9 (business combinations) and question 17 (unit-linked contracts) are intentionally omitted, as we defer in these matters to respondents with substantial input.

Question 1

Should the recognition and derecognition requirements for insurance contracts be consistent with those in IAS 39 for financial instruments? Why or why not?

Response

The recognition and derecognition requirements for financial instruments in IAS 39 are appropriate for use in a new accounting standard for insurance contracts. It seems fundamental that a reporting entity’s balance sheet (i.e., statement of financial position) should recognize all rights and obligations only as soon as, and for as long as, the entity is subject to such rights or obligations according to the terms of the defining instrument.

While these broad recognition and derecognition requirements are appropriate for either financial instruments or insurance contracts, we nonetheless believe that there are important differences between financial instruments as defined in IAS 39 and insurance contracts. Most notably, investors in financial instruments generally have active and transparent markets (or market-observable inputs for similar financial instruments) that can be used to compare their expectations about the potential risks and rewards of their

rights and obligations. Further, these markets provide a reliable and relevant basis for accounting valuation of their rights and obligations and an opportunity to “realize” this value by transacting in these markets. By contrast, no such market exists for insurance contracts, and insurers are rarely free to transact their rights and obligations under insurance contracts without the express approval of their policyholders and regulators.

Question 2

Should an insurer measure all its insurance liabilities using the following three building blocks:

- (a) explicit, unbiased, market-consistent, probability-weighted and current estimates of the contractual cash flows,
- (b) current market discount rates that adjust the estimated future cash flows for the time value of money, and
- (c) an explicit and unbiased estimate of the margin that market participants require for bearing risk (a risk margin) and for providing other services, if any (a service margin)?

If not, what approach do you propose, and why?

Response

The specific building blocks above generally provide an appropriate conceptual framework for estimating the fair value of insurance liabilities. However, use of this framework for measurements that directly affect financial statements should be contingent on the resolution of certain important conceptual and practical issues detailed below. Whether this framework is the most appropriate among all available alternatives for financial statement liability measurement is an assessment that cannot reasonably be made until these issues are addressed.

Regarding cash flows, it is acknowledged in the DP (paragraph 38b and 58) that many significant estimates of future cash flows relate to variables that cannot be observed directly from transaction prices and other market-observable data. In absence of relevant, reliable and persuasive “market-consistent” information, a company should be permitted to use assumptions that are consistent with its own experience and informed expectations (e.g., mortality/morbidity experience or lapse rates). For these variables, allowing the use of best-estimate assumptions (as opposed to a variety of scenarios each probability-weighted) will reduce the complexity and cost of liability measurements without meaningfully affecting the outcome.

Regarding the proposed requirement that cash flows be “contractual,” please see our comments on question 16 below regarding the importance of including all estimated future cash flows related to the insurance contract, including participating dividends and other non-guaranteed benefits, even if they are solely at the discretion of the insurer according to the contract.

Regarding selection of an appropriate discount rate, the DP (paragraph 69) asserts that the discount rate should be consistent with observable current market prices for cash flows whose characteristics “match” those of the insurance liability. For many longer-duration insurance contracts, a relevant, market-observable rate may not exist (e.g., the observable public market for fixed income financial instruments may not include securities with “matching” term-to-maturity or credit characteristics). Likewise, no observable market currently exists to provide a reliable basis for assumed risk or service margins.

For many insurance contracts, including most participating insurance contracts, the future contract benefits associated with the investment of net cash inflows are ultimately determined by the actual returns of the insurer’s investment portfolio. To be most consistent with this economic reality, and in light of the practical barriers to identification and use of “market-consistent” discount rates and risk/service margins noted above, we recommend that the rate used to discount future cash flows be based on the actual investment returns anticipated by the insurer over the life of the contract. This estimated rate of return should be re-evaluated at each subsequent liability measurement date and updated (i.e., “unlocked”) if expectations change due to actual investment returns, changes in market conditions or changes in the insurer’s own investment strategy. We believe this alternative would produce liability measurements, and periodic changes in these measurements, that would be more relevant, reliable and consistently applied for users of an insurer’s financial statements.

Question 3

Is the draft guidance on cash flows (appendix E) and risk margins (appendix F) at the right level of detail? Should any of that guidance be modified, deleted or extended? Why or why not?

Response

We believe that any new accounting standard for insurance contracts will require the development of related actuarial professional practice standards. These actuarial standards will likely require significant modification, clarification and extension of the guidance in appendix E and F. The nature and extent of these modifications would best be established by those bodies that govern actuarial practice standards, as the responsibility to perform these measurements will certainly be made by actuaries with appropriate professional training and experience. Further, these actuarial standards can only be developed after the Board and national accounting standard-setters agree upon a clear accounting measurement objective and related financial reporting framework.

For these reasons, we suggest the Board focus its standard-setting efforts on selection of an appropriate conceptual measurement objective for insurance liabilities, clarity regarding the manner in which periodic changes in these measurements will be presented in an insurer’s financial statements and the related disclosure requirements that would best serve the interests of financial statement users.

Question 4

What role should the actual premium charged by the insurer play in the calibration of margins, and why? Please say which of the following alternatives you support.

- (a) The insurer should calibrate the margin directly to the actual premium (less relevant acquisition costs), subject to a liability adequacy test. As a result, an insurer should never recognise a profit at the inception of an insurance contract.
- (b) There should be a rebuttable presumption that the margin implied by the actual premium (less relevant acquisition costs) is consistent with the margin that market participants require. If you prefer this approach, what evidence should be needed to rebut the presumption?
- (c) The premium (less relevant acquisition costs) may provide evidence of the margin that market participants would require, but has no higher status than other possible evidence. In most cases, insurance contracts are expected to provide a margin consistent with the requirements of market participants. Therefore, if a significant profit or loss appears to arise at inception, further investigation is needed. Nevertheless, if the insurer concludes, after further investigation, that the estimated market price for risk and service differs from the price implied by the premiums that it charges, the insurer would recognise a profit or loss at inception.
- (d) Other (please specify).

Response

We support alternative described under (a). As most insurance markets are relatively mature and competitive, the initial arms-length transaction with the policyholder provides the most relevant input regarding a “marketplace” valuation of the insurer’s obligations (and rights) under the contract. Especially in absence of other reliable, market-observable inputs for most insurance products, the alternatives described under (b) and (c) would permit a significant degree of subjectivity with the obvious potential hazard of recognizing excessive profits at issue and likely diminishing the comparability of reported profits between companies.

Further, we believe that the concept of financial statement profit recognition at policy issuance is not consistent with the underlying economics of our industry and products. Life insurance companies earn their margins by accepting, pooling and managing a portfolio of risks on behalf of their policyholders. Economically, insurers are only released from these risks gradually as time and the underlying risks to its policyholders expire. Significant profits recognized at a contract’s issuance would likely be a product of erroneous assumptions regarding “market” risk margins or modeling error. This would be especially evident if significant profit at contract issuance continued over time, as any such “excess” profits would likely be eliminated by the competitive marketplace in short order.

Question 5

This paper proposes that the measurement attribute for insurance liabilities should be the amount the insurer would expect to pay at the reporting date to transfer its remaining contractual rights and obligations immediately to another entity. The paper labels that measurement attribute “current exit value.”

- (a) Is that measurement attribute appropriate for insurance liabilities? Why or why not? If not, which measurement attribute do you favour, and why?
- (b) Is “current exit value” the best label for that measurement attribute? Why or why not?

Response

We do not believe that the measurement attribute described in the DP as “exit value” is an appropriate alternative for an insurer operating and reporting as a going concern. As a practical matter, no secondary market for insurance contracts exists that is sufficiently transparent and efficient to provide relevant, reliable and persuasive input to such a measurement that is faithful to its conceptual objective. We believe a more appropriate and practical alternative is described in the DP in paragraph 97 as “current entry value.” The primary reasons for this preference are summarized above in our response to question 4.

We noted with interest the Board’s conclusion in paragraph 98 that the “alternative A” implementation of “current exit value” would, in practice, likely produce significantly similar results to “current entry value” (i.e., they would only differ to the degree that an insurer determines its own pricing methodology and risk margin requirements to be irrational).

The use of the term “current exit value” to describe this measurement attribute seems to be a misnomer, absent the intent and ability of the insurer to “exit” from its rights and obligations under the insurance contract by transacting the liability to a third party.

Question 6

In this paper, beneficial policyholder behaviour refers to a policyholder’s exercise of a contractual option in a way that generates net economic benefits for the insurer. For expected future cash flows resulting from beneficial policyholder behaviour, should an insurer:

- (a) incorporate them in the current exit value of a separately recognised customer relationship asset? Why or why not?
- (b) incorporate them, as a reduction, in the current exit value of insurance liabilities? Why or why not?
- (c) not recognise them? Why or why not?

Response

We believe an insurer should include estimated cash flows related to all contract provisions, including those resulting from beneficial policyholder behavior, in the measurement of its insurance liabilities. This preference is based on both conceptual and practical grounds. In substance, insurers act as risk pools, with policyholders who ultimately provide net economic benefits to the insurer subsidizing the net economic costs of the rest. These portfolios of risk should be valued in total, including supportable assumptions regarding future trends in optional policyholder behavior. We do not agree with the Board's conclusion in paragraph 140 that these cash flows are attributable to a generic "customer relationship" rather than the insurance contract. Future events favorable to the insurer are not necessarily unfavorable to the policyholders, who presumably act in their self-interests, as they often have a variety of extra-contractual motivations influencing their actions.

As a practical matter, the information needed to reliably segregate policyholders into such classes (e.g., net economic benefit vs. net economic loss, healthy vs. unhealthy per the DP example) and support alternatives (a) or (c) is not readily available. We certainly agree with the Board's preliminary view that the cost of implementing alternative (a) would likely exceed the benefits to financial statement users.

Question 7

A list follows of possible criteria to determine which cash flows an insurer should recognise relating to beneficial policyholder behaviour. Which criterion should the Board adopt, and why?

- (a) Cash flows resulting from payments that policyholders must make to retain a right to guaranteed insurability (less additional benefit payments that result from those premiums). The Board favours this criterion, and defines guaranteed insurability as a right that permits continued coverage without reconfirmation of the policyholder's risk profile and at a price that is contractually constrained.
- (b) All cash flows that arise from existing contracts, regardless of whether the insurer can enforce those cash flows. If you favour this criterion, how would you distinguish existing contracts from new contracts?
- (c) All cash flows that arise from those terms of existing contracts that have commercial substance (ie have a discernible effect on the economics of the contract by significantly modifying the risk, amount or timing of the cash flows).
- (d) Cash flows resulting from payments that policyholders must make to retain a right to any guarantee that compels the insurer to stand ready, at a price that is contractually constrained,
 - (i) to bear insurance risk or financial risk, or
 - (ii) to provide other services. This criterion relates to all contractual guarantees, whereas the criterion described in (a) relates only to insurance risk.
- (e) No cash flows that result from beneficial policyholder behaviour.
- (f) Other (please specify).

Response

We believe that alternative (b) is the appropriate criterion. To achieve a liability measurement that best represents the net economic obligations of an insurer (whether estimated from the perspective of the insurer given its own informed experience or from the perspective of a hypothetical transferee), the measurement must include all future cash flows reasonable to expect based on the nature of the insurance contract taken as a whole. As noted above in our response to question 6, we do not believe that it is conceptually appropriate or practically feasible to segregate policyholders within a given risk pool on the basis of estimated future net economic gain or loss to the insurer, or to apply different criteria to their inclusion in estimated future cash flows. The premise for question 7 also presumes that reliable information necessary to segregate policyholders on this basis is available to insurers, which is very questionable.

Regarding the distinction between “existing” contracts and “new” contracts, we believe this distinction is self-explanatory and would be readily evidenced by the execution of a new defining instrument between an insurer and its policyholder (as distinct from the parties exercising their rights or meeting their obligations under an existing contract).

Question 8

Should an insurer recognise acquisition costs as an expense when incurred? Why or why not?

Response

Presuming a measurement method for insurance liabilities that includes all future premiums in expected cash flows, acquisition costs should be expensed as incurred. If there are limitations placed on the premiums that can be included in estimated future cash flows (e.g., related to favorable policyholder behavior), this conclusion regarding acquisition costs would require reconsideration in order to avoid recognition of initial losses not consistent with the economics of our business.

Question 10

Do you have any comments on the measurement of assets held to back insurance liabilities?

Response

As acknowledged in paragraph 177 of the DP, many current insurance accounting models invite “accounting mismatch” and unwarranted volatility in profits or equity. These mismatches are typically due to market volatility in the fair value of investment assets (e.g., due to changes in market interest rates) that back insurance liabilities reported on a basis consistent with the insurer’s transaction with its policyholder (sometimes referred to as “amortized cost”). We understand that the Board does not intend to propose changes to the existing guidance in IAS 39 regarding financial asset measurement, which permits either a fair value or an amortized cost measurement for these instruments based on management’s assertions regarding their intentions in managing the financial assets.

The asset/liability management relationship between insurance obligations and the financial assets that back them (either explicitly or implicitly) can vary among products and among different insurers. Some insurance contracts are designed, priced and managed with an integral relationship between the insurance contract obligations of the insurer and the investment assets funded by policyholder premiums. This is certainly true for the participating insurance contracts issued by Northwestern Mutual.

In order to best represent the net economic position, risk and performance of an insurer for such contracts, this integral relationship should be acknowledged. As such, we recommend that the Board offer insurers that issue participating insurance contracts (or other contracts where this integral relationship can be demonstrated) the option to value insurance contract liabilities at “amortized cost” (i.e., entry value with assumptions locked-in absent shortfalls) in order to most accurately present the financial position of the insurer. This option should be subject to reasonable criteria and disclosures that help assure that such an option would reduce accounting mismatches without masking true and significant economic mismatches.

Question 11

Should risk margins:

- a) be determined for a portfolio of insurance contracts? Why or why not? If yes, should the portfolio be defined as in IFRS 4 (a portfolio of contracts that are subject to broadly similar risks and managed together as a single portfolio)? Why or why not?
- (b) reflect the benefits of diversification between (and negative correlation between) portfolios? Why or why not?

Response

We agree with the Board’s preliminary view that risk margins should be determined on a portfolio basis, not contract-by-contract, and support the reasoning for this conclusion as outlined in paragraphs 192-198 of the DP. This approach is most consistent with the fundamental economic purpose of insurance, the pooling of risks, and is most consistent with the way insurers price products and manage risk once accepted from the policyholder.

Regarding the benefits of correlation, we support the recognition of these benefits in the measurement of a company’s aggregate insurance liabilities. However, implementation of such an approach would call for development of actuarial guidance on how these benefits would be measured, validated and attributed to the various liability portfolios among which the diversification benefit exists. It might also call for an assertion by the insurer that they have the intent and ability to retain to contractual maturity the various obligations that together provide the diversification benefit.

Question 12

(a) Should a cedant measure reinsurance assets at current exit value? Why or why not?

(b) Do you agree that the consequences of measuring reinsurance assets at current exit value include the following? Why or why not?

(i) A risk margin typically increases the measurement of the reinsurance asset, and equals the risk margin for the corresponding part of the underlying insurance contract.

(ii) An expected loss model would be used for defaults and disputes, not the incurred loss model required by IFRS 4 and IAS 39.

(iii) If the cedant has a contractual right to obtain reinsurance for contracts that it has not yet issued, the current exit value of the cedant's reinsurance asset includes the current exit value of that right. However, the current exit value of that contractual right is not likely to be material if it relates to insurance contracts that will be priced at current exit value.

Response

We believe that a cedant should measure reinsurance assets using the same method used to measure the related direct insurance liabilities, whether it be current exit value, current entry value or another measurement method. To do otherwise would create accounting anomalies and invite "accounting arbitrage" as a motivation for the use of reinsurance.

We agree that reinsurance assets, if measured at current exit value, should include a risk margin that would increase, rather than decrease, the asset, as the cedant is willing to pay more than the expected value of the cash flows to reduce risk and variability of its cash flows. In practice, this risk margin would likely equal that of the underlying insurance contract for proportional reinsurance transactions. In this context, we agree that an expected loss model for reinsurance assets is a more appropriate framework than an incurred loss model because the expected loss model is based on the present value of expected cash flows and is thereby consistent with the framework for measurement of the related direct insurance obligations. A contractual right to obtain reinsurance for contracts not yet issued has the potential for economic value to an insurer, analogous to a put option for a financial instrument. However, measurement (and ultimate realization) of this potential value would be dependent on the future issuance of a new insurance contract to a policyholder, an event that is not assured or within the sole discretion of the insurer. For this reason, we recommend that such a right not be included in the measurement of a reinsurance asset, and share the Board's view that the value of such a right is unlikely to be material for conventional reinsurance contracts.

Question 13

If an insurance contract contains deposit or service components, should an insurer unbundle them? Why or why not?

Response

We believe that any requirement for “unbundling” the various components of an insurance contract would be fundamentally inconsistent with the way most insurance products are designed, priced and managed. For most insurance contracts, the risk protection, deposit and servicing components are so interdependent that valuation of the unbundled components would be arbitrary and would offer little apparent benefit to users of financial statements. To the contrary, the potential for inconsistent treatment across the spectrum of insurance products and among different insurers would be high. This lack of consistency and comparability would outweigh any potential benefit users would receive from unbundled measurements or disclosures.

Question 14

- (a) Is the current exit value of a liability the price for a transfer that neither improves nor impairs its credit characteristics? Why or why not?
- (b) Should the measurement of an insurance liability reflect
 - (i) its credit characteristics at inception and
 - (ii) subsequent changes in their effect? Why or why not?

Response

We do not believe that the credit characteristics of an insurer should affect the measurement of its insurance liabilities, whether at inception or subsequently. We note that current exit value is based on a hypothetical transfer transaction and understand the conceptual objective of a “credit-neutral” assumption in this context. However, users of financial statements will not be well served by the potentially misleading impacts.

Weak or deteriorating credit standing, if reflected in the measurement of the insurer’s insurance liabilities, would have the impact of reducing the net liability and increasing profits and equity. These financial statement results would be misleading to users of financial statements in that they would be fundamentally inconsistent with the economic reality of this circumstance, particularly for a going concern operating in the U.S. insurance regulatory environment. This environment generally acts swiftly to conserve assets for the purpose of fully meeting policyholder obligations at the expense of other creditors or equity holders.

Question 15

Appendix B identifies some inconsistencies between the proposed treatment of insurance liabilities and the existing treatment under IAS 39 of financial liabilities. Should the Board consider changing the treatment of some or all financial liabilities to avoid those inconsistencies? If so, what changes should the Board consider, and why?

Response

With respect to the known or potential inconsistencies noted in appendix B, we believe that the most significant is item 2 regarding gain or loss at inception (i.e., not permitted under IAS 39 for most financial liabilities, but permitted in certain circumstances

according to the Board's expressed preliminary views in chapter 3 of the DP). This potential inconsistency would be eliminated by adopting our recommendation to eliminate the potential for profit or loss upon issuance of an insurance contract (see question 4 above).

Item 4 in appendix B acknowledges that IAS 39 requires that financial liabilities with a demand feature be measured at no less than the amount payable on demand ("surrender value floor"). We agree with the Board's preliminary view, also summarized in appendix B, that the surrender value of an insurance contract does not establish a lower limit for the measurement of a portfolio of insurance contracts at fair value. We believe this inconsistency could be justified by the differences between insurance contracts and other "demand" liabilities such as retail bank deposits. It is also justified by the portfolio (vs. contract-by-contract) measurement concept fundamental to the insurance business and already favored by the Board in its preliminary views (see question 6).

Lastly, item 6 acknowledges the potential for inconsistency regarding revenue vs. deposit accounting for premium inflows, an issue that will need to be addressed once the Board forms its preliminary views on this important topic as regards insurance contracts. See question 18 below.

Question 16

(a) For participating contracts, should the cash flows for each scenario incorporate an unbiased estimate of the policyholder dividends payable in that scenario to satisfy a legal or constructive obligation that exists at the reporting date? Why or why not?

(b) An exposure draft of June 2005 proposed amendments to IAS 37 (see paragraphs 247–253 of this paper). Do those proposals give enough guidance for an insurer to determine when a participating contract gives rise to a legal or constructive obligation to pay policyholder dividends?

Response

We believe that for participating contracts, cash flows for each scenario should incorporate an unbiased estimate of future policyholder dividends that is consistent with other assumptions regarding contract cash flows on which dividends are dependent. We do not believe that participating dividends should be subject to a restrictive requirement that they satisfy a legal or constructive obligation requirement. In our circumstance, which is typical for participating contracts issued by U.S. insurers, these dividends are contractually at the discretion of the insurer.

This is important to avoid misrepresenting the economic substance of a participating contract or its financial impact for the insurer. Dividends are an integral component of the participating contract, and their exclusion or limitation for the purpose of estimating future cash flows is inconsistent with the conceptual objective of "exit value" or any other economically realistic measurement attribute. Under U.S. insurance regulation, any attempt to transfer obligations to a third party would require regulatory provision for future dividends. Excluding dividends on the basis of a "constructive obligation"

criterion, which would necessarily be subjective, would create an accounting mismatch and significantly misleading financial statement results for the insurer.

Question 18

Should an insurer present premiums as revenue or as deposits? Why?

Response

Premiums should be presented as revenue for all contracts that transfer significant insurance risk, while those that do not meet this fundamental definition of insurance would continue to be governed by IAS 39 and use deposit accounting. Premiums represent the primary compensation that an insurer receives in return for accepting, pooling and managing a portfolio of risks and for standing ready to provide benefits or perform services under the contract.

Question 19

Which items of income and expense should an insurer present separately on the face of its income statement? Why?

Response

We believe that the face of an insurer's income statement should at a minimum include revenue items for premiums, net investment income, capital gains or losses, and other revenue (e.g., fees), if relevant. It should also separately present contract benefits paid, changes in insurance liabilities, operating expenses, participating dividends and income taxes. In reaction to the discussion in DP paragraph 325, some of the components of a net change in insurance liabilities might warrant disclosure for the benefit of users, but do not warrant separate presentation in the insurer's income statement.

Question 20

Should the income statement include all income and expense arising from changes in insurance liabilities? Why or why not?

Response

An appropriate response to this question will depend upon the measurement framework established for insurance liabilities and thereby the components of the periodic change in these liabilities. For example, we would view any "profit" recognized at contract issuance to be unrealized and most appropriately presented as a direct adjustment to surplus. Potential changes in the liability due to changes in the insurer's credit standing (see question 14) would also be unrealized and not appropriate for inclusion in a measurement of annual operating performance.

We also note that the ongoing FASB project, *Financial Statement Presentation*, could significantly alter the traditional format of the income statement for U.S. companies. We have conveyed to the FASB our view that this project should be completed before any

conclusions are reached regarding the financial statement presentation requirements of this insurance contracts project.

We appreciate the opportunity to provide input to the Board's preliminary views on accounting for insurance contracts.

Please contact Mr. Walter Givler (wallygivler@northwesternmutual.com) if you desire clarification or expansion of our comments, or if we can be of further service to the Board during future work on this project.

Sincerely,



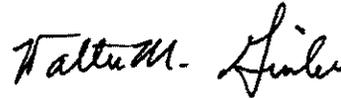
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