

Paul Graham
Vice President, Insurance Regulation & Chief Actuary



LETTER OF COMMENT NO.

39

November 26, 2007

Mr. Robert Herz
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

Re: Invitation to Comment (ITC) on the FASB Agenda Proposal: Accounting for Insurance Contracts by Insurers and Policyholders, Including the IASB Discussion Paper, *Preliminary Views on Insurance Contracts*(DP)

Dear Mr. Herz:

The American Council of Life Insurers (ACLI) is pleased to submit the following comments regarding the Invitation to Comment (ITC) on the FASB Agenda Proposal: Accounting for Insurance Contracts by Insurers and Policyholders, Including the IASB Discussion Paper, *Preliminary Views on Insurance Contracts* ("DP"). The ACLI represents three hundred seventy-three (373) member companies operating in the United States, of which three hundred sixty-four (364) are legal reserve life insurance companies, and nine (9) are fraternal benefit societies. These 373 member companies account for 93 percent of total assets, 91 percent of the life insurance premiums, and 95 percent of annuity considerations in the United States.

We commend the Board for its interest in this project and strongly recommend that the FASB join with the IASB in the development and finalization of the insurance contracts project. Accounting for insurance contracts remains one of the few major areas of International Financial Reporting Standards (IFRS) that lacks a complete standard. Given the recent decision by the Securities and Exchange Commission to eliminate the reconciliation to U.S. GAAP for certain foreign private issuers and the concept release that could dramatically expand the use of IFRS in the U.S., we believe that it is of critical importance to have an international standard for insurance contracts in the very near future. We further believe that U.S. GAAP- given its long history and relatively high amount of acceptance - along with the DP and related responses, together provide an acceptable starting point for the creation of a global standard for the accounting for insurance contracts. We believe that an acceptable starting point is to review the two together, meet with both the user and preparer communities and develop a conceptual framework for the project. There are several conceptual issues that the Boards will need to address prior to moving forward with the project. While our response to the DP illustrates some of our views on the answers to certain conceptual questions, we are willing to work with the Boards in providing more information.

Given the number of joint projects under development (e.g., conceptual framework, revenue recognition, financial statement presentation, etc.) that have a direct bearing on the accounting for insurance contracts, we also request that the Boards develop new insurance standards in an orderly manner to avoid setting a precedent in one project that would result in additional changes

to insurance accounting and reporting in the future. We believe, though, that adequate scope needs to be given to this project, or addressed as a precedent to this project, for the income statement treatment of insurance transactions and the changes in reserves. Addressing the accounting for insurance contract liabilities without consideration for the income statement implications (as the IASB has done in the DP) is a significantly flawed approach. We continue to believe that the current U.S. GAAP income statement fails to adequately reflect the distinction between realized and unrealized contributions to income. To the extent a new insurance accounting standard contains similar elements, we believe that additional income statement and footnote disclosure will be useful in order to separate the impact of realized from unrealized contributions. We are hopeful that these high priority projects can be incorporated onto the Board's agenda within a timeframe necessary to support global convergence.

We are available to assist the Boards in the development of a new insurance contracts standard along with any related field testing as this project moves forward. The questions contained in the ITC and our detailed comments to those questions can be found in the attached Appendix.

Sincerely,

A handwritten signature in cursive script that reads "Paul S. Graham III". The signature is written in dark ink and includes a stylized flourish at the end.

Paul S. Graham, III, FSA, MAAA

APPENDIX

Question 1

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

We strongly support the notion that a need exists for a comprehensive review of the accounting for insurance contracts on an international level. We believe that U.S. GAAP accounting for insurance contracts is generally well-understood in the preparer and user communities and depicts the long-term nature of life insurance. With that said, there remain improvement opportunities within U.S. GAAP that can be addressed through this project. There also is a significant amount of momentum towards allowing IFRS as an accepted accounting basis for companies listing on U.S. exchanges. Given the complexity of insurance accounting, having a converged IFRS and U.S. GAAP accounting standard for insurance contracts is critical to sustain the ability of financial statement users to understand and compare financial statements of listed insurance companies. Since some of the largest life insurance writers in the U.S. are foreign-owned companies, having this consistency of insurance contract accounting is of paramount importance to our industry.

a. What aspects of existing U.S. GAAP accounting for insurance contracts could be improved or simplified and how pervasive are these issues?

We believe that there would be a substantial benefit in codifying the accounting for insurance contracts into a single comprehensive standard. The multitude of standards that provide guidance for insurance contracts, from time-to-time, contributes to confusion and misunderstanding of insurance accounting by preparers, causing a higher risk for errors in financial reporting and a steep learning curve for those entering the business.

For life insurance contracts, there are areas of current U.S. GAAP that should be reconsidered, improved or eliminated. Currently, U.S. GAAP has extensive rules-based guidance (e.g., SOP 05-1, SOP 03-1, and Statement of Financial Accounting Standards (FAS) 133/149) that require a substantial effort by companies with very little benefit to the users of the financial statements. There are multiple accounting models in use today (e.g., FAS 60 and FAS 97), resulting in different measurement and presentation of revenue. Additionally, FAS 133 requires bifurcation of embedded derivatives at fair value that allows for inconsistent treatment of similar product features. It is our belief that the liability valuation should encompass the entire economics of the contract since the product features are integrated.

U.S. GAAP does not contain a definition for insurance contracts. We believe the definition contained within IFRS No. 4, *Insurance Contracts*, is an appropriate definition to carry over into a new standard. We support a definition that incorporates all insurance contracts including those not written by insurance entities.

b. How important is the development of a common, high-quality standard used in both the U.S. and IFRS jurisdictions?

We believe that as businesses become more global in nature, it is important that a level playing field exists for all participants. We believe that appropriate global standards for insurance accounting would enable analysts and investors to compare the financial statements of entities with similar products across the world.

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? If not, why not?

We have significant concerns regarding the DP. We have articulated those concerns in a separate comment letter to the IASB. While we will not repeat those concerns within the content of this response, we will provide some of our high level concerns with the DP as follows:

Guidance should be principles-based - The building blocks proposed in the DP for measuring insurance liabilities are too detailed in prescribing techniques in determining the value of the liability. We believe that the details should be provided by the actuarial profession to determine the best approach to value the liabilities based on the principles-based guidance provided by standard setters. The recommendation of the DP to use probability-weighted cash flows, for example, would prescribe a valuation approach that may not be the most effective and/or efficient for a given measurement.

Gain and losses at issue - We are very concerned with the notion of recognizing accounting gains and losses at issue when observable market inputs do not exist in a manner that should override the pricing of the contract in a competitive market. We believe strongly that the insurance liability should be calibrated to the premium so that there is no gain or loss at issue, except in the rare cases where a loss is anticipated.

Consideration of all cash flows - We believe that all cash flows should be considered when measuring liabilities. This is consistent not only with the way companies price their products but also with the way a market participant would value them. Cash flows should not be artificially constrained by excluding cash flows resulting from beneficial policyholder behavior as the DP suggests.

Unbundling of insurance contracts - We are strongly supportive of the notion that insurance contracts are instruments that should not require unbundling. Contracts are priced as a single unit and are typically transferred as a single unit. Requiring unbundling ignores the substance and form of an insurance contract. Once the contract is issued, the insurer cannot unilaterally terminate the agreement or sell parts of it. The components are closely related both in policy structure and in the way they are priced. Cash flows from all components affect the settlement of the contract. The impact of unbundling will lead to confusion and inexplicable results.

Use of exit value for measurement of liabilities - The definition of exit value as described in the DP, causes a concern about its appropriateness of this measurement basis for insurance contracts. Within the industry, there are differing views about the measurement based upon entry or exit value. Given that insurance companies have a held-to-maturity intent with the insurance contracts that they hold, it is unclear which method, or a combination, is a more appropriate measure. For that reason, we believe that additional research needs to be conducted to determine the most relevant measure for insurance liabilities. If a fair value measure is determined to be appropriate, we believe that special consideration will need to be given to the lack of active markets for insurance contracts and a possible modification will be required to permit some level of entity-

specific inputs. We are also concerned about the incorporation of the insurer's own credit rating into the determination of insurance liabilities.

a. 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?

No. We have significant concerns about our ability to implement the guidance proposed by the DP. The determination of market assumptions when an active market does not exist; the determination of probability-weighted cash flows when that may not be the most efficient model to use for the valuing liabilities; the determination and rationalization of gains and losses recognized at issue; and the efforts around unbundling all represent significant challenges in implementing this guidance. We have expanded upon these concerns within our response to the DP.

b. 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 financial statements?

See our response to Question 1a.

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?

We are not aware of significant issues with the accounting by policyholders for insurance contracts and therefore believe that it should have a lower priority. Additionally, we believe that the accounting used by policyholders, particularly commercial enterprises, should be evaluated in the context of the policyholders' accounting, not the insurers' accounting.

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?

We believe it is paramount that the Board addresses the income statement impact of realized and unrealized contributions especially those changes due to fair value measurement prior to the issuance of any insurance standard. Insurance company income statements will experience substantial amounts of volatility if the resulting accounting standard were to contain elements of fair value. While some of that volatility may be of interest to the user community, it is only one element of performance of the company during any given period. The user community also has keen interest in performance measures resulting from realized activity during the period. We believe the user community should be provided with an income statement that can present multiple elements of performance without sacrificing the quality of data. The ability of users to understand the income statement of many insurance companies today is already significantly impaired due to the fair value components of the current accounting model with some changes in fair value reported in income while other changes reported in OCI. The result is that insurance companies prepare non-GAAP measures to provide users with a better reflection of company

performance than that provided through U.S. GAAP. Therefore, depending on the extent of fair value elements adopted through this project, we would view the financial statement presentation project as precedential. It is important though that any precedential projects are addressed in a timely fashion as to not delay the ultimate implementation of the joint project given the initiative for convergence.