

April 1, 2011

Sir David Tweedie, Chairman International Accounting Standards Board 30 Cannon Street London, EC4M 6XH United Kingdom Leslie Seidman, Chairman Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116

Via email: director@fasb.org Via email: director@fasb.org

Re: Financial Instruments: Impairment – Supplement to ED/2009/12 (IASB)
Impairment – Supplementary Document; Technical Reference No. 2011-150 (FASB)

Sir Tweedie and Ms. Seidman:

On behalf of The Northwestern Mutual Life Insurance Company ("Northwestern Mutual"), we are pleased to offer our comments and perspectives to the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) on the *Financial Instruments: Impairment - Supplementary Document* issued January 31, 2011 ("SD"). We appreciate the ongoing effort by the Boards toward achieving a unified solution to this important financial reporting topic.

#### Our Company and Perspectives

Northwestern Mutual, headquartered in Milwaukee, Wisconsin, was founded in 1857 and today is our country's 10th largest life insurance group based on total assets. We offer our policyowners a full array of life insurance products, including permanent whole life, term and universal life. In addition, we offer annuities, disability and long-term care insurance. Our company continues to earn the highest available ratings for financial strength from each of Standards & Poor's, Moody's Investor Services, Fitch Ratings and A.M. Best.

The vast majority of our \$175 billion in total assets are financial instruments that would be subject to the requirements of this emerging standard. Our general investment account is approximately 85% allocated to fixed income securities (including public and private bonds, mortgage-backed securities and commercial mortgage loans), with the remainder allocated to various equity asset classes (primarily public and private common stocks, real estate and partnership/joint venture interests). This broad diversification reduces overall volatility while enhancing long-term total return. The perspectives reflected in this letter represent the views a preparer of financial statements subject to the scope of the SD, as well as an institutional investor that relies on financial statement and other information made available to the marketplace by other investees.

A principal component of our investment strategy is to manage risk and reward trade-offs through careful underwriting and selection of individual investment securities, paired with active monitoring of actual

investee financial performance and ongoing assessments of their future prospects relative to the broader investment marketplace. To accomplish this efficiently and still achieve the desired level of diversification, we generally require a minimum investment in any given security of \$25 million. While we appreciate that the exposure to credit risk, market risk or other sources of potential impairment can be distinguished broadly between these various asset classes, we generally do not invest in securities that we "expect" to become impaired, and our ability to predict which asset classes, let alone individual securities, will ultimately become impaired is very limited and only marginally informed by broad portfolio or marketplace experience.

### **Incurred Loss and Expected Loss Models**

At the heart of the concepts explored in the SD is the distinction between an accounting model based on "incurred losses" in contrast to one based on "expected losses." Over the actual lifespan of a given security or portfolio subset, the actual losses will obviously be the same. Thus the practical distinction between these two models is one of timing of loss recognition and the resulting pattern of actual losses as they influence a preparer/investor's financial statements over longer periods of time. As a large institutional investor, we share some of the Boards' frustrations with the "too little, too late" aspects of investment loss recognition by some preparers/investors during the recent financial crisis. However, we cannot support the required implementation of an expected loss model that would sacrifice the quality and credibility of annual financial statement results to achieve the conceptual objective of accelerating potential losses into earlier annual accounting periods. Rather, we suggest that the "too little, too late" issue would be best addressed by company governance and regulatory inquiry standards that compel preparers/investors and their auditors to diligently apply an incurred loss-based standard in the spirit in which it is intended.

We consider an incurred loss model to be superior in that it bases its reported results directly on observable facts and circumstances surrounding an individual security and its issuer. When applied in a timely and diligent manner, this provides higher-quality (i.e., fact-based) financial information about the quality of management's selection and monitoring of their investments than an expected loss approach. The latter would necessarily require the use of broad estimates of potential loss based on historical portfolio or marketplace loss experience (which may or may not be useful for predicting exposure to losses in the future), or worse yet the application of extreme subjectivity by management in estimating future losses that would influence allowance targets and changes in these targets as market cycles come and go. For example, the default expectations evidenced by the historically high credit spreads for the broad market of high-yield securities during the extreme market stress at the end of 2008 were significantly in excess of the actual marketplace loss experience during 2009 and current market expectations. If preparers/investors had been required to reflect the market-implied expectations in their loss allowances at year-end 2008, the panic-driven overreaction of the market would have greatly exaggerated reported losses for 2008 financial reporting, only to have these losses reversed during 2009 and 2010.

The current use of allowance-based impairment accounting is much more prevalent among and appropriate for use by banks, where the individual investments in open portfolios tend to be smaller and relatively more homogeneous within a given portfolio than is typically the case for a life insurer. As a practical matter, a requirement that insurers use an expected loss model as described in the SD would

require them to organize and segment their investments (i.e., "good book" versus "bad book") in a way that is not consistent with the way in which these investments and portfolios are managed. This invites significant incremental costs driven purely by accounting requirements that seem to offer little additional value to financial statement users. Given the additional degree of subjectivity required of management by the expected loss model, it invites not only the non-representative exaggeration of loss volatility cited in the high-yield market example above, but also the potential for excessive "smoothing" of the recognition of actual losses that, in the real world, experience peaks and valleys across the timespan of market cycles that are impossible to predict with accuracy.

#### Our Recommendation

While we appreciate the appeal of consistency and uniformity in accounting models across (seemingly) similar industries and issuers, the reality is that the business models, investment strategies and capabilities of preparers/investors vary widely. The accounting standard should reflect this diversity and avoid requiring a single approach in circumstances where it is less effective or simply inappropriate. Permitting financial statement preparers to select an accounting model among reasonable alternatives that will be more or less suitable to their investment activities seems to be a more balanced approach. In either case, appropriate disclosures will help financial statement users to understand the relationship between reported results and an investor's actual experience. It would also give regulators and other informed users of financial statements a reasonable basis on which to challenge management's selection of an accounting model or its diligent application if need be.

We recommend that the final standard offer financial statement preparers an option between these two reasonable alternatives (incurred loss or expected loss), including general guidance on which model would be more appropriate based on the qualities or factual circumstances of their investment activities and portfolios. We also recommend that the finalization of the impairment SD be integrated with the finalization of the broader *Financial Instruments* accounting model. This includes needed clarity regarding the interaction of impairment accounting with the various alternative valuation and reporting bases (i.e., amortized cost, fair value though net income, fair value through other comprehensive income) still under consideration.

#### **Portfolios**

The scope paragraph of the SD states:

"For the IASB, the proposals in this supplementary document would be applied to *financial assets* that are measured at *amortised cost* if they are managed on an open *portfolio* basis, except short-term receivables without a stated interest rate that are so short-term that the effect of discounting for the time value of money is immaterial. For the FASB, the proposals in this supplementary document would be applied to open portfolios of loans and debt instruments that are not measured at fair value with changes in value recognised in net income."

The question section of the SD states:

"...the Boards are asking for views on whether the proposals outlined in this document could be applied to closed portfolios, single instruments and any other types of instruments."

As stated above, our investment management emphasis is applied at the individual security level, and in our circumstance we believe that an incurred loss model is most appropriate and useful to the users of our financial statements. In concept, the distinction between "open" and "closed" portfolios alone would not seem to recommend one or another accounting basis. Permit us to repeat our concerns above about the questionable utility, opacity and subjectivity and operational complexity and cost of required application of any portfolio-level allowance model in circumstances for which it is not appropriate or necessary.

Thank you in advance for your thoughtful consideration of our comments. We would welcome an opportunity to discuss these matters further. Our responses to your specific questions are included in the attached appendix. Please contact Walter Givler (wallygivler@northwesternmutual.com) if you desire clarification or additional input.

Sincerely,

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Executive Vice President and Chief Investment Officer Vice President and Chief Financial Officer

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Attachment: APPENDIX - Responses to the Questions for Recipients Contained in the Proposal

### **APPENDIX – Responses to the Questions for Recipients Contained in the Proposal**

#### General

Question 1 – Do you believe the proposed approach for recognition of impairment described in this supplementary document deals with this weakness (ie delayed recognition of expected credit losses)? If not, how do you believe the proposed model should be revised and why?

As an institutional investor, Northwestern Mutual shares the Boards' frustration with the delayed recognition of financial instrument impairment losses by some preparers/investors during the recent economic and financial crisis. However, we believe that the problem had more to do with a lack of diligence on the part of some preparers/investors in applying the current incurred loss accounting model than with the accounting model itself. While the required application of an expected loss model as proposed in the SD might accelerate loss recognition upon initial implementation, it would likely do so at the substantial sacrifice of quality in reported financial results in subsequent periods. This is especially true for preparers/investors such as life insurers, whose investment portfolios are typically comprised of fewer, larger and more diverse assets. Allowance-based (i.e., expected loss) accounting models are generally more effective and appropriate for asset portfolios where individual securities are relatively smaller and more homogeneous, such as retail mortgage and other loans held by banks. In these circumstances, recent trends in actual portfolio experience or changes in the macroeconomic environment or outlook tend to have a more predictable relationship to ultimate loss experience. When properly applied, this can accelerate loss recognition without undue sacrifice of representational quality of the financial statements as to the timing and magnitude of loss recognition. For portfolios such as ours, in which securities are relatively larger, more diverse and actively monitored on an individual basis, impairment losses are promptly recognized (assuming diligent application by management). The representational quality of reported results is better because loss recognition is based on the facts and circumstances for individual financial instruments, not on the potentially inappropriate extrapolation of a few loss events to an entire portfolio. Further, it avoids basing current loss recognition upon the ultimate loss experience implied by today's market references or management's entirely subjective expectations about the future. Both the incurred loss model and the expected loss model are reasonable conceptual frameworks, but each is more or less appropriate for a given portfolio of financial instruments. We recommend that the final standard permit an alternative among these two models based on the nature of the investment portfolio and with respect for the balance between quality financial reporting and the costs to preparers/investors of applying a given model to its own circumstances.

Question 2 – Is the impairment model proposed in the supplementary document at least as operational for closed portfolios and other instruments as it is for open portfolios? Why or why not?

Although the supplementary document seeks views on whether the proposed approach is suitable for open portfolios, the boards welcome any comments on its suitability for single assets and closed portfolios and also comments on how important it is to have a single impairment approach for all relevant financial assets.

We believe that the appropriateness and operability of an expected loss model is best determined based on the nature of the individual investment securities in a given "portfolio" (e.g., relative size of individual securities compared to the portfolio cohort, degree of homogeneity among securities, expected correlation of actual loss experience to other observable market or economic factors to a cohort's ultimate loss experience) than whether a given portfolio is "open" or "closed" as a matter of portfolio management technique. As noted above, we believe that an incurred loss model, when diligently applied, is more effective and appropriate for our investment portfolio and those of most large life insurers.

See question 3 below regarding our concerns about the operability of the proposed standard to life insurance company investment portfolios.

# Question 3 – Do you agree that for financial assets in the 'good book' it is appropriate to recognize the impairment allowance using the proposed approach described above? Why or why not?

We understand that the "good book" versus "bad book" distinction is typically used by commercial and investment banks as a matter of general portfolio management for certain asset classes, and in these circumstances the proposed expected loss approach might be conceptually appropriate and operationally efficient. The "good book/bad book" distinction is not used in our own investment management practice and to our knowledge is not prevalent in the life insurance industry as a whole.

We are especially concerned with the language in paragraph B4 that states..."Entities that do not manage credit risk using an approach that differentiates the management of financial assets depending on the uncertainty about their collectibility in a way similar to the principle in paragraph 3 (i.e., "good book/bad book") must still differentiate their financial assets in to two groups for the purpose of determining the impairment allowance in accordance with paragraph 2." Beyond our objections above to the mandatory use of an expected loss model for investment portfolios for which it is not conceptually appropriate, such a mandatory requirement would force life insurance companies into the costly and burdensome task of creating and maintaining this operational distinction purely for accounting purposes with no apparent value to financial statement users.

## Question 4 – Would the proposed approach to determining the impairment allowance on a time-proportional basis be operational? Why or why not?

The operability of a given accounting model or standard is best assessed based on the balance between the incremental cost and complexity required of preparers to implement and the relative value, relevance and reliability of the resulting financial reporting output for financial statement users. For investment portfolios in which the active monitoring of individual securities is not feasible or appropriate from a cost/benefit perspective, the use of an expected loss model and general portfolio loss allowances may best achieve this balance. Such methods are inherently statistical, and any method for establishing portfolio loss allowance targets must take into account the original and remaining term-to-maturity of the portfolio cohort. If one accepts the effectiveness and conceptual appropriateness of the proposed allowance-based model for a given investment portfolio, the time-proportional approach in the SD seems reasonable. We should qualify our response with the acknowledgement that we have no significant operational experience with allowance-based methods.

Our general concern about operability regarding the proposed standard is that its mandatory adoption by our company and most life insurers would significantly increase cost, complexity and subjectivity in its application with a likely reduction in the quality, relevance and reliability of reported financial statement results for users.

# Question 5 – Would the proposed approach provide information that is useful for decision-making? If not, how would you modify the proposal?

As explained in our introduction and specific responses above, the required adoption of an expected loss model would be fundamentally inconsistent with the way in which we manage our investment portfolios and make portfolio management decisions. From our perspective as an institutional investor and a user of financial statements prepared by investees, we are concerned that the mandatory adoption of an expected loss accounting model to investee portfolios for which this model is ill-suited would actually diminish the quality, relevance and reliability of the investee's financial results while at the same time increasing their operational costs.

Depending on the investee's method for managing its loss allowance targets and the manner in which these allowances are relieved for actual losses, the proposed approach could invite undue volatility if allowance targets are managed too actively with too much reference to the loss experience implicit in the observable marketplace. Conversely, it could also invite excessive "smoothing" of the recognition of the actual losses, which in the real world experience natural peaks and valleys across the timespan of market cycles that are often impossible to predict with any reliability.

As noted above, we would modify the proposal to allow preparers the option of either an incurred loss model or an expected loss model, with appropriate disclosure of management's reasoning for the selection of a given alternative and the results of its application to their portfolios.

Question 6 – Is the proposed requirement to differentiate between the two groups (ie 'good book' and 'bad book') for the purpose of determining the impairment allowance clearly described? If not, how could it be described more clearly?

Where this approach is appropriate, we believe the proposed requirement to differentiate between the "good book" and the "bad book" for the purpose of determining an impairment allowance is adequately described. However, we again reiterate that we do not believe this approach is appropriate for non-homogenous portfolios of individually managed assets.

Question 7 – Is the proposed requirement to differentiate between the two groups (ie 'good book' and 'bad book') for the purpose of determining the impairment allowance operational and/or auditable? If not, how could it be made more operational and/or auditable?

We have serious concerns about the operability of the proposed standard to circumstances such as ours. See question 3.

Question 8 – Do you agree with the proposed requirement to differentiate between the two groups (ie 'good book' and 'bad book') for the purpose of determining the impairment allowance? If not, what requirement would you propose and why?

We do not agree with the mandatory application of the "good book/bad book" distinction to circumstances such as ours. See question 3.

Question 9 – The boards are seeking comment with respect to the minimum allowance amount (floor) that would be required under this proposed model. Specifically, on the following issues:

(a) Do you agree with the proposal to require a floor for the impairment allowance related to the 'good book'? Why or why not?

In our circumstances, we believe that the diligent application of an incurred loss model produces a conservative and appropriate adjustment to the valuation of potentially-impaired securities. The mandatory application of an expected loss model with a minimum floor for the allowance appears to introduce a potentially arbitrary degree of conservatism while diminishing the quality, relevance and reliability of reported financial statement results.

(b) Alternatively, do you believe that an entity should be required to invoke a floor for the impairment allowance related to the 'good book' only in circumstances in which there is evidence of an early loss pattern?

In concept, this alternative appears preferable to a mandatory floor because it is based upon actual loss experience in the portfolio rather than a relatively arbitrary allowance floor.

(c) If you agree with a proposed minimum allowance amount, do you further agree that it should be determined on the basis of losses expected to occur within the foreseeable future (and no less than twelve months)? Why or why not? If you disagree, how would you prefer the minimum allowance to be determined and why?

Not applicable to our response, see question 9(a).

(d) For the foreseeable future, would the period considered in developing the expected loss estimate change on the basis of changes in economic conditions?

Not applicable to our response, see question 9(a).

(e) Do you believe that the foreseeable future period (for purposes of a credit impairment model) is typically a period greater than twelve months? Why or why not? Please provide data to support your response, including details of particular portfolios for which you believe this will be the case.

Not applicable to our response, see question 9(a).

(f) If you agree that the foreseeable future is typically a period greater than twelve months, in order to facilitate comparability, do you believe that a 'ceiling' should be established for determining the amount of credit impairment to be recognized under the 'floor' requirement (for example, no more than three years after an entity's reporting date)? If so, please provide data and/or reasons to support your response.

Not applicable to our response, see question 9(a).

Question 10 - Do you believe that the floor will typically be equal to or higher than the amount calculated in accordance with paragraph 2(a)(i)? Please provide data and/or reasons to support your response, including details of particular portfolios for which you believe this will be the case.

Not applicable to our response, see question 9(a).

Question 11 – The boards are seeking comment with respect to the flexibility related to using discounted amounts. Specifically, on the following issues:

(a) Do you agree with the flexibility permitted to use either a discounted or undiscounted estimate when applying the proposed approach described in paragraph B8(a)? Why or why not?

Yes. With appropriate disclosure, this allows a practical alternative for portfolios where the impact of discounting is less relevant or immaterial.

(b) Do you agree with permitting flexibility in the selection of a discount rate when using a discounted expected loss amount? Why or why not?

Yes. With appropriate disclosure, the selection of an appropriate discount rate is better made my management in light of the nature of portfolio assets and with reference to observable and relevant market inputs.

Question 12 – Would you prefer the IASB's approach for open portfolios of financial assets measured at amortized cost to the common proposal in this document? Why or why not? If you would not prefer this specific approach, do you prefer the general concept of the IASB's approach (ie to recognize expected credit losses over the life of the assets)? Why or why not?

Yes, for open portfolios of financial assets measured at amortized cost and where an allowance-based accounting model is appropriate, we support the IASB's approach versus the common proposal included within the SD. We understand the conceptual appeal of better matching the actual credit losses with the receipt and recognition of the periodic interest payments that compensate investors for taking credit risk. For this reason, the time-proportionate methodology appears more conceptually consistent with an expected loss approach. For reasons previously stated, we would modify the proposal to allow preparers the option of either an incurred loss or an expected loss model, with appropriate disclosure of management's reasons for the selection of a given alternative and the results of its application. The availability of multiple measurement models better enables preparers to apply the most effective measurement approach in the case of the general financial instruments standard and impairment accounting. We are hopeful the larger financial instruments project reconciles the differing views of the respective boards with the broader recognition of the appropriateness of amortized cost as a measurement basis for fixed income securities that are held for the collection of cash flows and principal

Question 13 – Would you prefer the FASB's approach for assets in the scope of this document to the common proposal in this document? Why or why not? If you would not prefer this specific approach, do you prefer the general concept of the FASB's approach (ie to recognize currently credit losses expected to occur in the foreseeable future)? Why or why not?

We would prefer the common proposal because it incorporates a time proportionate component. In the context of this question, we refer you to our previously mentioned reasons and support for the availability of both incurred and expected loss models in the final standard. Concerning the FASB's approach to recognize currently credit losses expected to occur in the foreseeable future, we believe the general concept is inconsistent with matching actual credit losses with the receipt and recognition of periodic interest payments. We would expect that the operability of applying the foreseeable future requirement to be very difficult at best.