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Letter of Comment No: 2 (
File Reference: FSPFAS133A

November 22, 2005

Mr. Lawrence W. Smith
Director of Technical Application and Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Re: File Reference No. FSP FAS 133-a, Accounting for Unrealized Gains (Losses) Relating to Derivative Instruments Measured at Fair Value under Statement 133

Dear Mr. Smith:

PricewaterhouseCoopers LLP appreciates the opportunity to respond to the Financial Accounting Standards Board (FASB or the "Board") regarding its proposed FASB Staff Position No. FSP FAS 133-a, Accounting for Unrealized Gains (Losses) Relating to Derivative Instruments Measured at Fair Value under Statement 133 (the "proposed FSP").

We commend the Board for addressing this important issue. In our response letter (dated September 7, 2004) on the Board's exposure draft Fair Value Measurements, we encouraged the Board to also address the issues related to the guidance that the Emerging Issues Task Force (EITF) specified in EITF Issue No. 02-3, Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities (EITF 02-3). Several other constituents had also requested guidance on this issue because of the diversity in current practice. We appreciate the Board's timely response to the constituents' requests.

Our views on the proposed FSP are summarized in the following subsections of this letter:

- Provisions with which we agree those related to initial recognition of a derivative instrument
- Summary of operational concerns primarily for certain hybrid insurance contracts
- Provisions with which we disagree those related to subsequent accounting for gain (loss) deferred at initial recognition

We have also included Appendix A which more fully describes our operational concerns, particularly regarding the insurance industry.

### Provisions of the proposed FSP with which we agree

We agree with the definitions of fair value and reference market in FASB Statement No. 15X, Fair Value Measurements, (the "FVM Standard") contained in the working draft published on the FASB's website on October 21, 2005. Under those definitions, fair value is the price that would be received for an asset or paid to transfer a liability in a current transaction between marketplace participants in the reference market for the asset or liability. The reference market is the most advantageous market in which the company would transact for the asset or liability.

The proposed FSP states that for derivative instruments, the transaction price presumption is not rebutted at initial recognition if the market in which the transaction occurs is the reference market for the derivative instrument. We agree with this view because, in those circumstances, the reference market is the most relevant measure of fair value. Accordingly, there is no unrealized gain (loss) at initial recognition arising from the difference between the transaction price and the fair-value estimate in the reference market (referred to herein as the "Day One" amount).

If the company executes a transaction in a market that is not its reference market for the instrument, we agree that the transaction-price presumption may be rebutted at initial recognition because the transaction price is not generated from the company's reference market for that instrument subject to the minimum reliability threshold of the proposed FSP.

## Our operational concerns about the proposed FSP's provisions

While we agree with the above-described provisions of the proposed FSP, we have concerns about their clarity and operationality. Our concerns principally relate to:

- How a company should determine whether it has conducted a transaction in its reference market or an alternative reference market, including a hypothetical reference market. Additional explanation of the thought process considered by the Board in making a company's assessment of the reference market either in the FSP or in the FVM standard would be helpful. For example, does the transaction in the reference market have to be identical to the transaction in the market in which the company transacted in order to be the appropriate reference market for purposes of estimating fair value? It may be particularly difficult for insurance companies to develop a hypothetical reference market for certain products such as certain variable annuity contracts.
- The proposed FSP implicitly requires an entity to estimate a fair value for certain hybrid contracts issued by insurance companies. Previous standard setting activities have determined that doing so is impracticable. We believe that the proposed FSP should exclude hybrid insurance contracts from its scope because the FSP process is not the forum to propose such a fundamental change to the basic accounting model for the insurance industry.

These concerns are more fully discussed in Appendix A to this letter.

### Provisions of the proposed FSP with which we disagree

We disagree with the proposed FSP's requirements for the accounting subsequent to the initiation of the transaction (i.e. Day 2 accounting) that is applied to derivative instruments that have a deferred Day One amount. Rather, we believe that the deferred Day One amount should be recognized in income in periods subsequent to the initiation of the transaction through a systematic and rational method of allocation through the date ending on the earlier of either (i) the date that the fair-value estimate falls within levels 1 through 4 or (ii) when the instrument is exercised or matures. The reasons for our view are summarized below:

# A systematic and rational method of allocation would better reflect the underlying economics for certain derivative instruments.

Certain derivative instruments are long-dated contracts without observable markets. In many cases, the company does not expect that the fair-value estimate for these derivatives will meet the minimum reliability threshold during the contract's term. That is, the company does not expect that the fair-value estimate will fall within the range of levels 1 through 4 in the fair value hierarchy in periods subsequent to entering into the derivative contract.

For such instruments, a model value that appropriately considers the exit value of the instrument would converge with the terminal value over the contract's term. In other words, the model value (i.e., a "level 5" estimate) would be corroborated over the contract's term because the valuation model's inputs and risk factors would be adjusted to reflect both the passage of time and changes in facts and circumstances. The causes of any original difference between a model value and the transaction value would dissipate over time. We believe that a company's systematic and rational allocation of the Day One amount over the contract's term better reflects the underlying economics of these derivative instruments because it considers changes in the model's value including the passage of time over the contract's term.

We know that the nature of the Day One amount will vary among the different types of derivative instruments. For example, it could represent a measurement error, a structuring fee, a service fee, or the difference between a wholesale market price and a retail market price (as illustrated in paragraph 3 of the proposed FSP). Consequently, in some cases, the Day One amount might already have been earned at initiation; while in other cases the Day One amount might be earned over the contract's term (e.g., a guarantee fee). Regardless of the specific nature of the Day One amount, if the company does not expect to change the fair-value estimate from level 5 to at least level 4, we believe that recognition of the Day One amount in periods subsequent to initial recognition in a systematic and rational manner would better reflect the substance of the transaction as opposed to waiting until the instrument's exercise or maturity.

A systematic and rational method of allocation would improve convergence with international accounting standards.

In December 2003, the International Accounting Standards Board (IASB) amended International Accounting Standard 39, Financial Instruments: Recognition and Measurement (IAS 39), to achieve convergence with the United States' generally

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accepted accounting principles (U.S. GAAP) that pertain to the recognition of a Day One amount (paragraph BC 104 of IAS 39). The IASB further amended IAS 39 in December 2004 to converge its guidance on the transitional provisions and the subsequent recognition of a Day One amount with the guidance under U.S. GAAP. These amendments indicate that accounting for an unrecognized Day One amount in periods subsequent to initial recognition should consider the passage of time, which, under international practice, generally calls for some type of amortization (paragraph AG76A of IAS 39, specifically its reference to "time factor").

IAS 39 presumes that upon the inception of a derivative instrument, its fair value equals the transaction price. IAS 39 provides a rebuttal of this presumption only if all of the valuation model's inputs are observable. If the transaction-price presumption is not rebutted, the company must calibrate its model to the transaction price at initial recognition and upon subsequent measurement. For most instruments, an amortization of a Day One amount over the life of the instrument generally approximates the results of calibrating the valuation model that occurred at initial recognition. Additionally, amortization of the Day One amount follows established valuation theory by considering the passage of time and other changes in facts and circumstances over the contract's term. Accordingly, companies that follow IAS 39 generally recognize some type of amortization of a Day One amount over the life of the instrument.

Consequently, the proposed FSP's accounting for the Day One amount would create a new divergence between U.S. GAAP and IAS 39 because the proposed FSP lowers the bar for a company to recognize the Day One amount. IAS 39 is currently applied following a methodology that is similar to existing US GAAP. The accounting in periods subsequent to initial recognition for level 5 fair value estimates under the proposed FSP will result in additional divergence. For foreign private issuers that reconcile their accounting with U.S. GAAP, the proposed FSP would create a new difference between their accounting under IAS 39 and their accounting under U.S. GAAP. A systematic and rational method of allocation, on the other hand, would improve convergence.

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We appreciate the opportunity to express our views on the proposal. If you have any questions regarding our comments, please contact John Lawton (973-236-7449) or John Horan (973-236-4997).

Sincerely,

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PricewaterhouseCoopers LLP

Appendix A

Detailed comments about our operational concerns and suggestions to improve the proposed FSP's clarity

As indicated in the body of our letter, we have the following concerns about the proposed FSP:

Paragraph 3: The concept of a reference market is introduced for the first time in the FVM Standard and paragraph 3 of the proposed FSP addresses the implications of that concept as it relates to the Day One amount for derivative instruments. Because "reference market" is a new concept, it would be helpful if the FASB were to provide additional explanation of the thought process that a company should employ to determine whether there is a separate reference market other than the market in which a transaction occurs. For example, assume that a dealer enters into several derivative contracts with different customers in a retail market, as described in paragraph 3(a) of the proposed FSP. As stated in paragraph 3(b), the dealer has access to a wholesale market that is more advantageous than other markets for purposes of "laying off" the acquired risks; but this might be true only on a group (i.e., an aggregated) basis, not on a "one-for-one identicalinstrument" basis. The proposed FSP should clarify whether a hypothetical transaction in a separate reference market must be identical to the actual transaction.

In addition, for some derivative instruments or embedded derivatives requiring bifurcation from host instruments (e.g., some insurance products with guaranteed minimum accumulation benefits or withdrawal benefits embedded in certain variable annuity contracts), there might not be an observable "wholesale" market for these embedded derivatives for the insurer. For some insurance products with embedded derivatives, there is currently no reinsurance market or any other separate "wholesale" market in which an insurer can "lay off" the risks and rewards of the original transaction that was entered into with the customer in the "retail" reference market. Therefore, under such circumstances, we believe that the insurer could conclude that the transaction price presumption is not rebutted.

We understand, however, that in cases where there is no observable layoff market, the proposed FSP requires the insurer to construct a hypothetical reference market (see paragraph 3(b) of the proposed FSP and paragraphs 5, 8, and C27 of the FVM Standard) in order to estimate fair value of the embedded derivative using a valuation technique. It is not clear, however, (from the guidance related to reference markets either (1) in the FVM Standard or (2) in the proposed FSP) whether the insurer's fair value estimate using a valuation technique must show a Day One amount for the embedded derivative simply because the hypothetical reference market constructed by the insurer is supposed to be more advantageous to the insurer than the retail market in which the transaction occurred.

We believe, however, that the use of a valuation technique for a fair value estimate in a hypothetical reference market (e.g., a level 5 estimate) would not necessarily imply that the insurer has a Day One amount in all circumstances. Based on the individual facts and circumstances, the insurer may have a Day One gain, a Day One (loss), or neither gain nor loss. We recommend that the proposed FSP clarify that a fair value estimate in a

hypothetical market using a valuation technique does not necessarily result in a Day One amount in all cases.

With respect to the embedded derivative instrument of the insurer discussed above, we believe that some insurers would conclude that there is not sufficient information available to identify any component of the transaction price as representing a Day One amount (or "dealer" profit) as opposed to the risk premium on the embedded derivative. Therefore, the insurer would neither immediately recognize nor defer any Day One amount on the embedded derivative instrument. In our view, such accounting by the insurer would be appropriate under the circumstances.

We recommend that the proposed FSP include the insurer's embedded derivative example discussed above to clarify the application of the concept of the reference market in situations in which the company uses a level 5 fair value estimate and constructs a hypothetical reference market.

Paragraph 8: Amendment to Statement 133, Implementation Issue B6: This paragraph requires that when an embedded derivative meets the criteria in paragraph 3(b) of the proposed FSP, the fair value of the entire hybrid instrument should be estimated to calculate the unrealized gain (loss) component of the hybrid instrument. This requirement to estimate fair value would be applicable to certain hybrid insurance contracts such as variable annuity contracts with minimum guarantee derivatives (see example discussed above). We believe that imposing a fair value measurement requirement for an insurance contract, at this point, would be premature.

The concept of fair value for insurance contracts has been heavily debated for several years, with many parties (including the FASB, the IASB, and the insurance industry), recognizing the many measurement challenges inherent in these complex products that have elements of insurance, service, and market risk. At present, the IASB's project on insurance contract valuation has identified several potential measurement models for insurance contracts, but the project is in its earlier stages. In providing an exception for insurance contracts in FAS 133, the Board recognized that "definitional and valuation difficulties still existed...the insurance industry and the accounting and actuarial professions have not reached a common understanding about how to estimate the fair value of insurance contracts." We believe that this observation holds true today, and that an FSP that relates principally to a derivative valuation issue should not require a fundamental change to the basic accounting model of the insurance industry.

Further, the proposed FSP would change the accounting model for a portion of the underlying insurance contract host from recognition of such unrealized gain over time, as risk expires, to the end of the contract. Such a change would raise additional questions about how the new accounting impacts on the related deferred acquisition cost asset. Accordingly, we recommend that the revision to DIG B6 that would require calculation of an unrealized gain (loss) on the hybrid instrument exclude from its scope hybrid insurance contracts. Despite the recommended scope exception, derivative instruments embedded in hybrid insurance contracts would continue to be subject to the proposed FSP.