

Letter of Comment No: 16
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Director TA&I - FSP
Financial Accounting Standards Board
401 Merritt 7
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Norwalk, Connecticut 06586-5116

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

To Whom It May Concern:

The Hartford Financial Services Group, Inc. (The Hartford) appreciates the opportunity to comment on the proposed FASB Staff Position No. 133-A, "Accounting for Unrealized Gains (Losses) Relating to Derivative Instruments Measured at Fair Value under Statement 133" (the FSP). We support the Board's objective of developing a statement to establish a framework clarifying the application of fair value measurement in current U.S. GAAP. However, as a significant writer of variable annuity contracts, many which contain guarantees that are embedded derivatives under Statement 133, The Hartford believes application of the FSP to those hybrid instruments creates the following issues:

1. We understand that Staff and the Board were concerned that certain entities were embedding derivatives in hybrid instruments to recognize earnings on those derivatives prior to that which would have been allowed under EITF 02-3. The embedded derivative guarantees offered with traditional variable annuity contracts are specific product features. The insurance industry offers those features as a benefit to the contract holder as a part of the traditional variable annuity not as a way to change the profit recognition model for the embedded derivative or for the host contract (The host contract is the primary source of revenues and expenses within the hybrid instrument.).

In addition, when the hybrid instrument is a variable annuity with an embedded derivative guarantee, the host contract is the traditional variable annuity in accordance with Statement 133 Implementation Issue B8. The host contract is not a debt or equity instrument, but rather is typically accounted for as a universal life-type contract, due to the significance of the mortality guarantees, in accordance with Statement 97. As a result, the revenues and expenses within a traditional variable annuity contract are different from those of a debt or equity instrument. Accounting recognition for the traditional variable annuity's revenues

and expenses are clearly prescribed in Statement 97. Statement 97 requires recognition of revenues when amounts are assessed against the contract holder account balance and expenses are recognized as incurred.

The FSP, by requiring an unrealized gain or loss component of the entire hybrid instrument to be separately recognized and deferred (as measurement uses Level 5 inputs), fundamentally changes the revenue and profit recognition model prescribed by Statement 97. By applying the FSP to the variable annuity hybrid instrument, not only is a profit component of the embedded derivative deferred, a substantial portion to substantially all, depending on the valuation model, of the profit on the traditional variable annuity host contract is deferred. Statement 97, in a way, also defers revenue and profit recognition; however, those revenues and profits are recognized over the life of the contract rather than at contract termination or maturity. We do not believe the Board intended to overturn the fundamental accounting model in Statement 97, as it relates to traditional variable annuities, by prescribing, in the FSP, certain accounting for embedded derivatives.

2. As variable annuity contracts are typically recorded in separate accounts in accordance with SOP 03-1, determining the initial carrying value to be assigned to the host contract in accordance with paragraph 8 of the FSP results in separate account assets not equaling separate account liabilities. In addition separate account liabilities will no longer equal the contract holder's account value as is prescribed by paragraph 11 of SOP 03-1.

For these reasons, we recommend that the Board exclude from the scope of the FSP host contracts which are accounted for under the provisions of Statement 97. We would recommend that derivatives embedded in host contracts that are accounted for under Statement 97 be accounted for in a manner consistent with the current accounting prescribed in Statement 133 Implementation Issue B6. Given the short 30 day comment period, we have focused our comment letter on derivatives embedded in host contracts currently accounted for under Statement 97. Similar issues to those described above may exist for hybrid instruments issued by insurance enterprises where the host contract is an insurance or reinsurance contract accounted for under Statement 60 or 113.

We have attached a more detailed discussion document where we describe in greater detail The Hartford's variable annuity product, our current accounting and our interpretation of how the FSP would impact The Hartford and other variable annuity writers.

It would be our pleasure to further discuss our comments in greater detail with the Board or Staff. Questions should be directed to Jim Yanosy, Assistant Vice President and Director, Accounting Policy – Hartford Life. Jim can be reached at (860) 843-6964.

Sincerely,

Robert J. Price
Senior Vice President and Controller
The Hartford Financial Services Group, Inc.

Discussion Document

The Product

The Hartford sells variable annuity contracts to individuals in the United States, Japan and the United Kingdom. Variable annuity contracts, during the accumulation phase, are essentially mutual funds wrapped by an insurance contract. Absent the more significant death benefit guarantees, the mortality risk within a traditional variable annuity contract is insignificant. The contract holder elects which mutual funds they wish to invest in from a suite of funds offered by the issuer. The returns from those funds (positive or negative) are passed directly to the contract holder. On a daily basis, The Hartford withdraws from the contract holder's funds a fee to cover mortality, administrative and other benefit expenses offered through the contract. The contract holder's deposits, plus the returns generated from the funds, less the fees withdrawn, less any contract holder withdrawals represent the contract holder's account value.

In 2002, The Hartford added a guaranteed minimum withdrawal benefit (GMWB) "rider" to its traditional variable annuity contract. A "rider" is an optional benefit that may be elected by the contract holder at his/her discretion. The GMWB rider may be elected at inception or subsequent to initial issuance. The price to be paid for the rider is fixed at contract inception, even if The Hartford raises the price for new contract holders.

A GMWB is a form of principal guarantee that provides that if the contract holder's account value is reduced to zero through negative returns from the funds and/or a series of withdrawals (which are limited by the terms of the contract), a guaranteed balance (calculated by the terms of the contract) will be paid to the contract holder over a fixed period of time (determined by the terms of the contract).

The Hartford's Accounting

The Hartford believes its current accounting for GMWB is materially consistent with other variable annuity writers in the United States.

The Hartford has concluded that the GMWB rider represents an embedded derivative that requires bifurcation from the traditional variable annuity host contract in accordance with the provisions of Statement 133. As a result, the GMWB rider is recorded at fair value with changes in fair value recorded in earnings. The traditional variable annuity contract is accounted for consistent with a universal life-type contract in Statement 97.

By analogy to capital market instruments, The Hartford believes the GMWB rider is most like a swap, where both legs are variable. The contract holder pays a fee to The Hartford (the "receive leg") in exchange for benefits to be paid if the contract holder's account value were to ever be reduced to zero (the "pay leg") by a combination of market declines and contract holder withdrawals. Upon contract holder election of the GMWB rider (which occurs predominantly at inception of the variable annuity contract), the pay leg is valued, using both observable and non-observable capital market inputs, as well as The Hartford's own

assumptions for contract holder behavior, to determine how much The Hartford expects to pay in benefits. In effect, The Hartford is a principal to a variable rate swap and is attempting to estimate the future payments under the swap. Based on the pay leg calculation, The Hartford determines how much of the fee charged for the benefit should be attributed to the benefit or the embedded derivative (the receive leg) and how much should be attributed to the traditional variable annuity host contract, using the with or without method described in Statement 133 Implementation Issue B6, prior to the FSP modifications. In this way, at inception, when the contract is "at the money", the value of the receive leg is set equal to the value of the pay leg, by locking in the fees ascribed to the embedded derivative. Each leg of the GMWB embedded derivative is revalued each period to derive the fair value of the GMWB embedded derivative. Changes in fair value of the GMWB embedded derivative are recorded in earnings.

Fees ascribed to the traditional variable annuity host contract, along with other mortality and administrative fees prescribed by the contract, are recorded as revenue, as collected, consistent with the accounting for universal life-type contracts in Statement 97. The contract holder's account value is recorded in separate account assets and liabilities representing the amount the contract holder would receive, before surrender penalties, upon surrender of their contract or withdrawal. As the value of the GMWB embedded derivative (a general account liability) is zero at inception, the accounting for separate account assets and liabilities is not disrupted by the initial value of the GMWB embedded derivative. In addition, future changes in value of the GMWB embedded derivative do not impact separate account assets or liabilities. Rather separate account assets and liabilities are impacted by the transactions and events which one would expect to impact the contract holder's account value (notably investment returns of the underlying funds and charges withdrawn). Through this process, the accounting for the host contract, as described in Statement 97 is maintained.

Implementing the FSP

As the GMWB rider is an embedded derivative in the traditional variable annuity host contract, The Hartford believes that the FSP's modifications to Statement 133 Implementation Issue B6 within paragraph 8 are applicable. The FSP requires an entity to answer the following question. Does the transaction occur in the reference market? The Hartford has taken this to mean, "Does the sale of the variable annuity contract with the GMWB rider, to the contract holder, occur in the reference market?" As described in paragraph 2 of the FSP, "The reference market is the most advantageous market in which the entity would transact for the asset or liability." The Hartford believes the retail market is not the reference market. We believe our reference market would be either the reinsurance market or a customized derivative dealer market as offered by an investment bank, both of which are currently hypothetical markets. The reinsurance or investment bank market will likely result in more favorable exchange terms to The Hartford when compared to the transaction price in the retail market (The Hartford views the hybrid variable annuity contract as an unrecorded asset. The amount to be received by The Hartford, if the hybrid variable annuity contract were sold or reinsured would be greater than the transaction price in the retail market. In addition the "lay-off" price for the GMWB embedded derivative would be lower than the explicit rider fee in the contract.). It is therefore more advantageous to transact in the reinsurance or investment bank market than the retail market.

Once the reference market is identified as being a different market from that market in which the transaction takes place, paragraph 8 of the FSP requires the unrealized gain or loss component of the hybrid contract to be calculated. As described in paragraph 4 of the FSP, this requires a comparison of the transaction price for the hybrid instrument to the fair value of the hybrid instrument. At inception of a variable annuity contract, the transaction price is zero. The contract holder makes a deposit; however, no fees have yet been collected. The fair value of a hybrid variable annuity contract with a GMWB rider will contain the present value of a significant portion to substantially all of the profits to be earned on the contract, depending upon the valuation model used. As a result, the unrealized gain on sale of a hybrid variable annuity contract or group of contracts represents a significant component of the profit, exclusive of the profit embedded in the discount rate, expected to be generated from those contracts.

For example, assume a group of contract holders deposit \$100,000 with The Hartford to invest in a variable annuity contract with a GMWB rider. Assume The Hartford calculates the fair value of the hybrid instrument to be \$6,000 (present value of all fees, including those of the GMWB rider in excess of the present value of all benefits to be paid, using a risk adjusted discount rate). As described above, since the transaction price is \$0, the unrealized gain is \$6,000.

After calculating the unrealized gain for the hybrid instrument, the fair value of the embedded derivative is needed to determine the amount to be allocated to the host contract. The Hartford sells its GMWB rider for 50 basis points. We interpret the FSP, as written, to require that the receive leg on the GMWB swap is the present value of the 50 basis points to be received over time. Under this guidance, the pay leg is equivalent to the “lay off” price. In other words, the amount that The Hartford would have to pay an unrelated party for them to assume the GMWB risk. For purposes of illustration and example, assume this hypothetical “lay off” price is 45 basis points. As described above, at this point, any “lay off” price would be hypothetical and determined through use of a model with both observable and non-observable capital market inputs as well as The Hartford’s own assumptions for contract holder behavior. Assuming a receive leg of 50 basis points and a pay leg of 45 basis points, at inception, The Hartford believes the GMWB rider/swap is an asset and would have resulted in an unrealized gain if it were a free standing derivative. For illustration purposes, assume the calculation of that asset equaled \$400.

Based on our interpretation of the FSP, The Hartford would expect to record the following journal entry at inception of the issuance of the variable annuity contracts described in our example:

Dr. Separate Account Assets	\$100,000	
Dr. GMWB Embedded Derivative	400	
Cr. Unrealized Gain		6,000
Cr. Separate Account Liabilities		94,400

As is illustrated by this example entry, separate account assets do not equal separate account liabilities. In addition separate account liabilities do not equal the contract holders’ account

value of \$100,000. The accounting prescribed by the FSP has changed the accounting for the traditional variable annuity host contract from that required by Statement 97 and SOP 03-1.

Subsequent to contract issuance, separate account assets will change in value based upon the performance of the underlying mutual funds. One would expect separate account liabilities to change by the same amount.

The GMWB embedded derivative will change in value with changes in value recorded in earnings.

It is not expected that the valuation of the hybrid instrument will change from a Level 5 measurement to a more reliable measurement until surrender of the contract or contract maturity. This would result in a revenue and profit recognition model contingent upon contract termination. This profit recognition model is inconsistent with the profit recognition model for the traditional variable annuity host contract in Statement 97.

It is not clear that the separate account liability balance should accrete to a par value, as would likely be the case with a debt host contract. It would seem that it should, so that the liability could eventually equal the surrender value before surrender penalties. If separate account liabilities did accrete to a par value, a variable annuity writer would not recognize profit on a variable annuity contract, other than the interest associated with the discount rate, until the contract was surrendered. Accretion of separate account liabilities is inconsistent with the accounting for the traditional variable annuity host contract prescribed by Statement 97, as the contract holder can surrender the contract for the surrender value (excluding certain surrender fees and penalties) and therefore, separate account liabilities would not represent the amount required under Statement 97 or SOP 03-1.