



Executive Offices

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Technical Director – File Reference No. 1870-100
Financial Accounting Standards Board
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Response to FASB Discussion Paper – Preliminary Views on Insurance Contracts

The Principal Financial Group (“Principal”) appreciates the opportunity to offer our views on the Financial Accounting Standards Board’s (“FASB”) *Discussion Paper – Preliminary Views on Insurance Contracts* (“DP”). The Principal is a leader in offering businesses, individuals and institutional clients a wide range of financial products and services, including retirement and investment services, life and health insurance, and banking through its diverse family of financial services companies. A member of the Fortune 500, the Principal Financial Group has \$306 billion in assets under management and serves some 18.9 million customers worldwide from offices in Asia, Australia, Europe, Latin America and the United States.

Because the DP is largely based on the International Accounting Standards Board’s *Exposure Draft: Insurance Contracts*, the comments below address our concerns with the document. We fully support the FASB’s and IASB’s (“the Boards”) objective of developing a single, high-quality, principles-based accounting model for insurance contracts. In general, we feel that the building blocks described in the Exposure Draft provide a sound foundation for a high-quality accounting model. However, we have several concerns with specific aspects of the model described in the Exposure Draft. In addition, there are several areas where we feel that the guidance is unclear. We recommend that the Boards provide further clarification in these areas, in order to improve the comparability of results across companies.

The Principal participated in the drafting of the Exposure Draft responses by the American Council of Life Insurers (“ACLI”), and we generally support the views expressed in the ACLI’s response. In addition to signing the ACLI letter, we wanted to take the opportunity to highlight a few items that we view as key areas of concern.

Discount rates (Question 3 – IASB’s Exposure Draft)

Paragraph 31 of the Exposure Draft indicates that if the cash flows of an insurance contract do not depend on the performance of specific assets, the discount rate shall be based on the risk-free yield curve with an adjustment for illiquidity. We feel that the prescribed discount rate is inconsistent with the manner in which insurance contracts are priced and managed, and it may produce artificial losses at inception for certain products.

When pricing a product, insurers generally consider the yield that they expect to earn on the assets backing the liability. This yield is composed of a risk-free rate, a liquidity premium, and a credit spread.

Excluding the credit spread from the discount rate may result in a discount rate that is significantly lower than the earned rate assumed in pricing. This may result in an artificial loss at issue for many products that are expected to be profitable. While we are not opposed to recording a loss at issue if the accounting reflects the economics of the contract, we believe that reporting an artificial loss at issue on a product that is expected to be profitable does not reflect the economics of the product, and it does not provide decision-useful information to the users of financial statements.

We also believe the discount rate guidance in the Exposure Draft is inconsistent with that of other recent exposure drafts. For example, paragraph B13 of the Exposure Draft on Leases states that “both the lessee’s incremental borrowing rate and the rate the lessor charges the lessee would reflect the nature of the transaction and the specific terms of the lease, such as lease payments, lease term, expected contingent rentals...” Paragraph IG82 of the Exposure Draft on Revenue from Contracts with customers states that “an entity shall use the discount rate that would be reflected in a separate financing transaction between the entity and its customer. That rate would reflect the credit characteristics of the parties to the contract as well as any collateral or security provided by the customer or the entity, which might include goods transferred in the contract...” The guidance in these exposure drafts appears to allow for use of a discount rate that reflects the economics of the transaction.

Therefore, we recommend that the discount rate guidance be amended to allow for the use of discount rates that better reflect the economics of the business.

Lastly, we believe that additional clarification is needed regarding the selection of a discount rate for contracts where the amount, timing, or uncertainty of cash flows depends on the performance of specific assets. Paragraph 32 suggests using a replicating portfolio to reflect the dependence. However, it generally is not feasible to construct a replicating portfolio for insurance contracts, because there are no assets available that would replicate policyholder behavior. We feel that additional guidance is needed on how to reflect the dependence of cash flows when the use of a replicating portfolio is not practical or feasible. We believe that a reasonable alternative would be to discount the cash flows using a rate that reflects the expected rate of return on the specific assets on which the cash flows depend.

Acquisition costs (Question 7 – IASB’s Exposure Draft)

While we support the decision to include acquisition costs in the liability measurement, we believe that the definition of incremental acquisition costs proposed in the Exposure Draft is too narrow. Paragraph B61(f) indicates that acquisition “costs are identified at the level of an individual insurance contract rather than at the level of a portfolio of insurance contracts.” Many of the acquisition costs incurred by insurers – such as underwriting and policy issuance – are measured and managed at the portfolio level, rather than at the individual contract level. For example, the salary of an employee who performs tasks related to policy issuance generally is not attributable to the sale of any particular contract. However, a portion of policy issuance expenses are directly related to the acquisition of new business, and they would be expected to increase as sales increase at the portfolio level. Therefore, we believe that it is appropriate to include such costs in the measurement of insurance liabilities.

Furthermore, the requirement to measure acquisition costs at an individual contract level is inconsistent with the guidance elsewhere in the Exposure Draft regarding the level of aggregation. Paragraph 23 states that “estimates of cash flows for a portfolio of insurance contracts shall include all incremental cash

inflows and cash outflows arising from that portfolio". In addition, paragraphs 20 and 36 indicate that the risk adjustment and the residual margin should be measured at the portfolio level. We see no reason why the level of aggregation for acquisition costs should differ from the level of aggregation for other cash flows and margins.

Additionally, "incremental acquisition costs" are defined as "the costs of selling, underwriting and initiating an insurance contract that would not have been incurred if the insurer had not issued that particular contract." We believe this definition as currently written is confusing. It appears that the IASB intends for costs of efforts such as underwriting to be included in the liability measurement. However, these costs are generally incurred on all contracts regardless of whether the contract was actually issued so they do not appear to be incremental at the contract level.

We recommend that the Boards revise the guidance to clarify that incremental direct acquisition costs of contract acquisition as well as costs related to functions such as underwriting, policy issuance and processing, and medical and inspection for contracts actually acquired can be used in the liability measurement. This definition is consistent with the guidance in Accounting Standards Update 2010-26, *Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts*, which was recently adopted by the Financial Accounting Standards Board. We also recommend that the Boards remove the requirement to identify acquisition costs at the individual contract level. These revisions would better reflect the economics of insurance contracts, and they would make the measurement of acquisition costs more consistent with the measurement of other types of cash flows.

Unbundling (Question 12 – IASB’s Exposure Draft)

We found the Exposure Draft’s guidance on unbundling to be confusing and, in some cases, contradictory. We believe that greater clarity is needed regarding (1) when unbundling is required and (2) how to account for the separate components in cases where unbundling is required.

The Exposure Draft indicates that unbundling is required for components that are not closely related to the insurance coverage; paragraph 8 provides examples of common product features that are not closely related to the insurance coverage. However, in many cases, the components described in paragraph 8 are closely related to the insurance coverage. For example, variable universal life (VUL) contracts have an account balance that is credited with an explicit return, and the crediting rate is based on the investment performance of the underlying separate account investments. Therefore, paragraph 8(a) would indicate that unbundling is required. However, the death benefit and the account value in a VUL contract are closely interrelated. For example, the monthly mortality charges are typically a function of the difference between the death benefit and the account value. In addition, the death benefit may be adjusted as the account value increases, in order to ensure that the contract continues to qualify as life insurance for tax purposes. Due to this interdependence, separating the components would require arbitrary allocations that would not provide meaningful or decision-useful information. Similar considerations would apply for other types of permanent life insurance, including fixed universal life and whole life.

The unbundling principle proposed in the Exposure Draft is to separate components of a contract when the components are not closely related to the insurance coverage in the contract. We do not believe the principle is sufficiently defined to allow for consistent interpretation. The guidance begins to define the principle by requiring unbundling for all contracts that contain specified features (such as account

balances that meet the criteria of paragraph 8(a)). We believe that the guidance should go further and clarify that unbundling is not required in cases where the cash flows are so interdependent that the components cannot be measured separately on a basis that is not arbitrary. We would also recommend that the guidance provide examples discussing the applicability of unbundling to common insurance products (similar to the embedded derivative examples that are provided in paragraphs AG30 – AG33 of IAS 39).

Furthermore, in the cases where unbundling is appropriate, clearer guidance is needed regarding how to account for the separate components. For example, it is unclear whether acquisition and maintenance expenses should be allocated to the insurance component or the deposit component, or split between the two components.

Disclosure (Question 14 – IASB’s Exposure Draft)

We support the stated objective of “helping users of financial statements understand the amount, timing, and uncertainty of future cash flows arising from insurance contracts.” However, we have concerns regarding the volume and content of disclosures required by the Exposure Draft. The guidance in the Exposure Draft represents a significant increase in the volume of required disclosures. We believe that the additional disclosure requirements will generate significant costs for the preparers of financial statements, while providing little if any additional benefit to the users of financial statements. Furthermore, the sheer volume of required disclosures may diminish the usefulness of the disclosures by making it difficult for users to pick out the truly important information.

Complying with the proposed disclosure requirements will substantially increase the amount of time required for insurers to prepare their financial statements. As a result, insurers will likely be forced to either significantly lengthen their close cycles or prepare financial statements based on data from a prior month-end. Both of these solutions would adversely impact the timeliness and relevance of the financial statements.

We recommend that the Boards remove the requirement for sensitivity disclosures described in paragraph 92(e)(i). We feel that this requirement is overly broad, and we question whether the information is auditable. We believe that it would be more appropriate to include such information in Management’s Discussion and Analysis. We also note that the measurement uncertainty analysis described in paragraph 90(d) appears to be redundant with other sensitivity disclosure requirements. We question whether this requirement provides additional value to the users of financial statements. Therefore, we recommend that the requirement in paragraph 90(d) be removed.

In addition to the specific recommendations above, we would encourage the Boards to undertake a comprehensive review of the proposed disclosure requirements, with the goals of (1) achieving a reasonable balance between the costs to preparers and the benefits to the users of financial statements and (2) reducing the volume of required disclosures in order to avoid obscuring important information or overwhelming the users of financial statements.

Transition (Question 17 – IASB’s Exposure Draft)

For contracts that are in-force as of the transition date, paragraph 100 indicates that “the measurement, both at transition and subsequently, does not include a residual margin.” Due to the absence of a residual

margin, a contract that is in-force as of the transition date will have lower profits going forward than an otherwise similar contract that is issued after the transition date. For risk-based products such as term insurance and disability income insurance, we expect the release of residual margins to be a significant driver of earnings. This fact has been confirmed through our initial modeling results and those of others in the industry. Therefore, we believe that eliminating the residual margin for existing contracts will impair the comparability of results between existing business and new business.

We recognize that there are significant practical difficulties associated with estimating residual margins for in-force business. However, we believe that it would be appropriate to include a residual margin in the measurement of existing contracts, perhaps using a simplified method to estimate the margin.

Reinsurance contracts (Question 16 – IASB’s Exposure Draft)

We are generally supportive of the Exposure Draft’s proposed approach for measuring reinsurance contracts. However, we disagree with the guidance on establishing residual margins for reinsurance contracts. Paragraph 45 indicates that “if the present value of the fulfillment cash flows for the reinsurance contract is less than zero (i.e. the expected present value of future cash flows plus the risk adjustment is less than the expected present value of future cash outflows) the cedant shall establish that amount as the residual margin at initial measurement.”

If the expected loss is not recognized at inception, the losses will emerge gradually over the life of the contract. We believe that this result is inappropriate, and it is inconsistent with existing accounting guidance. Under US GAAP Accounting Standards Codification 450-20, *Contingencies - Loss Contingencies*, and IASB International Accounting Standard 37, *Provisions, Contingent Liabilities and Contingent Assets*, losses are accrued when they are probable and can be reasonably estimated. Therefore, if a reinsurance contract is expected to produce a loss for the ceding company (i.e. the present value of fulfillment cash flows is negative), we believe it would be appropriate to reflect this loss in the measurement at inception, rather than using a residual margin to offset the expected loss.

Subsequent measurement of residual margins (Question 6 – IASB’s Exposure Draft)

We feel that greater clarity is needed regarding the subsequent measure of residual margins. Paragraph 51 states that interest should be accreted on the residual margin “using the discount rate specified in paragraph 30.” However, paragraphs 30 and 31 indicate that cash flows should be discounted using an entire yield curve, rather than a single rate. It is unclear which point on the yield curve should be used for accreting interest to the residual margin.

Paragraph 53 indicates that the residual margin should be reduced if fewer contracts than expected remain in-force, but it should not be increased if more contracts than expected remain in-force. We feel that further explanation is needed regarding how to adjust the amortization pattern going forward.

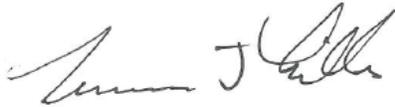
Portfolio transfers and business combinations (Question 18 – IASB’s Exposure Draft)

We believe that minor clarifications are needed in the guidance on portfolio transfers and business combinations. Paragraph 40 refers to “the consideration received.” We assume that this refers to the assets that are transferred, net of any payments from the acquirer. We recommend that the Boards clarify this point.

In addition, paragraph 40 refers to an adjustment for “any other assets and liabilities acquired in the same transaction, such as financial assets and customer relationships.” We recommend that similar language be added to paragraph 42.

We appreciate your consideration of our comments. If you would like to discuss this letter, please contact me at (515)247-4885 or Lillis.Terry@Principal.com

Sincerely,

A handwritten signature in black ink, appearing to read "Terrance J. Lillis". The signature is fluid and cursive, with the first name being the most prominent.

Terrance J. Lillis
Senior Vice President and Chief Financial Officer