



NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

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Technical Director:

Thank you for the opportunity to comment on the Exposure Draft, *The Fair Value Option for Financial Assets and Financial Liabilities, Including an amendment of FASB Statement No. 115*. On behalf of the Statutory Accounting Principles Working Group (SAPWG) of the National Association of Insurance Commissioners (NAIC), I am pleased to provide you with comments on the Exposure Draft.

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Purpose for NAIC Comment

The Statutory Accounting Principles Working Group (SAPWG) of the NAIC has the responsibility of developing and proposing new Statements of Statutory Accounting Principles (SSAPs) to be used by insurers in the United States. Statutory Accounting Principles (SAP) utilizes a framework established by GAAP; therefore, the NAIC believes it is important to comment on GAAP exposure drafts that will affect SAP before such guidance is finalized. The SAPWG understands the guidance contained in this Exposure Draft pertains to general purpose accounting statements and will comment to this end. Comments included in this letter are directed specifically to the issues contained in the Exposure Draft. The NAIC will formally review the final Statement in its entirety during our normal process to establish our conclusion on the finalized FASB guidance in relation to SAP.

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Issue 1 – Should an entity not be permitted the option to initially and subsequently measure those financial assets and financial liabilities or any others at fair value?

The NAIC understands the Financial Accounting Standards Board (FASB)(the Board) has made a commitment to develop high quality accounting standards that are consistent with those being developed by the International Accounting Standards Board (IASB) in order to promote consistent and comparable financial statements for companies operating within the world's capital markets. In light of this convergence of accounting standards, the NAIC encourages the FASB to incorporate the constraints included in IAS 39, which allows the fair value option (FVO) to be utilized if:

- The use of the FVO should result in more relevant information; and
- The use of a fair value measurement eliminates or significantly reduces an accounting mismatch; or
- A group of financial assets or financial liabilities are managed in a documented manner on a fair value basis (with public disclosure of the objectives and strategies for use of the fair value option)

The NAIC has concerns that, without the above constraints, the FVO might be used in an inappropriate manner to manipulate and/or manage earnings. In addition, the NAIC notes the

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IASB specifically excludes insurance contracts from the scope of IAS 39. Specifically including insurance and reinsurance contracts within the scope of this Proposed Statement is inconsistent with the commitment to establish accounting standards consistent with those of the IASB.

The NAIC is aware that the IASB and the FASB have agreed to a modified joint approach to the IASB Project – Insurance Contracts. After the IASB publishes a Discussion Paper, the FASB is expected to solicit comments and determine whether to add a joint FASB/IASB project to its agenda to develop a comprehensive standard on accounting for insurance contracts. It is expected this comprehensive standard will include guidance on appropriate measurement attributes for the valuation of insurance liabilities. While it is expected the attributes will likely share many of the characteristics of fair value, it remains unclear as to whether the measurement attributes will be a robust, full fair value. Without the understanding of the final measurement attributes to be applied to insurance liabilities, the NAIC opposes the inclusion of insurance and reinsurance contracts that are financial instruments within the scope of this Proposed Statement.

The NAIC is aware of the Board’s consideration of FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments* (FAS 107), exclusions and the ultimate support of a broad application of the FVO. However, the NAIC notes the rationale for excluding insurance contracts from the fair value disclosure requirements of FAS 107 stated “the Board believes that definitional and valuation difficulties are present to a certain extent in those contracts and obligations, and that further consideration is required before decisions can be made about whether to apply the definition to components of those contracts and whether to require disclosures about fair value for the financial components”. The NAIC believes definitional and valuation difficulties still exist, as evidenced by the above mentioned modified joint project of the FASB and IASB.

While the NAIC agrees with the desire to alleviate the mismatch of measuring some assets and liabilities at fair value while requiring other related assets and liabilities to be measured using another measurement attribute, the NAIC is highly concerned with the use of optionality as a means to achieve this goal. The use of optionality will negatively impact consistency and comparability in general-purpose financial statements.

If so, why should those financial assets and financial liabilities be excluded from the scope of this proposed statement?

The NAIC’s comment related to the above question is directed specifically to the issue of optionality, which as previously stated, we have concerns with because it will reduce comparability resulting from inconsistent reporting. As it pertains to the scope of this statement, the NAIC is opposed to the inclusion of insurance and reinsurance contracts within this Exposure Draft as outlined above. In addition to the above stated reasons for opposition, there is no active secondary market for most insurance contracts and as such, what the FASB can expect insurance enterprises to use in their valuation of these liabilities are present value models or actuarial techniques designed to emulate an approximate fair value. The Proposed Statement No. 15X, *Fair Value Measurements* defines fair value as “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.” This definition appears to remove the concept of settlement of a liability from the current definition. While many may have concerns with this apparent exclusion, the NAIC notes that insurance contracts are written with the expectation that the insurance obligation will be settled directly with the policyholder or beneficiary, and the vast majority are discharged by the insurer through settlement rather than through transfer. However, in the unusual and infrequent event the insurance liability is transferred, by law the transferee must be a

licensed insurer, who would be required to contemplate settlement when establishing the reserve. As a result, measurement of insurance contracts retains the concept of settlement in the hypothetical transfer market for the insurance liability.

The NAIC further notes that the IASB's Insurance Contract project considers an additional margin for risk (Risk Margin) within the guidance for measurement of insurance liabilities. The purpose of a Risk Margin in the IASB project is to provide a return for taking on risk, yet it is also, perhaps coincidentally, consistent with the fundamental concept under the NAIC's statutory accounting framework of conservatism. Whether described in terms of risk or otherwise, the NAIC believes such a risk margin is necessary for adequate protection of policyholder interests and should also be allowed for general-purpose financial statements. The NAIC agrees with the IASB that the fair value measurement attribute for insurance and reinsurance liabilities must include a risk margin, but notes this concept has not been quantitatively defined. Until the Boards agree to a robust measurement methodology for risk margins, the NAIC further believes the inclusion of insurance and reinsurance contracts within the scope of the Proposed Statement is premature.

In summary, the NAIC does not support the current exposure draft, which includes insurance and reinsurance contracts, and recommends that these be excluded from the scope pending the promulgation of any possible future, robust, fair value measurement attribute for insurance contracts.

Issue 2 – Should an entity be permitted the option to recognize those firm commitments at fair value at inception of the contract?

The NAIC believes the decision to include firm commitments at inception of the contract is consistent with a fair value model. For those reasons, we agree firm commitments should be allowed under this statement. However, the NAIC refers the Board to the previous comment on optionality and notes the SAPWG has adopted the general framework of FASB Statement No. 133 – *Accounting for Derivative Instruments and Hedging Activities* into its general framework and believes there are conflicts that will need to be addressed for hedge accounting if this Proposed Statement is adopted.

If so, why is the availability of the fair value option election important for those contracts and what types of entities would likely avail themselves of that fair value election?

No comment

Should the scope be limited to forward contracts that meet the definition of firm commitments under FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities (that is, requiring that the terms of the forward contract include a disincentive for nonperformance that is sufficiently large to make performance probable)? If not, why not?

No comment

Issue 3 – Should an entity be permitted the fair value option election for [written loan commitments and financial liabilities for demand deposit accounts]? If so, why? What would be the appropriate unit of account for determining the fair value of demand deposit liabilities? What other financial assets and financial liabilities for which their fair values involve consideration of nonfinancial components should be excluded from the scope of this proposed statement?

The NAIC is aware there may be a view that likens demand deposit accounts to cash surrender values of life insurance contracts. While no comment is provided on the use of the FVO for written loan commitments, the NAIC is concerned that application of this option to life insurance contracts would measure these contracts at their surrender value, which disregards the effect of policyholder behavior on future cash flows and may not be the most appropriate measurement. We would refer the FASB to the discussions at the IASB's Insurance Working Group on this issue. In addition, projection of the surrender value as a measurement basis for life insurance contracts interrelates with the unit of account and risk margin issues, both of which have not yet been finalized at the IASB. The NAIC believes that this is further evidence supporting the exclusion of insurance and reinsurance contracts from the scope of this Proposed Statement.

Issue 4 – Should an entity be permitted the fair value option election for [financial instruments that deal with a) an investment that would otherwise be consolidated; b) obligations for pension benefits, other postretirement and post employment benefits, employee stock option and stock purchase plans, and other forms of deferred compensation arrangements; c) financial liabilities under lease contracts]?

The NAIC agrees with the FASB's conclusion to exclude these from the current fair value option. Specifically, applying fair value to an investment that would be consolidated appears to result in practical elimination issues; applying fair value to benefit plans will presumably be considered by the Board in their consideration of modifying FASB Statement No. 87, *Employers' Accounting for Pensions*, and applying fair value to the already complicated area of leases appears problematic and exclusion is a reasonable approach.

Issues 5 – Please provide details of those nonfinancial instruments and why they should be eligible for the fair value option [in Phase 2 of the FASB's Fair Value Option Project]. How would applying the fair value option to those nonfinancial instruments (a) improve financial reporting, (b) mitigate problems for reporting earnings caused by the mixed attribute model, and (c) enable an entity to simplify its accounting methods? Is fair value information readily available for those nonfinancial instruments?

The NAIC is of the opinion that because fair value information might not be readily available for the type of nonfinancial instruments held by insurers, including such items within the scope of Phase 2 of this fair value option project, should be limited to those where reasonable fair value techniques can be established by all reporting entities. The NAIC is concerned that nonfinancial assets and nonfinancial liabilities that do not have a representative market will be scoped into the fair value model during Phase 2. The NAIC believes this would actually result in deterioration in financial reporting since many smaller companies may lack the resources to demonstrate to their auditors that the estimation techniques are reliable. The NAIC recommends that the Board coordinate Phase 2 of this project with accounting and reporting guidance included in the Fair Value Measurements project.

Issue 6 – Do you agree with the Board's decision [to record liabilities at fair value when the fair value option has been elected with all changes in fair value, including changes resulting from changes in the issuer's own creditworthiness, recorded in earnings]? If not, why? What alternative approaches or additional disclosure requirements should the board consider?

No, the NAIC understands the theoretical purpose of considering ones own credit standing in measuring its liabilities but believes this distorts the true financial position of the reporting entity for those financial liabilities that cannot be traded (i.e., in fair value hierarchy levels 2 & 3) and will result in incomparability of two companies that otherwise could be compared without this

measurement requirement. In particular, the NAIC believes that insurance liabilities (which almost certainly would be measured at level 3 in the fair value hierarchy) cannot be settled or traded in a manner that reflects the issuer's own credit standing.

Allowing for the issuer's own creditworthiness is incompatible with the valuation of insurance liabilities in a going concern. In most states, consistently endeavoring to settle policyholder liabilities at a lower level due to credit rating changes would be illegal and violate policyholder protection laws such as unfair trade practices, and could ultimately lead to regulatory intervention up to and including receivership or liquidation. As such, settlement of liabilities at consistently low levels due to credit standing could breach the underlying going concern assumption. Insurers cannot generally exit their liabilities except through settlement with the policyholder/claimant in accordance with the terms of the insurance contract. Therefore, the actual exit price for an insurer's liabilities cannot, both in practice and legally, reflect its credit standing.

The NAIC would not oppose a disclosure of the existence of, for example, a credit rating and movements in that credit rating.

Issue 7 – How should changes in the fair values of assets and liabilities subsequently measured at fair value as a result of a fair value election be reported? Should those changes be aggregated with the effects on earnings derived from other similar financial assets and financial liabilities in the income statement, or should separate display of those changes in the income statement be required? What level of aggregation should be permitted? What additional disclosure requirements should the Board consider?

As noted previously, the NAIC is most concerned with the use of a fair value option because it impairs consistent and comparable reporting. For that same reason, the NAIC supports separate presentation for items reported under this Proposed Statement in the income statement. The NAIC believes that changes in the fair value of financial assets and financial liabilities measured at fair value under the requirements of this Proposed Statement should be clearly distinguishable from those that are not. Information relating to changes in fair value resulting from the use of different valuation hierarchy levels (i.e., Level 1, Level 2, and Level 3) is also useful to users of the financial statements. The NAIC suggests this disaggregated detail be disclosed in the notes to the financial statements. The NAIC further suggests the FASB consider additional disclosures for reasons for movements at each hierarchy level in both fair value changes and movements between levels, as well as qualitative disclosures for fair value changes in Level 3 items. To the extent that this suggested level of detail is not supported, the NAIC strongly recommends complete disaggregation of the items impacted in the income statement, as the current level of disclosure is not considered sufficient to address the impairment of consistency and comparability that would be imposed by this Proposed Statement.

Summary

The NAIC is supportive of the Board's efforts on convergence with the IASB and agrees that fair value is more relevant to financial statement users than cost for assessing current financial position. As the Board's reasons for issuing the Proposed Statement are financial statement relevance to users and convergence with IASB standards, the NAIC provides the following comments:

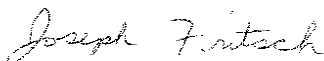
- The NAIC strongly suggests the incorporation of the constraints to utilization of the FVO, as adopted by the IASB in IAS 39, into the proposed statement to ensure the option is not used in an inappropriate manner.
- The NAIC is currently opposed to the inclusion of insurance and reinsurance contracts within the Proposed Statement pending the promulgation of any possible future, robust,

fair value measurement attribute for insurance contracts. Additionally, the IASB specifically excluded insurance contracts from the scope of IAS 39, which should be considered as part of the commitment to converge accounting standards with the IASB.

- The NAIC agrees with the IASB that the fair value measurement attribute for insurance and reinsurance liabilities must include a risk margin, but notes this concept has not been quantitatively defined. Until the Boards agree to a robust measurement methodology for risk margins, the NAIC further believes the inclusion of insurance and reinsurance contracts within the scope of the Proposed Statement is premature.
- The NAIC is concerned with the use of optionality as a means to alleviate the mismatch of measuring some assets and liabilities using different measurement attributes as currently required by US GAAP due to the impairment of consistency and comparability resulting from this Proposed Statement.
- The NAIC is concerned that application of the FVO to life insurance contracts would measure these contracts at their surrender value, which may not be the most appropriate measurement.
- The NAIC believes that allowing for an issuer's own creditworthiness is incompatible with the valuation of insurance liabilities.
- The NAIC is opposed to aggregation of effects on earnings for changes in fair value resulting from the election of the FVO. The NAIC suggests information relating to changes in fair value resulting from the use of different valuation hierarchy levels (i.e., Level 1, Level 2, and Level 3) is also useful to users of the financial statements. The NAIC suggests this disaggregated detail be disclosed in the notes to the financial statements. The NAIC further suggests the FASB consider additional disclosures for reasons for movements at each hierarchy level in both fair value changes and movements between levels, as well as qualitative disclosures for fair value changes in Level 3 items.

We appreciate the opportunity to comment on the Exposure Draft, *The Fair Value Option for Financial Assets and Financial Liabilities, including an amendment of FASB Statement No. 115*. Should you have any questions, please contact me at (212) 480-2299, or John Tittle (NAIC Staff) at (816) 783-8120.

Sincerely,



Joseph Fritsch
Chair, NAIC Statutory Accounting Principles Working Group

Background and NAIC Process

Formed in 1871, the NAIC is a voluntary organization of the chief insurance regulatory officials of the 50 states of the United States of America, the District of Columbia, American Samoa, Guam, Puerto Rico and the Virgin Islands. The mission of the NAIC is to assist state insurance regulators, individually and collectively, in serving the public interest in a responsive, efficient and cost-effective manner, consistent with the objectives of its members.

In fulfilling this mission, the NAIC has developed significant experience and expertise in the development of meaningful accounting principles for use in the financial statements of insurance enterprises. The NAIC has the responsibility to establish and interpret statutory accounting principles. The codification of statutory accounting principles by the NAIC produced a comprehensive guide for use by insurance departments, insurers, and auditors.

The fundamental concepts upon which these principles were promulgated are conservatism, consistency and recognition. While these principles are not identical to the framework used by the FASB, which govern general-purpose financial statements, the NAIC has developed expertise with general-purpose financial statements prepared in accordance with U.S. Generally Accepted Accounting Principles (U.S. GAAP). The NAIC reviews all U.S. GAAP pronouncements to determine their relevance for statutory accounting purposes.

These comments have been prepared by the SAPWG of the NAIC. As part of the NAIC's due process procedures, these comments have also been shared with interested parties to the SAPWG, all of whom were given an opportunity to contribute to the SAPWG's deliberations of these issues. However, the SAPWG does not wish to imply that these comments are shared by all of the SAPWG interested parties.