

November 16, 2007

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File Reference 1540-100
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Financial Accounting Standards Board
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Technical Director:

Thank you for the opportunity to comment on the FASB Agenda Proposal: *Accounting for Insurance Contracts by Insurers and Policyholders, Including the IASB Discussion Paper, Preliminary Views on Insurance Contracts*. 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 agenda proposal.

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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 items 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 Agenda Proposal. 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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Question 1: Is there a need for the FASB to comprehensively address accounting for insurance contracts? Why or why not?

- a. What aspects of existing U.S. GAAP accounting for insurance contracts could be improved or simplified and how pervasive are these issues?
- b. How important is the development of a common, high-quality standard used in both the U.S. and IFRS jurisdictions?

Answer 1: Yes. Insurance and reinsurance are international businesses that would benefit from a common general purpose accounting standard applicable internationally. The SAPWG notes that the FASB committed to work towards convergence with international accounting standards of the International Accounting Standards Board (IASB) in the Norwalk Agreement. The current work undertaken by the IASB in Phase II of its Insurance Contracts Project is designed to result in a comprehensive international standard. As the United States is currently the largest private market for insurance, the SAPWG strongly believes the FASB should add to its agenda, a joint project with the IASB to comprehensively address accounting for insurance contracts. Our position is further supported by the recommendation by the Securities Exchange Commission

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(SEC) to eliminate the reconciliation requirement for foreign private issuers filing financial statements under International Financial Reporting Standards (IFRS).

Question 2: Are the preliminary views expressed in the IASB's Discussion Paper a suitable starting point for a project to improve, simplify, and converge U.S. financial reporting for insurance contracts? If not, why not?

- a. Do you believe the preliminary views would be feasible to implement? If not, what aspects of the preliminary views do you believe could be difficult to apply and why?
- b. Are there other alternatives to improve or simplify U.S. financial reporting for insurance contracts that you would recommend? What would be the benefits of those alternatives to users of financial statements?

Answer: The SAPWG is fully aware of the concern and opposition to the IASB's Discussion Paper in some parts of the Insurance Industry. The concerns expressed tend to concentrate upon the current exit value measurement attribute and the associated building blocks (unbiased probability weighted estimates of cash flows, time value of money adjustments thereof, and a margin that would be demanded by market participants). It is the SAPWG's understanding that the IASB has developed the three building blocks to allow a means for measuring the economic attributes of the insurance liability. The discussion paper acknowledges that the use of a measurement model using the three building blocks is not meant to imply that insurance liabilities can, will or should be transferred to another party. The SAPWG believes this point is important, and because this point is clear, we do not disagree with the approach for general purpose financial statements. The SAPWG also notes that the International Solvency and Accounting Working Group (ISAWG) of the NAIC has tentatively adopted a comment letter to the International Association of Insurance Supervisors (IAIS) regarding the IASB discussion paper. Some of the concerns addressed within the letter pertain to utilization of an insurer's own credit standing to measure liabilities and recognizing potential material profit on inception as a result of the exit value. The ISAWG comment letter is included as an appendix to this comment letter and includes the ISAWG's concerns with the building blocks (Appendix A–Question 2).

Overall, the SAPWG is supportive of the use of the three building blocks as an appropriate proxy for the attribute that the IASB is trying to attain. We believe the second building block, the effect of the time value of money, should be based on risk free rates for general purpose valuations of insurance contracts. The third building block, the margin, is clearly more difficult to estimate. The SAPWG notes that much work is being undertaken by the International Actuarial Association and the IAIS on the calibration of risk margins. We believe this work should help frame the debate on this element of the building blocks. The behavior of margins over time is a crucial issue that remains to be addressed and will certainly be a part of the debate.

Question 3: Is there a need to address accounting by policyholders in an insurance contracts project? Why? If yes, should accounting by policyholders be addressed at the same time as the accounting by insurers? Can or should that wait until after the accounting by insurers is completed?

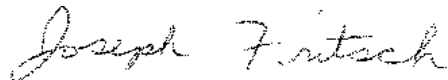
Answer 3: It would be preferable if there was accounting guidance for policyholders. Nonetheless, practical and cost/benefit considerations make it less important that accounting by direct policyholders be addressed with the same level of urgency as accounting by insurers and reinsurers. Therefore, the SAPWG believes that addressing accounting by policyholders, other than insurers, could indeed wait until after the accounting by insurers is completed, at which stage the Boards could consider the practicality of applying the full results of the project to direct policyholders.

Question 4: How would you address the interaction between the accounting for insurance contracts and the FASB's other projects on the conceptual framework, revenue recognition, liabilities and equity, financial instruments, and financial statement presentation? Are certain projects precedential?

Answer 4: It is highly likely that, in particular, the work on the revenue recognition and the work on liabilities and equity will strongly inter-relate with the work on insurance contracts. We do not believe any one project should take precedence over another. Clearly, in an ideal world, it would be best if all projects were interlinked and shared similar objectives. However, the SAPWG does not expect the FASB projects to progress at the same rate and, therefore, recommends that project teams communicate with each other to ensure consistency in the deliberative process. Consequently we would simply urge the Board to ensure that communication among project teams occurs. We would also encourage the FASB and the IASB to coordinate their projects on fair value measurements with the insurance contracts project.

We appreciate the opportunity to comment on the FASB Agenda Proposal: *Accounting for Insurance Contracts by Insurers and Policyholders, Including the IASB Discussion Paper, Preliminary Views on Insurance Contracts*. Should you have any questions, please contact me at (212) 480-2299, or John Tittle (NAIC Staff) at (816) 783-8120.

Sincerely,

A handwritten signature in cursive script that reads "Joseph Fritsch".

Joseph Fritsch
Chair, NAIC Statutory Accounting Principles Working Group



 NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

August 23, 2007

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Thank you for the opportunity to work with insurance regulators of other jurisdictions in providing comments to the International Accounting Standards Board on the Discussion Paper, *Preliminary Views on Insurance Contracts*, (Insurance Contracts). On behalf of the International Solvency and Accounting Working Group of the National Association of Insurance Commissioners (NAIC), I am pleased to provide you with our initial comments on the Discussion Paper. In common with the International Association of Insurance Supervisors (IAIS), the NAIC views on the discussion paper are evolving and the views expressed in this letter may not represent our final views.

Purpose for NAIC Comment

The International Solvency and Accounting Working Group (Working Group) of the NAIC is responsible for monitoring the developments of the International Accounting Standards Board (IASB) and the International Association of Insurance Supervisors as they relate to insurance accounting issues. Although members of the NAIC primarily utilize Statutory Accounting Principles (SAP) for regulatory purposes, they also review all other sources of information in monitoring the financial solvency of insurers, including but not limited to general purpose financial statements. The Working Group understands the guidance contained in this Discussion Paper pertains to general purpose accounting statements and will comment to this end. However, as supervisors of the world's single largest market for the insurance industry, we believe our understanding of the insurance market and our use of the general purpose financial statements for the insurers located in that market is important, and this comment letter should be part of the discussion for development of a similar comment letter directly to the IASB.

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Question 1

Should the recognition and derecognition requirements for insurance contracts be consistent with those in IAS 39 for financial instruments? Why or why not?

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The Working Group agrees with the theory supporting a consistent requirement for insurance contracts and financial assets and financial liabilities included in the preliminary views. We have noted situations in our response to the rest of the questions in this paper where the accounting for insurance contracts should differ from that which exists within IAS 39, but in general we support the idea of trying to make the requirements as consistent as possible where possible.

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The Working Group notes that recognition issues arise for insurance contracts for periods prior to the effective date. This issue is discussed in more detail below.

It is the Working Group's understanding that paragraph 27 of IAS 39 provides the following:

An entity shall recognize a financial asset or a financial liability when, and only when, the entity becomes a party to the contractual provisions of the instrument.

Based upon this requirement, the adoption of this principle for insurance contracts would result in some changes for most insurance entities. More specifically, the above criteria would modify an insurer's initial recognition of the insurance contract. Currently non life insurers typically recognize an insurance liability on the effective date of the coverage, while life insurers typically recognize an insurance liability upon receipt of the initial premium and accompanying insurance contract. In both cases, the insurer becomes a party to and coverage is or can be bound prior to the effective date of the coverage. As a result, adoption of the recognition criteria within IAS 39 would result in changes for the industry, and these changes could be significant in terms of changes to existing processes and systems.

As stated above, while there are aspects of insurance that are unique when compared to other industries, the Working Group believes that the recognition of the insurance contract liability when the insurer becomes party to the insurance contract does provide a very relevant criteria and we cannot identify a specific reason why this criteria should not be applied to insurance contracts. However, we believe that if this recognition criteria is established, it could create an inconsistency in the recognition of profit or loss depending upon how these contracts are classified. More specifically, some may believe that it is appropriate to classify the contract as a forward commitment, follow IAS 32, in which case a loss would be recorded (if applicable) but a gain would not (be recorded). Others may believe that it may be more appropriate to classify the contract as a derivative, follow IAS 39, in which case a loss would be recorded, but a gain would only be recorded if the criteria in AG 76 was met. Finally, others may believe that it would be more appropriate to classify the contract as insurance, and if recorded using an exist value, result in either a loss or a gain at inception. The Working Group believes the intent of board should be clarified on this matter.

As it relates to the derecognition criteria, we agree with previous discussions that have occurred among the supervisors of the IAIS. That is, the Working Group believes that insurance contracts liabilities – represented by IBNR and outstanding claims liabilities – could continue indefinitely, and may just fade away.

Under normal circumstances, the claim liability is extinguished when all possible claims under the policy are finally settled. In some cases this can be clearly determined, as when the sum insured under a life policy is paid on the death of the insured. In others, such as third party liability policies, multiple claims are possible and there is no certainty that further claims will not be lodged. Statutes of limitation help, but courts can have a degree of discretion in special circumstances. Claims can remain dormant for long periods and, depending on the terms of settlement, settled claims can sometimes be reopened.

Although the Working Group does not disagree with the criteria, we believe further clarification on this issue may be necessary as it relates to insurance contracts. The justification for such additional guidance – perhaps in implementation guidance – can be illustrated by the amount of guidance considered necessary for insurance contracts already included within the discussion

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paper. The measurement of insurance liabilities is a complex topic, therefore additional guidance as it relates to derecognition of these insurance liabilities is appropriate.

Question 2

Should an insurer measure all its insurance liabilities using the following three building blocks:

- a. explicit, unbiased, market-consistent, probability-weighted and current estimates of the contractual cash flows,**
- b. current market discount rates that adjust the estimated future cash flows for the time value of money, and**
- c. an explicit and unbiased estimate of the margin that market participants require for bearing risk (a risk margin) and for providing other services, if any (a service margin)?**

If not, what approach do you propose, and why?

It is the Working Group's understanding that the IASB Board has developed the three building blocks to allow a means for measuring the economic attributes of the insurance liability. The discussion paper acknowledges that the use of a measurement model using the three building blocks is not meant to imply that insurance liabilities can, will or should be transferred to another party. The Working Group believes this point is important, and because this point is clear, we agree with the approach for general purpose financial statements. In fact, we believe that the use of the three building blocks should result in a value that reflects the amount the insurer would expect to pay at the reporting date to transfer the remaining contractual rights to another entity (exit value).

However, the Working Group is concerned with the focus the paper places on each of the individual building blocks and the impression that these blocks should be unbundled. The Working Group believes the use of an exit value will result in the measurement of an amount that most closely matches the economic attribute desired by the board, but does not believe the risk margin, or any of the other individual building blocks should be overemphasized in the establishment of the insurer's liability. To the extent this very important point is not emphasized, the Working Group does have some concern with the first building block, and more specifically the requirement for market consistent and probability-weighted data within this individual block.

Although we believe that market consistent data is necessary to develop a measurement for the economic value of the contractual obligations, we believe the market consistent requirement should be included in the risk margin, as opposed to the estimate of cash flows. The Working Group believes the best source of estimated cash flows are those that have been experienced by the reporting entity. Entity specific cash flows can be observed at a far lower level of granularity than industry specific data, providing a more solid base to build the estimate. Resulting from this point of view, the Working Group believes entity specific cash flows should be used as the starting point for building blocks 1 and 2. To the extent those cash flows would not be a fair representation of the exit value, any modifications for that difference should be reflected in total, or within the risk margin if necessary, since the risk margin would be the value that would adjust for the uncertainty associated with the insurance liabilities.

Another issue arises from the requirement for market consistent data for differences in efficiencies and cost structures of insurers. Requiring market consistent information throughout the estimation process would not reflect the individual insurer's estimated cash flows and

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therefore, overstating the claims and claim adjustment expense liabilities for efficient insurers, and understating the same liabilities for inefficient insurers.

The Working Group is also concerned about the inclusion of probability weighted cash flows in the first building block from a practical point of view. Although the Working Group supports the use of expected value in the statistical sense, we don't believe the use of probability weighting is always practical but believe current actuarial practice in the United States already captures the essence of what the Board desires. We suggest the Board consider clarifying this point and consider leaving the application of this principle to the actuarial community.

The Working Group believes that modifying the first building block to exclude market consistent data facilitates the capture of differences in market versus company (entity) specific data, thus eliminating the concern that highly efficient and highly inefficient companies would not reflect this entity specific difference at all in their estimate of total liabilities. To the extent this change is not made, we believe at a minimum, insurers should be explicitly required to reflect the market as their floor for establishing the liability, since an exit value requires the total value to reflect this fact. Such a requirement could also be provided through the addition of language that allows a rebuttable presumption that the insurer's cost structure is market consistent unless evidence exists otherwise.

The Working Group also believes that it is very difficult, if not impossible, to identify what market participants require in the way of a margin for bearing risk. Accordingly, the Working Group suggests the board consider revising the third building block to add the word "would" so that the building block reads as follows:

- c. **an explicit and unbiased estimate of the margin that market participants would require for bearing risk (a risk margin) and for providing other services, if any (a service margin)**

Further, the Working Group suggests the board describe in its paper that a risk margin would include among other things, the cost of providing the capital to support the risk.

Question 3

Is the draft guidance on cash flows (appendix E) and risk margins (appendix F) at the right level of detail? Should any of that guidance be modified, deleted or extended? Why or why not?

We believe that the guidance in Appendices E and F is more detailed than is required. The accounting standard should set out the measurement objective for the liability. The professional actuarial standard setters should then set the details of how current estimates, discount rates and risk margins are determined, provided they are established in accordance with the objectives of board.

The actuarial profession in each country should set the guidance standards for that country. In the US, the Actuarial Standards Board, an independent entity, would be the standard setting group. Given the differences in product, market and legal environment among the developed countries of the world, it is not possible for one set of guidance to fit all situations.

Question 4

What role should the actual premium charged by the insurer play in the calibration of margins, and why? Please say which of the following alternatives you support.

- a. The insurer should calibrate the margin directly to the actual premium (less relevant acquisition costs), subject to a liability adequacy test. As a result, an insurer should never recognize a profit at the inception of an insurance contract.**
- b. There should be a rebuttable presumption that the margin implied by the actual premium (less relevant acquisition costs) is consistent with the margin that market participants require. If you prefer this approach, what evidence should be needed to rebut the presumption?**
- c. The premium (less relevant acquisition costs) may provide evidence of the margin that market participants would require, but has no higher status than other possible evidence. In most cases, insurance contracts are expected to provide a margin consistent with the requirements of market participants. Therefore, if a significant profit or loss appears to arise at inception, further investigation is needed. Nevertheless, if the insurer concludes, after further investigation, that the estimated market price for risk and service differs from the price implied by the premiums that it charges, the insurer would recognize a profit or loss at inception.**
- d. Other (please specify).**

We believe that alternative C is consistent with the overall purpose of a risk margin, which is to provide a measurement for the compensation that another entity would require for taking on the risk associated with the insurance contract. Therefore, we agree with the belief that the premium provides evidence of the implicit margin that market participants would require, but believe premium received should have no higher status than other available market evidence. Although premiums for commonly available, and relatively homogenous products in a competitive market are generally consistent amongst the industry (players in the market), it is not uncommon for the prices to differ by significant amounts during a soft market. Therefore the use of all relevant information must be considered, not just premium.

However, the Working Group is concerned with the practical implications of alternative C, and believe in practice, most insurers would follow an approach more similar to alternative B. The calculation of the risk margin requires actuarial skills and techniques that are beyond the scope of the discussion paper, and the board should seek the advice of the actuarial community for the development of more specific application guidance on this topic. The application guidance developed should discuss methods for calculating a risk margin under different situations, including the attempt to develop methods that provide a result consistent with alternative c, but utilize techniques that may be more consistent with alternative B.

As it relates to the recognition of profit or loss at inception, the use of a current exit value approach suggests that the valuation of the liability is most relevant and any profit or loss resulting from pricing greater than the cash flows associated with the liability should be reflected in the period in which valuation of the liability is modified. We support the use of the current exit value and therefore are not opposed to the recognition of profit or loss at inception, but note that we would not expect frequent significant profit on inception, except in certain niche markets. The Working Group notes that any large scale recognition of profit would suggest the miscalibration of the risk margin.

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Question 5

This paper proposes that the measurement attribute for insurance liabilities should be the amount the insurer would expect to pay at the reporting date to transfer its remaining contractual rights and obligations immediately to another entity. The paper labels that measurement attribute ‘current exit value’.

- a. Is that measurement attribute appropriate for insurance liabilities. Why or why not? If not, which measurement attribute do you favor, and why?**

Yes, we believe that current exit value captures the amount an insurer would expect to pay at the reporting date to transfer its remaining contractual rights and obligations to another entity, and for general purpose financial statements, this is appropriate. Having said that, we agree with comments previously made among the supervisors of the IAIS. That is, the attribute is based upon the notion of a transfer, and such a transfer would be strongly influenced by the amount of the settlement, and that the full ultimate settlement appropriately adjusted for the time value of money should represent a minimum value.

- b. Is ‘current exit value’ the best label for that measurement attribute? Why or why not?**

Similar to the response provided for 5 a., we agree with comments previously made among the supervisors of the IAIS. Those comments are focused on the fact that this question cannot be answered until the outcome of the work on fair value measurements is completed.

Question 6

In this paper, beneficial policyholder behavior refers to a policyholder’s exercise of a contractual option in a way that generates net economic benefits for the insurer. For expected future cash flows resulting from beneficial policyholder behavior, should an insurer:

- a. incorporate them in the current exit value of a separately recognized customer relationship asset? Why or why not?**
b. incorporate them, as a reduction, in the current exit value of insurance liabilities? Why or why not?
c. not recognize them? Why or why not?

The Working Group believes that if a true exit value is used using probability weighting of all cash flows (or an appropriate approximation thereto), responses to questions 6 and 7 are not necessary. However, to address this specific question, for this reason, the Working Group believes that alternative (b) is most appropriate. During discussions at the IAIS, it has been noted that this cash flow associated with future premiums does not exist in isolation, but only exists in connection with the rest of the contract, therefore reporting as a reduction of the current exit value of the liability is most appropriate.

Question 7

A list follows of possible criteria to determine which cash flows an insurer should recognize relating to beneficial policyholder behavior. Which criterion should the Board adopt, and why?

- a. Cash flows resulting from payments that policyholders must make to retain a right to guaranteed insurability (less additional benefit payments that result from those premiums). The Board favors this criterion, and defines guaranteed insurability as a**

- right that permits continued coverage without reconfirmation of the policyholder's risk profile and at a price that is contractually constrained.**
- b. All cash flows that arise from existing contracts, regardless of whether the insurer can enforce those cash flows. If you favor this criterion, how would you distinguish existing contracts from new contracts?**
 - c. All cash flows that arise from those terms of existing contracts that have commercial substance (ie have a discernible effect on the economics of the contract by significantly modifying the risk, amount or timing of the cash flows).**
 - d. Cash flows resulting from payments that policyholders must make to retain a right to any guarantee that compels the insurer to stand ready, at a price that is contractually constrained, (i) to bear insurance risk or financial risk, or (ii) to provide other services. This criterion relates to all contractual guarantees, whereas the criterion described in (a) relates only to insurance risk.**
 - e. No cash flows that result from beneficial policyholder behavior.**
 - f. Other (please specify).**

The Working Group believes that alternative B, which includes all expected cash flows that arise from the contracts, is the appropriate criterion. The Working Group believes that an approach that does not consider all cash flows is inconsistent with the criteria utilized in the recognition of insurance liabilities, and more importantly, does not consider all relevant information. The Working Group also believes that the use of anything other than "all expected cash flows" appropriately weighted for probability (or approximations thereof) is inconsistent with the information the insurer used in pricing the product, which would have included some estimate of the cash flows expected to be received and paid in the future. We believe most insurers price their long-term products in a manner that represents a long-term contract with a cancellation option available to the customer, which may be used differently by that customer depending upon the circumstances. These expectations are used throughout the cycle of the contract to determine the value of the business, expected future profits, and for U.S. companies, the value of this asset at any given point in time. These expectations of all future cash flows should be the basis for the recognition of beneficial policyholder behavior.

We understand that the information to present this item in the financial statements may be more difficult to obtain for some insurers compared to others, but believe this fact should not be the deciding factor in making this determination. We believe additional guidance should be developed by the proponents of this view, which would increase the consistency in reporting for all reporting entities that have tracked the information necessary to estimate these cash flows.

As it relates to the issue of guaranteed insurability, the Working Group believes this criterion is confusing. However, the Working Group notes that if the purpose of the criterion is to avoid issues related to the guaranteed renewable health or property casualty contracts, it may be a valid criterion. If this is the case, additional discussion and guidance should be developed since long-term contracts (e.g. life and annuities) are different than these products and this point is not clear within the existing paper.

Question 8

Should an insurer recognize acquisition costs as an expense when incurred? Why or why not?

The Working Group believes that acquisition costs should be recognized when incurred. Having said that, the Working Group believes that the marketplace (another insurer) does assign positive

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value to these costs that have already been paid in an acquisition of another insurer (particularly long-tailed lines of business).

The Working Group believes that if the board is unable to live with the consequences of an exit value that represents a true probability weighting of all cash flows, the recognition of a customer relationship asset that is not artificially constrained may be necessary. The Working Group also notes that the Board's use of future premiums should also not be artificially constrained if this approach is taken. The Working Group believes the Discussion Paper's approach for addressing uncertainty associated with the future premium (guaranteed insurability) is inconsistent with the exit value approach in the measurement of insurance liabilities. We believe the uncertainty associated with the future premium should be incorporated into the valuation of the customer relationship asset, although it would be more appropriate to report as a component of the risk margin. The valuation of this asset, if its determined to be a separately recognized asset, should involve explicit current estimates of the cash flows, the time value of money, and explicit margins, similar to the exit value of the other cash flows. The Working Group notes that the above inconsistency is the result of unbundling of the cash flows of the exit value, which as discussed in our response to question 2, is not appropriate.

Question 9

Do you have any comments on the treatment of insurance contracts acquired in a business combination or portfolio transfer?

The Working Group's understanding of this issue is that IFRS 3 Business Combinations requires an entity to measure at fair value the assets acquired and liabilities assumed in a business combination. However, because it has not yet been determined if the current exit value is the same as fair value, additional disclosure is allowed of insurers to present both the recorded value of the insurance liabilities and an intangible asset which represents the difference between 1) the fair value of the net rights and obligations acquired and 2) the recorded liabilities. The Working Group's comment is consistent with the comment on question 5 b., that this question cannot be completely answered until the outcome of the work on fair value measurements is completed. However, the Working Group believes that the above described disclosure is a reasonable method of providing users of insurance company financial statements adequate information.

As it relates to insurance contracts acquired in a portfolio transfer, we agree that to the extent the transaction is considered a business combination within the scope of IFRS 3, the additional disclosure described above should be available. The Discussion Paper outlines the situation where subsequent to recognition of this intangible asset, other differences exist, and questions how this difference should be treated (paragraph 172). It is the Working Group's understanding that the Board believes this difference should be recorded as income or expense. The Working Group is not opposed to this approach, given IFRS 3 requires all other assets and liabilities assumed in a business combination to be measured at fair value.

Question 10

Do you have any comments on the measurement of assets held to back insurance liabilities?

The Working Group believes consideration needs to be given for consistent measurement of assets and liabilities. Just as it should be helpful for the market to have insurance liabilities presented using an exit value, it would also appear to be helpful for the market to have other financial information presented in a manner that reduces accounting mismatch. We believe that if

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the current exit value is determined by the board to be the same as fair value, the corresponding value of assets that support these liabilities should be capable of being measured at fair value. If this is adopted, a one time redesignation provision should be allowed. A full fair value approach would reduce accounting mismatch, and would reduce the possibility of inconsistent reporting that can occur through the use of the fair value option. However, we believe such an approach should not be specific to insurers, and instead strong consideration should be given to modifying IAS 39 to reduce the existing accounting mismatches that may result from applying different methods of valuation. Having said that, the reliability of fair value information on certain types of assets (e.g. private placement bonds and real estate) and liabilities does differ from other types of assets and liabilities, but this point is already clear in the United States within FAS 157.

Question 11

Should risk margins:

- a. be determined for a portfolio of insurance contracts? Why or why not? If yes, should the portfolio be defined as in IFRS 4 (a portfolio of contracts that are subject to broadly similar risks and managed together as a single portfolio)? Why or why not?**

Yes, the Working Group agrees that risk margins should be determined for a portfolio of insurance contracts. The Working Group believes that in practice, most insurers will develop risk margins on a portfolio of contracts as this is consistent with their methods for similar types of measurements. The Working Group supports the use of a portfolio measurement of risk margins because the use of large numbers on homogenous risks within the same portfolio is a practical and reliable means for measuring risks.

- b. reflect the benefits of diversification between (and negative correlation between) portfolios? Why or why not?**

The Working Group agrees with the IASB that risk margins should not reflect the benefits of diversification between portfolios and negative correlation between portfolios. We believe that if the liabilities are to be reported at an exit value, where the amount of those liabilities is reported at an amount the insurer would expect to pay to transfer those rights and obligations to another entity, diversification should not be a factor in determining the total value of the insurance liabilities. Since the most important factor in determining that value is the amount another entity would pay, we believe an exit value, by definition, prevents an insurer from utilizing the diversification it has within its own portfolio of insurance contracts. Although the Working Group does not believe these items should be reflected in the measurement of the liability, the impact of diversification benefits could be reflected in the determination of the supervisory capital requirements.

Question 12

- a. Should a cedant measure reinsurance assets at current exit value? Why or why not?**

The Working Group believes that the measurement of reinsurance assets should be consistent with the measurement of insurance liabilities.

- b. Do you agree that the consequences of measuring reinsurance assets at current exit value include the following? Why or why not?**

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- i. A risk margin typically increases the measurement of the reinsurance asset, and equals the risk margin for the corresponding part of the underlying insurance contract.**
- ii. An expected loss model would be used for defaults and disputes, not the incurred loss model required by IFRS 4 and IAS 39.**
- iii. If the cedant has a contractual right to obtain reinsurance for contracts that it has not yet issued, the current exit value of the cedant's reinsurance asset includes the current exit value of that right. However, the current exit value of that contractual right is not likely to be material if it relates to insurance contracts that will be priced at current exit value.**

Yes, we believe measuring reinsurance assets at an exit value will result in each of the consequences included above. However, the expected loss model for defaults and disputes would not necessarily mirror the accounting for the obligation of the reinsurer. The Working Group believes it is important to note that although the risk margin will increase the reinsurance asset, this will be offset by the risk margin included in the underlying insurance contract.

The Working Group notes that although the second sentence in consequence (iii) is a basis for conclusion, it should not represent a standard as inferred through the inclusion in this item.

Question 13

If an insurance contract contains deposit or service components, should an insurer unbundle them? Why or why not?

The Working Group agrees with the preliminary conclusions of the IAIS, which believes that 1) if the components are not interdependent, the Phase II standard should apply to the insurance component and the IAS 39 standard should apply to the deposit component; 2) if the components are so interdependent that they cannot be split other than on an arbitrary basis, then the Phase II standard should apply to the whole contract. The Working Group also agrees with the IAIS that measuring the entire contract in accordance with the Phase II standard, but with the IAS 39 amount split, out would lead to inconsistencies such that what remained would no longer be measured in accordance with the Phase II standard and would not provide meaningful information

Question 14

- a. Is the current exit value of a liability the price for a transfer that neither improves nor impairs its credit characteristics? Why or why not?**
- b. Should the measurement of an insurance liability reflect (i) its credit characteristics at inception and (ii) subsequent changes in their effect? Why or why not?**

This is an issue that the NAIC has commented on in the past. The NAIC continues to believe that it is inappropriate to consider the credit characteristics of the reporting entity when valuing its insurance liabilities. While we understand that those that hold the reporting entity's obligations as assets would consider the effect of any defaults, we do not believe that modifies the amount at which the reporting entity would legally be required to pay in a going concern and one's own credit standing should not modify the liability in any instance, particularly when using a probability weighted expected value.

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To the extent this measure has to be taken into consideration somewhere within the statement of financial position, we would suggest it be reported elsewhere within a separate financial statement line item.

Question 15

Appendix B identifies some inconsistencies between the proposed treatment of insurance liabilities and the existing treatment under IAS 39 of financial liabilities. Should the Board consider changing the treatment of some or all financial liabilities to avoid those inconsistencies? If so, what changes should the Board consider, and why?

The Working Group provides the following comments regarding changing the treatment of some or all financial liabilities to avoid inconsistencies between the proposed treatment of insurance liabilities and the existing treatment under IAS 39 of financial liabilities.

- 1) Initial measurement, and acquisition costs
 - a) The Working Group notes that current exit value may or may not be the same as fair value as noted in the Discussion Paper. In addition, the Working Group notes the current project on fair value measurements considers the exit value perspective, which is consistent with the preliminary views.
 - b) The Working Group tentatively believes the basis for the conclusion to expense acquisition costs in paragraphs 165 and 166 supports a change to IAS 39 for financial liabilities and financial assets. Acquisition costs are elements of the transaction to acquire the financial asset or financial liability and not attributable to the financial asset or financial liability individually. In addition, see response to Question 8.
- 2) Gain or loss at inception
 - a) See comment to 1.a.
- 3) Subsequent measurement
 - a) See comment to 1.a.
- 4) Surrender value floor and policyholder behavior
 - a) The NAIC does not believe that the comparison between a demand deposit and the surrender value floor and policyholder behavior is appropriate. The Working Group believes that the surrender value is one scenario that should be probability weighted with all other potential scenarios in determining the expected cash flows. Therefore the surrender value should not be required to represent a minimum liability.
- 5) Unit of account
 - a) See comment to 10a. This comment supports a different view of unit account for insurance contracts than what exists within IAS 39.
- 6) Presentation of premiums
 - a) See comment to 18 and 19.
- 7) Separation of investment management component
 - a) The Working Group does not believe it is necessary for non insurance financial assets and financial liabilities related to management services to be consistent with the preliminary views on insurance contracts.
- 7(a) Investment management component – origination costs
 - a) See comment to 7
- 7(b) Service fee revenue
 - a) We support the recognition of a customer relationship asset, which does differ from IAS 39.

Question 16

- a. For participating contracts, should the cash flows for each scenario incorporate an unbiased estimate of the policyholder dividends payable in that scenario to satisfy a legal or constructive obligation that exists at the reporting date? Why or why not?**

The Working Group believes an unbiased estimate of the future policyholder dividends should be incorporated in the estimated future cash flows for each scenario when measuring insurance liabilities. The Working Group agrees with the following position taken by the IAIS in the Second Liabilities Paper:

The IAIS believes that amounts relating to future policyholder distributions in respect of both the guaranteed and discretionary elements of participating contracts should be treated as liabilities based upon the expected future cash flows. To treat them as equity would misrepresent the financial position of the company.

While the reporting entity may have discretion pertaining to participating elements of insurance contracts, the Working Group notes this discretion is usually constrained such that the reporting entity has a lesser argument that policyholder surplus (as defined in paragraph 242 of the Discussion Paper) is not, by definition, a liability. These constraints facilitate the estimable amount to be allocated and ultimately distributed. As such, allowing policyholder surplus to “fall” to equity (defined as “the residual interest in the assets of the entity after deducting all its liabilities”) is inconsistent with the discussion of the reporting entity’s obligation relating to participating contracts.

Lastly, the Working Group agrees future payments from participating contracts have an observable value in a transfer and hence economic substance as part of the liability measurement, which is consistent with the current exit value approach.

- b. An exposure draft of June 2005 proposed amendments to IAS 37 (see paragraphs 247–253 of this paper). Do those proposals give enough guidance for an insurer to determine when a participating contract gives rise to a legal or constructive obligation to pay policyholder dividends?**

The Working Group is confused by the exposed guidance included in the Discussion Paper relating to IAS 37 on legal and constructive obligations. The Working Group notes that paragraph 15 of the exposure draft describes situations where the reporting entity has little, if any, discretion in avoidance of the constructive obligation. The Working Group believes that the proposed changes to IAS 37 are inconsistent with the use of an exit value for insurance liabilities, and other concepts that the IASB appears to be striving for in their accounting model. In addition, Item (c) states, “the other parties will either benefit from the entity’s performance or suffer harm from its non-performance.” This item (c) does not appear to provide relevant guidance defining a constructive obligation. The Working Group believes further guidance is necessary to support why such obligations, and similar obligations should not be reported in the financial statements. With that being said, the Working Group agrees with the IAIS when it states “We understand that at its July 2007 meeting the Board decided not to go beyond the scope of IAS 37 in defining constructive obligations, and therefore we would not necessarily expect the definition within IAS 37 to be extended to participating insurance contracts.”

Question 17

Should the Board do some or all of the following to eliminate accounting mismatches that could arise for unit-linked contracts? Why or why not?

- a. **Permit or require insurers to recognize treasury shares as an asset if they are held to back a unit-linked liability (even though they do not meet the Framework's definition of an asset).**
- b. **Permit or require insurers to recognize internally generated goodwill of a subsidiary if the investment in that subsidiary is held to back a unit-linked liability (even though IFRSs prohibit the recognition of internally generated goodwill in all other cases).**
- c. **Permit or require insurers to measure assets at fair value through profit or loss if they are held to back a unit-linked liability (even if IFRSs do not permit that treatment for identical assets held for another purpose).**
- d. **Exclude from the current exit value of a unit-linked liability any differences between the carrying amount of the assets held to back that liability and their fair value (even though some view this as conflicting with the definition of current exit value).**

As discussed within the response to question 10, the Working Group believes that if the current exit value is determined by the board to be the same as fair value, the corresponding value of assets that support these liabilities should be fair value. This includes all insurance assets and insurance liabilities, including those involving unit-linked accounts.

The Working Group notes that it believes the accounting mismatches that are contemplated within this question are rare, and is not familiar with such events actually occurring within the United States market. For this reason, it does not seem appropriate to consider these as items for which specific accounting would be developed to address. However, to the extent something was developed to address these rare situations, the Working Group believes it would be most appropriate to support option d, since this approach results in the valuation of a liability that is most closely matched to the amount that is determined by the asset value.

Question 18

Should an insurer present premiums as revenue or as deposits? Why?

The Working Group believes that all contracts that meet the definition of insurance as defined within IFRS 4 should be accounted for as such, with all premium related to such contracts reported as revenue.

Question 19

Which items of income and expense should an insurer present separately on the face of its income statement? Why?

The Working Group believes consideration should be given to align the presentation with the requirements for "level 3" inputs from the fair value hierarchy included in FAS 157. The Working Group also believes that as a general rule, current U.S. GAAP reporting on non-life business provides very useful information to the users of the financial statements. This information includes the translation of the figures into certain non GAAP financial information on loss, expense, and combined ratios. The Working Group believes these components should continue to be reported on the face of the income statement for companies.

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The Working Group notes that with the introduction of risk margins, discounting, possible profit on inception, further consideration will need to be given regarding the most decision useful information to be presented on the face of an insurers financial statements. We suggest these items, as well the most appropriate reporting for insurance contracts in general, be considered more carefully in the Performance Reporting Project.

Question 20

Should the income statement include all income and expense arising from changes in insurance liabilities? Why or why not?

See response to question 19.

We appreciate the opportunity to comment on the Discussion Paper, *Preliminary Views on Insurance Contracts*. Should you have any questions, please contact me at (804) 371-9802, or Dan Daveline or John Tittle (NAIC Staff) at (816) 783-8402 or (816) 783-8120, respectively.

Sincerely,

Commissioner Alfred Gross, Virginia
Chair, NAIC International Solvency and Accounting Working Group

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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, the Virgin Islands and the Northern Mariana 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. While these principles are not identical to the framework used by the IASB, 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 and also reviews financial statements prepared by insurers using U.S. GAAP on a routine basis.

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

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