August 7, 2009

Leslie Seidman, Member
Marc Siegel, Member
Financial Accounting Standards Board
401 Merritt 7, PO Box 5116
Norwalk, CT 06856-5116

Dear Ms. Seidman and Mr. Siegel:

The Group of North American Insurance Enterprises is concerned that FASB is apparently considering using a risk free discount rate when calculating life insurance liability values under the joint Insurance Contracts project. The reason given for considering this is that it would make the model simpler and that all insurers would be using the same discount rate for similar types of liabilities, and thus the result would be better comparability and understandability. GNAIE does not believe that these supposed benefits would occur. We also note that a risk free discount rate for life insurance contracts would be inconsistent with the preliminary view taken in the revenue recognition project, and inconsistent with the US GAAP discount rate guidance for pension liabilities, as per paragraph 44A of FASB Statement No. 87. More importantly, using a risk free discount rate would generate life insurance liability values that are not representationally faithful.

Measuring life insurance liability values using a risk free discount rate would not be representationally faithful for two main reasons. First of all, it is not consistent with the rate that insurers are required, or have promised, to credit, and would thus create artificial losses at contract inception. Secondly, it is not consistent with the interest rates inherent in the fair values of the invested assets insurers hold to produce the promised cash flows inherent in the liabilities. Thus, if liabilities are measured at a current value (such as current fulfillment value) using risk free discount rates, and invested assets are measured at fair value, periodic re-measurement of the liability would generate artificial volatility in the financial statements.

Although the credit risk in most life insurance contracts is small, it is greater than a true risk free instrument, such as US Treasury obligations, even after accounting for guarantee funds that protect some, but not all, life insurance benefits. Furthermore, life insurance liabilities have different liquidity characteristics than obligations that trade at rates considered "risk free", such as US Treasury obligations or LIBOR. It is clear that life insurance obligations that carry an explicit credited rate are forced to credit rates higher than risk free in order to attract customers in the market. This is especially the case when it is recognized that the interest rate credited on many products is reduced by implicit fees to cover the cost of guarantees (such as minimum interest guarantees) and of services included in the contract. Products without an explicit credited rate but with dividends, such as participating whole life, also clearly require credited rates above risk free. And other long term products such as non-participating whole life, disability income and long term care insurance also require implicit credited rates in excess of risk free rates. Since customers require insurers to credit rates in excess of risk free in order to sell life insurance contacts, discounting the obligation at inception at risk free rates would artificially increase the present value of cash flows. At the very least, this would reduce the composite or residual margin. In many cases the composite or residual margin would be inadequate to absorb this impact. In those cases, discounting the life

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insurance liability at risk free rates would create an artificial loss at issue, on top of any loss that is created by the treatment of acquisition costs.

Such treatment would also be inconsistent with FASB's preliminary view in the financial instruments project, where debt would be at fair value or, in some cases at amortized cost. Neither approach would discount expected cash flows using a risk free rate, and either approach would produce a lower liability value than discounting expected cash flows at a risk free rate. So for debt, FASB's preliminary view would not produce an artificial loss at inception. Such disparate treatment would create pressure on the dividing line separating insurance contracts from financial instruments.

Another problem with discounting life insurance contracts at risk free rates is the artificial accounting mismatch it would create between invested assets and insurance liabilities. Assuming invested assets are held at fair value, the fair value of invested assets would fluctuate based on changes in market spreads over risk free. But if life insurance liabilities are discounted at risk free rates, the liability values would not reflect the impact of changes in market spreads over risk free. The artificial volatility that would be thus introduced can be enormous. Assume that an insurer has $100 billion of assets and liabilities in well matched portfolios with durations of 5 years. And assume that market spreads over risk free change by 50 basis points. The asset value would change by:

100 x 5 x 0.5% = $2.5 billion, with no offset in liability values.

$2.5 billion would likely be more than any $100 billion insurer is likely to earn in any given reporting period, so that actual income from operations would be completely overwhelmed by the artificial volatility introduced by using an accounting model that reflects changes in market spreads over risk free in assets but not in liabilities.

If the assets are held at fair value with periodic fair value changes recognized in net income, this artificial volatility would manifest itself in net income. But even if changes in asset fair value are recognized in other comprehensive income, the artificial volatility to comprehensive income and to the balance sheet would be enormous. And holding the assets at fair value with changes in fair value in other comprehensive income would create additional artificial volatility in net income from other sources, such as when the general level of interest rates change. Holding assets at amortized cost, even if permitted, would not be a viable option to eliminate this artificial volatility either. The mismatch between assets at amortized cost and liabilities at current value would also create artificial volatility from other causes, such as if the general level of interest rates changed.

A related issue is that discounting liabilities at risk free rates distorts their duration. For very long tailed liabilities, such as long term care, the duration difference between discounting at risk free rates and discounting at a rate with a spread appropriate to its credit and liquidity characteristics can be several years. This duration distortion will create artificial volatility between asset and liability values whenever interest rates change, even if only risk free rates change and spreads over risk free remain constant. That is because if the duration of the assets is perfectly matched to the duration of the liabilities based on the liabilities' economic value, there will still be a duration mismatch on an accounting basis if the accounting basis requires discounting at risk free rates.

Any possible benefit of using risk free discount rates pales in comparison to the problems they would introduce. But even the proposed benefits are not likely to be realized. Life insurance contracts are complex instruments, and the current value methods being proposed are all complex calculations. This is the case whether the current value method is current exit value, current fulfillment value or an IAS 37 approach. Using a risk free discount rate instead of an appropriate discount rates may make the current value models mechanically simpler, but in light of the complexities inherent in these models, the mechanical simplicity would not be meaningful. And the explanations that would be required to users so they could understand the artificial losses at inception and the

artificial volatility introduced periodically would more than offset any benefit in simplifying the current value calculation. And if a simple model is the goal, FAS 60 already accomplishes that.

Further, risk free discount rates would not insure that all insurers would use the same rate for similar types of liabilities. For dollar denominated liabilities, some insurers would use LIBOR and others would use US Treasury rates. Even these rates incorporate very different liquidity characteristics than any life insurance obligation, excluding any credit related differences, and so may not be directly applicable to a life insurance liability. And for liabilities denominated in other currencies, the definition of a "risk free rate" is less clear, and in some cases an objective definition may not exist.

Finally, although this may not have been an issue in FASB discussions, we are aware that some parties are proposing a risk free discount rate in order to be consistent with proposed regulatory accounting. We do not believe this argument has any merit. General purpose accounting statements are not necessarily appropriate for regulatory purposes. The recent experience of banks being regulated based on US GAAP financial statements should have made that clear. Certainly insurance regulators in the United States recognize this fact. And ever since issuing FAS 60, FASB has understood that regulatory accounting statements are not appropriate for use as general purpose accounting statements. Therefore, we do not believe that the GAAP insurance contracts standard should be compromised to achieve consistency with regulatory requirements.

We believe that there are several better alternatives to risk free rates for discounting life insurance liabilities. Determining an appropriate discount rate for life insurance liabilities is a complex issue that cannot be adequately addressed within a short letter. If you would like to discuss this issue in more depth, we would be happy to do so at your convenience.

Sincerely,

Kevin Spataro

Kevin A. Spataro
Chair, GNAIE Accounting Convergence Committee

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