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May IASB Meeting – Fair Value Measurement Board Agenda Item

Dear Sir David,

The Group of North American Insurance Enterprises (“GNAIE”) has reviewed the Observer Notes (“Notes”) for the IASB’s May meeting as it relates specifically to the Fair Value Measurements (“FVM”) agenda topic and would like to share the following observations with the Board in advance of the meeting. We also reviewed the materials related to Phase II of the Insurance Contracts Project and as such a number of the following observations relate to both projects.

The Notes indicate that at the May meeting, IASB Staff will discuss certain aspects of the working draft of the FASB’s Fair Value Measurements Standard (“FVMS”). The stated intent of the IASB Staff is to (a) identify questions and issues to discuss in the invitation to comment, and to provide feedback to the FASB on the FVMS prior to its issuance. IASB Staff also plans to ask the Board to decide on whether to support the principles that form the foundation of the FVMS (including the revised definition of fair value) as well as the revised three-level hierarchy in the FVMS.

While we have specific observations to share concerning each of the FVM topics scheduled to be discussed at the May meeting, we would like to begin with a somewhat broad observation. More specifically, it is our understanding that the intent of the FASB in developing the FVMS was not to “broaden the application of fair value” but rather to develop formal guidance that defines fair value, provides general guidelines on how to measure fair value, and enhances disclosures about fair value. In connection with the preceding, the FASB appears to have developed a definition of fair value that is reflective of an “exit price” (i.e. price that would be received for an asset or paid to transfer a liability in a transaction between market participants at the measurement date) as well as a three-level hierarchy that prioritizes the inputs used to measure fair value based on their “market observable” or “market unobservable” nature.

As it relates to both the definition of fair value and the existence of the three-level hierarchy, GNAIE does not believe adequate consideration has been given to situations where inputs are not predominantly “market observable” nor does there appear to be any substantive differentiation in the FVMS for assets (liabilities) whose fair value was

To influence the development of international accounting standards to ensure that they result in robust, high quality standards for insurance enterprises

determined at different levels within the fair value measurement hierarchy.

In connection with the preceding, we believe the Board should carefully consider whether the definition of fair value should include level-three measurements (“LTM’s”) where no active, liquid, principal market exists through which a reporting entity could sell or otherwise dispose of an asset or transfer a liability. In the case of insurance liabilities, which contain significant non-financial components (e.g. mortality, morbidity, and insurance risk), are almost exclusively settled with the insured, and for which there is no active, liquid, principal market through which an insurer’s liabilities could be transferred, a requirement to measure such contracts at fair value using LTM’s would introduce a level of subjectivity into the determination of financial statement balances and earnings that has heretofore never existed.

GNAIE believes the introduction of excessive subjectivity would impair both the relevance and reliability of financial statements and as such we strongly recommend that either ¹(a) the Board consider amending the definition of fair value to exclude from its scope any amounts determined through the use of LTM’s or (b) ensure that no accounting or reporting standards require the use of fair value measurement where there exists no active, liquid, principal market through which a reporting entity could sell or otherwise dispose of the affected asset or transfer the affected liability.

Following are more specific observations that coincide with specific Notes:

I. Principles and Definition (Agenda Paper 8A)

FASB’s revised definition of fair value is as follows: “*Fair Value* is the price that would be received for an asset or paid to transfer a liability in a transaction between market participants at the measurement date.” The revised definition is similar to the definition tentatively approved by the IASB in December 2005 which was: “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.” The primary differences are (a) elimination of defined term “reference market” from the definition, and (b) rewording from “current transaction” to “transaction...at the measurement date.”

IASB Staff suggest that the objective of a fair value measurement is to determine the price that would be received for an asset or paid to transfer a liability in a transaction between market participants at the measurement date. They also believe a fair value measurement should reflect market views of the attributes of the asset or liability being measured and should not include views of the reporting entity that differ from market expectations.

GNAIE believes that where active, liquid, principal markets do not exist, through which a reporting entity could sell or otherwise dispose of assets or transfer liabilities, there should equivalently exist no requirement to “fair value” such assets or liabilities as it is not possible to incorporate “market views” into the asset and liability measurement process and reliably calibrate periodic market value changes. For example, in the case of insurance contracts, if insurance companies were required to measure insurance contracts at “fair value” at inception and on an on-going basis, the measurements would necessarily be largely reflective of the subjective views of the reporting entity because there exists no “market” from which fair value measurement changes could be periodically, objectively calibrated.

¹ GNAIE’s comments specifically relate to insurance liabilities. These comments do not address the applicability of the proposed paradigm to insurance enterprises’ investments.

II. Revised Fair Value Hierarchy (Agenda Paper 8B)

The FVMS indicates valuation techniques used to measure fair value shall maximize the use of “market observable” inputs and minimize the use of “market unobservable” inputs. Moreover, the hierarchy prioritizes the inputs to valuation techniques used to measure fair value based on their observable or unobservable nature. The three-level hierarchy is summarized in Agenda paper 8B as follows:

- (a) Level 1 inputs are observable inputs that reflect quoted prices for identical assets or liabilities in active markets the reporting entity has the ability to access at the measurement date.
- (b) Level 2 inputs are observable inputs other than quoted prices for identical assets or liabilities in active markets at the measurement date.
- (c) Level 3 inputs are unobservable inputs, for example, inputs derived through extrapolation or interpolation that cannot be corroborated by observable data. However, the fair value measurement objective remains the same. Therefore, unobservable inputs should be adjusted for entity information that is inconsistent with market expectations. Unobservable inputs should also consider the risk premium a market participant (buyer) would demand to assume the inherent uncertainty in the unobservable input.

The FASB emphasizes the market-based objective in determining fair value measurements. In that connection, it clarified the wording in the lowest level of the hierarchy to specify that a level-three input is a “market unobservable” input rather than an “entity” input. This was apparently done to clarify that even in circumstances where an input is not “market observable” the measurement objective remains the same (i.e. inputs should reflect market views and should be adjusted to exclude any entity specific views that are inconsistent with the market’s expectation).

GNAIE believes that simply changing the designation of an input from “entity determined” to “unobservable market” does not in any way change either the nature of the input or the basic fact that the input cannot be independently verified by reference to a market based transaction and as such, by its nature is an entity determined input that likely contains a significant degree of subjectivity. Accordingly, GNAIE believes it would be appropriate to either² (a) simply remove the “fair value” designation from amounts determined using level-three inputs or (b) ensure that no accounting or reporting standards require the use of fair value measurement where there exists no active, liquid, principal market through which a reporting entity could sell or otherwise dispose of the affected asset or transfer the affected liability.

III. Unit of Account and Principal vs. Most-Advantageous Market (Agenda Paper 8C)

Unit of Account

GNAIE is in agreement that the unit of account in the FVMS should be consistent with the unit of account that is determined based on the guidance in the accounting or reporting standard that is requiring the fair value measurement.

² GNAIE’s comments specifically relate to insurance liabilities. These comments do not address the applicability of the proposed paradigm to insurance enterprises’ investments.

Principal vs. Most-Advantageous Market

GNAIE believes it would be appropriate for IASB and FASB to address the situation that exists with insurance contracts where there exists no active, liquid, principal market through which a reporting entity could sell or otherwise dispose of an asset or transfer a liability.

GNAIE notes in paragraph 9 of the Agenda Paper that “strategic” and “financial” buyers have been grouped together as fair value “in-use” purchasers, however, it is our general understanding that “financial” purchasers are typically not considered in-use purchasers as they most often assess acquisitions based on liquidation as opposed to going-concern values.

IV. Transaction Price Presumption (Agenda Paper 8D)

While GNAIE believes it would be wholly inappropriate to fair value insurance liabilities, in the event it were required to do so, and giving due consideration to the lack of any active, liquid, principal market through which an insurer could sell or otherwise transfer insurance liabilities, we believe the transaction price (or entry value) is the only point at which a purely objective fair value estimate is available. Despite the preceding, GNAIE would not be a proponent of fair valuing insurance contracts using entry values as this would have to rely on entity specific (and therefore subjective) estimates. Moreover, we do not believe the mere sale of new contracts (which may or may not have terms that are identical to existing contracts) should give rise to the recognition of gains or losses on existing contracts.

GNAIE also believes the IASB and FASB should address the issue of day one gains before such time as the FVMS is issued in final form.

V. Fair Value within the Bid-Ask Spread (Agenda Paper 8E)

GNAIE agrees with the IASB’s concerns about the use of a consistently applied pricing convention in less liquid or highly volatile markets and as such support the dissemination of the additional question concerning this issue.

VI. Transaction and Transportation Costs (Agenda Paper 8F)

No issues or observations.

We appreciate the opportunity to share these observations with the Board and would be happy to discuss any of the individual observations in more detail if the Board so desires.

Sincerely,



Douglas Wm. Barnert
Executive Director

- Copies to:
- Robert H. Herz, Chairman, FASB
 - FASB Members
 - Linda MacDonald, Fair Value Measurements Project Manger
 - IASB Members
 - Wayne Upton, IASB Research Director
 - Jon Nelson, IASB Practice Fellow
 - Peter Clark, IASB Senior Project Manager
 - Jeffrey Cropsey, Insurance Risk Transfer Project Manager