AMERICAN ACADEMY *of* ACTUARIES

February 12, 2014

Mr. Thomas J. Linsmeier
Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856-5116

Dear Mr. Linsmeier,

On behalf of the American Academy of Actuaries'[1] Financial Reporting Committee (FRC), I appreciate the opportunity to address your informal questions regarding discount rates. At the Dec. 2, 2013 roundtable discussion on the insurance contracts exposure draft, you requested proposed wording that could clarify the methodology to be used in determining the "top down" discount rate. You noted that you believed the approach in the exposure draft was consistent with the Academy's 2009 white paper on *Discount Rates in Accounting Present Value Estimates*.[2] As such, you questioned why the FRC had concerns about the proposed application guidance included in the exposure draft.

Conceptually, the exposure draft captures the intent of the white paper on discounting. In particular, when determining the insurance liability discount rate by starting with the yield on the assets backing the liability, a deduction needs to be taken into account for the asset risks retained by the company that are not inherent in the liability. However, the white paper did not go into detail about how to determine this deduction. Our concerns with the language in the exposure draft relate to possible interpretations as to how this deduction would be calculated.

The portion of the asset spread relating to compensation for risks that are not inherent in the liability will rarely, if ever, be observable. Therefore, the deduction for risks that are not inherent in the liability would need to be determined based on historical experience, as with other unobservable assumptions used in the insurance contract liability valuation.

However, we have learned that some auditors consider the daily fluctuations in asset spreads that occur in the capital markets to be observable information related to asset risks that are not inherent in the liability. Further, they have noted that such observable information should form the basis of the top-down asset spread. While such movement in asset spreads may be informative, and it may be appropriate to consider when deciding whether to change the assumption used for determining the deduction, these fluctuations do not necessarily represent changes in the asset risks that are not inherent in the liability. It is important that such

[1] The American Academy of Actuaries is a 18,000-member professional association whose mission is to serve the public on behalf of the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

[2] http://actuary.org/files/publications/discount_091509.pdf

fluctuations not override longer-term estimates of such risks that are based on historical observation.

We believe that the approach to determining the top down discount rate can be clarified in the exposure draft. The clarified language would explicitly state that the deductions for risks retained by the company generally will not be observable and will need to be a long-term average, estimated taking historical information into consideration. In particular, it would be helpful for paragraph BC 152 to include a reference to Level 3 estimates, as does paragraph BC 151 that discusses discount rates for tenors beyond the observable yield curve.

We have two other suggestions for improving paragraph BC 152:

1. Paragraph BC 152 provides an example of a risk inherent in the assets that is not inherent in the liability that appears to address default losses on debt, or perhaps even losses due to market price changes on assets. It would be helpful to clarify this further, noting that these risks also include the risk of price fluctuations in the asset value, even if the price fluctuations do not represent a loss, which is particularly relevant for equity instruments.

2. Item (a) of paragraph BC 152 requires matching the durations of the liabilities with those of the assets used as the starting point for applying the top down discount rates. Under most circumstances, this should not be necessary. As long as the discount curve is based on assets with tenors that span the liability cash flows,[3] the appropriate discount rates will apply to each liability cash flow, even if the assets and liabilities are not matched.

   For example, assume that the liability pays a single cash flow at the end of year 5, but the assets in the portfolio backing the liability have cash flows ranging from one to seven years. Even though the assets and liabilities are not matched, the asset yield for the 5-year asset still would provide an appropriate starting point for determining the discount rate of the liability cash flow. The economic impact of the asset/liability mismatch would be reflected in the financial statements since the asset and liability values would change by different amounts when interest rates change. So the asset/liability mismatch should not disqualify the asset yields from serving as the basis for the liability discount rates.

As a result, we would propose revising paragraph BC152 as follows:

> BC152. The Board considered the adjustments that would need to be made to the yield curve determined based on an entity's actual portfolio of assets or a reference portfolio and determined that entities should (a) ~~adjust for differences between the timing of the cash flows to~~ ensure that the assets in the portfolio (actual or reference) selected as a starting point ~~are matched with the duration of the liability cash flows~~ <u>span the liability cash flows so that an appropriate discount rate can be determined for each liability cash flow</u> and (b) adjust for risks inherent in the assets that are not inherent in the liability such as expected and unexpected losses, <u>~~such as~~</u> ~~the risk of losses exceeding the expected value~~ <u>potentially including but not limited to defaults in excess of expected levels, earlier</u>

[3] Of course, this would not address issues of extending the yield curve beyond the observable period, for which there would likely not be available assets and which is covered in BC 151.

than anticipated repayment of principal, and loss in value of equity investments. The adjustment for risks inherent in the assets that are not inherent in the liability generally will not be observable. Short-term movements in asset spreads will not necessarily capture this item since these asset spreads cover multiple risks, including some that are inherent in the liability. Thus, this adjustment generally will need to be estimated in a manner that is consistent with existing U.S. GAAP guidance on fair value measurement, particularly for Level 3 fair value measurement, which would tend to put more weight on longer-term estimates based on historical observation than on short-term fluctuations.

Thank you again for this opportunity to provide input. If you have any questions, please contact Tina Getachew, Senior Policy Analyst, Risk Management and Financial Reporting Council, by phone (202/223/8196) or email (getachew@actuary.org) or Leonard Reback at (908/ 253/1172) or email (lreback@metlife.com).

Sincerely,

Leonard J. Reback, MAAA, FSA
Chairperson, Financial Reporting Committee
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