



AMERICAN ACADEMY of ACTUARIES

DATE: July 28, 2004
TO: National Association of Insurance Commissioners – International Accounting Standards Work Group
FROM: American Academy of Actuaries – Financial Reporting Committee
RE: IAIS Accounting Subcommittee project on insurance liabilities at fair value: Financial Reporting Committee response to June 23, 2004 memorandum sent by Rob Essen

The following are the statements found in the June 23, 2004 memo from Rob Essen, outlining common themes for discussion of the IAIS Accounting Subcommittee with the IASB regarding fair value accounting proposals. Following each statement is a response from the Financial Reporting Committee of the American Academy of Actuaries. We would note that these responses reflect the consensus of this Committee, but have not yet undergone the normal Academy review process and therefore are not official Academy positions. In making these comments, we do not intend to imply that the Committee supports a Fair Value or Asset / Liability approach to insurance accounting or believes that such an approach is inevitable. Our responses are also based on the assumption that there will continue to be separate accounting systems for GAAP versus regulatory purposes.

1. **Own credit worthiness is unacceptable as an element in the measurement criteria for insurance liabilities.** This seems to be a universal position in all comments received from insurance supervisors. A related issue for further exploration by the Subcommittee will likely be the relationship between reinsurance of a liability and novation of that liability.

(Committee response: We agree. Some of our members have differing views relative to GAAP accounting, but not for regulatory accounting.)

2. **Determination of Market Value in respect of an observed market is not always possible.** While there are, for example, observed markets in specialist areas such as catastrophe bonds, the Subcommittee will continue to explore the alternatives to observed secondary markets for most insurance liabilities.

(Committee response: We agree that an observed market value is not always possible. In fact, for most, if not all, insurance liabilities, observable market values do not exist. This is why attempts to estimate a “fair value” for such liabilities would have to rely on model-based estimates.)

Members of the Financial Reporting Committee include: Ralph S. Blanchard, FCAS, MAAA, Chairperson; Henry W. Siegel, FSA, MAAA, Vice-Chairperson; Mark G. Beilke, ASA, MAAA; Rowen B. Bell, FSA, MAAA; Errol Cramer, FSA, MAAA; William C. Hines, FSA, MAAA; Darrell D. Knapp, FSA, MAAA; Ken A. LaSorella, FSA, MAAA; Jinn-Feng Lin, FSA, MCA, MAAA; Mary D. Miller, FCAS, MAAA; Mark F. Oberholtzer, FSA, MAAA; William J. Sohn, FCA, FSA, MAAA; Stephen J. Strommen, FSA, MAAA; Andrea M. Sweeny, FCA, FCAS, MAAA; Nancy P. Watkins, FCAS, MAAA; James F. Verlautz, FCA, FSA, MAAA.

3. **Market Value Margin is problematical at best and probably needs to be expressed in terms of a confidence level.** This tentative conclusion will also need further work.

(Committee response: We agree that reliability of Market Value Margins for insurance liabilities is a major issue, particularly with regard to the difficulty of calibrating such margins to the market.

For those products with the greatest difficulty in calibration, confidence level measures may not be reliable, and may not be the desired approach to determining market value margins. The Committee believes that it is premature and possibly inappropriate to select a confidence level approach to market value margins. We believe discussion of the selected measure should be deferred, with current discussion limited to the identification of the variety of possible measures and the possibility that different measures might be appropriate for different products/situations.)

4. **Discount rate should be at a market rate of some form.** Opinion is slightly divided on the exact nature of the market rate whether it be risk free or some other rate. The Subcommittee also expects to investigate further the matching of blocks of assets and liabilities, even though this is not seemingly a preferred direction by the IASB.

*(Committee response: The Committee would like to direct the NAIC (and IAIS) to the discussion about discount rates found in its 2002 monograph on fair value. This monograph can be found at the following web address:
http://www.actuary.org/pdf/finreport/fairval_sept02.pdf*

The discussions found on page 4 and page 32 of this monograph address the topic of discount rate and how a risk free rate might be defined.

With regard to products that contain investment or savings components, we note that it is impossible to address the topic of discount rates without also addressing the topic of investment margins – i.e., whether the valuations should assume future asset returns greater than the risk free rate. We note that transactions involving the transfer of life insurance and annuity portfolios have always anticipated such investment margins, implying that a true “fair value” calculation should also reflect such margins.)

5. **Deferred acquisition costs should be eliminated.** This position predicated upon the underlying assumptions that the IASB will utilize a prospective asset liability model in Phase II.

(Committee response: We can accept such a position for regulatory accounting purposes, but note that this could have material implications for some long-duration products with high up-front acquisition costs. The net impact of this and other positions (discussed here and in future discussions) could be a material loss at the time of product sale that significantly impacts the capital requirements for these products. The net impact could be a material impact on the market for such products, which may have public policy implications. Ultimately, the effect of this decision will depend in many cases on the methodology adopted for calculating reserves for future benefits.)

6. **Liability measurement should not be less than the surrender value.** While the determination as to whether this should be on an aggregate basis or a contract-by-contract basis is an open question, the concept that liabilities should not be measured at less than the surrender value is seemingly widely supported. There may be additional debate over whether the liability associated with a book of contracts should not be less than the amount resulting from the separate calculation for each contract (i.e. contract by contract basis).

(Committee response: (NOTE: Our response assumes that this issue is only being addressed with respect to insurance contract liabilities.) Regulators have a legitimate need to ensure that insurers will be able to pay surrender values on demand. However, this need can be addressed in other ways, such as through liquidity requirements, cash flow testing, and RBC determination. Setting surrender value as a floor is inconsistent with the concept of fair value and inconsistent with the prospective asset/liability accounting model. Use of a surrender value floor would significantly distort reported earnings and capital in some situations, with implications that may not be in the interest of regulators.

With regard to property/casualty products with a mid-term cancellation feature (at the customer's option), we note that this approach would recreate the existing Unearned Premium Liability found in current deferral-matching accounting systems for such products.)

Other Committee comments: We believe that it is important to understand how the resulting performance would be measured, from both a balance sheet and income statement perspective, before finalizing any future insurance accounting standard.