

GROUP OF NORTH AMERICAN INSURANCE ENTERPRISES

June 11, 2003

Sir David Tweedie
Chairman, International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir David:

We, the undersigned North American insurance enterprises, fully support the objective of developing high quality international accounting standards that can improve financial reporting worldwide. In this context, we support the effort to develop global accounting standards for insurance contracts. Good accounting standards can assist customers and investors in understanding company performance and in determining which companies they should do business with or invest in. Such standards can aid analysts in making recommendations and regulators in encouraging solvency.

We are writing to you today to express our concern that the Insurance Contracts project of the International Accounting Standards Board (IASB) currently appears unlikely to result in high quality accounting standards for insurance. We believe that an effective plan for this project would be to start with the existing well-developed standards for insurance accounting and identify where these standards may need improvement. Instead of using this approach, the preliminary decisions recorded for the IASB Insurance Contracts project indicate an intent to toss out the accumulated wisdom of current insurance accounting standards and to replace those standards with an experimental approach not used anywhere in the world.

There is a worldwide emphasis today on accounting transparency and understandable financial reporting, an emphasis wholly at variance with requiring insurance enterprises to produce financial statements based on the asset / liability accounting model and the "fair value" approach to insurance liability valuation. This untested accounting model and valuation approach will produce financial statements both dominated by the transient effects of capital markets volatility and much less effective at distinguishing good company performance from bad. Financial statements prepared in this manner will not provide useful or desired information to investment analysts or other users of financial information. Additionally, insurers do not currently and will not in the future use the proposed accounting model in developing the financial reports used in managing their insurance business operations. We see no demand for or interest in the proposed accounting model from insurance industry investors, customers, managers, or regulators.

Accordingly, the undersigned North American insurance enterprises request that the IASB take steps to provide substantial consideration of our concerns in the ongoing IASB

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Insurance Contracts project. In particular, we believe that the substantial body of insurance accounting literature that constitutes part of Generally Accepted Accounting Principles (GAAP) developed under the auspices of the Financial Accounting Standards Board (FASB) in the United States should be one of the most significant starting points in this effort. We do not assert that improvement in U.S. GAAP for insurance enterprises is impossible, but we do believe that an immense amount of consideration over a long period of time has gone into the development of these standards. We would be glad to work with the IASB, with FASB and with users of financial statements to identify areas where U.S. GAAP may fall short, or where other accounting standards may be superior, so that a high quality, robust global insurance accounting standard based on tested ideas can be developed.

Note that we are considering the IASB Insurance Contracts project taken as a whole, although we recognize that to meet the needs of some constituents the IASB is attempting to divide consideration of some issues between a Phase I “interim” standard and a Phase II “ultimate” standard.

The “Norwalk Agreement” between the IASB and FASB requires that each International Financial Reporting Standard (IFRS) developed by the IASB be considered for adoption by FASB as part of U.S. GAAP. As noted above, we support the development of and convergence to high quality global accounting standards for insurance contracts, but achievement of this objective requires the active participation of the worldwide insurance industry in the global standards development process. It is now clear to the undersigned North American insurance enterprises that we must take a more active role in the IASB’s deliberations because of the ultimate impact any IFRS may have on U.S. GAAP.

In the balance of this letter we will indicate in a little more detail some of the substantive and procedural issues we are requesting the IASB to consider. We will discuss first issues that apply generally to all insurance enterprises, followed by discussions of issues that may be more significant for life insurers, and then by issues that may be most significant for non-life insurers.

Issues for all insurance enterprises

- As a starting point for consideration of insurance contracts accounting, there should be a project to ascertain what works and what doesn’t from the viewpoints of preparers and users of financial information. Examples of “broken” accounting should be gathered, along with examples of how existing accounting works to enable managers, customers, analysts, regulators, investors, and creditors to make good or bad decisions about the types of enterprise under consideration. Review of this material should be used to identify the objectives of the project to develop new accounting standards.
- The “single comprehensive statement of income” contemplated under the asset / liability accounting model using the “fair value” valuation standard will generate

volatile performance measurements based on changes in the net asset value of a “mark to model” balance sheet. Currently, analysts of insurer performance generally look at insurer operating performance measures that exclude the volatile capital market gains or losses (realized or unrealized). The number of these volatile elements will be increased under the proposals under discussion, and immense confusion will be caused for typical users of financial information who see only summaries of results.

- “Fair value” for insurance liabilities includes the effect of “own credit risk” on the value of the liabilities. This means that identical liabilities will be posted at progressively lower amounts as an insurer’s credit standing deteriorates. The balance sheet in turn becomes progressively less meaningful and less informative to users attempting to distinguish between insurers on the basis of solvency or credit quality.
- “Fair value” is an irrelevant and misleading concept for liability valuation. “Fair value” is intended to mean “market value” or as close to market value as can be attained. For assets, this means the price where closely similar assets are traded in secondary markets, supplemented by models calibrated on those markets where closely related transactions are unavailable. Such market prices for assets are often available, may be reasonably reliable, and may be relevant accounting values for some purposes. Modern financial economics has several plausible theories of asset valuation that may be useful in modeling asset prices where transactions are not readily available.

However, attempting to apply “fair value” to liabilities is a serious conceptual error that leads to impractical and unreasonable results. “Fair value” or “market value” is irrelevant to liabilities because obligors are not able to freely trade, or even trade at all, their obligations on secondary markets. An obligor can only “sell” its obligation either with the permission of the obligee or by using the power of a government to compel such implied permission. Neither case generates a trading “market value” analogous to those generated for assets. The relevant measure for liability valuation is what it will cost the enterprise to satisfy that obligation.

- The “deferral and matching” accounting model is a reasonable approach to generating meaningful performance measures for insurance enterprises. It recognizes that insurance enterprises are exposed to contracts whose ultimate values develop over a period of time, in some cases for many years longer than the exposure period in the contract. The balance sheet adjustments it requires, such as deferred acquisition costs and unearned premium reserves, generate useful information that is helpful in evaluating insurer operations. If a “conceptual framework” for accounting standards forbids such items because they do not meet some strict “theoretical” definition of an asset or liability, it appears to us that the “conceptual framework” needs to be rethought to bring it into accord with business realities.

Accounting and financial reporting is not and cannot become a theoretical exercise as if it were an abstruse branch of mathematics. Instead, accounting should provide a meaningful historical record of the enterprise's financial performance, recognizing its underlying business and cognizant of its ongoing obligations.

- We recognize that a "conceptual framework" can be a useful tool for accounting standards setters, but that tool can become harmful if it means that accounting standards become a rigid "one-size-fits-all-industries" straitjacket. Recent unfortunate events have re-demonstrated the importance of reliability as a criterion for accounting standards, and judgements of accounting reliability depend on conditions in the relevant industries. Reliability is not the only criteria for accounting standards, but it is essential. Another desirable criteria for accounting standards is relevance, but relevance that is achieved at the expense of reliability may ultimately destroy the reader's trust in financial statements prepared according to that standard.

This striving for relevance explains the attractiveness of approaches such as fair value. Unfortunately, the fair value valuation standard inevitably becomes a "mark-to-model" approach filled with subjective and untestable assumptions. We are greatly concerned that the fair value "mark-to-model" approach would substantially decrease comparability of financial statements across the insurance industry and make audit opinions much more difficult to form on any rational basis. Certainly in the United States, the requirements of the Sarbanes-Oxley bill and the new Public Company Accounting Oversight Board will make auditors more leery of signing off on accounting statements so filled with subjective judgments.

- We are concerned that the fair value approach to liability valuation combined with the asset / liability accounting model could lead to recognition of substantial accounting gains or losses on inception of policies.

In the case of possible accounting gains, an artificial and dangerous incentive is created for potentially troubled insurers to write a great deal of new business in order to show profits. It has been proposed that an arbitrary adjustment to fair value be made to eliminate such gains.. Such a proposal actually recognizes one of the virtues of the deferral and matching accounting model, but it eliminates the logic and justification for the fair value method of valuing liabilities. This issue of accounting gains at inception may arise both for life and non-life products.

We are concerned about the possible accounting losses at inception caused by the way the fair value model treats the normal unwinding of the profits arising from some products. The proposed IASB accounting model does not recognize that some insurance products are designed to be sold and managed with regard to the actual returns available and obtained in the investment markets. In these cases, the IASB's proposed model might recognize a substantial loss at inception only to require increased profit recognition over the remaining relevant term of the policy. The

proposed IASB approach creates an artificial and counterintuitive profit volatility, where the quickest way to improve insurer “profitability” would be to stop writing new business. The issue of accounting losses at inception under the IASB proposal may arise more frequently for life insurance products, but a similar concern about accounting losses at inception may arise in the case of direct marketed life or non-life insurance products where marketing costs in one period are expected to benefit financial results over several future periods.

- From a procedural point of view, the attempt to develop high quality global accounting standards requires us all to move to a new level of openness and due process. A policy for disclosure of IASB discussion drafts that might be reasonable for an individual national accounting standard setter will be inadequate for consideration of new international accounting standards, especially at the beginning of the process of developing such standards. Normally, commenters on proposals being considered by a national accounting standard setter are dealing with incremental changes to a well-understood accounting regime. Even so, it takes time and effort for interested parties to properly consider what impact the new proposals might have. But for a new global standard, and especially for a proposal unlike any existing accounting standard, the effort to consider such proposals is multiplied several times over. Each commenter is considering items from his own national perspective (with differing legal and accounting issues and traditions) as well as from a theoretical future global perspective. There is also the realization that in many cases, the most effective comments are those provided before the “official” comment period. Everyone understands that new ideas receive more reasonable consideration before people become committed to positions, even if only on a “draft” basis.

Accordingly, the IASB Insurance Contracts project needs to make all project documents available as soon as possible, and to go out of its way to make opportunities for and solicit comments on the proposals. When thoughtful comments are provided, it would immensely help the interested parties understand the IASB’s logic if the IASB provided its rationale for rejecting or accepting the comments.

- In the case of a radical and untested proposal such as the asset / liability accounting model in conjunction with the “fair value” valuation approach, there should first be an obligation on proponents to demonstrate that the new approach provides more useful information to customers and investors than existing methods, because existing methods have at least the virtue of not requiring implementation costs. If such a demonstration produces mixed but promising results, a second step of requiring disclosure in the notes of financial statements of information related to the new approach can be made. This allows the virtues of the new approach to be further tested without requiring wasted implementation costs if it turns out that the new information does not turn out to have benefits commensurate with the costs of producing it.

- Interested parties in different countries have different traditions and legal relationships with their national accounting standards setters. In the United States the FASB has a process that is at once more open and more explicitly independent of the preparer community than is the case for most other countries. This means that FASB does not play the role of gathering and coordinating preparer opinion for incorporation into preliminary IASB discussions that may occur in some other jurisdictions. Accordingly, the openness and due process recommended above to the IASB as a generic good global standards setting practice is particularly necessary if United States financial statement preparers are to be able to participate in the IASB process on equal grounds with preparers from other countries who may receive IASB non-public documents from their national accounting standards setters.

Issues for life insurers

- We believe that the life insurance accounting model that is currently followed by US life insurers meets the needs of the financial statement users. The U.S. GAAP model, which has evolved over the course of time in response to the development of new life insurance and annuity products, is effective at providing information that faithfully represents the performance of U.S. life insurers and is understood by the users of our financial statements. We believe that the U.S. GAAP model provides for reasonable comparability among industry participants because updated guidance is continually developed which serves to lessen the divergence of practice among U.S. life insurers. The U.S. GAAP life insurance model has survived the test of time and has well served the financial statement users. Although there are things in the U.S. GAAP life insurance model that could be improved, the U.S. GAAP model has the advantage of being a “complete” model that has supporting interpretive literature that will limit diversity in application and enhance comparability of life insurance financial reporting.
- Notwithstanding the fair value model’s conceptual problems discussed above, the practical challenges of developing adequate life insurance modeling techniques to support the fair value approach will be significant. In particular, determining the fair value of a wide range of insurance liabilities on a reliable and verifiable basis poses difficult issues with determination of assumptions and development of appropriate models. There are virtually thousands of assumptions that an entity would have to revisit each time it estimates the fair value of its life insurance liabilities. These difficulties are multiplied if there is no specific guidance on application of a fair value standard. Consistency from period to period within a given enterprise will be difficult to maintain, monitor and audit. Achieving comparability between entities across the industry will be even more problematic.
- A number of life insurance contracts are designed to be sold and managed on a basis that recognizes and depends on the margins that can be obtained relative to returns available in the investment markets. Insurers actually manage their portfolios of

assets and liabilities in recognition of this relationship, and insurers seek margins sufficient to compensate them for the risk they take on by selling these contracts. The proposed IASB accounting model values assets and liabilities independent of each other even when such a business model would make no sense.

We are concerned that the IASB approach may generate accounting losses at inception of such policies, followed by increased accounting profits, when what is really happening is that the insurer is earning a steady margin on the policies it has issued. It is important that meaningful changes in performance measures be a sign that something significant has happened rather than a normal consequence of the ongoing volatility of returns in the investment markets. Existing accounting models recognize this business reality.

- We are concerned that the IASB's attempts to distinguish insurance contracts without reference to the business practices of the insurance enterprise may cause substantially similar insurance policies to receive differing accounting treatments. For example, Universal Life policies, participating policies, and Unit Linked policies may have substantially similar allocations of risks and rewards between insurer and insured, but details of contractual guarantees in remote circumstances may cause them to have substantially differing accounting under the IASB's proposed accounting model. Such differences could cause substantial reported performance differences among insurers with actually very similar portfolios of products and customers.

Issues for non-life insurers

- The "deferral and matching" accounting model is fundamental to the concepts of earned premium, combined ratio, and underwriting profit that are critical to the management of non-life insurers and are used to communicate with regulators, investors, and all other interested observers of the performance of non-life insurers. The "deferral and matching" approach allows separation of the concepts of underwriting and investment performance. The lack of success of so-called "cash flow underwriting" as a business strategy for non-life insurers shows that non-life insurance is not simply a financial activity. There are real operations and real risk management and claims management services being provided, so the attempt to record all events at the inception of the policy simply does not reflect the reality of the non-life insurance product or company. Thus, the proposed new accounting model will make more difficult the analysis of insurance underwriting which is critical to the evaluation of non-life insurer performance.
- While everyone recognizes that funding a dollar to be paid with certainty a year from now does not require a full dollar of assets today, non-life insurance claims liabilities do not generally satisfy the condition of certainty. Even with all of the advances in actuarial science and computerized information, there is substantial uncertainty in estimates of the amount that will be paid in subsequent periods on claims that the

insurer is obligated to cover as of today. Studies of industry loss reserve development show that on the whole, the non-life insurance industry has generally not been able to accurately estimate its future claims payments. Generally these estimates have been too low (sometimes by truly remarkable amounts) but occasionally for some categories of claims the estimates prove to be substantially high.

This issue of estimating the claims obligation is both very difficult and absolutely critical to evaluating the financial and operating performance of non-life insurers. It is not clear that discounting these estimates for the time value of money helps to make these estimates better information. Even if it is determined that some level of discounting is appropriate (e.g., for claims with fixed and determinable payout patterns), it is still less evident that readers of financial statements will be helped if the discount rate is a constantly varying market rate of interest. Such a market rate of discount can end up causing substantial period to period volatility of results while actually hiding the more significant impact of changes in the underlying estimates of the ultimate costs of claims. Understanding the adequacy of the booked claims liabilities using the concept of loss reserve development is critical to the evaluation of non-life insurance enterprises, and the proposed new accounting model makes these evaluations more complex and difficult for readers of financial statements to understand.

- Given the critical importance of estimated claims liabilities to evaluation of the performance of non-life insurers, the inappropriateness of “fair value” as a standard for liability valuation is worth a special note here. In addition to the volatility induced by capital markets that disguises the significant changes in estimates of ultimate losses by “accident year” (noted in the paragraph above), the “fair value” concept actually requires the company to estimate the “market value” of the liabilities. As noted earlier, liabilities do not trade in secondary markets and thus have no market value, so this criteria simply becomes “mark to model of a pseudo-market”. Even on the asset side of the balance sheet we have seen examples, such as that of Enron, of how out of control and unmeaningful valuation measures based on so-called “market values” can become when they are not tied to anything real. Market value is the wrong standard for evaluating insurance liabilities. The right standard is anticipated costs, and that standard can ultimately be tested by the liability development schedule.

Concluding remarks

Please note that the issues listed above are not a complete list of those that need to be considered. They represent the more important ones that have led to the writing of this letter.

In addition, please be aware that the companies listed below are not a complete list of those sharing this point of view. They represent a selection of interested companies based on contacts made during a relatively short period of time. We agreed that it was

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important to provide this letter to the IASB as soon as we could get it done in order to begin the process of providing more input concerning the consensus of the North American insurance industry. Although this letter expresses the views of North American insurance enterprises, the points it makes are consistent with those expressed in an earlier letter by a group of 20 primarily European and Japanese insurers and with issues raised in research sponsored by the Geneva Association.

Another indication of the North American insurance industry's interest in and activity in regard to international accounting standards for insurance contracts is provided by a number of communications of the American Council of Life Insurers (ACLI) to the IASB. In particular, the ACLI, together with the International Actuarial Association, has recently sent to the IASB the product of their research into issues relating to the valuation of insurance assets and liabilities.

We recognize that this letter contains a great deal of summarized information and that at times we may use shorthand descriptions for concepts familiar to participants in the North American insurance industry but perhaps less familiar to people from other backgrounds. Accordingly, we would be glad to meet with you to discuss this letter and the IASB Insurance Contracts project. We intend to meet with FASB to discuss these issues as well. We particularly want to find out how to make the issues discussed above more vivid and understandable to the IASB. We are convinced that such communication will result in better international accounting standards for insurance contracts, and that will ultimately benefit our customers and our investors.

For administrative convenience, please direct responses to this letter to the following:

Mr. Michael J. Castelli
Vice President and Comptroller
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Mr. Castelli will provide copies of responses to the undersigned.

Very truly yours,

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Mr. Howard I. Smith, Vice Chairman, CFO and Chief Administrative Officer

AXA Financial, Inc. and The Equitable Life Assurance Society of the United States
Mr. Stanley B. Tulin, Vice Chairman and Chief Financial Officer

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Mr. Robert V. Deutsch, Executive Vice President & Chief Financial Officer

General Re Corporation (a subsidiary of Berkshire Hathaway Inc.)

Ms. Elizabeth A. Monrad, Senior Vice President and Chief Financial Officer

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Dennis J. Langwell, Senior Vice President and Chief Financial Officer

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