40 Exchange Place, Suite 1707
New York, New York 10005
++1-212-480-0808
FAX ++1-212-480-9090
mail@gnaie.net

July 27, 2004

Ms. Julie M. Gann, CPA
Financial Examination Manager
National Association of Insurance Commissioners

Transmitted via E-mail

Dear Ms. Gann:

Thank you for the opportunity to comment on the NAIC International Accounting Standards Working Group's review of the IAIS Subcommittee proposed positions on Fair Valuation of Insurance Liabilities that were discussed with representatives of the International Accounting Standards Board in Oslo on June 24, 2004.

The Group of North American Insurance Enterprises (GNAIE) is composed of the Chief Financial Officers of eleven leading insurance companies including life insurers, property and casualty insurers, and reinsurers. GNAIE members include companies who are the largest global providers of insurance and substantial multi-national corporations. All are major participants in the US markets. The goals of GNAIE are to influence international accounting standards to ensure that they result in high quality accounting standards for insurance companies and, to that end, to increase communication between insurers doing business in North American and the International Accounting Standards Board and the US Financial Accounting Standards Board. GNAIE works to meet its goals through modeling of proposed accounting standards, analysis, comment, and coordination with various end users of financial reports

A GNAIE letter to Sir David Tweedie of June 11, 2003 lays out the fundamental accounting issues that GNAIE members agree on. That letter is available on the GNAIE website.

We have summarized our key points in a series of numbered headlines followed by brief discussions of those points. We would be glad to respond to any request for amplification or clarification on these issues.

As a preliminary point, we should note that GNAIE supports the idea that the NAIC and the IAIS should convey their perspectives to the IASB and to FASB as interested users of general purpose financial statements as well as of financial statements prepared using insurance regulatory accounting principles. In particular, solvency analysis is closely related to the perspective taken by a policyholder or other creditor of an insurer, so the regulatory perspective can be a useful corrective to accounting standards setters who sometimes focus on equity investors so much that the interests of creditors are forgotten.

1. The presumption of the IAIS Subcommittee proposed positions that the IASB will adopt a fair value model for insurance contracts is incorrect.

While it is true that the IASB has had extensive discussions of a fair value model for insurance contracts, it is also true that through those discussions the IASB has become aware of the very significant theoretical and practical difficulties inherent in any attempt to develop a fair value standard for insurance liabilities. For example, while the ED5 exposure draft relating to the IASB's insurance contracts phase 1 project proposed requiring the disclosure of the fair value of insurance liabilities by December 31, 2006, the adopted IFRS 4 dropped this requirement as it was clear that no satisfactory consistent definition of what is meant by a Fair Value Methodology for insurance contracts exists today.

In addition, the IASB's Phase 2 project on insurance contracts accounting is now taking shape, and it is clear that the accounting standards setters are committed to taking a serious look at insurance accounting standards that are not based on fair valuation of insurance liabilities. We call your attention to the following points:

- FASB now plans to play a significant role in the Phase 2 insurance contracts accounting project, and it has made none of the preliminary findings favorable to fair value for insurance contracts that were reported after some earlier IASB discussions of insurance contracts accounting;
- IASB is in the process of appointing a new insurance contracts accounting advisory group that is expected to contain experienced insurance accountants who are well aware of the practical difficulties that would be faced by a Fair Value Standard.
- Studies calling into question the reliability of fair value valuations of insurance liabilities have been released and the question of the reliability of fair valuation techniques has been commented on by accounting standards setters, including by Robert Herz, chair of FASB.

2. Identification of "acceptable" elements of the fair value model for insurance contracts is not consistent with the current adopted positions of the NAIC.

The existing insurance regulatory accounting standards (including those of Denmark, the Netherlands, the United Kingdom, Australia, and Canada) being reviewed by the IAIS are each a different method, but all called "fair value". None would meet the standards of fair value that have been discussed by the IASB and its predecessor and affiliated bodies. After careful review

of the Issues Paper exposed by the IASC in December 1999, the NAIC submitted a 43-page document responding to the 460 pages of potential issues in a potential fair value proposal.

If the IASWG wants to propose a change in the NAIC position, it needs to put this document on the table and determine where it disagrees with its conclusions.

3. Because insurance contracts do not trade except in artificial circumstances, a pure fair value model for insurance contracts is incorrect in theory. Even a simulated mathematical model would have to represent a situation that does not occur in practice.

Paramount to understanding the foregoing is the fact that there is a difference between a fair value transaction and a Fair Value Methodology. A Fair Value transaction means market value, or as close as you can come to market value. The IASB defines it as "The amount for which an asset could be exchanged or a liability settled, between knowledgeable, willing parties in an arm's length transaction." The three tier hierarchy of fair value measurements makes clear that "mark to model" is the least preferred methodology and that it should be calibrated to market transactions as much as possible. Market transactions means trades in the secondary market, and such trades do not exist for liabilities. Note that this does not refer to a thin market, but to a market that does not exist for conceptual reasons.

The secondary market for life and health insurance liabilities does not exist because of legal protection of the public interest. Owners of insurance policies are required to share an insurable interest in the loss. The "arbitrage" forces that keep bond prices in line should not apply to insurance risks, since that would leverage the financial incentives to actually cause the loss.

Industry agreement on the arms-length trading "fair value" of insurance services would of course be artificial and anti-competitive.

Insurers provide valuable services by creating new sorts of coverage, and by bundling them. While experts can estimate the cost of new features and interaction effects, they are uncertain by definition. Currently such confidential information is shared with regulators and auditors. If all aspects of such management estimates were public information, companies would innovate less than they do today.

Recognition of profits at issue was a major factor in the collapse of Baldwin United. Events have continued to reinforce the wisdom of recognizing life insurance profits over time rather than immediately.

Thus it is clear that for insurance, the public interest is served by prohibiting the mechanisms that apply in the bond market for fair valuation.

A Fair Value Methodology, as has been demonstrated by the various country presentations, can be anything you want it to be.

4. Attempts to fair value insurance liabilities would be unreliable in practice.

When discussing the question of how one might estimate the market value of a liability if a liability had a market value (see above), accounting standards setters have agreed that fair value estimates should incorporate explicit consideration of the time value of money using current market rates of interest and explicit consideration of a “market value margin” or “market risk margin” that reflects a market consideration for the uncertainty in the amount (or its timing) to be paid to resolve the liability. However, since there are no trading markets for liabilities, there is no place to calibrate these estimates.

While current statutory accounting standards have 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 most of the proposed accounting models make these evaluations more complex and difficult for readers of financial statements to understand.

Financial markets are guided by “The Law of One Price”, which states that all observers, regardless of their individual risk aversion or view of the future, will agree on the fair value of a traded instrument. This applies to any commodity in competitive equilibrium, be it bonds or donuts. The CAS study demonstrates that the law of one price does not apply to estimates of insurance liabilities, even if leading experts do the estimating.

Even the IASB, in its technical correction to the “Fair Value Option” guidance on IAS 39, (April 04 ED) requires that fair value estimates be “verifiable”. This new standard would eliminate some of the subjectivity in the treatment of financial instruments.

The Casualty Actuarial Society released in May 2004 a study showing the efforts of two respected groups of actuarial consultants to estimate the amount of discount and the amount of market value margin that would be required under a fair value standard. While there was some disagreement between the two groups on the amount of discount estimated, there was substantial disagreement on the amount of market value margin estimated by the two groups and thus substantial disagreement on how the original nominal value reserves compared to the sum of the discounted reserves and the estimated market value margins. The two groups of actuaries would come closer together if the accounting standards setters would prescribe exactly one method and exactly one set of assumptions, but these prescriptions would be arbitrary and would eliminate the supposed merit of fair value’s tie to the market.

It is clear that fair valuation of insurance liabilities, intended to improve transparency and comparability of financial results between insurers, instead results in increased subjectivity and required use of judgment unconstrained by any available comparison to reality. In several recent high profile accounting scandals, the parties took full advantage of these provisions to puff up their balance sheets and income statements and avoid regulatory attention. It is not clear why regulators would support that potential abuse.

5. Fair valuation is linked with an experimental and untested accounting model that throws out the performance measures best suited for managing and evaluating insurer performance.

Fair valuation for insurance liabilities is linked with the asset/liability accounting model under which performance (i.e., the equivalent of net income) is measured by the change in the net assets from the beginning to the end of the period. If interest rates decline in the period, the change in the fair valuation of the fixed income asset portfolio may easily outweigh all other elements of the performance of the insurer.

By contrast, current U.S. GAAP and U.S. Statutory insurance accounting depend on the deferral and matching or revenue and expense model that would be eliminated by fair value and the asset/liability accounting model. For life companies, the fair value proposals may generate accounting losses at the inception of some policies while generating increased gains later on, when what is really going on (and is currently reflected in today's accounting) is that the life insurer is earning a steady margin on the policies it has issued. For property and casualty companies, the concepts of an underwriting profit and the combined ratio would be eliminated, leaving only measures that intertwine underwriting and investment performance and thereby encourage the discredited concept of "cash flow underwriting". In addition, fair value throws out the ready comparison of property and casualty reserve balances to subsequent payments on those reserves in order to ultimately determine reserve adequacy. Reserve adequacy is the single most important factor in evaluating a property and casualty insurer, and fair value makes it harder.

Accounting statements are intended to provide rational communication between managers, owners, creditors, policyholders, regulators, and other stakeholders. "Fair Value" could mean a rational estimate of fundamental value, or it could mean a market price. In many cases, the two are not the same thing. Market prices can reflect fads, as they have from the South Sea Bubble in the early 1700s, to the Internet bubble of the 1990s. In such cases stakeholders would probably be better served with an expert fundamental analysis, yet US GAAP and stat both require disclosure of market prices.

In summary, the NAIC and the IAIS should continue to engage the IASB in discussions of insurance contracts accounting standards from the perspective of interested users of general purpose financial statements. Insurance regulators have a great deal of accumulated wisdom on the strengths and weaknesses of existing financial accounting and reporting standards and have much to contribute to the development of a high quality international accounting standards for insurance.

However, there is no reason today for the NAIC and the IAIS to spend scarce resources (in a search for the golden bullet) developing positions on how to utilize fair value accounting for insurance contracts. Fair value is not here today and may well never be adopted as an insurance contracts accounting standard by the IASB, the NAIC or the FASB.

If the NAIC and IAIS understand with the reasoning behind GNAIE's recommendations above and are also in support of these positions, there is no need for detailed discussion of the particular technical recommendation contained in the memorandum on the Future Liabilities Project.

We would be glad to meet with you to further discuss these issues. We share with the NAIC the goal of developing high quality international accounting standards for insurance contracts and we expect to continue to work with the NAIC in making progress in this area.

Very truly yours,

Howard I. Smith
Chair, Group of North American Insurance Enterprises (http://www.gnaie.net)
Vice Chairman, CFO and Chief Administrative Officer
American International Group, Inc. (AIG)

E-copies to:
Members of the IASWG Working Group
Ramon Calderone, Chairman, Accounting Practices and Procedures Task Force
Kevin McCarty, Chair, Financial Condition (E) Committee
Members of the NAIC Executive Committee
Insurance Company Trade Associations