

September 27, 2010

Technical Director
File Reference 11810-100
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Mr. Golden:

Thank you for the opportunity to comment on the Exposure Draft, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*. On behalf of the Statutory Accounting Principles (E) Working Group (SAPWG) of the National Association of Insurance Commissioners (NAIC), I am pleased to provide you with comments on the Exposure Draft.

Purpose for NAIC Comment

The Statutory Accounting Principles (E) Working Group (SAPWG) of the NAIC has the responsibility of developing and proposing new Statements of Statutory Accounting Principles (SSAPs) to be used by insurers in the United States. Statutory Accounting Principles (SAP) utilizes a framework established by GAAP; therefore, the NAIC believes it is important to comment on GAAP exposure drafts that could materially affect SAP before such guidance is finalized. It should be noted, the NAIC is expecting a policy decision to be made by state insurance commissioners in 2011 which could result in a major modification to the current SAP framework. Although discussions regarding this policy decision are just beginning, it should be noted that the range of possible outcomes includes a continuum of options, including but not limited to replacement of SAP with either US GAAP or International Financial Reporting Standards (IFRS). Our comments consider the possibility of such a policy decision. Please note, our comments are limited to those areas or questions where U.S. insurance regulators either have strong opinions, or are related to the general requirements of the proposed guidance.

Response to Proposed General Guidance

U.S. insurance regulators recognize the divergent views regarding the use of fair value, particularly among regulators and note the following advantages and disadvantages to the use of amortized cost/fair value:

Advantages to Amortized Cost/Disadvantages to Fair Value

- Amortized cost is consistent with insurers' business practice to match assets with liabilities by holding those assets backing the liabilities to maturity.
- Amortized cost results in a consistent earnings process for fixed income securities but still allows for the use of impairment rules to require a write down of such securities to the expected cash flows, where a decision to sell a security has been made, or where the entity will not be able to recover the full amortized cost.
- Amortized cost better reflects revenues when earned and the corresponding costs; and is more consistent with the historical use of the income statement.
- Fair value can cause fluctuations within an insurer's financial statements that are inconsistent with the insurance business model; thus reflecting a financial position that doesn't depict the most relevant information to the user of the financial statements.

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- Fair value accounting, during illiquid markets, creates earnings volatility and concerns that may not be warranted.

Advantages to Fair Value/Disadvantages to Amortized Cost

- Fair value may be more consistent with the proposed valuation of insurance liabilities currently being considered by the FASB and the International Accounting Standards Board.
- Fair value provides a more timely and representative depiction of an entity's involvement in and potential current impact of financial instruments.
- Fair value accounting promotes transparency more than fair value disclosure.
- Amortized cost ignores economic realities that entities must address who are holding financial instruments.
- Amortized cost is dependent upon entity specific data

US insurance regulators note that the current US statutory accounting model favors the use of amortized cost. More specifically, current requirements provide that all high quality bonds are held at amortized cost. This existing approach has been driven by a number of factors; the most significant being the concern that the mere fluctuation in interest rates may require a regulator to put an otherwise financially solvent insurer into receivership. Additionally, regulators place limits on the amount of money an insurer can pay out in dividends, and there has always been concern with the use of an accounting model that would allow insurance groups to drain more assets from an insurer in the strong market years. The use of lower of cost or market accounting is utilized by U.S. insurance regulators for non-investment grade bonds, but there has also been a desire for the basis of accounting to be aligned with the general valuation of liabilities. Under current US practice, life insurers are required to hold policyholder liabilities that have generally been well in excess of economic values.

Consequently, at this time US regulators believe that IFRS 9—Financial Instruments, as issued by the International Accounting Standards Board (IASB) in late 2009, is much closer to the current statutory accounting requirements and therefore may provide for a much easier transition to the extent US insurance regulators make a policy decision to converge with either US GAAP or IFRS. However, US insurance regulators place a high emphasis on consistency and do favor that aspect of this exposure draft since it results in all financial instruments being reported at fair value. U.S. insurance regulators also appreciate the FASB's attempt to develop an accounting method that can be used for regulatory purposes based upon the comment on page 4 of the exposure which states, "...the proposed guidance also would continue to provide, if so desired, prudential regulators with the information necessary to compute regulatory capital using either fair value or amortized cost amounts." US insurance regulators have discussed how they could make adjustments to their capital model to the extent a policy decision is made that would result in the replacement of SAP with either US GAAP or IFRS. However, since such a decision has yet to be made, and because US insurance regulators currently electronically capture fair value information for each individual investment owned by an insurer, the NAIC is not yet ready to consider if it would adopt, adopt with modification or reject the accounting guidance in this exposure draft if it were adopted. US insurance regulators are very interested in being involved in any future roundtable discussions the FASB holds on this topic because of the pending policy decision and because of the difference of opinion between the FASB and IASB.

Sincerely,



Joseph Fritsch
Chair, NAIC Statutory Accounting Principles Working Group

Responses to Specific Questions

Question 1: Do you agree with the scope of financial instruments included in this proposed Update? If not, which other financial instruments do you believe should be excluded or which financial instruments should be included that are proposed to be excluded? Why?

U.S. insurance regulators believe that considering one's own credit standing in measuring its liabilities would distort the true financial position of the reporting entity for those financial liabilities that cannot be traded (i.e., in fair value hierarchy levels 2 & 3) and will result in incomparability of two companies that otherwise could be compared without this measurement requirement. Therefore, the NAIC does not support the use of fair value for their own liabilities or debt.

Question 3: The proposed guidance would require deposit-type and investment contracts of insurance and other entities to be measured at fair value. Do you agree that deposit-type and investment contracts should be included in the scope? If not, why?

U.S. insurance regulators believe that all types of financial instruments that are written by insurers as part of their insurance operations should be excluded from the scope of this proposed update. More specifically, those contracts within the scope of 1) the deposit method of accounting set forth in Subtopic 340-30 on insurance contracts that do not transfer insurance risk; and 2) an investment contract accounted for in accordance with paragraphs 944-825-25-1 through 25-2 on accounting for insurance entities. Therefore, we suggest removal of these items from paragraph 4d. We understand the desire to utilize the same accounting for virtually all types of financial instruments, but we believe insurers should account for their same contracts using the same basic concepts for their products (i.e., these products should be subject to Insurance Contracts).

Question 4: The proposed guidance would require an entity to not only determine if they have significant influence over the investee as described currently in Topic 323 on accounting for equity method investments and joint ventures but also to determine if the operations of the investee are related to the entity's consolidated business to qualify for the equity method of accounting. Do you agree with this proposed change to the criteria for equity method of accounting? If not, why?

It is our understanding that under the proposed guidance, if only one of the two criteria is met, the investor shall account for the investment in the equity security at fair value with all changes in fair value recognized in net income. U.S. insurance regulators have some concern with this, only because we believe the equity method of accounting may be more appropriate on certain types of investments made by insurers—more specifically, joint ventures and limited partnerships where the fair value may be less determinable. We believe the use of an equity method of accounting in such situations generally captures the concerns of regulators. Of particular concern to regulators is the second criteria dealing with the operations of the investee being related to the entity's consolidated business. Having said that, our existing accounting guidance includes various provisions that are intended to deter insurers from establishing entities as a means to circumvent statutory accounting. Therefore, we would suggest the addition of the following to the list of items that the reporting entity must consider.

The investor could avoid the recognition of transactions by forming the entity in a manner that resulted in a less punitive basis of accounting for that transaction.

Question 6: The proposed guidance would require money market funds that comply with Rule 2a-7 of the Investment Company Act of 1940 to measure their investments at fair value rather than amortized cost. Do you believe that reporting those investments at fair value rather than amortized cost will provide decision-useful information? If yes, how will the information provided influence your analysis of the fund? If not, why?

U.S. insurance regulators have generally required all money market funds to be carried at their fair value, with limited exception. Specifically, money market funds that meet the conditions of 17 C.F.R. 270.2a-7 and certain bond mutual funds that are registered with the Securities and Exchange Commission under the Investment

Company Act of 1940 (15 U.S.C. 80a-1 et seq.) may be valued at amortized cost. This current practice is based on the current linkage between U.S. insurance regulators capital requirements, perceived investment risk and accounting. The current valuation is a by product of this system, and regulators are more concerned about an accounting system that is as consistent throughout its application as possible.