AMERICAN ACADEMY *of* ACTUARIES

September 14, 2009

International Accounting Standards Board (IASB)
30 Cannon Street
London, EC4M 6XH
United Kingdom

These comments are from the Life Financial Reporting Committee and Financial Reporting Committee of the American Academy of Actuaries[1] concerning the Exposure Draft on Financial Instruments: Classification and Measurement (FI CM).

While we considered the overall issues addressed in the FI CM, we particularly considered the proposals from the perspective of how they would apply to the classification and measurement of financial liabilities for contracts issued by insurance organizations, and how the measurement of financial assets and liabilities would impact asset/liability management for insurance organizations. Nevertheless, we make comments in this letter on broader classification and measurement as well, in the hope they will also be helpful to the Board.

We explain our conclusions in response to the Board's questions below.

Question 1

Does amortized cost provide decision-useful information for a financial asset or financial liability that has basic loan features and is managed on a contractual yield basis? If not, why?

Yes, amortized cost provides decision-useful information since, in the event that the entity holds an asset to maturity, amortized cost is an appropriate reflection of value. In addition, amortized cost can provide useful information in the event that determining fair value is particularly challenging. We believe that in the event amortized cost is used as a measurement basis, that disclosures of the fair value is important for the shareholder as well. We believe fair value is a preferred basis of measurement however we recognize and agree with the desire to avoid undue cost and effort. It is important to consider cost/benefit and tradeoffs in making a decision.

Question 2

Do you believe that the exposure draft proposes sufficient, operational guidance on the application of whether an instrument has 'basic loan features' and 'is managed on a contractual yield basis'? If not, why? What additional guidance would you propose and why?

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[1] The American Academy of Actuaries ("Academy") is a 16,000-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.

Although the guidance in the exposure draft is a good start, we believe it will be necessary to provide some additional guidance and examples to demonstrate how the principles should be applied to situations not currently addressed by the exposure draft. For example, some guaranteed investment contracts sold by insurance entities have a “window period” during which certificate holders can invest money at a rate set at inception. It is not clear from the examples given whether such a window period would be considered a basic loan feature.

We have concerns about how this guidance would be applied to investment contracts issued by insurance entities. It is not clear whether the provisions in certain guaranteed investment contracts, fixed deferred annuities, or certain reinsurance contracts where US GAAP currently requires deposit accounting would qualify for amortized cost under this guidance. Neither fair value nor amortized cost is consistent with the valuation method being proposed for insurance liabilities. This could place pressure on the boundary between insurance contracts and investment contracts. We realize that under current IFRS, most fixed deferred annuities and reinsurance contracts that use deposit accounting under current US GAAP would be treated as insurance contracts. However, FASB and IASB currently have a joint project on insurance contracts and it is not yet clear how insurance contracts and investment contracts will be defined under that project. Therefore, we are concerned about how these contracts that are currently investment contracts under US GAAP but insurance contracts under IFRS would be treated under this project.

In addition, we believe that further clarification on whether instruments are managed on a contractual yield basis would be helpful. The examples in paragraphs B12 and B13 of the FI CM provide some helpful clarification. However there is still some uncertainty regarding the extent to which assets classified as available for sale could be considered to be managed on a contractual yield basis. Additional examples would help clarify this.

<u>Question 3</u>

Do you believe that other conditions would be more appropriate to identify which financial assets or financial liabilities should be measured at amortized cost? If so,

(a) what alternative conditions would you propose? Why are those conditions more appropriate?

(b) if additional financial assets or financial liabilities would be measured at amortized cost using those conditions, what are those additional financial assets or financial liabilities? Why does measurement at amortised cost result in information that is more decision-useful than measurement at fair value?

(c) if financial assets or financial liabilities that the exposure draft would measure at amortized cost do not meet your proposed conditions, do you think that those financial assets or financial liabilities should be measured at fair value? If not, what measurement attribute is appropriate and why?

We do not believe there are more appropriate conditions that still meet the objectives of reducing complexity. We wish to point out for the Board's benefit that we believe that, based on this guidance, most of the insurance contracts that meet the criteria in IFRS 4 to be financial instruments would be measured at fair value rather than at amortized cost.

Question 4

(a) Do you agree that the embedded derivative requirements for a hybrid contract with a financial host should be eliminated? If not, please describe any alternative proposal and explain how it simplifies the accounting requirements and how it would improve the decision-usefulness of information about hybrid contracts.

(b) Do you agree with the proposed application of the proposed classification approach to contractually subordinated interests (ie tranches)? If not, what approach would you propose for such contractually subordinated interests? How is that approach consistent with the proposed classification approach? How would that approach simplify the accounting requirements and improve the decision usefulness of information about contractually subordinated interests?

(a) In general, we agree with the Board's proposed elimination of embedded derivative bifurcation requirements. However, we would like to note that this could result in different treatment for insurance contracts under IFRS 4, since if a contract meets the definition of insurance there are still bifurcation requirements in IFRS 4.

(b) A concern we have with the proposed classification approach to contractually subordinated interests is that in an instrument with multiple tranches, the second most senior may be substantively much more similar to the most senior tranche than to an equity tranche. By contrast, the proposed approach would treat that second most senior tranche consistent with an equity tranche. We believe a better approach to be that tranches which receive more protection from more subordinated tranches than they provide to more senior tranches would be eligible for amortized cost. This could be achieved with a rebuttable presumption that only the most senior tranche is eligible for amortized cost, but the presumption could be rebutted by a demonstration that the tranche in question is likely to receive more protection from subordinated tranches than it provides to more senior tranches.

Question 5

Do you agree that entities should continue to be permitted to designate any financial asset or financial liability at fair value through profit or loss if such designation eliminates or significantly reduces an accounting mismatch? If not, why?

We strongly agree with retaining the Fair Value Option (FVO), as this will prevent catastrophic accounting mismatches as well as enable better disclosure of asset/liability matching. Given the differences that are emerging between this financial instruments project and the insurance contracts project, we believe it is particularly important to retain the Fair Value Option for insurance contracts as well.

Question 6

Should the fair value option be allowed under any other circumstances? If so, under what other circumstances should it be allowed and why?

In light of the general framework for IFRS as a whole, we believe that the FVO should be allowed in instances in which the company believes such valuation would provide better, more reliable, and more useful information to shareholders. We also believe that the rationale for electing fair value should be disclosed.

Question 7

Do you agree that reclassification should be prohibited? If not, in what circumstances do you believe reclassification is appropriate and why do such reclassifications provide understandable and useful information to users of financial statements? How would you account for such reclassifications, and why?

We believe that reclassification from fair value to amortized cost should be prohibited. As stated in our responses to Question 1 and Question 14, we believe that fair value provides important information to the financial statement user, and is generally a preferred basis of measurement, absent undue cost and effort. Therefore, if fair values are already being reported, we do not believe a reclassification to amortized cost should be permitted. However there may be instances where reclassification from amortized cost to fair value after contract issue would make sense to the extent a company is implementing a major change in its asset/liability strategy (e.g., implementing hedging for a block of inforce contracts). We also believe that if reclassification is permitted, it should be fully disclosed.

Question 8

Do you believe that more decision-useful information about investments in equity instruments (and derivatives on those equity instruments) results if all such investments are measured at fair value? If not, why?

We believe that fair value is the appropriate measurement basis for investments in equity instruments.

Question 9

Are there circumstances in which the benefits of improved decision-usefulness do not outweigh the costs of providing this information? What are those circumstances and why? In such circumstances, what impairment test would you require and why?

We are not aware of circumstances in which the benefits of improved decision-usefulness do not outweigh the costs of providing this information.

Question 10

Do you believe that presenting fair value changes (and dividends) for particular investments in equity instruments in other comprehensive income would improve financial reporting? If not, why?

We have no comments.

Question 11

Do you agree that an entity should be permitted to present in other comprehensive income changes in the fair value (and dividends) of any investment in equity instruments (other than those that are held for trading), only if it elects to do so at initial recognition? If not,

(a) how do you propose to identify those investments for which presentation in other comprehensive income is appropriate? Why?

(b) should entities present changes in fair value in other comprehensive income only in the periods in which the investments in equity instruments meet the proposed identification principle in (a)? Why?

We believe that fair value changes related to investments in equity instruments should be reflected in net income. Please also see our response to Question 14.

Question 12

Do you agree with the additional disclosure requirements proposed for entities that apply the proposed IFRS before its mandated effective date? If not, what would you propose instead and why?

We agree with additional disclosure for early adoption.

Question 13

Do you agree with applying the proposals retrospectively and the related proposed transition guidance? If not, why? What transition guidance would you propose instead and why?

We agree.

Question 14

Do you believe that this alternative approach provides more decision-useful information than measuring those financial assets at amortized cost, specifically:

(a) in the statement of financial position?

(b) in the statement of comprehensive income?

If so, why?

There are diverging views on this issue within the actuarial profession. Therefore, we thought it beneficial to present the advantages and disadvantages of recording the change in fair value through either the Income Statement (IS) or through Other Comprehensive Income (OCI).

View A: Record impact of all fair value changes through the IS

Reporting everything at fair value may be simpler and more useful to investors. The use of OCI as a mechanism to separate movements in instruments between market-related changes and non-market-related changes in and of itself does not appear to provide investors with valuable information, since the details of the instruments involved and the drivers of the movement are not made transparent simply by presenting a split between net income and other comprehensive income. In order to truly understand the distinction, detailed disclosures of the drivers of movements is required. However, holders of this view do recognize that for certain financial instruments, determination of fair value may involve undue cost and effort, and therefore some recognition of this in accounting standards appears appropriate. Absent of reporting everything at fair value, it would be appropriate for disclosures of fair value to be retained (again, to the extent not burdensome due to undue cost and effort), but beyond that, holders of this view do not believe that it is important to put the fair value changes through OCI.

View B: Record impact of all fair value changes through OCI

There are some reasons why putting fair value changes into OCI would be beneficial to users of insurance entities' financial statements. One reason is that, if the discount rate used for insurance liability current values is not the same as the discount rate implicit in invested asset fair values, significant non-economic mismatches would emerge between the asset and liability values. If such mismatches are reflected in net income, rather than OCI, the net income amount will be driven more by these discount rate differences than by the performance of the entity.

As an example, consider an insurance entity with $100 billion of invested assets and liabilities and an average 5-year duration on the assets and liabilities (perfectly matched). Assume that the change in invested asset yields during a reporting quarter differs from the change in the liability discount rate by just 10 basis points. As a result of this discount rate mismatch, there would be a mismatch in the change in asset and liability values of $500 million. A $500 million net income impact due to this mismatch would often be greater than the impact to quarterly net income from all other sources. The impact could be even greater than in that example. If, for example, insurance liability current values are in the future required to be discounted at default free rates, the mismatch between asset and liability discount rates will simply be equal to the change in market credit spreads during the quarter, which can easily far exceed 10 basis points. Also, many insurance liabilities (and their associated invested assets) have durations far in excess of 5 years, which would dramatically exacerbate these impacts.

There are other mismatches that could emerge as well. For example, assume that a $100 billion insurance entity had a 0.1 year mismatch between asset duration and liability duration. If interest rates moved during the period by 1%, this small duration mismatch would cause a $100 million valuation difference between assets and liabilities. Some actuaries believe that this valuation difference reflects the true economic performance of the entity and thus is appropriate to include in net income, while others believe it obscures the operating performance of the entity and thus is better included in OCI. We note, however, that even if assets and liabilities are perfectly matched on an economic basis, to the extent that valuation differences between assets and liabilities (such as discount rate) are required due to accounting rules, those valuation differences themselves would cause artificial duration mismatches on an accounting basis that would create such valuation impacts.

Question 15

Do you believe that either of the possible variants of the alternative approach provides more decision-useful information than the alternative approach and the approach proposed in the exposure draft? If so, which variant and why?

See response to question 14.

Thank you again for the opportunity to provide input.

Sincerely,

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