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

Ms. Leslie F. Seidman, Acting Chair
Financial Accounting Standards Board
401 Merrit 7
Norwalk, CT 06856-5116

Re: Discount rate-Insurance Contracts Exposure Draft (ED) - Question #3 & Preliminary Views on Insurance Contracts (DP) - Question #12

Dear Sir David Tweedie and Ms. Leslie Seidman:

The American Council of Life Insurers (ACLI)¹ welcomes the opportunity to provide comments on the topic of discount rate as described in the IASB Insurance Contracts Exposure Draft (ED), and FASB Preliminary Views on Insurance Contracts (DP).

We acknowledge the difficulty in developing a global standard for discounting. In part this is due to the fact that regulatory, tax, accounting, and even cultural differences have produced different business models and business strategies in different jurisdictions. At the same time, we understand the desire to provide comparability and consistency for the benefit of financial statement users around the globe. To that end, we acknowledge the desirability of using objective market inputs to the greatest extent possible.

However, we are concerned that the proposed discounting standard, which requires most insurance liabilities to be discounted at a risk-free rate with an adjustment for illiquidity, may not lead to comparability and consistency between users. Moreover, many of our members are concerned that the discounting guidance could inappropriately drive changes to their business strategies because the discount rate may produce at-issue losses when they reasonably anticipate profits. As a result, we believe that more latitude should be allowed in the choice of discount rates, with full disclosure provided for the benefit of users.

Our members' concerns about limiting the choice of discounting to risk free rates with an adjustment for illiquidity are as follows:

- **Income statement volatility.** The ED proposed "current value" model for measuring insurance contract liabilities may cause insurers to hold the assets backing those liabilities at fair value for matching purposes. Nevertheless, volatility would result because period-to-period changes in credit spreads would impact the fair value of assets but not the measurement of insurance liabilities. This is likely to produce significant fluctuations in reported income. Because life insurance is typically a long-term business, it is difficult to see how these fluctuations provide relevant and meaningful information to users. Having

¹ The American Council of Life Insurers represents more than 300 legal reserve life insurer and fraternal benefit society member companies operating in the United States. These member companies represent over 90% of the assets and premiums of the U.S life insurance and annuity industry.

said that, we do not support the inclusion of own credit in the liability measurement due to the counterintuitive effects produced by changes in the insurer's credit standing.

- **Uncertainty about how the illiquidity adjustment is to be determined.** While it seems plausible for the valuation of insurance obligations to reflect liquidity considerations, very difficult questions exist as to exactly what liquidity means in the context of insurance liabilities. Since the effects of liquidity in asset prices are not directly observable, setting a global standard for measuring illiquidity will require balancing the arbitrariness of a single defined rule versus an adjustment for illiquidity that would necessitate the use of entity specific assumptions and rationales. While we have no objection to using such assumptions, different entities will come to different conclusions about the illiquidity adjustment. This may or may not, from the Boards' point of view, result in a lack of comparability between reporting entities. Either method for calculating a liquidity premium runs the risk that the method used is an imperfect faithful representation of the economics of the business.
- **Inconsistency with pricing models.** Many of our members price and sell insurance products on what might be characterized as a "long term expectations" basis. These pricing models include hypothetical assets consistent with those that would be purchased to back the liability. The hypothetical asset returns are adjusted to reflect the impact of expected credit losses. The pricing generally reflects the expected outcomes, with risk reflected by typically requiring an expected rate of return that is above the risk-free rate. Our members believe that users of financial statements will find it misleading to report an accounting loss at-issue when the product is expected to be profitable on a long-term basis.
- **Accounting-driven disruption to the insurance marketplace.** Current U.S. GAAP accounting for traditional long-duration insurance contracts provides for the estimation of liabilities using, among other factors, "expected investment yields." An investment yield is defined as "The interest rate the entity expects to earn on the assets supporting policies, net of investment expense." Consequently, a shift to a risk-free rate adjusted for illiquidity as the sole discount method applied to a significant portion of the insurance business would materially change the recognition of profit on certain products that are important to the U.S. insurance-buying public, such as fixed annuities, long-term care, and life-contingent payout annuities. More specifically, our members believe that insurers may be compelled to raise prices or cease selling such products in order to avoid an accounting loss at-issue. The impact of these events would be an increased burden on the public sector to provide the financial security generated by these products

In reviewing other IFRS literature, we noted that there are notable differences in the discount rates applied. While there are similarities in the IAS 16 (Property, Plant & Equipment) and IAS 37 (Liabilities) guidance, the guidance in IAS 16 and IAS 37 is different when compared to the proposed guidance for Leases and Revenue Recognition. We believe that the Board recognizes the importance of tailoring the discount rate to reflect specific circumstances. Therefore, we have concluded that the insurance contracts accounting standard should contain a principle for the discount rate without specifying a specific method.

As a result, ACLI recommends the following:

- The overarching principle for the discount rate is that the rate should be consistent with the insurer's business strategy, including its pricing and approach for managing the assets and liabilities.

- The principle should be augmented with supplemental guidance describing how the reporting entity could satisfy the principle without prescribing a single method. For example, the guidance could describe a range or examples of methods that satisfies the principle. Methods that we think accomplish this objective include:
 - Asset earned rate less expected defaults
 - A benchmark rate
 - Risk-free rate with an adjustment for illiquidity
 - Risk-free rate
- The standard should continue to disallow the inclusion of the effects of own credit in the measurement.
- The standard should require robust disclosure about the discount rate(s) used and sensitivity analysis regarding the financial impact of changes in the rate. The disclosures should include the effects of changes in the composition of the asset portfolio, if an asset-based discount rate is used as well as the level of exposures to various market risks.

Conclusion

For long-term business, such as life insurance, the discount rate is a critical element of the accounting framework. We do not believe that a principle-based accounting standard should place arbitrary limits on the selection of the discount rate other than to require consistency with the insurer's business model, and we believe that concerns about comparability are best addressed through disclosure.

The Appendix, which follows, contains our responses to the relevant questions asked in the ED and DP about the discount rate. We appreciate the opportunity to provide comments and look forward to continuing to work with you to produce a high quality accounting standard for insurance contracts.

Sincerely,



cc: Warren McGregor, IASB Board member
Marc Siegel, FASB Board member
Peter Clark, IASB staff
Jennifer Weiner, FASB staff

Appendix-ACLI response to discount rate questions

IASB Question 3 – Discount rate (paragraphs 30–34 and BC88–BC104)

(a) Do you agree that the discount rate used by the insurer for non-participating contracts should reflect the characteristics of the insurance contract liability and not those of the assets backing that liability? Why or why not?

(b) Do you agree with the proposal to consider the effect of liquidity, and with the guidance on liquidity (see paragraphs 30(a), 31 and 34)? Why or why not?

(c) Some have expressed concerns that the proposed discount rate may misrepresent the economic substance of some long-duration insurance contracts. Are those concerns valid? Why or why not?

If they are valid, what approach do you suggest and why?

For example, should the Board reconsider its conclusion that the present value of the fulfilment cash flows should not reflect the risk of non-performance by the insurer?

ACLI Response:

- (a) We believe that the overarching principle for the discount rate should be consistency with the insurer's business strategy, including its pricing and approach for matching assets and liabilities. As a result, we do not agree that the measurement should necessarily exclude taking into account the assets backing the liabilities. Many insurers issuing long-duration contracts, such as life, disability and long-term care insurance take into account the expectations about investment performance in pricing the products, and we believe that the reporting standard for discounting should not create dissonance with pricing.
- (b) No, we do not support the proposed guidance on liquidity in its present form. While it seems plausible for the valuation of insurance obligations to reflect liquidity considerations, very difficult questions exist as to exactly what liquidity means in the context of insurance liabilities. Moreover, the effects of liquidity in asset prices are not directly observable, not to mention how such effects should apply to liabilities. For this and other reasons as noted earlier in this letter, a risk-free rate adjusted for illiquidity should not be prescribed as the sole discounting method.
- (c) Yes, the majority of our members believe that the proposed discount rate misrepresents the economic substance for certain long-duration contracts because the proposed rate would be inconsistent with their strategy to price and manage such products. Many insurers price and sell insurance products on what might be characterized as a "long term expectations" basis. They employ asset-liability pricing models that include hypothetical assets that would be consistent with those that would be purchased to back the liability. The pricing generally reflects the expected outcomes, with risk reflected by typically requiring an expected rate of return that is different than the risk-free rate. The proposed guidance has the potential of causing volatility in results because period-to-period changes in credit spreads would impact the fair value of assets but not the measurement of insurance liabilities. Such volatility would not be faithful representation of the entity's performance. In addition, most of our members believe that it is misleading to report accounting losses at-issue when the product is expected to be profitable on a long-term basis.

FASB Question 12 – Discount rate

- (a) Do you agree that the carrying amount of all insurance contracts should be discounted if the effect is material?
- (b) Do you agree with the proposed guidance on the discount rate that should be used to measure the carrying amount of insurance contracts? If not, which discount rate should be used?

ACLI Response:

- (a) Yes, we believe that a discount rate should be applied to the expected cash flows for long-duration contracts at each reporting period. However, we do not support the risk-free rate adjusted for illiquidity as the sole discount method nor should the risk-free rate be implied as the only rate representing the "time value of money" for measuring insurance contract liabilities.
- (b) See the ACLI response to IASB question #3 above.