



**ASSOCIATION ACTUARIELLE INTERNATIONALE
INTERNATIONAL ACTUARIAL ASSOCIATION**

May 4, 2007

Mr. Jon Nelson
International Accounting Standards Board
30 Cannon Street
London, EC4M 6XH
United Kingdom

Dear Mr. Nelson,

Re: IAA comments on *Fair Value Measurements*

In response to the request for comments on the Discussion Paper *Fair Value Measurements*, I am pleased to transmit on behalf of the International Actuarial Association (IAA) our comments and recommendations.

These comments have been prepared by a task force of the Committee on Insurance Accounting of the IAA. If, upon reading these comments, you identify any points that you wish to pursue, please do not hesitate to contact the chairperson of that Committee, Sam Gutterman, or any of the other members of the Committee. The IAA will be pleased to develop these ideas further with you. In particular, we wish to participate in round-table meetings on the discussion paper.

Yours sincerely,

Yves Guérard
Secretary General

Attachment: IAA comments

**A Commentary on the
DISCUSSION PAPER ON FAIR VALUE MEASUREMENTS
Released by the International Accounting Standards Board: November 2006**

INTERNATIONAL ACTUARIAL ASSOCIATION

The International Actuarial Association (the “IAA”) represents the international actuarial profession. Our fifty-six full member actuarial associations represent more than 95% of all actuaries practicing around the world and are listed in an Appendix to these comments. The IAA promotes high standards of actuarial professionalism across the globe and serves as the voice of the actuarial profession when dealing with other international bodies on matters falling within or likely to have an impact on the areas of expertise of actuaries. The IAA appreciates the opportunity to provide comments on this IASB discussion paper.

These comments have been prepared by a task force of the Committee on Insurance Accounting. Our comments are written from the perspective of actuaries involved in financial reporting for insurers around the world, with an emphasis on measurement of insurance liabilities and reinsurance assets. Statements in this letter with respect to industry practices reflect the collective experience of the actuaries who participated in the preparation of this comment letter, which we believe represents an accurate and fairly comprehensive view of the insurance industry globally. The members of the task force and committee are listed in an Appendix to this statement. It has also been subject to the due process required for it to constitute a formal view of the IAA, and will be posted to the IAA’s official web site.

GENERAL COMMENTS

Support for a standard on fair value measurement

We support the issuance of general guidance on fair value measurements. It will provide guidance in one place and should facilitate compliance. It should facilitate the use of more consistent measurement across financial instruments and other assets and liabilities when a fair value measure is required.

While we support adoption of a standard for fair value measurements that is generally consistent with SFAS 157, we also believe that a standard on fair value measurements should place emphasis on the measurement objective that is appropriate for the specific assets and liabilities that are subject to a fair value measure. We believe that the measurement objective may not always be achieved by use of an exit value; hence, we believe that a standard on fair value measurement should not be limited to an exit value approach. We note that for insurance contracts any transfer notion will reflect the settlement of contracts over time.

With some reservations, we find the guidance in SFAS 157 is superior to the measurement guidance currently included in IAS 39 for reasons that we give in our response to Q2. We find SFAS 157 to be more principles based, but we regret the loss of some of the robustness in IAS 39. In particular, we are concerned that SFAS 157 does not adequately address situations when

fair value estimates depend on unobservable inputs and does not provide any guidance for situations where fair value measurement is not reliable. We expand on these points in our responses to the questions raised in the Discussion Paper.

Current applications of fair value measurement by insurers

A significant amount of our experience relates to the financial reporting of insurance contracts and investment contracts issued by insurers. Current application of fair value measurement to insurance contracts includes business combinations and portfolio transfers. Other applications include derivatives embedded in insurance contracts that must be separated and measured at fair value through profit and loss under guidance found in IFRS 4. In addition, application of fair value may become pervasive if the Board decides that the measurement objective of insurance liabilities should be fair value. Even if the anticipated insurance standard is not a fair value measurement, the Board's decisions with regard to fair-value measurements may have significant implications for the insurance contracts standard, as the Board has already tentatively decided on a current exit-value measure, which will likely share many attributes with a fair value measurement.

Investment contracts are a significant part of many insurers' portfolios and are often measured at fair value through profit and loss. The effect of adopting a fair value measurement standard like SFAS 157 on many unit-linked contracts will be especially important to insurers. We believe that ultimately the measurement of the liability of insurance contracts and investment contracts should be similar, if not identical. For example, we believe that it is inappropriate to impose a requirement for a demand deposit floor (corresponding to a cash value floor in insurance contracts) -- we do not believe that this constraint is consistent with observable market prices and should not be imposed for either investment or insurance contracts.

Relationship to Phase II of the IASB's Insurance Contracts Project and to the improvements to its Conceptual Framework

The Board has stated that its insurance contract standard must be consistent with principles underlying other standards. The measurement of financial instruments at fair value is likely to be an important standard with which consistency must be achieved. We recommend that the Board not make final decisions on accounting for insurance contracts until it has concluded its project on fair value measurements, or at least confirm that the underlying principles involved are consistent.

SFAS 157 emphasizes that a fair value is a market-based measurement and not an entity-specific measurement. This emphasis is a significant commitment to the concept of market-based measures, perhaps presaging the direction of the Board in its project on improving the IASB's Conceptual Framework. The Board should consider deferring the final adoption of a standard on fair value measurements until it has substantively completed the measurement topic of its project to improve the Conceptual Framework and it has affirmed the commitment to market-based measurement.

In-use value of liabilities

We find merit in the concept of in-use value as it is provided for in SFAS 157. However, in SFAS 157 the in-use valuation premise relates only to assets. We believe that application of the

premise should be considered for the measurement of liabilities. We expand on this point in our response to Question 17.

Consistency of measurement of assets and liabilities

The application of a fair-value measurement is significant to entities within the financial service industry, including insurers, not only as it relates to insurance contracts, but also because many insurer investments are measured at fair value. The consistency of measurement of assets and liabilities has long been a concern of actuaries because of the spurious profits and losses that sometimes occur if assets and liabilities are measured in an inconsistent manner. As noted, even if a fair-value measurement is not adopted for insurance contracts, we believe that the adopted measurement is likely to have dynamics similar to fair-value measurement so that changes in economic and operating environments will need to have consistent effects on their measurement.

Disclosure

Disclosures are an important part of any standard. We believe that some of the disclosures now required of insurers may have applicability to any level 3 measurement. We expand on this point in our response to Question 24.

Please note that although in certain places in this commentary we are not commenting on the appropriateness of the use of fair values for the financial reporting of insurance contracts, some of our responses to the issues raised in this Discussion Paper have been presented as if they were applicable to insurance contracts. In many cases, these comments are also applicable to other financial items whose values cannot be directly determined using observable market prices. The IAA will give its view on the direction of the Board in the Insurance Project in its comment letter responding to the IASB's Discussion Paper on Insurance Contracts.

RESPONSES TO QUESTIONS

Issue 1. SFAS 157 and fair value measurement guidance in current IFRSs

Q1. In your view, would a single source of guidance for all fair value measurements in IFRSs both reduce complexity and improve consistency in measuring fair value? Why or why not?

We support the issuance of general guidance on fair value measurements. It will provide guidance in one place and facilitate the use of more consistent measurement across financial instruments and other assets and liabilities when a fair value measure is required.

While we support a principles based approach to the general guidance on fair value measurements, we are skeptical that a single standard can provide complete guidance for all applications of fair-value measurement. We expect that when a fair-value measurement is prescribed, there may be a need for more focused principles-based guidance relevant to those

applications. To attempt to provide comprehensive guidance in one standard to fit all applications may not be practical and would necessarily increase its complexity.

At the same time, it would be helpful if the Board would expand guidance on fair value measurements when there are not observable inputs. Does the reference to principal markets extend to pricing techniques as well as to inputs? That is, is the calculated fair value based on common practices in the principal markets? It is common to use the present value of **probability** weighted cash flows plus a margin for risk as a model when the fair value is measured on a mark-to-model basis. Can such a model be presumed to be market consistent or must there be some validation or calibration of the model or its results?

Q2. Is there fair value measurement guidance in IFRSs that you believe is preferable to the provisions of SFAS 157? If so, please explain.

At present there is no fair value guidance in IFRS that is specifically applicable to insurance contracts. Although insurance contracts are not in the scope of IAS 39, most insurance contracts have characteristics that are similar to those of certain financial instruments. IAS 39 is the standard that is most often referred to when fair value concepts are discussed in the context of insurance. It is our observation that entities currently measure the fair value of insurance contracts acquired through business combinations by using calculations that are consistent with the methods used in pricing the transactions. As we read it, SFAS 157 in effect calls for the use of valuation techniques commonly used by market participants. Hence, we believe that the general intent of SFAS 157 is to codify established practices, although certain guidance in SFAS 157, such as the requirement to consider non-performance risk in the measurement of liabilities, may create conflicts with existing practices.

We believe that it is inevitable that, for some assets and liabilities when measured consistent with a fair value objective, certain variables will be based on management's estimates of the market view rather than on observable prices. SFAS 157 more clearly acknowledges that variables can be based on management's estimates of the market-consistent assumptions.

However, certain requirements of IAS 39 are ambiguous, because it refers to techniques commonly used by market participants, while it also refers to pricing techniques that are consistent with accepted economic methodologies. The latter phrase is usually interpreted as a reference to pricing techniques used for pricing financial instruments in liquid observable markets, which is often referred to as "option pricing". Portfolios of insurance contracts are priced by approaches that sometimes use option pricing techniques, but which also often differ from option pricing. IAS 39 fails to distinguish practices commonly used by market participants in specific sectors from those described in financial economics.

While we generally prefer the more principled approach found in SFAS 157 as compared to that found in certain areas in IAS 39, there are topics related to fair value measurement for which we would like to see more robust principles-based guidance. For example, we would like the standard to clarify whether it is appropriate for a gain to be recognized at issue.

Issue 2A. Exit Price Measurement Objective

Q3 Do you agree that fair value should be defined as an exit price from the perspective of a market participant that holds the asset or owes the liability? Why or why not?

From the perspective of users of financial statements, this may be the most intuitive definition. However, we recall the term “fair value” was originally introduced to encompass the measurement of assets and liabilities for which a “market-value” could not be readily determined. We believe that if a fair value measurement standard is to have broad application, the term fair value should be broadly construed in a corresponding manner. When adopting a basis for measurement of a class of assets or liabilities, the Board should determine the measurement objective, which may be exit value, entry value or value in use. Any of these can be seen to be a fair value and hence the definition of fair value should not be limited to exit value. Rather, the standard should provide guidance on fair value measurement under any of these objectives.

For many liabilities, including those for most insurance contracts, transfers are unusual. A current measure of the value to settle contracts over time, may be more representative of the economics of an actual disposition of these obligations. It would be preferable if the possibility of a value to settle contracts over time were not precluded from application as a fair value.

Q4 Do you believe an entry price also reflects current market-based expectations of flows of economic benefit into or out of the entity? Why or why not? Additionally, do you agree with the view that, excluding transaction costs, entry and exit prices will differ only when they occur in different markets? Please provide a basis for your views.

As the term has been used in the Insurance Contracts project, current entry-value is not completely market-based, as the margin (or price for risk) per unit would be fixed at the time of contract inception. Hence, remaining margins on contracts issued in accounting periods prior to the current period may not reflect current market-based margins. For insurance contracts, current entry value and current exit value would differ not only with respect to differing markets but also with respect to the measurement date. After inception they would only coincidentally be the same. It is important to distinguish the definition in SFAS 157 from the usage of the term in the Insurance Contracts project. The Board should consider changing the terminology in the Insurance Contracts project to avoid confusion with the concept of entry value in fair-value measurement.

Entry price is defined in SFAS 157 as the amount received to assume obligations in an orderly transaction. We believe that entry value by this definition can reflect current market-based expectations of economic benefits at the time that the obligation is assumed. However, it is not representative of market-based flows of economic benefits at subsequent measurement dates if it depends on parameters determined by reference to a transaction price.

The standard should not presume that the entry price and the exit price are the same in all markets at all times. There may be situations where some market participants are not as well informed as others; these situations may give rise to opportunities for arbitrage. We agree that

the difference in price between an entry value and an exit value can be associated with the ability to transact in different markets. Such access may in fact represent an intangible asset that should be considered separately for recognition and measurement.

Q5 Would it be advisable to eliminate the term ‘fair value’ and replace it with terms, such as ‘current exit price’ or ‘current entry price’, that more closely reflect the measurement objective for each situation? Please provide a basis for your views.

We believe that the use of a more descriptive term than fair value would be more appropriate as a caption in financial statements, although the term fair value may remain useful in a fair value measurements standard in reference to a family of measures. We agree with the requirement in SFAS 157 to disclose on the face of the financial statements the level of the fair value hierarchy in which the assets and liabilities fall. We also believe that the concepts underlying the measurement should be more completely described in the accounting policy notes.

Q6 Does the exit price measurement objective in SFAS 157 differs from fair value measurements in IFRSs as applied in practice? If so, which fair value measurements in IFRSs differ from the measurement objective in SFAS 157? In those circumstances, is the measurement objective as applied in practice an entry price? If not, what is the measurement objective applied in practice? Please provide a basis for your views.

The use of fair value for insurance contracts is currently most commonly applicable for business combinations when the fair value of liabilities must be determined at the acquisition date. Many investment contracts, especially unit-linked contracts, are measured at fair value through profit and loss.

In a business combination, fair value measurement is used to allocate the purchase price to assets and liabilities acquired. The value attributed to insurance contracts most often corresponds to the value that the acquiring entity placed on the contracts in the price negotiations. Absent specific information to the contrary, the presumption is likely to be that the price paid provides the most relevant information and that an exit price would not differ materially from the valuation the insurer placed on the portfolio as part of the price determination.

Unit-linked contracts are commonly measured at the fair value of its units, which is generally the bid price of the corresponding assets. This can be considered to be an exit price.

Issue 2B. Market participant view

Q7. Do you agree with how the market participant view is articulated in SFAS 157? Why or why not?

While we generally agree that a fair-value measurement should reflect the assumptions that would be made by market participants, we believe the reference to knowledge that would be obtained through due diligence needs clarification. "Due diligence" commonly refers to a process associated with a possible transaction which involves obtaining unpublished information and in

some instances can not be made public. In contrast, when prices are observed, they are arguably prices of willing buyers determined without the benefit of due diligence. We suggest that the Board should clarify whether it intends that the presumed level of knowledge is greater when there are level 2 or level 3 inputs than when prices are observed.

Q8. Do you agree that the market participant view in SFAS 157 is consistent with the concepts of ‘knowledgeable, willing parties’ and ‘arm’s length transaction’ as defined in IFRSs? If not, how do you believe they differ?

While we find the views to be generally consistent, the area of emphasis is important. The reference to a market view seems to imply that there is a crystallized view among participants in a particular market regarding the prices of assets and obligations. In transactions involving insurance contracts there is rarely such a view and a market view represents the estimate underlying the pricing basis that would result in an agreement between a buyer and a seller. The reference to “knowledgeable willing parties” is a clearer description of a market price, especially when prices are not observable. The task for management when attempting to estimate fair value is to answer the question:

“if there was a motivated seller of a portfolio like mine, at what price would there be a buyer willing to take on the obligation?”

The reference then is to the consideration of market participants rather than to general market conditions. As indicated in paragraph 11 of SFAS 157,

“... the reporting entity should identify characteristics that distinguish market participants generally, considering factors specific to market participants with whom the reporting entity would transact in that market.”

It should also be noted that a market participant’s view is shaped not only by perceptions of transactions among market participants, but from other inputs as well. Some inputs to the measurement of the liability for insurance contracts may be based on observable prices of instruments that are not insurance and that are traded in other markets. We note that, although there may not be observable market prices for insurance liabilities, these can be valued by use of inputs based in part or in whole on other observable market prices, with the remaining items (mostly the risk margins) modeled.

Other examples include the value of financial guarantees embedded in insurance contracts.

Issue 2C. Transfer versus settlement of a liability

Q9 Do you agree that the fair value of a liability should be based on the price that would be paid to transfer the liability to a market participant? Why or why not?

For insurance contracts, transfers of liabilities relate to portfolios of contracts. A transfer price is generally based on the expected settlement of these contracts over time. The price is most often based on the assumption that the entity that takes over the rights and obligations of the contracts will settle them over time as anticipated in the contracts, rather than by means of an attempt to

settle the contracts immediately for a commuted value or to transfer them again in a subsequent transaction. The difference between the value arising from an immediate settlement and the value in a transfer is that:

- the reference to settlement in IFRS is to a current, immediate settlement, not to payment in due course (settlement over time), and
- the relative efficiency in settlement of a third party as compared to the reporting entity.

It is impractical to determine the current, immediate settlement value of certain assets and liabilities, including the liability for insurance contracts. In addition, their current settlement value is of no particular relevance to the reporting entity or to users of financial statements. We agree that the value in transfer is a better measure of fair value, although we believe the value in transfer reflects the expectation that obligations will be settled in due course. We believe this observation is also likely to be as applicable to the measurement of a transfer value for most financial instruments as it is a general requirement that the party acquiring the instruments must be licensed to transact the business.

Q10 Does the transfer measurement objective for liabilities in SFAS 157 differ from fair value measurements required by IFRSs as applied in practice? If so, in practice which fair value measurements under IFRSs differ from the transfer measurement objective in SFAS 157 and how do they differ?

As we have noted, the most common use of fair value for insurance contracts occurs when an insurer accounts for a business combination or for a portfolio transfer. Absent specific guidance, insurers have commonly applied techniques used in the pricing of the transaction. Currently practice varies among companies with respect to determining fair value in these situations. In addition, some companies use the two-part presentation permitted by IFRS 4. While we cannot make a general statement about how the requirements of SFAS 157 differ from current practices, we believe the difference could be significant for some insurers.

Unit-linked investment contracts are measured at the fair value of their linked assets, which corresponds to a transfer value. We believe that there would be little difference in application for these contracts.

Issue 3. Transaction price and fair value at initial recognition

Q11 In your view is it appropriate to use a measurement that includes inputs that are not observable in a market as fair value at initial recognition, even if this measurement differs from the transaction price? Alternatively, in your view, in the absence of a fair value measurement based solely on observable market inputs, should the transaction price be presumed to be fair value at initial recognition, thereby potentially resulting in the deferral of day-one gains and losses? Please give reasons for your views.

We have already stated that we believe that an entry value is not a presumptive fair value, because entry and exit values for insurance contracts represent transactions in different markets.

At the time that the sale of an asset or the transfer of a liability represents evidence of a transaction between market participants. A gain or loss indicates that the transaction occurs in a different market from the market in which a subsequent transaction would occur or in a market in which market imperfections exist. We believe that a standard should neither presume that the transaction price is the exit price nor to treat it as a rebuttable presumption. The reporting entity should be able to make the case that the transaction value is the acquirer's exit value or to justify that an exit value would be at a different price. Therefore, the use of the transaction price as exit value may be reasonable, but its use should be capable of being justified. Likewise, the use of a value other than the transaction price also needs to be supportable. Losses on acquiring an asset or taking on a liability should be uncommon, as a loss would indicate a willingness to enter into a transaction to the detriment of shareholders.

We note that in a business combination when an allocation of a purchase price is needed, there is no transaction price with which to calibrate individual assets and liabilities. In this case observable inputs can be used to the extent available with the remaining items modeled. In this case, the fair value of individual assets or liabilities just determines the future pattern of profit recognition, without any resultant profit or loss on the transaction date. Nevertheless, we also believe that the basis for subsequent measurement should be consistent with that of the initial measurement.

Q12 Do you believe that the provisions of SFAS 157, considered in conjunction with the unit of account guidance in IAS 39, would result in a portfolio-based valuation of identifiable risks of instruments considered in aggregate, or an in-exchange exit price for the individual instruments? Please give reasons for your views.

SFAS 157 refers to other standards for determining the unit of account. As insurance contracts are not in the scope of IAS 39 (and, for that matter, not currently addressed elsewhere), the effect of SFAS 157 on them may be uncertain. However, we believe that a probability based approach should be applied to some types of financial instruments, for example, consumer loans and insurance contracts, that are managed on the basis of a pooling concept to have a portfolio of contracts that contains similar risks as the unit of account. Without specific guidance for insurance contracts, the unit of account is not certain. We believe that either the standard on fair value measurements or the standard that indicates under what conditions or circumstances fair value should be used, such as the one addressing the financial reporting of insurance contracts, should clarify the unit of account to be used. As mentioned, we believe that the proper unit of account for insurance contracts is a portfolio of contracts, which in fact captures the probability concept inherent in insurance business.

Issue 4. Principal (or most advantageous) market

Q13 Do you agree that a fair value measurement should be based on the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability? Why or why not?

We agree with the guidance provided. However, we are concerned that, in the case of insurance contracts, the market provides little relevant information from which to base measurement. We suggest that the Board expand on how it believes a fair value measurement can be made in such a circumstance.

We note again that inputs to the measurement of insurance contracts may come from prices observed in markets that are not the principal market for insurance contracts. We do not believe that this invalidates the concept of a principal market, but rather is a reflection of practice within the principal market. It would be preferable that the standard would acknowledge this point.

Issue 5. Attributes specific to the asset or liability

Q14 Do you agree that a fair value measurement should consider attributes specific to the asset or liability that market participants would consider in pricing the asset or liability? If not, why?

We find it axiomatic that a measure that takes a market view would consider attributes specific to the asset or liability. For insurance contracts, such a consideration might be, for example, the relative amount of litigation related to insurance claims in various locations in which contracts are issued or the risk characteristics of the portfolio that would affect future mortality or morbidity of the portfolio as underwritten by an insurer.

Q15 Do you agree that transaction costs that would be incurred in a transaction to sell an asset or transfer a liability are an attribute of the transaction and not of the asset or liability? If not, why?

Insurance contracts sold in retail markets generally have high acquisition costs, either reflective of commissions or direct marketing costs. These costs are an attribute of these contracts rather than of the transaction. Thus they should be considered in a fair value measurement. In particular, any relevant future commissions should be also considered in the measurement of the liability of the insurance contracts.

In contrast, on a transfer of a portfolio there are often costs of brokers and others involved in the completion of the transfer. These costs are not an attribute of the contracts involved and should not be considered in the measurement of insurance liabilities.

There are usually other costs associated with a transfer of a portfolio of insurance contracts as well. For example, there may be significant costs associated with converting the acquired contracts to the acquirer's administrative systems. The Board should clarify whether it believes, as we do, that these costs are similar to transportation costs in the case of assets, and as a result represent an attribute of the liability and not of the transaction. We note that, in some markets, conversion costs associated with a transaction can be quite large, which would indicate that the use of the value to maintain and settle the contracts over time rather than its transfer value may be appropriate.

Issue 6. Valuation of liabilities

Q16 Do you agree that the risk of non-performance, including credit risk, should be considered in measuring the fair value of a liability? If not, why?

We believe that it is not axiomatic that the measurement of a liability reflects nonperformance risk (or credit standing). In a fair-value measure, market phenomenon should determine the extent to which these factors are reflected. In a transfer of insurance contracts there is generally no explicit variable for nonperformance risk.

Non-performance risk may affect measurement to the extent that credit standing affects variables such as voluntary lapse rates, although it is generally impracticable to isolate and quantify the effects on variables of a change in credit standing. Further, its effect, if any, may not be evident in the period in which credit standing changes occur, but may become apparent only over several accounting periods. Also, to the extent that risk margins reflect the cost of capital which may be affected by credit standing, it may also have an indirect influence on the measurement of the liabilities.

We recommend that the Board not impose a requirement that nonperformance risk or credit standing be reflected in the measurement of liabilities, but rather state that the measurement should follow market pricing and that the effects, if any, should be reflected in the same or similar manner in which they influence prices. As the effects may not be able to be quantified, the Board should not require disclosure of the effects on the measurement of liabilities from a change in credit standing, except when credit standing is represented by an explicit variable.

Issue 7. 'In-use valuation premise' versus 'value in use'

Q17 Is it clear that the 'in-use valuation premise' used to measure the fair value of an asset in SFAS 157 is different from 'value in use' in IAS 36? Why or why not?

While it is clear, we think it is unfortunate that the terms "in-use value" and "value in use" have different meanings. The one is an approach to fair value while the other is an alternative to exit value, and indeed is the one that the Board may wish to consider for measuring liabilities for insurance contracts. We hope that the Board can identify better terminology to avoid the confusion that undoubtedly will result if these different concepts have such similar names.

We wonder whether the in-use valuation premise can also be applied to liabilities. We suggest that the Board discuss whether the in-use valuation premise has applicability to the liability for insurance contracts and to other liabilities.

Issue 8. Fair value hierarchy

Q18 Do you agree with the hierarchy in SFAS 157? If not, why?

In general, we agree with the hierarchy in SFAS 157, although we believe that a level 3 input based on management's estimates of the market view of unobservable inputs may sometimes be impractical. However, before requiring fair value measurement, the Board should consider whether the guidance in SFAS 157 is suitable in this case. In addition to fair value being the preferred measurement objective, the Board must be able to conclude that the guidance provided is sufficiently robust and that there is adequate market evidence from which management can base estimates on unobservable inputs. In particular, we believe that the Board needs to be comfortable that these questions can be answered affirmatively before requiring a fair value measurement objective for insurance contracts.

At the same time, the Board should not confuse uncertainty in cash flows with reliability. Uncertainty is a characteristic of many assets and liabilities and is reflected in applicable risk margins.

Q19 Are the differences between the levels of the hierarchy clear? If not, what additional information would be helpful in clarifying the differences between the levels?

A bright line between the levels two and three does not normally exist, and we doubt that it is feasible to provide sufficient guidance to create such a bright line. The difference is a matter of how sensitive the measurement is to inferred or estimated inputs. Some additional application guidance in this area would be helpful, but it is not realistic to expect to be able to eliminate the need to use judgment in deciding if a measure is level two or level three.

Issue 9. Large positions of a single financial instrument (blocks)

Q20 Do you agree with the provision of SFAS 157 that a blockage adjustment should be prohibited for financial instruments when there is a price for the financial instrument in an active market (Level 1)? In addition, do you agree that this provision should apply as a principle to all levels of the hierarchy? Please provide a basis for your views.

Regardless of the level hierarchy, this issue relates to the choice of the unit of account. As we believe that insurance contracts should be measured as a portfolio of similar risks, the effects of a transfer of a portfolio rather than the price of individual contracts will be naturally reflected. If the Board prohibits, in whole or in part the use of a blockage adjustment, it should clarify that the prohibition does not apply when the unit of account is a portfolio. The Board may wish to prohibit reflecting the effect on fair value measurement of selling combinations of portfolios.

Issue 10. Measuring fair value within the bid-ask spread

Q21 Do you agree that fair value measurements should be determined using the price within the bid-ask spread that is most representative of fair value in the circumstances, as

prescribed by paragraph 31 of SFAS 157? Alternatively, do you believe that the guidance contained in IFRSs, which generally requires assets to be valued at the bid price and liabilities at the ask price, is more appropriate? Please explain the basis for your view.

We agree that fair value measurements should be determined using the price within the bid-ask spread that is most representative of fair value in the circumstances, as prescribed by paragraph 31 of SFAS 157. The area of greatest interest to us is insurance contracts whose liability value is linked to the value of an asset or portfolio of assets. When there is a direct linkage, the measures should be consistent. Direct linkage occurs when there is no possibility that the insurer will have profit or loss, apart from the effect of any fees expressed as a percentage of asset value, from a change in the market value of the investments because the changes and all associated risks are borne by policyholders. This concept has been referred to as the “no leakage” concept. When there is no leakage, the measurement of liabilities should be consistent with the measurement of the backing assets, at the price that is most representative of fair value in the circumstances.

Q22 Should a pricing convention (such as mid-market pricing or bid price for assets and ask price for liabilities) be allowed even when another price within the bid-ask spread might be more representative of fair value? Why or why not?

Yes, for the reasons given in our response to Q21.

Q23 Should bid-ask pricing guidance apply to all levels of the hierarchy, including when the fair value measurement includes unobservable inputs? Why or why not?

Yes, although we note that the standard should not imply that there is always a bid-ask spread and that the difference between an entry value and an exit value is not always explained by a bid-offer spread.

Issue 11. Disclosures

Q24 Do the disclosure requirements of SFAS 157 provide sufficient information? If not, what additional disclosures do you believe would be helpful to users and why? Alternatively, are there disclosures required by SFAS 157 that you believe are excessive or not beneficial when considered in conjunction with other disclosures required by IFRSs? Please provide a basis for your view.

We believe that the disclosure of fair value measures would benefit by including information similar to that now required or suggested for insurance contracts in IFRS 4. Specifically, for level 3 measures, disclosures should include a discussion of the basis for the estimates of unobservable inputs and the sensitivities to these inputs. The disclosures should include information that would enable users to relate changes in the unobservable inputs to changes in market conditions. This would be aided by disclosure of the nature of the evidence that the entity uses when deriving its estimates of unobservable inputs, providing summary quantitative information when practical.

Issue 12. Application guidance

Q25 Does the guidance in Appendices A and B of SFAS 157 sufficiently illustrate the standard's principles and provisions as they would apply under IFRSs? If not, please specify what additional guidance you believe is needed and why.

The guidance provided is helpful, but it is unrealistic for the standard to anticipate all of the application issues that will arise. We believe that, even if the IASB were to adopt a fair-value objective for measuring insurance liabilities, there would need to be specific guidance beyond that provided in SFAS 157 for applying the standard to insurance contracts, for example, for participating features.

We believe the guidance needs to be expanded or clarified in some specific regards, including:

- Paragraph B2(c) states that the time value of money is represented by risk free rates and goes on to stipulate that in the United States the yield curve for U.S. Treasury securities determines risk-free interest rates. This view seems inconsistent with the view expressed by the Board in its tentative conclusions with respect to insurance contracts, which is that discount rates are to be consistent with observable market prices for matching cash flows, adjusted for differing factors; e.g. liquidity. The Board should reconcile these two views before it completes its projects on fair value measurements and on insurance contracts.
- Paragraph B2 (e) states that a fair value measure should capture other case-specific factors that would be considered by market participants. This seems to be a sweeping, inclusive statement that would allow, for example, the effects of taxation on the value of the asset or liability. The reference to after-tax cash flows and after-tax discount rates in paragraph B3 (d) is consistent with this interpretation. There is further reference in B3 (b) to consider only factors attributed to the asset or liability being measured. The meaning of "attributed to" should be clarified. For example, are income taxes attributed to an asset or liability? If not, would they be excluded from consideration even if they are a factor that market participants typically consider? We believe that a fair value measure should reflect the pricing practices of market participants and that guidance that forces measurement to deviate from these practices creates a risk that prices in actual transactions will be inherently different from corresponding measurement. We recommend that the guidance provided regarding present value techniques be reviewed and clarified in this regard.
- The section on expected present values refers to discounting weighted average cash flows. The Board should clarify that cash flows should be internally consistent within a scenario. This consistency should also extend to discount rates. When the variability of cash flows is caused, at least in part, by the potential variability in interest rates (i.e., scenarios are interest rate-dependent), then consideration should be given to how discounting can be consistent with estimated cash flows. It may be necessary to apply scenario-specific discount rates to each scenario and to then weight the present values, rather than to discount weighted-average cash flows.

Q26 Does the guidance in Appendices A and B of SFAS 157 sufficiently illustrate the standard's principles and provisions as they would apply in emerging or developing markets? If not, please specify what additional guidance you believe is needed and the most effective way to provide this guidance (for example, through additional implementation guidance or through focused education efforts).

Even if a fair value objective is not adopted for insurance contracts, it seems likely that the accounting objective will be a current value objective. Determining estimates of future cash flows, setting margins and selecting discount rates are especially challenging in emerging markets. The purchase and sale of assets and liabilities can only mean that they have been priced and that market participants have found satisfactory approaches to dealing with the challenges involved. As fair value represents a market view, financial reporting guidance should be based on the approaches used by market participants. The most effective way to provide such guidance is first to understand how pricing is conducted and then to decide how the pricing approaches can be applied to measurement.

For insurance contracts, the additional guidance needed would be in setting criteria for margins where the risk is greater than in developed countries and in setting discount rates when observable rates for the terms of insurance contracts are not available.

Issue 13. Other matters.

Q27. Please provide comments on any other matter raised by the discussion paper.

We appreciate the need for robust principles-based guidance for fair value measurements and we are aware of the particular difficulties presented for level 3 input measures. If a fair value measurements standard requires measurement of assets and liabilities according to the views of a market participant, we suggest that the Board avoid overly prescriptive rules, that is, detailed rules-based guidance that will cause measurement to deviate from what be transaction prices if a relevant market existed in which reliable prices could be observed. We have noted in our response to the specific questions raised some examples of where SFAS 157 may be overly prescriptive (but admittedly we have also suggested elsewhere areas for expanded guidance).

We find it useful to think in terms of what happens in an actual sale of an asset or a transfer of a liability. If the accounting measure is different from the price in the transaction, it is the result of a difference between estimated values and realized values or an inherent difference created by the accounting requirements. The former is understandable and practically speaking unavoidable for level 3 measures. The latter is anomalous and contrary to the fundamental concepts underlying fair value measurement and should be avoided.

Given the need for a sufficiently robust and principle-based standard to provide users confidence that fair values are reliable, the Board should consider how to provide guidance with respect to the process to determine market practices and the market view of unobservable inputs.

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