TOWERS PERRIN

November 13, 2008

Mr. Christopher Cox
Chairman
Securities and Exchange Commission
100 F Street N.E., Mail Stop 1070
Washington, DC 20549

SEC STUDY OF MARK-TO-MARKET ACCOUNTING (FILE NO. 4-573)

Dear Chairman Cox:

Towers Perrin appreciates the opportunity to comment on the SEC Study of Mark-to-Market Accounting (File No. 4-573).

Towers Perrin is a global professional services firm that helps organizations improve their performance through effective people, risk and financial management. We are one of the world's largest employers of actuaries. We advise many of the largest corporations on the design and valuation of their pension plans; in addition, through our insurance consulting business, we provide actuarial and risk management consulting to major life and property/casualty insurance companies. We also provide independent asset consulting and advice on the valuation and effectiveness of hedge instruments to both financial and non-financial institutions.

The comments in this letter reflect our experience in mark-to-market valuation for primarily insurance company assets and liabilities. That said, we believe many of our comments are equally applicable to other types of financial institutions.

The views expressed in this letter are those of Towers Perrin only. In addition, our views are based on current facts and circumstances. Our views may change as relevant facts and circumstances change.

Summary of key points

- We support mark-to-market accounting for financial instruments. In our experience, differences between accounting valuations and market valuations can encourage uneconomic decisions, poor risk management and mispricing of financial products.

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- We believe the FAS 157 valuation hierarchy has not operated optimally because companies have not adopted Level 3 mark-to-model valuation in the face of an inactive market for Collateralized Debt Obligations (CDOs). We suggest that the SEC sponsor the development of a standard for determining when a market is inactive.
- We believe there may be some reticence to adopt Level 3 of FAS 157 because of references in the standard to "management judgment" and potential inappropriate negative connotations.
- We believe that over the longer term the investing public would be well served by the recognition of a professional organization that would have oversight of those responsible for valuing "hard-to-value" financial instruments using Level 3 mark-to-model approaches.
- A specific issue with the valuation of CDOs at some companies is the lack of the requisite underlying data necessary to construct cash flow models. This data must be available to meet minimum standards for Level 3 valuations.
- The European CFO Forum's development of principles and standards for the market-consistent valuation of insurance liabilities could serve as a model for Level 3 mark-to-model valuations.

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We support mark-to-market accounting

We are a proponent of mark-to-market valuation of financial instruments, on both the asset and liability sides of the balance sheet. Our support for mark-to-market stems from the belief that investors and other users of financial statements are best served by valuations of financial instruments that correspond with observed market prices in active markets.

For the last several years Towers Perrin has provided thought leadership to European life insurers on the development of supplemental financial reporting, referred to as Market-Consistent Embedded Values (MCEV), in which both assets and liabilities are valued on a *market-consistent* (defined below) basis. Development of MCEV has been a collaborative effort under the leadership of the CFO Forum.[1] We have also been involved with the Comité Européen des Assurances (CEA), a European federation of insurance associations, in helping to shape the new European Solvency II regulations that are built around the concept of a market-consistent balance sheet. Under Solvency II, capital requirements for insurance companies will be determined by applying stress tests to the market-consistent balance sheet.

[1] The CFO Forum, formed in 2002, is a high-level discussion group that consists of Chief Financial Officers of major European listed, and some non-listed, insurance companies.

We refer to these mark-to-market valuations as “market-consistent” to avoid any confusion on fair value terminology adopted by accounting standards boards. However, the core principle underlying both concepts is the same: Financial assets and financial liabilities should be valued in a manner consistent with current observable market prices of risk.

In our view, mark-to-market/market-consistent valuation has three advantages over alternatives. First, mark-to-market valuations are objective and transparent. Second, when financial instruments are marked to market, the company can trade out of its positions without any further financial gain or loss. Third, if the financial instruments are valued inconsistently with the market, the possibility exists for management, investors or both to arbitrage the difference.

When financial statement values differ from market values, the company can dispose of instruments with book valuations below the market price to achieve accounting gains while continuing to hold instruments with valuations above the market price of risk to avoid accounting losses. In short, the presence of opportunities to create accounting profits or the desire to avoid accounting losses may encourage uneconomic decisions and poor risk management, and it can lead insurers to misprice their contracts and to implement investment strategies that reflect poor risk/return trade-offs.

For these reasons, we encourage the SEC not to suspend temporarily the operation of FAS 157 or to consider a move away from mark-to-market accounting for financial instruments. Rather, we support the extension of mark-to-market valuation to cover financial instruments on both sides of company balance sheets.

Issues with the operation of the FAS 157 hierarchy today

While we are proponents of mark-to-market, we believe there is room for improvement in the operation of FAS 157. In particular we do not believe that the current valuation hierarchy (i.e., mark-to-market, mark-to-index, mark-to-model) is operating in a manner that best serves users of financial statements.

First, we share the view that there can be instances, while rare, when a market is disrupted to the point that the concept of “willing buyer-willing seller” no longer operates. In such circumstances, FAS 157 should permit a change in valuation method. We consider active markets to exist where the bid-ask spread is within a reasonable range and volumes are adequate to indicate that there is sufficient consensus between sellers and buyers as to the value of the financial instrument. However, as volume drops and bid-ask spreads widen, the market must at some point be considered inactive. At that point one can logically conclude that there is a valuation disconnect between the holders of the instrument and potential buyers. These types of market disruptions are temporary; markets will eventually return to active status.

For example, in the current crisis, many believe the market for CDOs is sufficiently disrupted to be considered inactive. A similar situation occurred in the junk bond market in the early 1990s.

We recommend that the SEC consider whether an objective standard for determining the presence of an active market can be developed from historical market data. Such a standard would provide useful information for preparers of financial statements and help them decide when to adopt Level 3 mark-to-model measurement approaches.

If disruptive events cause a market to become inactive, we believe appropriate disclosures should be made. We suggest that FAS 157 be expanded to include disclosure requirements in the event of a market shut-down. Such disclosures could include the underlying reason for a change to Level 3 valuation, the previous and current carried values of the assets affected, the assumptions underlying the Level 3 valuation, and the extent to which the company has the ability to hold those assets until the market recovers.

In addition to applying to individual assets, we recommend that FAS 157 and associated guidance be expanded to cover inactive markets for entire asset classes. We also believe the standard could be further improved if an independent body such as the FASB or perhaps the Federal Reserve issued real-time pronouncements to guide preparers each quarter. Real-time pronouncements would decrease the uncertainty associated with peer actions and enhance the consistency of financial statements.

Several have suggested that a solution to the issue created by inactive markets is to continue to value the assets on the balance sheet using the observable market prices while providing additional disclosures relating to the mark-to-model valuations. Because users of the financial statements properly place their primary reliance on the published balance sheet, we believe that additional disclosures would not be sufficient to address the issue of inactive markets.

Need to improve the valuation of hard-to-value financial instruments

In addition to encouraging the use of Level 3 valuations in certain circumstances, FAS 157 should provide greater guidance on how such valuations should be conducted. Our experience with market-consistent valuation of insurance policy liabilities indicates that mark-to-model valuations can be enhanced by published standards of practice.

We believe that some of the reticence to adopt Level 3 of FAS 157 stems from references in the standard to "management judgment." While perhaps unintended, some have interpreted this language to imply that Level 3 valuations are a last resort and should be avoided because of the potential for the application of "management judgment" to skew results produced by a model. We believe it is critical to address this issue to assure that the hierarchy is properly interpreted, and to convey that the choice of a Level 3 approach to valuation does not carry inappropriate negative connotations.

Earlier we described the work of the CFO Forum to develop standards for market-consistent valuation for life insurers. Since there is no observable financial market for in-force insurance contract liabilities, they must be valued using a cash flow modeling approach. This approach is conceptually consistent with a Level 3 FAS 157 valuation.

Under market-consistent principles, the valuation of an insurance liability reflects the current observable market price of risk through the use of stochastic cash flow models calibrated to implied volatilities in relatively more liquid markets. Once properly calibrated, the valuation model can be validated by running any type of traded instrument through it. The model should return the actual market price (within small tolerances) of the instrument. Any non-traded instrument can then be run through the model to obtain its "market-consistent" value.

While not quite as robust as Level 1 and Level 2 valuations based on direct market price observation, the valuation of insurance liabilities using market-consistent cash flow models is quite robust when compared to other FAS 157 Level 3 valuation techniques.

The credibility of market-consistent valuations of insurance contract liabilities is increased as a result of being subject to independent review by actuaries. In addition to being recognized as having specialized expertise in the valuation of these liabilities through a formalized education and examination program, the actuarial profession has standards of practice and a code of professional conduct that formalizes the responsibility of the actuary in the delivery of his or her work product.

We believe that in the long run the public would be well served by the recognition of a professional organization that would govern those with responsibility for valuing "hard-to-value" financial assets and non-insurance financial liabilities using Level 3 mark-to-model valuation techniques. Such an organization could help to diminish any potentially negative connotations associated with Level 3 valuations, and enhance the quality of the valuation. The involvement of independent professionals would maintain the ability to exercise judgment while reducing the potential for management to manipulate the valuations.

Taken together, we believe our recommendations would improve the quality and objectivity of Level 3 FAS 157 valuations, making them more acceptable to users of financial statements.

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Thank you again for the opportunity to comment on this important policy issue.

Sincerely,

Stephen P. Lowe
Managing Director, Global Property & Casualty Insurance Practice Leader

Peter D. Needleman
Managing Director, Global Life Insurance Practice Leader

Prakash A. Shimpi
Managing Principal, Global Enterprise Risk Management Practice Leader