AMERICAN ACADEMY of ACTUARIES

May 14, 2003

Ms. Kim Kushmerick Hekker
Technical Manager
Accounting Standards, File 3162.DAC
AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

Proposed Statement of Position: *Accounting by Insurance Enterprises for Deferred Acquisition Costs on Internal Replacements Other Than Those Specifically Described in FASB Statement No. 97*

Dear Ms. Hekker:

The American Academy of Actuaries' (Academy) Life Financial Reporting Committee (LFRC) is pleased to have this opportunity to comment on the exposure draft of the proposed Statement of Position (SOP): *Accounting by Insurance Enterprises for Deferred Acquisition Costs on Internal Replacements Other Than Those Specifically Described in FASB Statement No. 97*. We appreciate the DAC on Internal Replacements Task Force's (Task Force) efforts in this area, and we would like to thank the Task Force in advance for consideration of our comments.

Our comments are as follows:

Issue #1: Definition on an Internal Replacement

We agree that the definition of an internal replacement should be based on the substance of the transaction and not the legal form. However, we believe the definition of an internal replacement in the exposure draft is too broad. As currently drafted, a myriad of routine contract changes or elections could be deemed to be internal replacements. Examples include:

1. Adding or dropping a rider or supplemental benefit coverage,
2. Changing the coverage amount,
3. Switching from Option A (level coverage) to Option B (increasing coverage) on a universal life policy,
4. Partial withdrawals, or
5. Changing the owner or insured.

We recommend that the fundamental nature and significance of the policy modification be considered when assessing whether it constitutes an internal replacement. In our view, the list of examples in paragraph 10 should be illustrative of the concepts and underlying principles, but not deemed to be the only situations that would not be defined as internal replacements. Accordingly, we recommend substantially changing or deleting the last sentence in paragraph 10, as it is too prescriptive and "rules-based".

We note that under current practice, riders are sometimes accounted for separately from the base policy. What is the intent of the SOP in this regard?

The proposal as written would appear to require companies to challenge the accounting treatment for each and every sale or modification to an existing contract for consideration as an "internal replacement", and could have unintended accounting or practical implications.

Issue #2 – "Not Substantially Different"

We agree that "not substantially different" should be one of the relevant criteria for assessing the appropriate accounting for an internal replacement transaction, but we question whether it should be the only consideration. We believe that other relevant considerations such as the following should be evaluated in determining the proper accounting treatment:

1. *Fundamental Nature of the Transaction* - Is the transaction fundamentally the surrender of an existing contract and a new issue, or is it a modification to an existing coverage? The more akin the transaction is to any other surrender and new sale, the more it would make sense to account for it as such. Conversely, if the transaction is fundamentally a continuation of coverage, writing off the DAC on the original coverage may be inappropriate. Some of the considerations include:
    a. Is a new first year commission being paid?
    b. Are new non-commission acquisition costs incurred?
    c. Is the policy being re-underwritten?
    d. Is a surrender charge being assessed?

2. *Consistency of the Accounting Impact and the Economics of the Transaction* - Does the insurer's accounting for the transaction parallel the economics of the transaction from the perspective of the insurer? We believe it is inappropriate and misleading to record a Generally Accepted Accounting Principles (GAAP) loss (caused by a DAC write-off) if the internal replacement transaction is expected to preserve or improve the insurer's future margins associated with the insurance contract.

The issue works both ways, i.e., the draft SOP might inadvertently include certain transactions as internal replacements rather than terminations. For example, given the industry downward trend in term premiums, a policyholder in good health might shop around to replace his or her term insurance policy with identical coverage but at lower cost. If the policyholder happens to select the same insurer, or even any insurer within the common GAAP reporting group, the draft SOP would treat this as an internal replacement to a 'not substantially different' contract with transfer of DAC. However, from the company's viewpoint, the sale might be indistinguishable from any other sale and transfer of DAC would be an unwarranted doubling up of deferred costs. There is also the practical issue of the company being able to track these events.

We observe that a fair value accounting model, by contrast, would look through the form of a transaction and reflect its economic impact. Given the desire for a more principle-based and fair value oriented accounting model, we question the desirability of implementing a rules-based approach at this time that fails to consider the transaction economics, and in many cases, would result in significantly different accounting results than a fair value model when an internal replacement occurs.

Inherent Nature

We agree that the inherent nature of the contract should be considered when assessing whether a contract is not substantially different. However, we believe the examples in the exposure draft in effect provide too many "bright line" tests and effectively constitute a highly-rules based approach. We disagree that many of the examples provided in paragraph 13 should always be deemed "substantially different" contracts.

In particular, while we understand the rationale, we believe it is somewhat peculiar to conclude that adding a minimum guaranteed death benefit (MGDB) rider to a variable annuity would be treated as 'substantially different', whereas adding a guaranteed minimum income benefit (GMIB) or guaranteed minimum accumulation benefit (GMAB) rider would be treated as 'not substantially different.' We observe that in all cases, the base policy benefits are unchanged, and we question the appropriateness of an accelerated write-off of base policy DAC when a MGDB is added.

Additional Deposit, Premium, or Charge

We disagree with the "bright line" test in paragraph 14. In our view, an additional deposit, premium, or charge requirement does not necessarily indicate a "substantially different" contract. In our view, such amounts could be appropriately reflected in the accounting for contracts that are deemed to be "not substantially different".

Net Decrease in the Balance Available to the Contract Holder

We also disagree with the "bright line" test in paragraph 15. In our view, a decrease in the net balance available to the contract holder does not necessarily indicate a "substantially different" contract. In our view, such differences could be appropriately reflected in the accounting for contracts that are deemed to be "not substantially different". (For example, the difference in the net balance available to the contract holder on a FAS 97 universal life type contract could be deemed an excess front-end load that is deferred and amortized in proportion to gross profits.)

Issue #3 – Accounting for Contracts That Are Substantially Different

We believe the proposed accounting for contracts deemed to be substantially different will be inappropriate and misleading in cases when the resulting financial statement impact materially distorts the true economics of the transaction. For example, consider the following:

- A fixed annuity that is exchanged for an equity indexed or a variable annuity (or vice-versa) shortly after the issue date of the fixed annuity (e.g., policy holder changed mind after free-look period).
- An internal replacement contract with substantially similar profitability as the replaced contract that fail the tests in paragraph 14 or 15.
- A variable annuity in a qualified plan that is replaced by a mutual fund in a qualified plan with very similar benefits and economics.
- A variable annuity initially characterized as an insurance contract (due to its MGDB features) that in later years becomes insignificant due to separate account performance that is replaced by a variable annuity without an MGDB that is classified as an investment contract.

In these and many other examples, the proposed accounting for the transactions would result in losses (due to accelerated DAC amortization) while the economics of the contractual benefits may be unaffected or even improved from the perspective of the insurer.

Issues #4 and #5 – Unamortized Deferred Acquisition Costs on Internal Replacements That Are Not Substantially Different

In general, we concur with the proposed accounting for contracts that are not substantially different.

However, although we understand that there is a certain amount of "noise" in insurance company financial statements caused by application of estimations and methodologies that differ immaterially from GAAP guidance, we believe that many companies will be introducing considerably more "noise" in applying the guidance proposed in this SOP.

We recommend the inclusion of a provision that allows for the option of writing-off DAC rather than requiring DAC carryover when the "not substantially different" criteria are met. For example:

- A mature fixed annuity well beyond the surrender charge period that is replaced by a new fixed annuity with a high surrender charge and a new first year commission for the distributor. Many, if not most, companies have some level of this type of activity (on annuity, Universal Life, or other contracts) and they generally treat this situation as a surrender and a new sale, in part for practice reasons and given a likely low level of unamortized DAC remaining. Going forward they would need to modify (and complicate) their valuation and accounting.
- In other situations, it may be difficult to obtain the necessary data or make the valuation system changes required by the SOP, in which case we believe companies should be allowed to use simplifying approaches or simply write-off the DAC if warranted by cost-benefit considerations (without necessarily having to demonstrate immateriality at each and every reporting period).

Additional Comments

Rules-Based vs. Principles-Based Approach

We believe the proposal as written is too rules-based versus principles-based in nature; this appears directionally inconsistent with our understanding of the intentions of the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB). In our view, the concept of "not substantially different" is too narrowly defined, and the rules and related examples are too prescriptive.

- By definition, for an internal replacement to have value to a policyholder, there would need to be a meaningful change to the contract or it would not be worthwhile for anyone involved.
- We believe the "not substantially different" concept has merit, but we suggest reserving the "bright line" tests for situations involving more substantive changes, such as the replacement of an accumulation contract with an insurance contract or vice-versa, or radical changes to expected future cash flows or estimated gross profits.

Cost-Benefit

More generally, we question whether the proposed guidance is "overkill" in relation to the perceived lack of guidance and disparity of practice.

We do not perceive the disparity of practice to be a significant or widespread problem. To the extent that abusive situations exist currently, we believe they could be effectively handled by disclosure and/or imposing certain guiding principles as constraints such as:

- Limiting the DAC on replaced contract to the DAC that would exist on a comparable newly issued policy
- Restricting the DAC amortization rate ("k" factor) on the replaced policy to be no more than the amortization rate on the old policy.
- Restricting the anticipated profit margin on the new contract to be at least as great as the profit margin on the existing contract.

As written, the proposed SOP would impose added cost and complexity on nearly all companies, but not necessarily result in improved accounting. In fact, in some cases, we believe the accounting would be inappropriate and misleading.

In light of our concerns identified above, we recommend: (1) adopting a more principles-based approach with fewer "bright line" tests, (2) considering factors other than just whether the contracts are "not substantially different", (3) giving more weight to the issue of whether the accounting impact of the proposed SOP is aligned with the economic substance of the transaction, and (4) providing some practical alternatives or "lee-way" to be responsive to cost-benefit considerations. We would be happy to continue to work with the Task Force to address these concerns and further enhance the proposed SOP.

In closing, we again want to thank the American Institute of Certified Public Accountants for the opportunity to share our views on the proposed SOP. If you have any questions, or need additional clarification, please contact Steve English, the Academy's senior life policy analyst (202-785-7880, english@actuary.org) or me (312-879-2122, michael.hughes@ey.com).

Sincerely,

Michael A. Hughes, Chairperson – Life Financial Reporting Committee
American Academy of Actuaries

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