May 2, 2025

Jackson M. Day
Technical Director
Financial Accounting Standards Board

Alex Casas
Financial Accounting Standards Board

Tiffany Wyszkowski
Financial Accounting Standards Board

Re: Agenda Request - Long-Duration Targeted Improvements (LDTI)

Dear Mr. Day,

On behalf of the Life GAAP Reporting Committee (Committee) of the American Academy of Actuaries,[1] I appreciate the opportunity to provide the following comments.

Accounting Standards Update (ASU) 2018-12 revised several key aspects of accounting for long-duration insurance contracts under U.S. GAAP. Since ASU 2018-12 was issued, large public insurance entities have completed implementation and have been reporting under the new guidance for two years. All other insurance entities are also now required to report under the revised guidance.

It has been the experience of members of the Committee that ASU 2018-12 has generated important improvements to insurance accounting, including:

- Updated assumptions and discount rates for most traditional contracts;
- Simplified deferred acquisition costs (DAC) amortization;
- More consistent and appropriate accounting for market risk benefits; and
- Improved and expanded disclosures.

There are a few areas where minor modifications to the revised standard could result in further improvements. These relate to DAC amortization, discount rates on life payout annuities, discount rates in currencies where a single-A rate is not available, and benefit ratios on additional liabilities for death and other insurance benefits and for annuitization benefits. We also note a possible improvement to reinsurance accounting, although this may be an issue suitable for the Emerging Issues Task Force (EITF).

Besides our suggested improvements to ASU 2018-12, there are also insurance accounting issues within Topic 815 that we think need to be addressed. These relate to hedge accounting, embedded derivatives in

[1] The American Academy of Actuaries is a 20,000+-member professional association whose mission is to serve the public and the U.S. actuarial profession. For 60 years, the Academy has assisted 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.

funds withheld and modified coinsurance agreements, and embedded derivatives within indexed products. We are addressing these issues in separate comment letters but note here that the indexed-product issue in particular has become more acute over the years, as sales and inforce of such products has expanded dramatically, and largely supplanted sales of variable annuities. The funds withheld and the modified coinsurance issues have also grown in importance, as use of these reinsurance types has increased and as ASU 2018-12 made the Other Comprehensive Income (OCI) more meaningful.

DAC Amortization

ASC 944-30-35-3B states, in part, "The balance of capitalized acquisition costs shall be reduced for actual experience in excess of expected experience (that is, as a result of unexpected contract terminations)."

This creates asymmetry between actual experience being less than expected vs. actual experience being in excess of what was expected. This creates misleading results because, in aggregate, actual experience may be equal to or even less than expected. However, there would still be excess write-off because some cohorts have experience in excess of expected. Similarly, there can also be misleading results for a given cohort over time, since some periods will experience terminations in excess of expected and other periods will experience terminations less than expected. Only the differential from periods when experience is in excess of expected will be recognized, even if over time experience is less than expected.

Shortly after ASU 2018-12 was issued, FASB staff clarified on a webcast that this asymmetry can be addressed by determining the expected termination experience for amortizing DAC as of the end of the reporting period. Because the expected termination experience would then match the actual termination experience, there would be no explicit DAC reduction for "actual experience in excess of expected experience."

This approach, colloquially sometimes referred to as the "webcast approach," did address the asymmetry issue. But it also created a different issue. Applying the webcast approach has the effect of DAC amortization being always calculated using a retrospective adjustment going back one reporting period. As a result, the current-period experience variance from expected has virtually no impact on the current-period DAC balance. For example, it may take a 90% reduction in inforce in a given period to result in a 50% reduction in DAC for that period. In periods when there are significant shock lapses, this can cause the DAC balance to be significantly overstated relative to the remaining inforce.

Given that implementation is complete, we would not recommend prohibiting the webcast approach. However, we believe that companies should be permitted to apply an amortization approach in which expected termination experience, as of the beginning of the reporting period, can be reflected symmetrically.

We understand that FASB would not want the DAC balance to increase because of the termination true up, and we agree with that concern. However, we believe that this concern could be best addressed by explicitly stating that the net impact of amortization and truing up termination experience in any given period may not result in an increase in DAC.

We believe that this could be achieved by amending 944-30-35-3B as follows:

> The balance of capitalized acquisition costs shall be reduced for actual experience in excess of expected experience (that is, as a result of unexpected contract terminations) <u>or increased for actual experience below expected experience. The net impact in any reporting period of</u>

amortization and increasing for actual experience below expected may not result in an increase to the balance of capitalized acquisition costs.

Discount Rates on Certain Traditional Long-Duration Liabilities

In the exposure draft that preceded ASU 2018-12, FASB proposed that the discount rate for traditional long-duration insurance liabilities should be a "high-quality fixed-income instrument yield," generally interpreted as an AA-rated fixed-income instrument yield. In response to constituent concerns, FASB revised the discount rate to be a "current upper-medium grade (low-credit-risk) fixed-income instrument yield," generally interpreted as an A-rated fixed-income instrument yield.

Our experience has been that the A-rated fixed-income instrument yield generally works well as the discount rate for traditional long-duration insurance liabilities for future policy benefits, reflecting an appropriate illiquidity premium for these contracts. There are two exceptions where an A-rated fixed-income instrument yield does not work well, which is where we offer a modification. These are:

- Life payout annuity contracts, and
- Contracts in currencies where A-rated fixed-income instruments are not available.

Life Payout Annuity Contracts

Payout annuity contracts with solely life-contingent payments are more illiquid than other insurance products and more illiquid than virtually any other financial instrument. Once payments start, the annuitant cannot surrender the contract for cash, because all payments are contingent on the annuitant's survival. Unlike most other insurance contracts without a cash surrender value, these contracts are paid for with a single premium, which means if a policyholder no longer wants to maintain the contract, there are no future premiums to cease paying.

As a result of the extreme illiquidity of life payout annuity contracts, an A-rated fixed income instrument yield often does not provide an adequate illiquidity that would be consistent with the illiquidity characteristics of the contract.

In the U.S., this is seen most often in the pension risk transfer market, in which insurers sell life-contingent income annuities to institutions to cover their pension obligations. The market consists primarily of large, sophisticated insurers and the contracts have historically been profitable based on both U.S. GAAP, and statutory accounting measures. Nonetheless, because of the inadequate illiquidity premiums in the discount rate, new contracts often result in losses at contract inception, even though there is no expectation of the contracts being unprofitable.

Although individual pure life payout annuity contracts are not a popular product in the U.S., in other regions of the world where U.S. insurance companies do significant business, they can be. Another example where the A-rated fixed income investment yield does not seem to provide an adequate illiquidity premium is the individual life payout annuities in Chile. Such annuities are a key element of the Chilean social security system. Because they are an important element of the social security system, the Chilean government publishes the interest rate inherent in each company's life payout annuity contracts every month. Between December 2020 and April 2024, the A-rated fixed income investment yield has been lower than the published liability rates about 80% of the time, providing evidence that the

A-rated fixed income investment yield is lower than a rate that would be consistent with the characteristics of the liability.

Since the GAAP discount rate on life payout annuities does not provide an illiquidity premium consistent with the extreme illiquidity characteristics of the contracts, these contracts often generate a loss at inception. Some insurers have addressed this through an adjustment to non-GAAP measures.

To avoid these non-GAAP adjustments, we recommend that FASB provide an exception to the normal discount rate requirements applicable to payout annuities where all, or perhaps substantially all, the benefit payments are contingent on the annuitant's survival. We would recommend that these contracts use a discount rate of either BBB-rated fixed income instruments or an average of BBB- and A-rated fixed income instruments.

Another alternative would be to permit the deferred profit liability (DPL) to be negative for these contracts. We would not recommend an unlimited negative DPL, because while the problem is that profitable contracts show accounting losses, it is possible for these contracts to be mispriced. In such an example, there would be real losses that should be reflected in the GAAP financial statements. So, if this approach were to be used, we would recommend a one-time test at issue to determine whether the contract is mispriced. We would recommend that should a positive or zero margin when discounting at a BBB-rated fixed income yield be calculated at issue, then the contract or cohort would be deemed appropriately priced. If there is a positive margin when discounted at inception using a BBB rate, then the initial DPL could be negative to absorb any loss at inception. If the margin when discounted at a BBB-rated fixed income yield is negative, then the initial negative DPL would be limited so that there is a loss recognized at inception equal to that negative margin. If the initial DPL is negative, that negative amount would be the floor on the DPL value upon remeasurement in future periods.

Currencies where A-rated Fixed-Income Instruments Are Not Available

The other situation where the A-rated fixed-income discount rate is problematic is where the insurance contract is denominated in currencies where the sovereign bond rate is rated below A. In such cases, ASU 2018-12 tells us to apply fair value, Level 3 principles to estimate what an A-rated fixed-income interest rate would be.

This creates problems with comparability and reliability in determining a key input into the valuation that cannot be validated objectively, even compared to typical unobservable fair value estimates. It also creates a problem of faithfulness of representation, in that we use interest rates that are not observable and may literally not exist in the given currency. This also often creates artificial losses at inception, leading to confusion and non-GAAP measures, because an A-rated discount rate would generally be lower than any interest rate available in the currency.

Even if there are a handful of A-rated corporate issuers, using those issuers as the basis for the insurance liability discount rate is problematic. Because there would likely be only a very few tenors with observable single-A rates, there would still need to be much estimation in filling out the discount curve, so there would still be significant comparability and reliability issues. If one of those few issuers is downgraded for a reason specific to that entity or there is some other significant change in its bond interest rate for an entity-specific reason, the discount rate used to value insurance contracts would change significantly for a reason that has nothing to do with the economics of those contracts.

We recommend resolving these issues by permitting the use of the sovereign debt rate as the discount rate for liabilities for future policy benefits as a safe harbor. This makes sense because sovereign debt is

fundamentally different from corporate debt in a relevant way. When a sovereign has difficulty repaying debt, it typically does not default but is much more likely to devalue the currency. The devaluation of the currency would mean that insurance payments in that currency would benefit from the devaluation, since payment would be made in the devalued currency. Thus, the devaluation possibility represents an element of the insurance liability. As a result, the true credit risk, which is what would provide the true illiquidity premium of the liability discount rate, of a sovereign bond may be less than or equal to that of an A-rated corporate bond, even if the sovereign bond is rated less than A.

This view is supported by the fact that in some countries there are a handful of corporate bonds which carry higher credit ratings than the sovereign debt. For example, Colombia's sovereign debt is rated BBB, but there are corporate issuers that we are aware of that is rated BBB+ on a global scale. These corporate issuers carry a higher interest rates than the sovereign bond, despite the higher credit rating (e.g., BBVA, GM Financial, Celsia). A similar situation exists in Mexico, where a handful of bonds have a higher credit rating than the sovereign BBB rating (e.g., Coca-Cola, Arca, America Movil, Televisa). Thus, we believe that the observable sovereign bond rate is a sensible discount rate for insurance contracts in currencies where the sovereign bond rating is less than A.

If FASB does not agree that it is appropriate to use the sovereign bond in all cases where the sovereign bond is rated below A, a reasonable approach could be to allow the approach but not permit the discount rate to exceed that of a B or even BB sovereign bond rate. This approach would reduce situations where an unobservable and artificial discount rate needs to be estimated. In situations where the discount rate does need to be estimated, this would limit the magnitude of the artificial adjustments.

Additional Liabilities

In the exposure draft that preceded ASU 2018-12, FASB proposed several significant changes to the valuation of additional liabilities for death or other insurance benefits and additional liabilities for annuitization benefits (colloquially referred to as SOP 03-1 liabilities). The final ASU appropriately did not make most of the proposed changes. One change that was proposed in the exposure draft that we would have retained in the final ASU and encourage FASB to reconsider is capping the benefit ratio at 100% and requiring an additional liability if the benefit ratio is capped.

SOP 03-1 liabilities are reported with liabilities for future policy benefits. ASU 2018-12 required that liabilities for future policy benefits on traditional long-duration contracts, other than those that meet the criteria of 944-20-15-3, must cap the net premium ratio at 100%. The net premium ratio in a traditional long-duration contract liability for future policy benefits is analogous to the benefit ratio in an SOP 03-1 liability. Not capping the benefit ratio creates an unnecessary and non-economic inconsistency between different liabilities reported in the same line.

More importantly, the failure to cap the SOP 03-1 liability benefit ratio defers losses that have been incurred, possibly for decades. That is because a benefit ratio over 100% implies that the present value of future expected benefits exceeds the present value of future expected assessments, which are the amounts from the contract (including future investment income) that can be used to fund the benefits. Instead of recognizing the loss at the time it is incurred, losses are recognized slowly over the remaining life of the contract, or until conditions change to eliminate the loss. Not capping the benefit ratio at 100% thus reduces the relevance of the financial information to investors, and reduces the degree to which the liability faithfully represents the economics of the contracts. For example, we are aware of one U.S. company that sold variable life contracts in Japan with no-lapse guarantees in the late 1980s and early

1990s. When the Japanese stock market fell and remained at low levels for decades, the resulting large loss was never fully reflected in that company's SOP 03-1 reserves.

Most SOP 03-1 reserves are on universal life-type products that are subject to premium deficiency testing. However, premium deficiency testing occurs at a high level of aggregation, so that profits from profitable contracts can offset the losses on contracts whose SOP 03-1 liability benefit ratio should have been capped at 100%. Some SOP 03-1 reserves (for annuitization benefits that are not market risk benefits) are on investment contracts that are not subject to premium deficiency testing at all.

Our suggestion to cap SOP 03-1 benefit ratio differs from our previous LDTI suggestions in that this would require insurance entities to make changes to their valuation calculation models. The other suggestions would be optional implementations or only require changes to inputs. However, the calculation changes would not be substantial.

Applying the 100% cap should be simple to code. A calculation of the additional liability under the retrospective calculation used for SOP 03-1 reserves would be necessary. However, that liability uses information that is used in current calculations – it would be:

(uncapped benefit ratio – 100%) x accumulated value of assessments.

Alternatively, the SOP 03-1 liability could be calculated on a prospective basis, consistent with the liability for future policy benefits, which is algebraically equivalent and may be simpler:

SOP 03-1 liability =
PV of future benefits – capped benefit ratio x PV of future assessments

Additionally, it would be necessary to generate annual cohorts in order to apply benefit ratio cap, consistent with the way cohorts are determined for liabilities for future policy benefits. Many companies already use annual cohorts for calculating SOP 03-1 liabilities, and many of those that do not would have annual cohorts in place for these contracts in order to amortize deferred acquisition costs under ASU 2018-12.

Although we believe that the workload necessary to affect the 100% cap on benefit ratios is low, there would be testing needed and we are sympathetic to the fact that companies will have recently gone through the extensive work to implement ASU 2018-12. This concern can be alleviated by permitting a longer implementation time, (2-3 years for large public companies and 3-4 years for other companies, for example). This would ensure that this improvement would occur within a reasonable timeframe without creating a substantial burden for preparers.

Reinsurance

The industry and actuarial profession are working through several reinsurance issues, but we believe that there is a pertinent issue that should be addressed as soon as possible. We believe that a gain on reinsurance from capping the net premium ratio at 100% should be permitted if there is a corresponding loss on the direct contract, when the direct and reinsurance contracts are entered into in contemplation of each other and at approximately the same time.

ASU 2018-12 did not make many explicit changes to reinsurance accounting, but the general accounting changes introduced by the ASU has impacted reinsurance accounting. During the implementation of the ASU, the AICPA issued several papers addressing ambiguities that resulted from applying the ASU guidance to reinsurance. One interpretation related to whether a gain could be taken on reinsurance of

non-participating traditional contracts by capping the net premium ratio on the reinsurance recoverable at 100%:

> FinREC believes that to the extent the insurer has recognized a loss on the reinsured portion of the direct contracts in the current period, the insurer should recognize an immediate gain on the reinsurance ceded contract. However, FinREC also believes the insurer should not recognize a gain at inception of a reinsurance transaction to offset a previously recognized loss on direct business as that would violate the ASC 944-40-25-33 prohibition of gain recognition upon entering into the reinsurance contract. [Issue #11AC, paragraph 8]

We agree that when a reinsurance agreement is entered into after a cohort of direct contracts is already in force, there should not be a gain recognized on the reinsurance to offset previous losses. However, there appears to be a difference of opinion about whether losses on direct contracts can be offset by a gain on reinsurance that is entered into simultaneously with selling the direct contracts.

We believe that if a reinsurance agreement is entered into simultaneously (or nearly so) with the direct contracts **and** if the direct and reinsurance contracts are entered into in contemplation of each other, **and** if the direct contracts have a loss at inception due to capping the net premium ratio, a gain should be permitted on the reinsurance agreement. We believe that this would accurately reflect the economic reality. Pricing of the direct contracts would have been impacted by the reinsurance agreement that was being negotiated at the same time. The direct contract and the reinsurance agreement are not independent of each other. The direct writer would likely not have priced the contracts at a loss, had it not been for the reinsurance benefits. Recognizing a gain on reinsurance in this case would not be offsetting a previously recognized loss, since the loss on the direct contracts occurs at the same time as the inception of the reinsurance contract.

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The Committees appreciate the opportunity to share these comments and our recommendations. If you have any questions or would like to discuss these comments further, please contact Amanda Barry-Moilanen, the Academy's policy project manager, life, (barrymoilanen@actuary.org).

Sincerely,

Leonard Reback, MAAA, FSA

Chairperson, Life GAAP Reporting Committee

American Academy of Actuaries