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December 14, 2016

Ms. Susan M. Cospers
Technical Director
File Reference No. 2016-330
Financial Accounting Standards Board
401 Merritt 7, PO Box 5116
Norwalk, CT 06856-5116
Via email to director@fasb.org

RE: *Proposed Accounting Standards Update: Financial Services – Insurance (Topic 944) Targeted Improvements to the Accounting for Long-Duration Contracts*

Dear Technical Director Cospers,

The Financial Reporting Committee of the American Academy of Actuaries¹ appreciates the opportunity to provide feedback on the Financial Accounting Standards Board's (FASB) Proposed Accounting Standards Update *Financial Services – Insurance (Topic 944) Targeted Improvements to the Accounting for Long-Duration Contracts*. Members of our committee are senior actuaries with extensive financial reporting experience with life, health, and general insurance companies.

The committee's view is that a more holistic approach along the lines of the approach FASB had proposed in 2013 is the best way to address all the deficiencies with U.S. GAAP accounting for long-duration insurance contracts. As such, convergence between FASB and the International Accounting Standards Board (IASB) on accounting for insurance contracts would be a preferred approach. After preparers and users have obtained experience with the International Financial Reporting Standards (IFRS) model and there has been an opportunity to address any problems that emerge, we would encourage FASB to consider revisiting such an approach.

Regarding the targeted improvements, FASB has identified the most important deficiencies to address. Generally, we agree that the proposed amendments will provide substantial and critical improvements to U.S. GAAP accounting guidance for long-duration insurance contracts. Updating assumptions and using current discount rates on traditional contracts while eliminating provisions for adverse deviations will provide users with more relevant information. Simplifying deferred acquisition cost (DAC) amortization will make financial information more understandable and may reduce costs for preparers, particularly by eliminating retrospective unlocking. Reporting market risk benefits at fair value will allow the financial statements to show economic volatility from unhedged risks while avoiding non-economic volatility from hedged risks. This also will avoid some bifurcations of market risk benefits that are currently required, reducing costs for preparers and increasing

¹ The American Academy of Actuaries is an 18,500+ member professional association whose mission is to serve the public and the U.S. actuarial profession. For more than 50 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.

understandability for users. Expanding required disclosures also will be beneficial in helping users understand insurers' financial performance.

We do, however, have some significant concerns with specific elements of the targeted changes. The proposed model for participating contracts is fundamentally flawed. The proposed model treats participating contracts the same as non-participating contracts and does not recognize the unique features of participating contracts, such as an adjustable credited rate. In particular, an appropriate model for participating contracts would recognize:

- The need for the discount rate to be internally consistent with the dividend credited rate of the liability (see question 10);
- The need for net income to be based on an interest accretion rate that adjusts consistently with the projected dividend credited rates used in the liability calculation (see question 11);
- The need for changes in discount rates to be treated consistently with changes in dividend credited rates within the liability calculation (see question 8); and
- The need to exclude dividends related to future profits on other businesses from the liability (see question 8).

We also have some specific concerns with the use of additional liabilities for death and annuitization benefits (per what used to be Statement of Position (SOP) 03-1) to address profits-followed-by-losses situations on nontraditional contracts. These concerns are addressed in the appendix labeled "SOP 03-1."

If the issues relating to participating contracts and additional liabilities can be addressed, the model described in the proposed standard will represent a substantial improvement over existing U.S. GAAP. In the answers to the specific questions posed in the accounting standards update (ASU), we have a number of suggestions to improve the model even further and reduce the burden to preparers. In particular:

- Unlocking cash flow assumptions prospectively rather than retrospectively, as this would reduce the administrative burden for preparers and make results easier for users to understand (see question 2);
- Revising the discount rate, because a "high-quality fixed-income instrument rate," as the term is currently used in U.S. GAAP, may not provide an appropriate illiquidity premium (see question 4);
- Changing the definition of market risk benefits to ensure that benefits with similar features are treated similarly (see question 13);
- Considering amortization of unearned revenue liabilities on nontraditional contracts similar to deferred profit liabilities rather than DAC (see question 16);
- Simplifying the calculation for demutualization closed block policyholder liabilities (see question 7);
- Eliminating some of the disclosure requirements, such as weighted average of assumptions, which may be unduly burdensome and not particularly meaningful; adding other disclosures, such as gross premiums, would aid understanding of financial results (see questions 18 and 19); and
- Simplifying some of the retrospective transition requirements, which may be unduly burdensome and may produce unintended consequences for contracts that have previously recognized a premium deficiency (see question 21).

Our specific comments are incorporated in our responses to the questions posed in the exposure draft. If you would like to discuss any of these further or if you have additional questions, please contact Nikhail Nigam, the Academy's risk management and financial reporting analyst, at 202-785-7851 or Nigam@actuary.org.

Sincerely,

Leonard Reback, MAAA, FSA
Chairperson, Financial Reporting Committee
Risk Management and Financial Reporting Council
American Academy of Actuaries

Liability for Future Policy Benefits—Contracts Other Than Participating Contracts

Question 1—Scope: *Do you agree with the scope of the proposed amendments on the accounting for the liability for future policy benefits for contracts other than participating contracts? If not, what types of contracts, contract features, or transactions should be included in or excluded from the scope and why?*

Answer:

We agree with the scope of the proposed amendments to Topic 944.

Although this is not a Topic 944 issue, as long as FASB is addressing insurance accounting, we recommend that FASB consider two changes to Topic 815 on embedded derivatives. Many modified coinsurance contracts and funds-withheld reinsurance contracts include an embedded derivative because the payment of investment income to the reinsurer depends on the returns on assets held by the ceding company (formerly DIG B36). Bifurcating these embedded derivatives adds complexity but provides little useful information. Because many reinsurance contracts will be reported using a current discount rate under the targeted improvements, the key information that would be provided by bifurcating these embedded derivatives would already be included in the financial statements. Therefore, exempting these embedded derivatives from bifurcation as embedded derivatives would reduce complexity and simplify the valuation process with little loss of useful information. Also, fixed indexed contracts include embedded derivatives that are bifurcated. We disagree with the boundary of the fixed indexed embedded derivative. Under existing U.S. GAAP, the current guarantee is bifurcated along with all projected future guarantees. As discussed in our comment letter on Topic 815,² complexity can be reduced and representational faithfulness can be improved by limiting the bifurcation of fixed indexed contracts' embedded derivatives to the current period guarantee.

Question 2—Cash flow assumption update method and presentation: *Do you agree that the effect of updating cash flow assumptions should be calculated and recognized on a retrospective basis in net income? If not, what other approach or approaches do you recommend and why?*

Answer:

Traditional contract future policy benefits

We support the use of a net premium methodology and capping the net premium ratio at 100 percent.

The committee believes that a prospective approach to unlocking the net premium ratio best meets the objectives of usefulness and cost-effective implementation. Under a prospective approach, the net premium ratio would be unlocked for future assumption changes so that the current liability is unaffected by the assumption change, subject to the 100 percent cap. Further, under this approach, actual experience would affect the financial statements immediately rather than spreading the impact over future periods, more faithfully reflecting the impact of events in the reporting period in which they occur. The prospective approach meets the objective of allowing profits to emerge on the basis of new assumptions. The reported earnings on the prospective method reflect that period's experience.

² Academy comment letter on [proposed Accounting Standards Update—Derivatives and Hedging \(Topic 815\): Disclosures about Hybrid Financial Instruments with Bifurcated Embedded Derivatives](#) (April 30, 2015).

With retrospective unlocking, when there is an assumption change, there will be a potentially large fluctuation in earnings that is unrelated to current period experience. This would be similar to how universal life-type DAC fluctuates today. The large fluctuations in universal life DAC unlocking that have troubled users of financial statements will be transferred to traditional life reserves if the retrospective approach is applied to assumption changes.

In the course of reviewing the exposure draft, we identified a case in which prospective unlocking is particularly beneficial. Prospective unlocking aligns with the economics of guaranteed renewable health contracts at the time of a rate increase when the rate increase can only account for future profitability and not recover past losses. Application of retrospective unlocking to products such as guaranteed renewable health insurance, where both the premiums and the benefits are changing, could have results that would be difficult to explain and would not align with how the business operates.

We acknowledge that under the retrospective approach there is a benefit in that the balance sheet does not depend on prior assumptions. However, the effect of a \$10,000 claim variance, for example, will be allocated between current and future earnings, consistent with the impact of a \$10,000 assumption change, rather than impacting current earnings by \$10,000. Under the prospective approach, such a variance would be charged to earnings when it happened.

We recognize that prospective unlocking would set insurance apart from other standards that address the need to update estimates of future cash flows. In the other standards that address non-insurance accounting, the uncertain nature of the estimates tends to be small relative to the entire contract. In insurance, uncertainty is inherent in the product. In long-duration insurance contracts, that uncertainty spans many years—often many decades. The magnitude and duration of uncertainty in insurance should warrant careful consideration of the practical implications of applying the same standards as other contracts and of alternative approaches. We note that one of the improvements recommended by FASB in its exposure draft is the elimination of retrospective adjustments to the amortization of DAC. At the same time, FASB is proposing to introduce retrospective adjustments to the benefit reserve, a much larger element of the balance sheet. This practice would not seem internally consistent and could result in an anomalous relationship between the two.

The retrospective approach will, as acknowledged in the exposure draft, require major systems changes to gather and track experience by cohort for traditional life. While companies currently gather history and apply a retrospective approach to universal life-type contracts, the systems used for traditional contracts are typically different. Reserves calculated using a retrospective method would most likely need to use a cohort methodology. Traditional contracts are now most often calculated policy by policy. Companies would need to replace their current set of controls, which would increase the risk of reporting errors. Prospective unlocking would also simplify transition.

Prospective application has most of the benefits of retrospective application but at a lower cost, with reported earnings that are not distorted as they would be by retrospective application of the net premium ratio. Prospective unlocking would be consistent with the approach to accounting for assumption changes and experience deviations under the IFRS 17 model, which would aid users in understanding and comparing results.

Additional liability for death and annuitization benefits

We recommend using prospective unlocking of the benefit ratio for changes to the expected cash flows on additional liabilities for death and annuitization benefits, which are currently valued under what was formerly SOP 03-1. More importantly, as discussed in the appendix labeled “SOP 03-1,” it is critical that additional liabilities set up after contract inception to resolve a profits-followed-by-losses situation be accrued prospectively. That is, the liability should begin to accrue from a zero balance as of the date a profits-followed-by-losses situation is identified. The approach discussed in the exposure draft of accruing the liability back to contract inception would be burdensome and would lead to anomalies in the financial statements when a small future loss could generate a large immediate liability accrual.

Another issue with these additional liabilities is that paragraphs 944-40-30-21, 944-40-30-26, 944-40-35-10, and 944-40-35-14 state that the benefit ratio may not exceed 100 percent, “which results in immediate loss recognition to the extent that the present value of expected excess payments exceeds the present value of expected assessments.” But because the mandated formula for calculating the additional liability accumulates assessments recognized in the past, this loss recognition would not occur automatically. An efficient way to address this is to calculate the additional liability consistently with future policy benefit liabilities. That is, as a present value of future excess payments less the present value of future assessments multiplied by the benefit ratio. We also have additional comments about these liabilities in the appendix labeled “SOP 03-1.”

Related issues to be clarified in the standard or in application guidance

Prospective unlocking introduces some possible ambiguities that should be addressed either in the standard or in application guidance to avoid inconsistent or inappropriate application.

In between assumption changes, the existing net premium ratio should be applied in a present value calculation at the valuation date of a projection on contracts then in force. It would not be appropriate to simply roll forward the liability by adding the product of the net premium ratio and actual gross premiums and then subtracting actual benefit payments. That approach would defer all cash flow variances rather than report the impact of the variances in current income.

It is not uncommon for future policy benefit liability or additional liability calculations to result in a negative liability amount. Under these conditions, the standards specify that the liability should be set to zero. If assumptions are changed at a time when the liability is floored at zero, it would be most appropriate to update the net premium ratio on the unconstrained liability before flooring at zero.

The liability for future policy benefits is intricately linked with the deferred profit liability for limited pay contracts. Ordinarily, the prospective method presents no practical problems for contracts that have both types of liability—the existing balance provides the starting point for determining subsequent accrual and amortization rates. A complication arises, however, when constraints force a change in the basic liability. This will happen if the net premium ratio hits the 100 percent cap, or if the contract is paid up (such that future revenue is zero). Under these conditions, the deferred profit liability should be adjusted to offset the change in the future policy benefit liability, subject to the constraint that the resulting deferred profit liability cannot be less than zero.

If FASB accepts our recommendation per our response to question 16 to amortize unearned revenue liabilities on nontraditional contracts similar to deferred profit liabilities, rather than similar to DAC, the same situation applies. The unearned revenue liability is intricately linked with any additional liability for annuitization, death, and other insurance benefits. So if the benefit ratio on the additional liability is 100 percent, the unearned revenue liability should be adjusted to offset the change in additional liability, subject to the constraint that it not be less than zero.

Question 3—Cash flow assumptions update frequency: *Do you agree that cash flow assumptions should be updated on an annual basis, at the same time every year, or more frequently if actual experience or other evidence indicates that earlier assumptions should be revised? If not, what other approach or approaches do you recommend and why?*

Answer:

We agree for the reasons discussed in the basis for conclusions.

One related issue that is unclear in the exposure draft is the timing of truing up experience deviations. It is not explicit in the exposure draft that the net premium ratio and liability must be updated each reporting period to reflect current period deviations of actual experience versus the liability assumption. Paragraph 944-40-35-6A (c) states that “(e)xperience adjustments shall be recognized in the period in which that experience arises.” However, that statement might be interpreted to suggest the effect of the experience deviation impacts the financial statements in the period in which that experience arises without necessarily adjusting the liability net premium ratio.

If the net premium ratio is not updated for experience deviations that arise each reporting period, then anomalies to the financial statements could result. For example, assume that mortality is better than expected by \$5 per quarter for three quarters. Furthermore, assume that retrospectively unlocking the net premium ratio would increase the liability by \$3 for a \$5 mortality experience deviation and that assumptions are unlocked in the fourth quarter and mortality is exactly as expected in the fourth quarter. Then the pattern of earnings effects from the mortality deviations would be +\$5 per quarter for the first three quarters, but -\$6 in the fourth quarter when the net premium ratio is updated, even though there is no experience deviation that quarter. Under the theoretically correct application of retrospective unlocking, the earnings effects each quarter should be +\$2 per quarter for the first three quarters and \$0 in the fourth quarter.

If prospective unlocking is used, as we recommend in our response to question 2, this issue is not relevant because there would be no need to update the net premium ratio for actual experience deviations.

Question 4—Discount rate assumptions: *Do you agree that expected future cash flows should be discounted on the basis of a high-quality fixed-income instrument yield that maximizes the use of current market observable inputs? If not, what other approach or approaches do you recommend and why?*

Answer:

We agree that an objective discount rate curve that excludes own credit risk but includes an appropriate provision for illiquidity and is consistent with current observable inputs is suitable for non-participating traditional insurance contracts. However, we are concerned that

the specific language of “high-quality fixed-income yield” will be interpreted to specifically require AA-rated instruments for USD-denominated liabilities.

The yield from AA instruments does not provide an illiquidity premium that is commensurate with the illiquidity of most insurance contracts. Insurance contracts are typically far less liquid than any publicly traded bond. Even large, highly rated insurance companies target a lower-rated investment-grade spread—on average between BBB and A—in order to back insurance contracts, which indicates that the illiquidity premium within those insurance contracts is greater than the spread on AA assets. If an insurance or reinsurance contract were priced based on a BBB or A spread and that represented the market price of the insurance contract, discounting the cash flows at a AA spread could generate a non-economic day 1 loss from the investment component of the insurance contract. This approach is inconsistent with accounting for investment contracts in general, where the effective yield method avoids immediate recognition of expected future losses. This approach is also inconsistent with the accounting when insurance companies issue debt. Many insurance company liabilities have highly predictable cash flows that are similar to debt, especially with respect to the interest rate component of the insurance liability. As a result, the FASB proposal also can create a difference upon a sale of a book of business between the liability value immediately before the sale and the liability value net of value of business acquired (VOBA) after the sale.

The inconsistency the FASB proposal creates between insurance and investment contracts can show up in particular for structured settlement payout annuities. Some structured settlements have no life contingencies and are accounted for as investment contracts, using an effective yield discount rate that avoids a loss at contract inception. Others have relatively limited life contingencies and would be discounted at a AA rate that may be less than the implicit credited rate for which the contract was priced. In the latter case, the AA rate may cause a loss at contract inception from the investment-related elements of a contract, even though such elements are identical to those found in a contract without life contingencies. While we recognize that a line needs to be drawn between insurance contracts and investment contracts, a potentially significant difference in results is not representative of the economics.

A further problem with AA is that relatively few bonds are rated AA or better—only 11 percent of investment-grade corporate bonds currently.³ It does not seem appropriate to discount insurance liabilities at a rate that represents only a small portion of the bond universe and thus cannot be a robust estimate of an appropriate illiquidity premium.

We acknowledge that illiquid pension liabilities are discounted using a AA rate, but this inconsistency is appropriate given the difference between insurance liabilities and pension liabilities. Insurance liabilities are not as risky as pension liabilities, are supplemented by surplus capital, and are typically subject to different regulatory requirements than pension contracts.

Therefore, we recommend that the discount rate requirements or application guidance permit an appropriate illiquidity premium and not effectively require a spread based on AA-quality assets for discounting non-participating liabilities. We recommend language be changed to reference a “diversified representative high-quality fixed-income yield.” An example of such a yield would be a proposed regulatory standard, VM-22, under which liabilities would be

³ Source: Bank of America Merrill Lynch U.S. Corporate Index (C0A0), as of Nov. 22, 2016.

discounted at a rate based on an average of Treasury, AA, A, and BBB instruments.⁴ The weightings are consistent with average industry allocations and generally are similar to market clearing prices. As such, they are consistent with the illiquidity inherent in these products. As a practical expedient, an A rate could be permitted to be used as the discount rate because it would be much more representative of the rate used to price most non-participating contracts. Utilizing either of these options would result in consistency and transparency among companies, while avoiding day 1 losses for limited pay contracts that would be inconsistent with accounting for other liabilities with similar characteristics.

Although the spread between A and AA instruments, or a weighted average as described above and AA, is not large under normal circumstances, in times of market dislocation the difference can grow to problematic levels. We are particularly concerned that in a market disruption, when the market becomes illiquid, the impact of discounting insurance contracts at AA rates, rather than more appropriate A rates, could result in a sharp drop in an insurer's GAAP equity and trigger a false signal of insurer insolvency. Insurance contracts are illiquid, so they should not be subject to an illiquidity premium in excess of the publicly traded assets backing them. The consequent pro-cyclicality is even more concerning because some insurance regulators are beginning to look to GAAP financial statements when evaluating insurer solvency. Using a diversified representative rate would mitigate some of the pro-cyclicality.

We agree with the guidance provided by paragraph 944-40-55-13E to use an assumption consistent with a level 3 fair value estimate for points on the yield curve for which there is limited or no observable data for high-quality fixed-income instruments.

Question 5—Discount rate assumption update method and presentation: Do you agree that the effect of updating discount rate assumptions should be recognized immediately in other comprehensive income? If not, what other approach or approaches do you recommend and why?

Answer:

We agree, except for long-tailed claim liabilities. Reporting the impact of updating discount rate assumptions immediately in other comprehensive income (OCI) would be consistent with the reporting of available-for-sale assets, for which the impact of the change in fair value resulting from discount rate changes is reported immediately through OCI.

We want to point out a technical correction. Paragraph 944-30-35-6A (a) states that “the updated liability for a future benefits [which according to the previous sentence is discounted at the original discount rate] shall then be compared with the carrying amount of the liability for future policy benefits to determine the cumulative catch-up adjustment to be recognized in current-period benefit expense.” Because the “carrying amount” is generally interpreted to be the amount on the balance sheet, this comparison is incorrect. The carrying amount on the balance sheet is discounted at a current rate, not the original discount rate. In order to correctly isolate the discount rate impact, as required in 944-30-35-6A (b), the updated liability for a future benefit discounted at the original discount rate needs to be compared to the liability amount discounted at the original discount rate prior to the cash flow assumption

⁴ VM-22 is a proposed regulatory reserving requirement for valuing single premium immediate annuities and similar products. The specific weightings currently proposed are 5 percent Treasury, 15 percent AA, 40 percent A and 40 percent BBB.

update. A similar clarification is needed in 944-605-35-1B (c) in order to correctly capture the impact of the cash flow assumption change for deferred profit liabilities.

When a claim occurs, we recommend that FASB consider releasing any amount in OCI. Future changes in claim liability resulting from changes in discount rate should be reported in net income, or if OCI is retained for claim liabilities, the interest accretion rate should be reset as of the claim date. Claim liabilities typically are managed separately from liabilities for future benefits, and it would be administratively burdensome to retain a locked-in discount rate from inception of the contract.

Upon a claim, the relevant discount rate is the rate as of the date the claim occurred. If changes in discount rates on claim liabilities are to be recorded in OCI, it would be more meaningful to measure OCI based on changes in interest rates from the claim date than from the issue date of the contract. Assuming OCI is used to record discount rate changes, measuring those changes from the rate as of the claim date would be more consistent with accounting for annuitization of a deferred annuity, where the interest accretion rate would be reset on the annuitization date.

Recording changes in discount rates on a claim liability through net income also can be supported, which would be consistent with the reporting of discounted claim liabilities on short-duration contracts, for which changes in discount rates are reported in net income. Also, it is unclear how to calculate OCI for incurred but not reported (IBNR) liabilities.

Question 6—Discount rate assumptions update frequency: *Do you agree that discount rate assumptions should be updated at each reporting date? If not, what other approach or approaches do you recommend and why?*

Answer:

We agree.

Updating the discount rate each reporting period would mitigate non-economic volatility in equity because the updated discount rates would better match the change in fair value of assets held to back the insurance liabilities. Asset fair values are updated each reporting period.

Liability for Future Policy Benefits—Participating Contracts

Question 7—Scope (participating contracts): *Do you agree with the scope of the proposed amendments on the accounting for the liability for future policy benefits for participating contracts, including closed block contracts issued by a demutualized insurance entity? If not, what types of contracts, contract features, or transactions should be included in or excluded from the scope and why?*

Answer:

Assuming that the issues raised in questions 8 through 12 are adequately addressed, we agree with the scope.

As currently proposed, the model for participating contracts is fundamentally flawed. The model is consistent with the characteristics of non-participating insurance liabilities but not

with the characteristics of participating liabilities, which have interrelated components and floating credited rates. In particular, the participating model does not address:

- The need for the discount rate to be internally consistent with the dividend credited rate of the liability (see question 10);
- The need for net income to be based on an interest accretion rate that adjusts consistently with the projected dividend credited rates used in the liability calculation (see question 11);
- The need for changes in discount rates to be treated consistently with changes in dividend credited rates within the liability calculation (see question 8); and
- The need to exclude from the liability dividends related to future profits on other businesses (see question 8).

If these issues cannot be adequately addressed, we would recommend that the current U.S. GAAP liability calculation methodology be maintained and that participating contracts be scoped out of the proposed amendments.

Issues specific to demutualization closed blocks

The cost and effort to adopt the proposed accounting changes for demutualization closed-block contracts would be significant, and the value to users would be minimal due to the nature of the closed block. In addition, due to the policyholder dividend obligation liability required for demutualization closed blocks, changes to future policy benefit liability often will be offset by changes to the policyholder dividend obligation liability. A potential simplification for the valuation of closed blocks of demutualized companies is to set the liability equal to the value of the segregated assets of the closed block. As all of those assets will be paid to the policyholders or for their benefit and none of the assets will inure to the shareholders, the entire asset amount should be recognized as a policyholder liability. The portion of the asset values reported in OCI should carry over to the liability values in order to avoid accounting mismatches.

As long as there remains the expectation that dividends will be paid, no additional amounts should be required from shareholders to fund the projected liabilities. Thus, no liability should be established in addition to the closed block assets unless the closed block assets are expected to be inadequate to cover the guaranteed benefits of the closed block liabilities. If the assets are expected to be inadequate relative to contract guarantees, an additional liability calculated consistently with what used to be called SOP 03-1 can be accrued. This practice would be consistent with the accounting for a universal life contract with an account balance, which would be consistent with the conceptual basis for Financial Accounting Standard (FAS) 120. Alternatively, a fair value liability could be accrued in all periods for the possibility of a future asset inadequacy. This approach would treat the closed block liability as being analogous to a separate account liability, which it resembles in many ways as long as the company remains a going concern. Regardless of the calculation approach, we expect this additional liability to almost always be small.

This simplified approach is a better representation of the economics of closed-block contracts than either existing GAAP or the proposed targeted improvements. Therefore, we would recommend adopting this approach for closed-block contracts regardless of whether other participating contracts are scoped into the targeted improvements.

If an approach along the lines proposed in the exposure draft is used for demutualization closed-block contract, there is one revision that needs to be made to Topic 220 on

comprehensive income. Under existing U.S. GAAP, a policyholder dividend obligation (PDO) liability is held to the extent cumulative earnings in the closed block exceed the actuarial calculation. To the extent there are unrealized capital gains on closed block assets reflected in OCI, there is also a shadow PDO offset through OCI, as long as cumulative comprehensive income exceeds the actuarial calculation. This process would seem to continue based on the proposed amendment to 220-10-55-15C, which requires such shadow adjustments to policy liabilities. But if the effect of discount rate changes on closed block future policy benefit liabilities will be reported in OCI, it is necessary that the shadow PDO reflect those impacts as well as the asset unrealized capital gains. Otherwise, an accounting mismatch will result.

Question 8—Cash flow assumption update method and presentation (participating contracts): *Do you agree that the effect of updating cash flow assumptions should be calculated and recognized on a retrospective basis in net income? If not, what other approach or approaches do you recommend and why?*

Answer:

General comments

See our response to question 2 for a broader discussion of retrospective cash flow assumption updates, which also apply to participating contracts. In addition to those comments, the following clarifications are needed in order for retrospective unlocking to be appropriate for participating contracts.

Consistency with discount rates

Because liability cash flows for participating contracts are highly dependent on the dividend rates, which like the discount rate assumptions are highly related to the interest rate environment, the process for retrospective update of the net premium ratio will need to take this interrelationship into consideration. In particular, assuming updated dividend rate projections are included in the retrospective update, there will be a portion of the general change in interest rates captured in the net premium ratio, when it more appropriately belongs in OCI. Because the discount rate change and the dividend credited rate change are intricately related to the market changes in interest rates, the effects of these changes need to be reported consistently. Therefore, FASB's guidance should be clarified to specify that the effect of changes in interest rates on projected cash flows should be excluded from the retrospective unlocking of the net premium ratio. Rather, the effect of updating interest sensitive cash flows should be recorded in OCI, consistent with the change in discount rates. This approach would be consistent with FASB's proposal in the 2013 exposure draft and would improve convergence with IFRS.

An alternative solution to the inconsistency is to allow the best estimate cash flows (including actual and updated projected dividends) to flow through the retrospective update, but use an interest accretion curve that adjusts in parallel to changes in projected dividend credited rates for unlocking the net premium ratio. This curve would be consistent with the updated interest accretion rate described in our response to question 11. As a result, this curve would provide for internal consistency within the calculation and result in a split between net income and OCI that is consistent with the economics of the underlying business.

As discussed in our response to question 2, our committee would recommend that the updating of assumptions be on a prospective, rather than retrospective, basis with the interest

accretion rate unlocked. This approach would not only simplify the calculation of the premium ratio but would put dividends on a consistent basis with the discount rate.

Dividend projections

Another situation that could arise relates to components of dividend formulas that may exist in some mutual companies. Some mutual companies have non-participating subsidiary businesses that may generate annual profits (e.g., a homeowners' insurance business or an asset management business). Some mutual insurers will include profits from those businesses in the amount they pay in policyholder dividends even though they don't arise from the participating contracts themselves. They also may include projections of those amounts in the amount of dividends they illustrate to participating policyholders.

Including future dividends from those other businesses in the cash flows used to calculate participating liabilities, however, might cause a problem. The entity would be establishing a liability for future dividends but would not be showing an offsetting stream of future profits from the subsidiary. If this practice causes the net premium ratio to exceed 100 percent, the company would be showing a non-economic loss, sometimes a significant one.

We recommend that future dividends arising from profits earned outside the participating business not be included in projected future cash flows, unless they are guaranteed. To the extent that these profits are generated by investments from surplus funds, this portion of dividends should only be included in the liability at such time as they are formally declared. This can be justified by the fact that this portion of dividends is essentially a return to mutual policyholders in their capacity as owners of the company, and are thus more analogous to a dividend to a shareholder than a liability to a customer.

Question 9—Cash flow assumption update frequency (participating contracts): Do you agree that cash flow assumptions should be updated on an annual basis, at the same time every year, or more frequently if actual experience or other evidence indicates that earlier assumptions should be revised? If not, what other approach or approaches do you recommend and why?

Answer:

As discussed in our response to question 3, we generally agree that cash flow assumptions should be reviewed for update on an annual basis, at the same time every year, or more frequently if actual experience or other evidence indicates that earlier revisions to assumptions should be made. However, there is an additional nuance for participating contracts. Some of the cash flows of participating contracts are interest-dependent. When interest rates change, the projected dividend credited rate will change, impacting projected future cash flows. Because this change in projected cash flows is the result of a market interest rate change, it is intricately linked to any liability discount rate change, which is also the result of market interest rate changes. So changes in projected cash flows resulting from changes in interest rates need to be made at the same frequency as discount rate changes in order to avoid accounting mismatches.

Question 10—Discount rate assumption (participating contracts): Do you agree that expected future cash flows should be discounted on the basis of a high-quality fixed-income instrument yield that maximizes the use of current market observable inputs? If not, what other approach or approaches do you recommend and why?

Answer:

We do not agree. The expected future cash flows for many participating contracts include future participating payments that depend upon an assumed investment yield that may differ from a high-quality fixed-income yield. Proper valuation requires consistency between the investment yield assumed when projecting the expected cash flows and that used for discounting them.

Consistency between the projected cash flows and the discount rate can be achieved in either of two ways.

- A. The discount rate can be adjusted consistent with the assumptions used when projecting the cash flows. As such, the discount rate would differ among companies because the projected participating payments are based on company-specific assumptions. Under this option, projected dividend cash flows would be derived from a current rate based on the company's expected investment returns and the method the company actually uses to determine dividends. For example, if the company bases dividends on asset book yield returns, then the projected dividends would reflect expected future book yields. The balance sheet liability discount rate would then be based on the current market yield on those assets. This option is consistent with accounting for nontraditional contracts, where the additional liability for death or annuitization benefits is discounted based on the credited rate of the contract.
- B. The projected cash flows can be adjusted to be consistent with the discount rate. In this case, the discount rate should be determined consistent with our response to question 4. This approach would mean that the projected cash flows are no longer the "expected future cash flows" described in option A, but are adjusted based on an assumed level of investment return used only for accounting purposes. As with option A, the approach to determining the projected dividends should be consistent with the company's approach to setting actual dividends; however, the projected dividends would be based on an assumption that the asset yield is consistent with the prescribed discount rate. Adjusting the projected cash flows in this manner is likely to be a burdensome process and would diverge from the basic principle of having the liability based on expected future cash flows.

We recommend option A because it would be more practical to apply. If option A is adopted, then guidance from FASB will be needed in setting the discount rate. This guidance should focus on the principle that the discount rate should be consistent with the level of risk being passed on to the participating policyholder through the participation mechanism. The greater the risk passed to the participating policyholder, the higher the discount rate. This is the same principle used in market pricing of investments—the greater the risk in the expected future cash flows, the higher the discount rate.

The level of risk that is passed to a participating policyholder is dependent on the way the participating payments are determined. There is a wide range of participating mechanisms, and the portion of investment risk that is passed to the participating policyholder ranges from 0 percent to 100 percent of the risk in the underlying investments.

In general, the discount rate for participating contracts should be less than or equal to the market yield the company assumes on the underlying investment portfolio net of investment expenses. If 100 percent of the investment risk is passed to the policyholder, then the discount rate should be equal to the full assumed net market yield. If less than 100 percent of

the risk is passed to the policyholder (due to minimum guarantees or other contract features), then the discount rate should be lower than the market yield assumed on the underlying investment portfolio by a spread that represents the market price for the risk the company retains. To the extent the insurer reduces dividend cash flows by expected default losses, a consistent reduction should be made to the discount rate. If 0 percent of the investment risk is passed to policyholders, then the discount rate using this approach should be equal to a high-quality fixed-income yield.

This approach appropriately reflects the characteristics of a participating contract when setting the discount rate. It is consistent with the use of a high-quality fixed-income yield in connection with non-participating contracts, because the investment portfolio of most insurers includes a higher level of risk and a higher expected return.

It would not be appropriate to use the approach mentioned in the basis for conclusions of splitting the discount rate and using a different rate to discount dividend cash flows than to discount benefit cash flows. The dividend credited rate is the amount credited to all funds in the participating insurance contract, and so a discount rate consistent with the dividend rate needs to be applied to all contract funds.

An analogy can be made to a floating-rate mortgage. In a floating-rate mortgage, there is a floating credited rate that is applied to all funds in the mortgage contract. The timing of the principal repayments may vary, but the amount of original principal to be repaid would not vary based on the floating credited rate. But when determining the current value of the mortgage, one would not discount the interest payments at one rate while discounting the principal repayments at a different rate. The resulting value would not be meaningful.

It is similar for a participating insurance contract, where the guaranteed surrender and death benefits are analogous to the principal repayments on a floating-rate mortgage. Even though the death benefit payment amounts may be different from expected as a result of mortality experience differing from experience, those differences are not a function of the time value of money. And in general for a participating contract, any deviations in mortality experience will be passed back to policyholders through the dividend mechanism, so even if deviations in mortality experience were relevant to validating a split discount rate, those deviations ultimately would have little impact on the total cash flows from a book of participating insurance contracts.

Question 11—Discount rate assumption update method and presentation (participating contracts): *Do you agree that the effect of updating discount rate assumptions should be recognized immediately in other comprehensive income? If not, what other approach or approaches do you recommend and why?*

Answer:

We have a significant concern with the method in the exposure draft for updating discount rates through OCI as it applies to participating contracts. If that concern can be addressed, we agree that the effect of updating discount rate assumptions should be recognized immediately in OCI.

The FASB exposure draft approach for calculating the impact of a change in discount rates to be reflected in OCI determines net income on an interest accretion rate that is locked in at contract inception. This is appropriate for non-participating contracts where policy values are

locked in at issue, but it is not appropriate for participating contracts where the credited rate can vary. The approach in the exposure draft does not reflect the floating-rate nature of participating contracts.

With a participating contract, if interest rates decline, the dividend credited rate would be expected to decline. This decline would reduce projected dividend cash flows. But under the FASB approach, these lower cash flows would be discounted at a locked-in interest accretion rate for determining net income, which would result in an automatic gain in net income, even though the contract is no more profitable economically than it was before the interest rate decline. As such, this gain would just reverse over time. The balance sheet liability would correctly discount the lower projected cash flows at a lower discount rate, consistent with the lower-interest-rate environment. So this is an issue of the allocation between net income and OCI, not of the balance sheet liability amount itself.

The opposite would occur if interest rates increase. Participating contract dividend credited rates would be expected to increase, causing projected dividend cash flows to increase. These increased cash flows would be discounted for net income purposes at the locked-in interest accretion rate, resulting in an automatic loss in net income. As such, this loss would be non-economic because the contract is no less profitable than it was before the interest rate increase. The increased cash flows are simply a function of the floating-rate nature of the liability. Again, the immediate loss would reverse over time.

We can see two approaches to fixing this issue. We recommend using interest accretion rates that are not locked in but rather a curve of rates that adjust in parallel to changes in projected dividend credited rates (i.e., the interest accretion curve would not adjust for changes in dividend mortality or expenses). This approach to update the interest accretion rate has been sometimes referred to as a “level spread” approach because it solves for a “level spread” relative to projected dividend credited rates in each future period such that the net effect of the change in credited rates and the change in interest accretion rate curve does not impact net income. This approach would be consistent with those permitted by the IASB to address OCI for contracts with participating features, and thus would enhance convergence with IFRS.

In most real-world circumstances, we would expect that theoretically correct level spread would need to be determined iteratively. We do not view this as a major obstacle because there have been actuarial calculations requiring iterative calculations for decades (e.g., under current U.S. GAAP, iterative solutions are sometimes needed to address interactions between unearned revenue liabilities and additional liabilities under what used to be called SOP 03-1). But if FASB does not want to require a potentially iterative calculation, it could permit companies to apply reasonable simplifications, such as adjusting the forward interest accretion rates by the same amount as the change in dividend credited rate projected in the corresponding period.

Another approach can be used to address the net income/OCI split for participating contracts. Under this approach, the interest accretion rate can be locked in. But then the projected dividends used in the liability calculated to determine net income also need to be based on the dividend credited rates locked in at inception. This would mean that there would be two dividend scales used for calculating financial statement information: a dividend scale based on current interest rates that would be used to calculate the balance sheet liability, and a dividend scale based on the locked-in dividend credited rates from contract inception that would be used to determine net income. Under this approach, both changes in discount rates

and changes in dividend credited rates would be reported in OCI. Net income would be reported based on the discount rate and dividend credited rates that were in effect at contract inception. Our view is that this approach of maintaining what is effectively a hypothetical dividend scale to determine net income is less practical than the approach of updating the interest accretion rate described above. But either approach would appropriately reflect the floating-rate nature of participating insurance contracts.

If this issue cannot be addressed, the only other solution would be not using OCI for participating contracts, which is problematic for the reasons FASB provided for why it chose to report changes in discount rates in OCI. But reporting the effect of discount rate changes in net income is preferable to requiring a net income/OCI split that is inconsistent with the characteristics of participating contracts and would provide misleading financial information.

Question 12—Discount rate assumption update frequency (participating contracts): Do you agree that discount rate assumptions should be updated at each reporting date? If not, what other approach or approaches do you recommend and why?

Answer:

We agree. Updating the discount rate—and interest-sensitive cash flows—each reporting period would provide the most relevant information. It also would avoid accounting mismatches with asset fair values that are updated each reporting period. Keeping the timing of liability discount and credited rate updates consistent with that of asset fair values would avoid non-economic fluctuations in GAAP equity.

Market Risk Benefits

Question 13—Scope: Do you agree with the scope of the proposed amendments on the accounting for market risk benefits? If not, what types of contract features should be included in or excluded from the scope and why?

Answer:

The FASB exposure draft lays out two criteria that a contract must meet in order to comply with the proposed requirement to be valued at fair value. The first requirement (Contract) is that the policyholder would need to have the ability to direct funds to one or more separate account investment alternatives maintained by an entity, as well as for the investment performance to be passed through to the policyholder (although the separate account does not need to be legally recognized as such).

We are concerned that this separate account criterion will result in inconsistent treatment of similar riders for benefits that vary with market performance but which have different underlying contract structures. In particular, in the marketplace today, annuity writers offer guaranteed lifetime withdrawal benefits (GLWBs) on both variable annuities (VAs) and fixed indexed annuities (FIAs). For both products, the policyholder can receive guaranteed benefits that may vary more than nominally based on adverse market performance. However, while the VAs will generally meet the separate account treatment, FIAs typically do not. Under U.S. GAAP today, these GLWBs are generally accounted for using insurance accounting (under the guidance formerly known as SOP 03-1). Because these guarantees are largely the same risk as GLWBs attached to VAs, it is appropriate that they be accounted for consistently and that fair value would be the appropriate measure. This is particularly the case for FIAs that are designed such that the policyholder can lose principal, which is becoming a more popular contract design. If the policyholder can lose principal, then the FIA guarantee is not

just guaranteeing a minimum rate of return on the contract, but is also providing reimbursement for capital market losses. Reporting GLWBs attached to FIAs at fair value would also be consistent with the accounting for the hedge assets that are used to back these liabilities.

An additional inconsistency that seems to be created by the current requirement relates to companies that write FIA contracts and utilize separate accounts to write the business. Depending on the operation of the separate accounts, guarantees on these FIA contracts would be market risk benefits, while guarantees on most FIA contracts would not. This inconsistency would seem to result in different treatment by writer.

We recognize that, under a targeted improvement project, it is necessary to separate market risk benefits from non-market guaranteed benefits that are not accounted for at fair value. It would be more appropriate to remove the separate account requirement in 944-40-25-25C (a) and replace it with a criterion that is based on the substance of the contract rather than the form. For the reasons discussed above, the committee's view is that a more appropriate and substantive distinction is between contracts for which an account balance can decrease due to adverse capital market changes and contracts for which an account balance can only decrease due to fees charged or due to negative interest credit. We therefore recommend that 944-40-25-25C (a) be revised as follows:

“Contract: The account balance can decrease in value as a result of adverse changes in capital market prices. Decreases in account value based solely on fees charged or negative interest rates credited are not decreases that result from adverse changes in capital market prices.”

Another consideration is whether the scope should exclude benefits payable only upon death, such as guaranteed minimum death benefits (GMDBs) on VAs and no-lapse guarantees on variable life insurance contracts.

Although the committee agrees with including living benefits within the scope of market risk benefits reported at fair value, the committee does not have a view on whether to include death benefits within the scope. We recommend that FASB take the following considerations into account in making the final decision whether GMDBs should be scoped in as a market risk benefit:

- Although adverse equity movements can result in an other-than-nominal increase in the GMDB net amount at risk, the underlying separate account value can be reasonably expected to recover as the equity market improves. This is especially true of a basic GMDB that offers only return of premium. The GMDB benefit is only payable on death, and the policyholder cannot choose to exercise the benefit against the insurance company. The existing accounting model for GMDB liabilities under ASC 944-40 is an accrual model where the reserves are built up over time. It can be argued that the accrual model is still an appropriate model for these basic GMDBs.
- Scoping in GMDB as a market risk benefit would encourage hedging for GMDB, which is not currently prevalent in the industry in part due to an insurance liability model for GMDB that creates a mismatch with accounting for hedging assets. Many smaller VA writers that don't offer complex living benefit guarantees may not have the infrastructure and expertise to hedge GMDB. If unhedged, the movement in fair value of the guarantees could cause a larger mismatch for these companies. If they

choose to hedge, it could impose significant costs on these companies that may not be commensurate with the benefits.

- On the other hand, some companies may want to hedge their GMDB risk and are discouraged from doing so because of the accounting mismatch that arises between the current accounting model for GMDBs and the fair value of hedging instruments. Including GMDB within the scope of market risk benefits would facilitate their ability to hedge the risk.
- For GMDBs that offer rich features such as roll-up, ratchet, and/or dollar-for-dollar adjustments on partial withdrawals, the account value recovery may be less likely to reach the guarantee level. These features may warrant inclusion of the GMDB within the market risk benefit definition. However, allowing bifurcation of the GMDB benefit (i.e., insurance liability model for the base GMDB benefit but market risk benefit accounting for enhanced features) could result in diverse practices. Practicality and consistency need to be considered in making the final determination.

There are two other technical points we would like to address with respect to market risk benefits scope:

- Because it is necessary to separate market risk benefits from non-market-related benefits, it would be beneficial if FASB provided a fair value option for benefits that do not meet the criteria for a market risk benefit but for which the company is hedging, without requiring fair valuing the host contract. This would be a one-time irrevocable election available at inception of the contract or on transition that could apply to a benefit accounted for as an additional liability under the former SOP 03-1 without fair valuing the entire contract. This approach would provide a way to mitigate accounting mismatches on hedged benefits that do not meet the criteria of a market risk benefit. Because the fair value of any hedge ineffectiveness would automatically be reported in net income each reporting period, there would not be a need for limitations on the use of this option.
- We generally agree with the proposed guidance in 944-40-25-40 that reinsurance of a market risk benefit should be accounted for as a market risk benefit. A ceding company should always account for reinsurance ceded on a market risk benefit at fair value to avoid accounting mismatches with a direct contract. But there may be some instances where FASB should consider exempting an assuming company from accounting for the reinsurance assumed at fair value. This would be the case if the assuming company is not accepting any market risk. One example would be if the assuming company is reinsuring a GMDB on a yearly renewable term basis and is always receiving a premium commensurate with the death benefit it is reinsuring. Even though the amount of death benefit may vary with capital markets, if the reinsurer is always receiving a commensurate premium, it is not exposed to capital market risk in this situation.

Question 14—Measurement: *Do you agree that all market risk benefits should be measured at fair value, with fair value changes attributable to a change in the instrument-specific credit risk recognized in other comprehensive income? If not, what other alternative or alternatives do you recommend and why?*

Answer:

We agree that market risk benefits should be measured at fair value, with fair value changes attributable to a change in the instrument-specific credit risk recognized in OCI, subject to the scope considerations discussed in our response to question 13 above.

Market risk benefits are subject to significant capital market risk and are often hedged using derivatives. Existing U.S. GAAP generates non-economic volatility to the extent certain market risk benefits are hedged because the hedging instruments are reported at fair value while certain market risk benefits are not. Even for market risk benefits that are reported at fair value currently, reporting the impact of changes in instrument-specific credit risk in OCI will improve the financial reporting match with hedging instruments. Additionally, to the extent that market risk benefits are unhedged, reporting the benefits at fair value will make the resulting economic volatility transparent to users.

Another benefit of reporting market risk benefits at fair value is that it will reduce the need to bifurcate benefits and increase comparability. Under existing U.S. GAAP, some market risk benefits need to be bifurcated between an embedded derivative and an additional liability that is not reported at fair value. This bifurcation can be complex and may not be performed consistently among different companies. Also, as projected cash flows move between the embedded derivative portion of the benefit and the additional liability portion, non-economic volatility can result.

We are concerned that the continuation of practices currently used in the application of fair value guidelines to contracts with market risk benefits could result in unintended consequences after implementation of these targeted improvements. Specifically, the current fair value calculation of these benefits sometimes uses an attributed fee approach to develop a net premium factor that is applied to the rider fees. This attributed fee is not currently capped at 100 percent, under the presumption that base contract mortality and expense charges are available to cover the expected rider benefits in excess of the rider charges.

We recommend that a cap on attributed fees for all market risk benefits equal to the sum of all contract charges be added to the targeted improvements (similar to that placed on the net premium ratio for traditional contracts) to ensure that no deficiencies emerge on these market risk benefits. Also, there should be an aggregate cap to ensure that the aggregate attributed fees used for both market risk benefits and embedded derivatives within a single contract do not exceed 100 percent of the total contract fees. If any market risk benefits that are currently accounted for as embedded derivatives have an attributed fee that exceeds 100 percent of total contract fees, this cap should result in an increased liability on transition.

Deferred Acquisition Costs

Question 15—Scope: Should the scope of the proposed amendments be expanded to include investment contract acquisition costs currently amortized using the interest method in Subtopic 310-20, Receivables—Nonrefundable Fees and Other Costs?

Answer:

The scope should not be expanded to include investment contracts. These models are used by more than just insurance companies, and introducing a different model for the same products would decrease comparability with those companies. Furthermore, the current approach for investment contracts does not have the complexities that amortizing with estimated gross profits has and is already well understood.

Question 16—Amortization: *Do you agree with the proposed amendments that would simplify the amortization of deferred acquisition costs? If not, what other simplified and reasonably estimable amortization approach or approaches do you recommend and why?*

Answer:

We agree that the proposed amendments would simplify amortization of DAC for universal life-type contracts. Eliminating the need to collect and maintain historical data will simplify the process of determining these balances for preparers. Removing the retrospective impact will enhance the transparency for users. This approach is not materially simpler than the existing amortization method for traditional products, but it is appropriate to also change the accounting for DAC on these products to be consistent with the model used for universal life-type contracts.

Because insurance in force is a driver of acquisition costs for certain products, we also agree insurance in force is appropriate for those products. However, we have concerns with using a straight-line approach for other products where in force either is not relevant or cannot be reasonably estimated. If the straight-line approach is retained, we also want to clarify how to apply the straight-line approach to a cohort of policies.

Initial insurance in force is an appropriate driver for acquisition costs for many long-duration products. Therefore, it also is an appropriate basis for expensing these costs. However, as FASB notes, in force cannot be reasonably estimated for several products (e.g., VAs) and is not relevant for other types of business (e.g., long-term care or investment contracts). We believe this is partly why paragraph 944-30-35-4 under existing U.S. GAAP offers several choices as an alternative to gross profits and not just in force for universal life-type contracts. We also recognize that using a straight-line approach makes it a challenge to comply with paragraph 944-30-35-3B regarding excess lapses while still using a cohort approach.

We recommend that capitalized acquisition costs be expensed in proportion to “policy size,” which could be defined based on the characteristics of the product and aligned to the appropriate driver of acquisition costs. Examples would include in force, level of benefits, initial deposits, or annualized premiums. Introducing these choices would preclude the need for the straight-line approach and would allow for more appropriate recognition of excess lapses. The required disclosures would then be provided separately for each of these drivers.

If the straight-line approach remains, applying this to a cohort of policies would be similar to using policy count as the basis instead of in force in the example beginning with paragraph 944-30-55-7. Such a method would blend policies with different acquisition costs and could not differentiate between excess lapses of policies with these different acquisition costs. Also, complying with paragraph 944-30-35-3B may require performing the calculation at a much lower level of aggregation, which is not consistent with the unchanged guidance in paragraph 944-30-25-1B. Requiring this lower level of aggregation either explicitly, or implicitly (as the exposure draft currently seems to imply for policies where in force cannot be reasonably estimated), would increase the number of cohorts significantly, as well as the complexity and cost of these calculations. For these reasons, we do not support using the straight-line basis while simultaneously requiring reductions for actual experience.

We also have a suggestion specific to unearned revenue liabilities. Using the DAC amortization approach, which excludes interest accretion and future anticipated deferrals,

would significantly defer revenue recognition on many nontraditional contracts. Many contracts charge extra non-level fees over a long period that are intended to fund services in all contract years. We suggest that it may be more appropriate to amortize these fees consistent with a deferred profit liability on a limited-payment contract, including interest and anticipating future fees. This would be more consistent with the revenue recognition principles in Topic 605.

Question 17—Impairment: *Do you agree that deferred acquisition costs should not be subject to impairment testing? If not, what alternative or alternatives do you recommend and why?*

Answer:

We agree, although acquisition costs are a significant portion of the overall income for insurance products and are more significant than debt issuance costs for those products. We also have concerns regarding holding these balances when the expected future income from the underlying insurance products do not support the balance. However, we do note that discontinuing the impairment test does simplify the reporting process and appropriate disclosures on these balances will be available for users. Therefore, we agree that DAC should not be subject to impairment tests. We also understand that since these balances are no longer interest-bearing, they will no longer be considered financial balances and are not subject to foreign exchange re-measurement. The additional disclosure requirement we recommend in our response to question 19—to disclose the present value of future gross premiums—would help users understand the extent to which any DAC is recoverable, at least on an aggregate basis.

Presentation and Disclosure

Question 18—Proposed requirements: *Do you agree that the presentation and disclosure requirements included in the proposed amendments would provide decision-useful information? If not, which presentation and/or disclosure requirement or requirements would you change and why?*

Answer:

We agree that most of the presentation and disclosure requirements would provide decision-useful information. This is particularly true if the companies focus on two items: change in cash flow assumptions and variances from cash flow assumptions. These items are relevant because they focus on changes that may reveal trends at the company level.

However, the requirement set forth in paragraphs 944-40-50-6 (b)(5), 944-40-50-6 (e), and 944-40-50-7B (b)(2) to include “ranges and weighted averages” in the disclosure of “Qualitative and quantitative information about the significant inputs, judgments, and assumptions used in measuring the liability” would not provide decision-useful information for the following reasons:

- The non-market assumptions, such as lapse rates, mortality rates, and benefit utilization rates, used in measuring long-duration contract liabilities will generally range from about 0 percent to 100 percent. For example, the mortality rate of a 22-year-old female would be very close to 0 percent, and the mortality rate of a 120-year-old male is about 100 percent. Users will not be able to compare ranges of assumptions among companies in any meaningful way.

- A comparison of the weighted averages of a given assumption among companies has no basis because it depends on too many variables, such as the duration of the contracts, the distribution channel, the mix of business between ages and genders, etc. For example, if two companies sell 5-year term life policies and use the same lapse rate assumptions of 5 percent, 5 percent, 6 percent, 20 percent, and 100 percent in durations 1-5 respectively, the company with more policies in its fourth and fifth durations will have a much higher average lapse rate than the company with more policies in the first and second durations. A weighted average disclosure for these assumptions also could be very complex to calculate because the assumptions vary over the course of the projection period for each contract—potentially over many years and possibly under multiple scenarios.

There is no simple and straightforward way to compare policyholder behavior or mortality assumptions among companies. Different companies have books of business with different demographics that were subject to different underwriting requirements and were sold through different distribution channels. The focus of the disclosures should be on gaining understanding of the impacts of changes in assumptions and how experience compares with assumptions. Because disclosures about assumption changes and actual experience are already required by the targeted improvements, these range and weighted average disclosures would not improve users’ understanding of the business or of insurer performance. It may be worthwhile to clarify that a direct comparison of actual experience versus the liability assumption during the reporting period is required, instead of the range and weighted average.

With regard to the duration disclosure requirement, it is not clear what it represents or how to calculate it. We believe that the discounted and undiscounted cash flow disclosures will provide the information that FASB is attempting to achieve with a duration disclosure.

Question 19—Additional requirements: *Are there any additional presentation or disclosure requirements that would provide decision-useful information? If so, please describe them and explain why.*

Answer:

We recommend the following additional presentation and disclosure requirements:

- We recommend that the table of undiscounted net premiums and expected future benefit payments shown in paragraph 944-40-55-29E be expanded to include a row for “Expected gross premiums” above the “Expected net premiums.” The liability rollforward table in paragraph 944-40-55-29E should also be expanded to show the present value of expected gross premiums. Including gross premiums in the disclosure will provide multiple benefits:
 - a. The addition of gross premiums to the present value disclosure will provide an economic measure of the current value of expected future margins.
 - b. The addition of gross premiums to the disclosure of undiscounted net premiums and benefits will highlight the sum of expected future margins.
 - c. As alluded to in our response to question 17 on DAC impairment, this disclosure will facilitate comparisons of DAC and other intangible asset balances to both discounted and undiscounted margins, permitting users to estimate the extent to which future profit may be available to investors.

- We recommend that disclosures similar to those for traditional future policy benefits be required for additional liabilities (per the former SOP 03-1) on nontraditional contracts. This disclosure could be performed by expanding the existing rollforward table and table of undiscounted net premiums and benefits to include additional liabilities on nontraditional contracts, replacing required disclosures of “premiums” with “premiums and assessments.” Alternatively, separate tables could be used for additional liabilities. This would provide a complete set of rollforward information.
- We recommend that a rollforward disclosure for long-tailed claim liabilities on long-duration contracts be included. Long-duration contracts such as disability income contracts and long-term care contracts can result in long-tailed claims that should be subject to a rollforward disclosure.
- With regard to the presentation requirements, we recommend that interest accruing on traditional future policy benefit liabilities (i.e., liabilities described in paragraphs 944-40-25-10A through 944-40-25-11) and on additional liabilities on nontraditional contracts (i.e., liabilities described in paragraphs 944-40-25-26 through 944-40-25-27A) be reported as a component of interest expense. Other changes in these liabilities should be reported as a component of benefit expense. Per the exposure draft, all changes in these liabilities would be reported as benefit expense. Because the interest accrual is more closely related to a borrowing cost than to insurance costs, showing interest accruals separately would provide more decision-useful information about the timing of cash flows and would facilitate evaluation of both an insurer’s insurance performance and its investment performance.

Effective Date and Transition

Question 20—Implementation date: *The board is interested in understanding the key drivers affecting the timing of implementation. What are those key drivers and how do they affect the time it will take to implement the proposed amendments? Should the effective date be the same for both public entities and nonpublic entities?*

Answer:

The FASB’s proposed model will take a significant amount of time and effort to implement. Even though FASB has limited itself to targeted improvements, some of these changes will still require extensive changes to valuation systems.

In particular, some of the calculations required are relatively complex. As discussed in our response to question 2, retrospective unlocking of the net premium ratio will present a complicated calculation that is not consistent with existing traditional long-duration liability valuation. Fair valuing market risk benefits also will require new complex calculations for market risk benefits currently accounted for under what used to be known as SOP 03-1. Although fair value is not inherently more complex than SOP 03-1, setting up the new fair value calculations will require significant valuation changes. Finally, even though DAC valuation is simplified, making the change to the new calculation approach also will require some time and effort.

Although most of the extensive additional disclosure requirements are justified, it will require extensive effort to set up the calculations and gather the necessary data. And, as discussed in our response to question 18, some of the proposed disclosures, including the weighted averages of assumptions, will be particularly challenging to calculate.

The transition approach also will contribute to the time needed for implementation. Retrospective transition, as is required for market risk benefits and for most traditional future policy benefits, requires significant time to obtain and/or estimate substantial volumes of historic data and then integrate that data into a calculation. This is also the case to the extent any nontraditional contracts require a retrospectively calculated additional liability (e.g., the former SOP 03-1) on transition due to expected profits followed by losses.

General issues that could affect implementation time include availability of software, availability of data, and the need to train people. People will need to be trained on the new required valuation approach and on how to interpret the results of the new approach. New processes and controls also would need to be developed.

External factors also need to be taken into account. The new IFRS insurance contracts standard is expected to become effective in 2021, along with a number of new regulatory valuation requirements becoming effective in the United States, including principle-based reserving for life insurance that will be effective in 2017 (with an option to defer until 2020) and changes to variable annuity reserves and capital. Further, the International Association of Insurance Supervisors is developing new capital standards for internationally active insurers that will be taking effect over the next few years. In many companies, the same people would be working on these implementation projects as will be working to implement the FASB-targeted improvements. So, the committee is concerned about the availability of already limited resources.

Because of these issues, we expect three to four years will be required to implement the targeted improvements as proposed, similar to the implementation time for the IFRS standard. Even though these changes impact only one industry, they are big, complex changes for that industry, at least as substantial as the new revenue recognition standard is for affected industries. And even though FASB's proposed changes are less extensive than the IFRS changes, U.S. GAAP requires an additional year of historical data to be restated on transition, which increases the time needed to implement.

There are a number of things FASB could do to reduce the time to implement the new standard:

- Prospectively unlock net premium ratios rather than retrospectively unlock;
- Permit or require prospective transition for market risk benefits and traditional future policy benefits;
- Begin accrual of an additional liability on a nontraditional contract only from the point at which a profit-followed-by-losses situation is identified; and/or
- Permit or require a practical approach for demutualization closed blocks.

We estimate that by making these changes, the time to implement the targeted improvements can be reduced by at least one year.

Question 21—Transition methods: *Are the proposed transition provisions operable and do they provide decision-useful information? If not, what would you recommend and why?*

Answer:

With a few exceptions, we expect the proposed transition provisions to be mostly operable and to provide decision-useful information. There are a few specific issues we want to highlight:

Traditional contracts additional liabilities for premium deficiency

The proposed FASB guidance requires retrospective transition for traditional insurance contracts unless impracticable. Using a prospective transition for all contracts would significantly simplify the transition and increase consistency because all contracts would then use the same transition approach. Many in force insurance contracts were sold decades ago, making retrospective transition burdensome. Although FASB appropriately permits prospective transition if retrospective transition is impracticable, impracticability is a difficult hurdle to overcome. Many contracts that have been in force for a long time would likely not meet the impracticability exception. Also, even for contracts for which retrospective transition is impracticable, significant effort will be required to prove it.

If FASB chooses to retain retrospective transition for most traditional contracts, there is one additional situation for which an exception is needed. For products that established additional liabilities for premium deficiency in prior years, retrospective application to the contract issue date could move that loss out of retained earnings and into accumulated OCI. This would not provide decision-useful information and could significantly distort subsequent earnings in a way that misleads users of financial statements.

In some—but not all—instances, the impracticability exception might alleviate this concern. That clause will probably not be available for all product segments.

Consider, for example, an immediate annuity that had originally used a 7 percent discount rate, which has since been changed to 4 percent and a loss booked at the time of change for the increased liability. Suppose (for simplicity) that a high-quality fixed-income asset yield at inception was also 7 percent and at the time of loss recognition was also 4 percent. Full retrospective application would remove the prior loss from retained earnings and move it into accumulated OCI. The balance sheet wouldn't change, but subsequent earnings would include ongoing losses for the deficiency between current asset yields and the 7 percent liability discount rate. Using a retrospective transition would not provide decision-useful information because the losses had already been recognized through net income.

The best alternative to prospective transition would be to apply the proposed standard retrospective to the date at which the discount rate was locked in. For most contracts, this date would be contract inception, but if there has been a premium deficiency on a contract, this date would be the date of the most recent premium deficiency loss.

Existing carrying amount of deferred acquisition costs

We agree that a prospective approach for transition of DAC would be most practical. But for some products, the proposed FASB approach will significantly alter the pattern of amortization. A transition approach that starts from the existing carrying amounts of the DAC asset could lead to significant distortions in the financial statements for several years after transition if the liability uses a retrospective transition.

For some traditional products, retrospective application to the liability for future policy benefits will significantly alter its relationship to DAC amortization after transitioning from the existing carrying amounts of the DAC asset. Similarly, this could lead to significant distortions in the financial statements for several years after transition.

In both cases, the distortions would resemble those that would have occurred after the effective date of ASU 2010-26 had that not permitted retrospective application.

This concern could be effectively addressed by again permitting (but not requiring) retrospective application to the DAC asset if the liability used a retrospective transition approach.

Because the factors affecting DAC amortization, the relationships between DAC amortization and liability development, and the liability transition approaches will vary by product type, we recommend the option to apply the new standard retrospectively be available separately for each major product type (i.e., traditional life, traditional health, universal life, fixed deferred annuities, variable deferred annuities, etc.)

Each insurer would have to decide, for each product type, whether the potential distortion is significant enough to warrant retrospective application and whether retrospective application is practicable. If elected for a given product type, retrospective application should be required for all business of that type—with one exception. For traditional life or health insurance contracts, retrospective application to DAC should not be allowed for any segment in which retrospective application to the liability is found to be impracticable.

If FASB accepts our suggestion to use a prospective transition for liabilities, that would resolve the DAC issue for traditional products. We would then suggest simply using prospective DAC transition for all products.

Retrospective application to market risk benefits

We are concerned about the transition provisions for market risk benefits. Paragraph 944-40-65-2 requires “retrospective application to all prior periods.” This would appear to require that, for market risk benefits that are valued as swaps, companies would need to determine the attributed fee for the market risk benefit such that the fair value of the market risk benefit would have been zero at inception of the contract.

This requirement presents a number of problems. Insurers may not have retained all the necessary data going back to inception. Market risk benefits have been issued for many years, especially GMDBs, which date back to at least the 1980s. Even if policy data were available, economic assumptions for all historical periods would need to be developed and stochastic scenarios would need to be generated for those periods. The original valuation system may not be available; for example, the insurer may no longer have the license or the software has been superseded by newer versions and is no longer being supported. Additionally, it is unlikely that, to the extent level 3 estimates are needed, they could be made objectively without some degree of hindsight impacting the result. For example, for a market risk benefit sold in 2005, an equity price scenarios might incorporate a higher likelihood of a financial market collapse because an actuary today would know there was a financial crisis in 2008. Even though the probability assigned to such a collapse may still be small, it would likely be far higher than an actuary would have assigned to such an event in 2005. Similarly, for a market risk benefit sold in 2010, interest rate scenarios would likely be at least somewhat influenced by the recent sustained negative interest rates in several major currencies, a factor that would have seemed a small probability in 2010.

In addition to the practical issues, retrospectively determining the attributed fee raises concerns about the potential financial statement impact. For market risk benefits sold before

the 2008 financial crisis, even if the attributed fee can be determined retrospectively in an objective manner, the resulting fee may cause a substantial increase to the liability. This would materially depress GAAP equity on transition, and the resulting equity decrease would be recycled into net income in the future. We are not sure that this pattern will be meaningful to financial statement users.

Our first recommendation would be to change the standard to require a prospective determination of the attributed fee, rather than retrospective. Because the concern from users was not that the current valuation of the liabilities is too high or too low, it would be reasonable to maintain the current value of the liabilities on transition. The existing liability amount would be an objective value from which to calibrate the post-transition liability. In the same manner that the terms of a market risk benefit can be determined such that its fair value is equal to zero at inception, the terms can be determined such that the fair value is equal to the pre-transition value at transition.

Although our recommendation would result in the fair value of the market risk benefit being equal to the additional liability (per the former SOP 03-1) immediately before transition, this result does not imply that the additional liability represents a fair value. The additional liability and the market risk benefit measure two different things. Although the benefit stream is the same, albeit calculated using different assumptions, the fees assumed to cover the benefit are different in each case. The additional liability does not use an attributed fee. Thus, the attributed fee can be defined such that the present value of the market risk benefit on transition—accounting for both the benefit stream and the attributed fees—happens to equal the additional liability as of that date.

We would suggest some limitations on this calculation. Because the attributed fee represents an allocation of contract fees between the market risk benefit and the host insurance contract, it would not make sense for the attributed fee to be larger than the fees in the contract. So if the attributed fee necessary to equate the fair value of the market risk benefit with the additional liability exceeds the contract fees, we suggest the attributed fees be capped and the fair value of the market risk benefit be higher than the additional liability on transition. The attributed fee also should be floored at zero, because an attributed fee less than zero would imply that the fees in the host contract are greater than the total contract fees.

The fact that the attributed fee represents an allocation of contract fees provides a mechanism to ensure that this calibration of the attributed fee at transition is used appropriately. To the extent that fees are allocated to market risk benefits in the form of attributed fees, those fees would not be available to the host contract as future profits.

Once the terms of the market risk benefit including the attributed fee are determined, the subsequent changes in fair value of the market risk benefits will diverge from what the additional liability would have been. If the market risk is being effectively hedged, the changes in fair value of the market risk benefit should be consistent with the changes in the related hedge assets.

If changing the standard to require prospective calibration of the attributed fee is not acceptable, some practical expedients should be allowed. Alternatives may include:

- Valuation of the liability on transition and subsequently using the actual terms of the market risk benefit. This approach would allow for the fixed leg of the swap to equal the fees expected to be collected for the benefit, whether explicitly (with a separate

charge from the host contract) or implicitly (with a portion of the host contract fee). One limitation of this alternative is that it does not account well for a guarantee that does not have an associated explicit fee. Many GMDBs in particular do not charge an explicit fee, but rather cover the cost of the guarantee implicitly through general contract charges. Using an attributed fee of zero for these benefits would seem to overstate the liability.

- Calibrate the attributed fee such that the fair value of the market risk benefit is zero at inception, using inputs and assumptions applicable to newly issued contracts with the same terms as of the transition date. This approach would be functionally equivalent to valuing the attributed fee retrospectively but would use market inputs and assumptions as of the transition date to avoid recreating assumptions that would have been made at the actual inception date of the contract. This approach would be somewhat analogous to the approach of updating net premiums using current assumptions, as is required for some other long-duration contracts. The attributed fees also would be capped at the total contract fees and floored at zero. The initial split between retained earnings and accumulated OCI on transition could be made using the instrument-specific credit spread at the transition date.

Note that the preceding discussion has addressed market risk benefits that the company has chosen to fair value using a methodology that considers them to be swaps. Companies that apply a valuation method that considers the market risk benefits to be options will encounter similar issues that may be addressed in an analogous manner. For example, companies that consider embedded guarantees on variable annuities to be options often calculate the fair value of the options at inception incorporating projections of future benefits and 100 percent of the rider fees. An adjustment to the host contract value is then made to ensure that the initial premium for the contract equals the initial liability (option value plus account value minus host adjustment). The host adjustment is then amortized over the expected life of the underlying contract.

While the accounting for a guarantee deemed to be a swap may appear different from the accounting for a guarantee deemed to be an option, the attributed fees on a swap can be closely analogized to the host adjustment for an option. The issue at transition then becomes not what attributed fees to assign to the market benefit feature but rather what host adjustment to recognize on adoption. The methods and considerations in determining such adjustment then follow closely the discussion on attributed fees for swaps presented above.

Question 22—Transition disclosure: *Do the proposed transition disclosure requirements provide decision-useful information? If not, what would you recommend and why?*

Answer:

The proposed transition disclosure requirements will provide decision-useful information. We have no recommendations for addition to or change in the proposed requirements.

Costs and Complexities

Question 23—Costs and complexities: *Describe the nature of the incremental costs of adopting the proposed amendments?*

Answer:

Many of the issues that will affect the implementation time also will increase the ongoing costs and complexities. For example, retrospectively unlocking the net premium ratio will be complex on an ongoing basis due to the need to maintain historic information, allocate current period experience to cohorts, and explain the resulting change to the liability, which will not be equal to the change in present value of future expected cash flows.

We would highlight in particular the need to retrospectively establish an additional liability (per the former SOP 03-1) on a nontraditional contract in the event of profits followed by losses as increasing cost and complexity. Although FASB reduced complexity by simplifying the DAC amortization method, much of the practical benefit is eliminated by the need to potentially retrospectively establish additional liabilities. Because the insurer does not know which contracts may eventually generate a profits-followed-by-losses situation, the insurer will need to maintain all the assessment and benefit data on a retrospective basis for all nontraditional contracts. This can be alleviated by starting to accrue the additional liability from zero at the time a profits-followed-by-losses situation becomes evident.

Our proposed changes to participating contracts would increase calculation complexity going forward. But these changes are necessary in order to have a valuation model that represents the economics of the contracts. And for many contracts, this complexity can be avoided if FASB also accepts our recommendation for a simplified calculation for closed-block contracts.

Appendix—SOP 03-1

The exposure draft introduces the concept of a market risk benefit, thereby eliminating the need to calculate liabilities using a “benefit ratio” method (originally defined in SOP 03-1) for certain guaranteed benefits. The exposure draft makes it clear, however, that this benefit ratio method still applies to annuitization, death, and other insurance benefits that do not meet the definition of an embedded derivative or of a market risk benefit and have an expectation of profits followed by losses from the benefit feature. Such features are commonly found in universal life insurance contracts with secondary guarantees, and in fixed indexed annuity contracts with guaranteed living benefits. The exposure draft modifies the treatment of such features by limiting the benefit ratio to 100 percent and by requiring that the profits-followed-by-losses test be applied throughout the life of a contract.

The revisions to calculations performed under the benefit ratio method described in the exposure draft present three main issues which the FASB may wish to consider in the development of the final standard. They are presented individually below.

The exposure draft wording does not properly describe the mathematical calculation needed to achieve the intent described for capping the benefit ratio at 100 percent in the provisions for additional liabilities on insurance and annuitization benefits.

The exposure draft indicates that capping of the benefit ratio at 100 percent “*results in immediate loss recognition to the extent that the present value of expected excess payments exceeds the present value of expected assessments.*” However, immediate recognition of losses would not occur using the calculation as stated. As described in Subsequent Measurement paragraphs 944-40-35-10 and 35-14, the liability valuation will result in deferral of losses unless or until cumulative excess payments exceed cumulative assessments. This is in direct conflict with the subsequent statements in the same sections.

To achieve immediate loss recognition when the benefit ratio reaches the cap, the liability valuation must employ the present value view described in paragraph 944-40-25-11(a) for the traditional contract liability for future policy benefits. While a retrospective accumulation approach, like the one originally developed in SOP 03-1 and now in 944-40-35-10, normally will give the same mathematical result as a prospective approach, this mathematical equivalence does not work when the benefit ratio is capped. This is a mathematical flaw with the exposure draft that needs to be corrected.

Consistent with this view, paragraph 944-40-35-10 for death or other insurance benefit features should read:

“The additional liability at the balance sheet date shall be equal to:

- a. The present value, discounted at the contract rate, of expected excess payments over the remaining life of the contract (excluding amounts reflected in claims payable liabilities)*
- b. Less the current benefit ratio multiplied by the present value, discounted at the contract rate, of total expected assessments over the remaining life of the contract.”*

However, at the same level of aggregation at which the additional liability is calculated, in no event shall the additional liability balance be less than zero, and in no event shall the benefit ratio exceed 100 percent, which results in immediate loss recognition to the extent

that the present value of expected excess payments exceeds the present value of expected assessments by more than the previously accrued liability. Additionally, at the same level of aggregation at which the additional liability is calculated, in no event shall the benefit ratio be less than 0 percent, which results in the largest value of the additional liability being no greater than the value described in 944-40-35-10 (a). (the present value, discounted at the contract rate, of expected excess payments over the remaining life of the contract).

Consistent with this view, paragraph 944-40-35-14 for annuitization benefits should read:

“The additional liability at the balance sheet date shall be equal to:

- a. The present value, discounted at the contract rate, of expected excess payments (at the expected time of annuitization) for the remaining life of the contract*
- b. Less the current benefit ratio multiplied by the present value, discounted at the contract rate, of total expected assessments over the remaining life of the contract.”*

However, at the same level of aggregation at which the additional liability is calculated, in no event shall the additional liability balance be less than zero, and in no event shall the benefit ratio exceed 100 percent, which results in immediate loss recognition to the extent that the present value of expected excess payments exceeds the present value of expected assessments by more than the previously accrued liability. Additionally, at the level of aggregation at which the additional liability is calculated, in no event shall the benefit ratio be less than 0 percent, which results in the largest value of the additional liability being no greater than the value described in 944-40-35-14 (a), (the present value, discounted at the contract rate, of expected excess payments beginning at the expected time of annuitization for the remaining life of the contract).

With this correction to paragraph 944-40-35-14, paragraph 35-15 must also be rewritten:

“Expected excess payments in paragraph 944-40-35-14 shall be calculated as the excess (if any) of:

- a. The present value of expected annuity payments and related claim adjustment expenses discounted at a high-quality fixed-income instrument yield to the corresponding annuitization date*
- b. Over the expected account balance at the same date.”*

Paragraph 944-40-35-16 can be deleted; it serves no purpose when the liability is calculated using present values.

Application of the profits-followed-by-losses test on annuitization and insurance benefit features after the contract issue date may introduce unintended and anomalous volatility in the liabilities recorded for contracts containing such features. The application of the profits-followed-by-losses test also may be unclear as currently phrased in the exposure draft. Also, using this approach would eliminate much of the practical benefit from simplifying the DAC amortization methodology.

SOP 03-1 stated insurance liabilities were to be tested for profits followed by losses at the issue of a contract. If the condition existed, an additional liability using a benefit risk

method (commonly referred to as an “SOP 03-1 liability”) would be established. If the condition did not exist, no liability would ever be established. The test was never to be repeated.

The FASB exposure draft proposes performing the test at each reporting period and establishing the SOP 03-1 liability if the test ever fails. This entails going back to issue for accumulated assessments. Paragraph 944-40-25-27A states:

If the contract feature is not required to be accounted for under the provisions of Topic 815 or paragraph 944-40-25-25C and if the amounts assessed against the contract holder each period for the insurance benefit feature of an insurance contract are assessed in a manner that is expected to result in profits in earlier years and losses in subsequent years from the insurance benefit function, a liability for death or other insurance benefits shall be recognized in addition to the account balance. This determination of whether profits are followed by losses shall be performed at contract inception and as assumptions are updated in subsequent periods.

Application of this FASB guidance as proposed could result in substantial non-economic volatility. For example, an insurance benefit feature that is not expected to have profits followed by losses when issued but then in a subsequent reporting period is expected to have minimal losses in the late years of the product’s lifetime would require a liability calculation to be performed at that time. Despite a minimal expectation of losses, a large liability could result because the liability mechanism builds the liability in proportion to total assessments and across the entire lifetime of the benefit feature. This could significantly alter the earnings pattern over the life of a product, making the pattern of assessments the key driver for the pattern of earnings rather than primarily recognizing gains and losses in the periods in which they occur.

Consider a simple example of a cohort of policies with the following estimated stream of excess insurance benefits and assessments. For simplicity, assume no other product features and a discount rate of zero. The product is expected to have no losses in any future years.

Year	Assessments	Excess Benefits	Extra Liability	Earnings
1	10	1	0	9
2	10	2	0	8
3	10	3	0	7
4	10	4	0	6
5	10	5	0	5
6	10	6	0	4
7	10	7	0	3
8	10	8	0	2
9	10	9	0	1
10	10	10	0	0

Now assume that the estimate of excess benefits at the end of year 5 changes such that there are now expected to be small losses in years 9 and 10. The exposure draft would require a liability to be established at the end of year 5 in recognition of the expected profits followed by losses. It also generates an increase in future profits in the out years in

which the losses from the insurance benefit feature were projected to occur. This is all a consequence of the retrospective/cumulative catch-up nature of the liability calculation. It generates a complete re-sloping of the recognition of the benefit feature over the life of the contract and generates a current period liability that far outweighs the small negative profits that are now being projected from the feature.

Year	Assessments	Excess Benefits	Extra Liability	Earnings
1	10	1	0	9
2	10	2	0	8
3	10	3	0	7
4	10	4	0	6
5	10	5	15	(10)
6	10	6	15	4
7	10	7	14	4
8	10	8	12	4
9	10	12	6	4
10	10	12	0	4

One way to address this anomalous volatility would be to start the accrual of a liability under a benefit ratio calculation from the period in which the profits followed by losses are first observed, eliminating the retrospective aspects of the calculation. This approach avoids a possible situation in which a large loss is taken in the current period that recognizes an accrual for past experience, which has the effect of generating profits in the future even where losses had previously been projected. It would not generate future profits beyond the level of the losses from the insurance benefit feature. The following chart shows the impact of such a method on the example above.

Year	Assessments	Excess Benefits	Extra Liability	Earnings
1	10	1	0	1
2	10	2	0	2
3	10	3	0	3
4	10	4	0	4
5	10	5	0	5
6	10	6	3	1
7	10	7	5	1
8	10	8	6	1
9	10	12	3	1
10	10	12	0	1

In addition, it is unclear whether an expectation of “profits followed by profits” for an insurance benefit feature on which a liability had been accruing previously would result in immediate release of that liability into earnings or whether the prior accrual and amortization mechanism already instituted when profits followed by losses had been expected would continue. One could envision a situation of significant increases and releases of reserves occurring from period to period as expectations of small profits in the out years swing to expectations of small losses, and vice versa, if the profits-followed-by-

losses test were required each period to determine whether a liability would be established.

This approach to addressing profits followed by losses also eliminates much of the practical benefit of simplifying the DAC amortization calculation. By requiring a retrospective accrual of the additional liability at the time a profits-followed-by-losses situation arises, all historic data for all nontraditional contracts would need to be retained in case a retrospective liability accrual is needed in the future. Because the method for accruing the additional liability is similar to the current method for calculating DAC amortization, this approach would essentially require most of the existing DAC amortization methodology to be retained.