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September 16, 2015

Ms. Susan M. Cosper
Technical Director
Financial Accounting Standards Board
401 Merritt 7, PO Box 5116
Norwalk, CT 06856-5116
Via email to director@fasb.org and acasas@fasb.org

RE: Unlocking Assumptions and Discount Rates Only in the Fourth Quarter for Long-Duration Insurance Contracts

Dear Technical Director Cosper,

On behalf of the American Academy of Actuaries'[1] Financial Reporting Committee, I appreciate the opportunity to provide feedback on the Financial Accounting Standards Board's (FASB) proposal to limit unlocking of the assumptions and discount rates for long-duration insurance contracts to only the fourth quarter. While there are some advantages to limiting the unlocking to the fourth quarter, we believe that the disadvantages of this restriction outweigh its benefits. Therefore, based on the advantages and disadvantages outlined in our comments below, we recommend FASB not adopt this proposal.

We note that the proposal codifies a number of practices informally adopted by many insurers for routine assumption changes in universal life-type products. Most, if not all, of the assumptions for these products are unlikely to change more than once a year. As such, insurers typically schedule experience and expense studies so that assumption changes occur in a common quarter. The assumption changes often occur in the third quarter, but almost never in the fourth quarter. While this is typical informal practice, reporting entities do not delay the implementation of loss recognition or material assumption changes if they become known during other reporting periods in the year.

Advantages

Unlocking only in the fourth quarter would increase the comparability of the timing of reserve changes related to assumption updates. However, because risks do not emerge on a regular and

[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. The Academy assists 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.

scheduled basis, the result of such a requirement would not be fully comparable between companies, because it could not reflect the timing at which different companies' risks emerged.

Unlocking only in the fourth quarter may save expenses in that companies would not be required to monitor experience or perform retrospective unlocking processes every quarter. Nevertheless, if the valuation systems are set up to handle the unlocking process, the extra cost to utilize it each quarter may be minimal. It may even turn out to be more expensive to have a "switch" to turn the process on and off, depending on the quarter. It may be easier for those running the system to do something more frequently (every quarter) rather than just once a year, for which the process and interpretation may have to be relearned. The expense savings generally do not depend on which quarter the once-a-year unlocking occurs in. However, conflicts with statutory or regulatory reporting requirements may mean that mandating fourth-quarter unlocking would result in less efficient scheduling of resources, reducing any expense savings.

Limiting the unlocking to only once a year in a common quarter may save companies from having to explain retrospective unlocking impacts every quarter. When multiple assumption changes have offsetting effects, unlocking only once a year could reduce the earnings volatility. Further, unlocking only once a year may simplify explanations when there are interactions among assumptions. The tradeoff is that limiting the unlocking could make the once-a-year explanation more complicated and thus difficult to understand.

Disadvantages

Limiting unlocking for assumptions and discounts rates to only the fourth quarter would create an accounting mismatch between the fair value of the assets whose value changes every quarter and the out-of-date "current value" of the liabilities for which discount rate changes would occur only in the fourth quarter. Because interest rate movements are actual, known events, they are less subjective than projected cash flow assumption changes. As such, changes to discount rates can be made quarterly with little subjectivity. In addition, because the discount rate update process is different from the cash flow projection assumption, there is no need to have the discount rate update process on the same schedule, even if FASB decides to limit the cash flow assumption updates to the fourth quarter only. As a result, regardless of the decisions on the timing of other assumption updates, updating the liability for changes in discount rates quarterly would improve financial reporting.

An insurer may know of material, pending assumption changes, but be unable to reflect them in the financial statements for up to three quarters if the unlocking is limited to the fourth quarter. An insurer could choose (or be required) to disclose the assumptions through the management discussion and analysis (MD&A), but doing so is contrary to FASB's decision to prohibit the assumption change from the financial statements, so that companies are not pressured into unlocking more often. We are concerned that the limit to annual unlocking would result in increased asymmetry of information between company insiders and other users. In addition, if there is a delay in an annual experience study that causes the fourth quarter unlocking deadline to be missed, the period between the need for an experience update and when it could be reflected could be more than a year.

Limiting unlocking to the fourth quarter also could defer recognition of an incurred loss. Under current generally accepted accounting principles (GAAP), loss recognition is considered each quarter. Under the FASB's tentative decisions for targeted improvements, premium deficiency testing would be eliminated, which is appropriate given that current assumptions are used in the normal valuation. However, if the assumption update is limited to only the fourth quarter, a premium deficiency may become apparent in an interim period but not recognized until the fourth-quarter assumption update. Such a practice would be inconsistent with FASB's rationale of eliminating premium deficiency testing because the most current assumptions are being used in the base liability.

If unlocking is limited to the fourth quarter, a disconnect may exist between when actual deviations from assumed experience materialize and when the reserve impact gets reflected. For example, assume the first quarter through the third quarter each have actual to expected experience deviations of +$10 to income (for a total of +$30), while the fourth quarter has actual equal to expected. The fourth-quarter reserves would reflect a reserve increase reducing net income by, for example, -$12, due to the cumulative catch up from prior periods, even though actual experience in the fourth quarter was exactly as expected. This may confuse users. In this case, the economics indicate income effects of +$6, +$6, +$6, 0, but the accounting results would show +$10, +$10, +$10, -$12. This confusion could be mitigated by requiring the reserve impact for actual experience deviations to be reflected each quarter, even if assumption updates are held off until the fourth quarter. Depending on a company's approach to interim valuation, limiting unlocking could increase or decrease costs. This situation also could be mitigated partially through explicit presentation or disclosure showing the actual experience and the impact of the cumulative catch up on the reserve, which would at least be transparent as to the source of the income deviations.

Furthermore, unlocking the net premium ratio only in the fourth quarter could lead to diversity in practice for interim statements. Some companies may update their cash flow projection to reflect changes in the insurance inforce each quarter, reflecting the quarterly changes in the number of contracts due to lapses and mortality being different than expected. Under this approach, if more contracts lapsed than had been expected, the reserve would decrease proportionately, separate from any impacts of deviations from expected cash flows. Other companies may update the projection annually, at the same time that assumptions and the net premium ratio are unlocked. Such differences in approaches may lead to significant differences in reported results between companies, reducing comparability even for similar deviations from expected.

Even if FASB restricted assumption updates and cumulative catch-ups to reserves to once a year, requiring the updates to be in fourth quarter is problematic. Mandating unlocking only in the fourth quarter may be burdensome because the timing would conflict with regulatory reporting requirements. Due to the desire to effectively use resources throughout the year, it is not uncommon to conduct annual experience studies during the summer and during the third quarter. We further note that, while assumption changes will result in unexpected deviations to earnings and equity regardless of which quarter they occur, users and preparers tend to prefer these deviations to occur before the fourth quarter. There is a trade-off in that the cumulative catch-up for fourth-quarter experience deviations would not be reflected in the current year, but the best way to address this is to not limit the catch-ups to once a year.

Recommendations

- We believe the disadvantages of mandating fourth-quarter unlocking outweigh the advantages. Therefore, we recommend permitting unlocking to occur when a material change is known.
- If FASB prefers to mandate a specified quarter for unlocking future cash flow assumptions, it is particularly important to require discount rates to be updated for each reporting period to avoid accounting mismatches with asset fair values.
- It would be beneficial to require cumulative catch-ups for known experience deviations to be reflected each reporting period.
    - If cumulative catch-ups are not performed each reporting period, we recommend that information about the impact of the catch-ups be made explicit through presentation or disclosures.
- If assumption changes are mandated to be in a common quarter, we recommend permitting or mandating a quarter other than the fourth quarter.

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Thank you for the opportunity to provide feedback to the FASB on its proposal to limit the unlocking of assumptions and discount rates to only the fourth quarter. If you have any questions or would like to discuss these issues in more detail, please contact Lauren Sarper, the Academy's senior policy analyst for risk management and financial reporting, at 202-223-8196 or sarper@actuary.org.

Sincerely,

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