June 30, 2014

Technical Director
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

Dear Ms. Cosper –

On behalf of the American Academy of Actuaries'[1] Financial Reporting Committee, I would like to submit the following comments regarding the Financial Accounting Standards Board (FASB or the Board) insurance contracts project. As discussed in our comment letter on the FASB exposure draft, *Proposed Accounting Standards Update: Insurance Contracts (Topic 834),* it is important to achieve a converged, high-quality insurance contracts standard from both FASB and the International Accounting Standards Board (IASB). We believe that the building block approach described in the exposure draft, with the inclusion of some critical changes outlined in our comment letter,[2] provides the best opportunity for a high-quality accounting standard for long-duration contracts. This approach would not only address key deficiencies within existing U.S. GAAP, but also would produce an essentially converged standard with IFRS. Therefore, we would encourage the Board to reconsider its decision and continue to work towards convergence for long-duration contracts.

If the Board decides not to pursue the building block approach, we have identified several key issues with existing U.S. GAAP for long-duration insurance contracts that the Board might wish to address as it pursues targeted improvements for financial reporting of these contracts. These issues can create misrepresentative financial information and can prevent users of insurance company financial statements from understanding the financial performance and position of insurance companies. We understand that in pursuing targeted improvements, the Board may wish to limit potential costs to preparers, which our comments attempt to take into account.

Issues that remain critical to address include:

- *The scope of insurance entities covered by Financial Accounting Standard (FAS) 60*[3] *does not explicitly include health insurance entities.* If the scope of the revised insurance contracts standards will apply to insurance entities rather than to insurance contracts, it is

[1] The American Academy of Actuaries is an 18,000-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.
[2] See Academy letter to FASB on its insurance contracts exposure draft (Oct. 24, 2013): http://actuary.org/files/Academy_Response_to_FASB.pdf
[3] For convenience, we use the old FASB statement numbers, which are still commonly used to describe different types of insurance contracts.

important that health insurance entities be specifically included in the scope.[4]

- *Multiple insurance accounting models for different contracts*. Under existing U.S. GAAP, there are multiple accounting models for long-duration insurance contracts. Contracts may be reported under different models, even if the economic differences between the contracts are not material (e.g., between whole life and universal life contracts). Furthermore, contracts accounted for under FAS 97 (universal life) use a retrospective approach to valuation of liabilities and deferred acquisition costs (DAC), although generally a prospective approach would be appropriate for valuation of liabilities of insurance contracts. This approach creates complexity for preparers and potential confusion for users of financial statements, and it is unclear how the different models can be entirely eliminated under a targeted improvement approach. Nevertheless, the suggestions we provide below should align the insurance accounting models in some key respects.

- *Lack of transparency of loss recognition testing (i.e., premium deficiency) margins on all long-duration contracts*. Under current U.S. GAAP, assumptions for FAS 60 and for FAS 97 limited pay contracts are locked in and only revised when a premium deficiency is recognized. There is no transparency to investors as margins decline until the premium deficiency is recognized and a loss is realized. There is a similar lack of transparency for FAS 97-UL and FAS 120 products.

  There are several ways this can be addressed. The simplest and least expensive to implement may be to require a disclosure of the loss recognition margin that results from the premium deficiency testing for all long-duration contracts. While we recommend this disclosure be added, it is not, by itself, our preferred recommendation, which is to apply the building block approach to all insurance contracts.

  As a preferable alternative to disclosure only, we recommend unlocking the FAS 60 assumptions in addition to disclosing the remaining loss recognition margins. In addition to having the benefit of more transparency to financial statement users, this would permit the loss recognition testing to occur on a more granular basis, providing more relevant information. Although this would require some changes to valuation systems, the calculation essentially would be unchanged and the method of determining assumptions would not need to change either, mitigating the cost. Also, many valuation systems already calculate such reserves for these contracts on a seriatim basis, which would facilitate application of a valuation approach requiring updated assumptions.

  To avoid potentially misleading short-term net income fluctuations that do not reflect the performance of long-term businesses, changes in the discount rate could be reported in other comprehensive income. This would be more consistent with reporting the value of the assets backing these contracts, assuming those assets are held as available for sale. The effect of changes in other assumptions relating to future performance or services could be absorbed by unlocking the provision for adverse deviation and/or the net

[4] It also would be beneficial to explicitly include mortgage guaranty insurance within the scope of the insurance contracts model to avoid diversity in practice and avoid front-ending profits on such contracts.

premium to gross premium ratio, producing more meaningful income statement results, as long as there is no associated deficiency.

An even more direct approach to address this concern would be to use a gross premium valuation (projection of expected costs) with no provision for adverse deviation, but with a deferred premium liability similar to that currently used for FAS 97 limited pay contracts to avoid any gains at inception. The deferred premium liability could be unlocked to avoid changes in net income from revised assumptions, as long as there is no premium deficiency. Showing the deferred premium liability also would enhance transparency of the premium deficiency margin. While this approach would require more system changes than continuing with the current net premium approach, it is consistent with how entities already test for premium deficiencies, and should not be overly expensive to implement.[5]

- *Use of current discount rates for assets but not for liabilities*. Under existing U.S. GAAP, invested assets backing most insurance liabilities[6] currently are classified as available-for-sale securities, which are reported on the balance sheet at fair value. Changes in market interest rates affect the fair value of these instruments, but these interest rate changes do not correspondingly affect the balance sheet value of the insurance liabilities backed by those assets. This resulting accounting mismatch significantly misrepresents the GAAP equity of insurance entities holding long-duration contracts. For large entities, these accounting mismatches can amount to tens of billions of dollars. In the current low interest rate environment, insurance entity equity is likely to be overstated by similarly large amounts. If interest rates rise, however, equity eventually may be understated by an equally misleading amount.

  To address this issue, we recommend using current discount rates for insurance contract liabilities on the balance sheet. This could be accomplished for FAS 60 and FAS 97 limited pay contracts if one of the recommended approaches described in item (3) is adopted. But the use of the present value of future cash flows using current discount rates could be reported on the balance sheet for FAS 97 universal life-type, FAS 97 investment, and FAS 120 contracts, as well. If assumptions other than interest rates are also updated, an unlocked deferred premium liability, similar to that described in item (3), could be applied to the valuation.

  This balance sheet calculation likely would require some revisions to valuation systems, introducing some cost. The cost could be reduced substantially compared to implementing the full building block approach by requiring only a single scenario, rather than stochastic scenarios. Insurers already have to project gross profits or gross margins for FAS 97 and FAS 120 contracts using updated assumptions under a single best estimate scenario. These processes could be adapted to perform the recommended calculation. In addition, insurers need to project and discount cash flows for these

[5] This approach has an additional potential benefit. Under a gross premium approach, it would be relatively simple to include acquisition cost cash flows directly within the liability calculation, avoiding the need for a separate DAC asset.

[6] Variable and unit-linked contracts would be the most notable exceptions.

contracts under deterministic scenarios for purposes such as cash flow testing required for regulatory purposes. Again, these models also could be leveraged to provide the calculations we have recommended.

Costs also would be reduced by determining the discount rate using methods already in use today for FAS 60 contracts. By limiting these values to the balance sheet (with the difference reported in other comprehensive income), potentially misleading short-term net income fluctuations that do not reflect the performance of long-term businesses would be reduced.

- *Retrospective unlocking of DAC under FAS 97 and FAS 120*. Most investors have limited understanding of the meaning and impact of retrospective DAC unlocking for FAS 97 universal life-type, FAS 97 investment, or FAS 120 contracts (i.e., current period changes in the DAC balance when experience deviations or assumption changes occur). While unlocking provides some insight into revised expectations of future profitability, at least as far as it affects the amortization of DAC, depending on the characteristics of the contracts such as their age, the retrospective aspect of the calculation can produce different reporting results even in cases in which the change in expected future profits are the same. Also, contracts sold in a manner that generated less DAC would have a smaller unlocking impact for the same change in expected profits than contracts with greater DAC.

  Due to the limitations and complexity of retrospective unlocking, it makes sense to eliminate retrospective unlocking of DAC when assumptions are changed and consider whether to eliminate or revise the approach to retrospective unlocking when experience deviations occur. Future DAC amortization would be updated to insure that the balance ends at zero. The information on future profitability that would be lost could be communicated more effectively by using a valuation approach for the balance sheet as suggested in item (4) and the disclosures described in (3). Disclosures also could be added to replace any lost information.

- *SOP 03-1 does not fully reflect the value of all covered guarantees*. Certain guarantees within insurance contracts that are not embedded derivatives are measured under SOP 03-1 (ASC 944-40-30-20 and 944-40-30-26). Under SOP 03-1, the value of the guarantee emerges over time. Thus, when the value of the guarantee changes, a retrospective element to the calculation (similar to retrospective unlocking of DAC) results in much of the change in value being spread over a future period, rather than being recognized immediately. Having a retrospective element also means that an event that has the same effect on the economic value of two guarantees can produce different accounting results due to factors such as the age of the contracts. In addition, although the SOP 03-1 calculation may incorporate stochastic scenarios, the calculation and effect are different from that of fair value measurement, creating an accounting mismatch between the value of the guarantee and the value of any derivatives used to hedge the guarantee. These flaws in SOP 03-1 mean that, for a large entity, unhedged exposures worth billions of dollars can remain hidden from users of financial statements, while exposures that are perfectly economically hedged can appear to be generating very large gains or losses.

One improvement to the value of information for SOP 03-1 benefits could be easily achieved by eliminating the retrospective element from the SOP 03-1 calculation. If the benefit ratio of the SOP 03-1 calculations is locked in, changes in the value of the guarantee provided would be reflected in financial statements immediately, rather than emerging over time. This would provide more transparent information to financial statement users about the amount of the entity's exposure to the guarantee. It also would move toward aligning the valuation of the guarantee with the fair value of any derivatives used to hedge the guarantee.

Another option to improve the value of information of SOP 03-1 guarantees would be to consider whether guarantees that meet certain criteria that make their characteristics similar to embedded derivatives (e.g., exercise of the guarantee is subject to policyholder election and the value of the guarantee is sensitive to fluctuations in equity prices) could be valued under a more fair value-like measure, They would be calibrated to observable market prices rather than best estimate assumptions about market related inputs, possibly excluding "own credit." It also would be beneficial to permit hedged risks in insurance contracts to be measured at fair value (or fair value excluding own credit), as discussed below in item (7).

- *Accounting mismatches result when certain risks are hedged.* Insurance entities hedge certain risks within insurance contracts using derivatives. Hedged risks may include guarantees subject to SOP 03-1, as discussed in item (6), and embedded derivatives that are closely related to the host contract, such as minimum interest guarantees. Hedged risks also may include insurance cash flows that extend beyond the horizon for available fixed income investments. Under existing hedge accounting requirements, such hedged risks within portfolios of insurance contracts rarely qualify for hedge accounting treatment. This creates accounting mismatches between the hedged risks and the hedging instruments.

  Both transparency and relevance of financial statements would be enhanced if hedged risks within insurance contract portfolios could be measured at fair value, subject to appropriate documentation requirements. Since insurance entities are heavily regulated, statutory requirements in the U.S. already require documentation for using derivatives, which should be adequate to support matched accounting treatment under U.S. GAAP. Regulatory requirements also limit the possibility of abuse of provisions permitting hedged risks to be measured at fair value. Effectively, hedged risks that qualify could be bifurcated and measured at fair value, similar to embedded derivatives.

- *FAS 60 reserves do not reflect changes in premium rates.* Premium rate changes for FAS 60 or FAS 97 limited pay contracts currently cannot be reflected in the valuation due to the lock-in principle. Although we have issues with locking in assumptions in general, reflecting actual premiums being charged is important to faithfully representing the economics of insurance contracts.

  We believe that the most appropriate way to address this issue, and several others that

have been mentioned in this letter, would be to enable assumptions for FAS 60 insurance contracts to be unlocked, as described in item (3). However, if FASB decides not to pursue such an approach, the premium issue at least can be addressed by explicitly permitting FAS 60 and FAS 97 limited pay assumptions to be unlocked to represent the actual premium rates being charged.

- *Under existing U.S. GAAP, disclosures for insurance contract liabilities are limited*. While the proposed disclosures included in the exposure draft may have been excessive, some additional disclosures would be useful to financial statement users. One additional disclosure that could be added would be a roll-forward of insurance liabilities, at an appropriate level of detail. Other disclosures could include qualitative information concerning the assumptions and methodologies used to value insurance contracts, as well as some disclosure of sensitivities to alternative reasonable assumptions.

- *The bifurcation of certain embedded derivatives that occur within some insurance contracts can create unnecessary complexity*. Many modified coinsurance contracts and funds withheld reinsurance contracts contain an embedded derivative relating to the fact that the payment of investment income to the reinsurer depends on the returns on assets held by the ceding company. Bifurcating these embedded derivatives adds complexity but little useful information. If our suggestions in items (3) and (4) to use current discount rates and other assumptions to measure insurance contracts are adopted, the key information that would be provided by bifurcating these embedded derivatives would already be included in the financial statements. Thus, it may be possible to simplify the valuation process by not requiring bifurcation of these derivatives.

  Equity indexed contracts contain embedded derivatives that should be bifurcated. We disagree, however, with the boundary of the equity indexed embedded derivative. Under existing U.S. GAAP, the current guarantee is bifurcated along with all future guarantees. While it is appropriate to bifurcate the current guarantee, bifurcating future guarantees leaves a host insurance contract that effectively locks in all future returns. This is not consistent with how the contract actually works. Complexity can be reduced and representational faithfulness can be improved by limiting the bifurcation of equity indexed embedded derivatives to the current period guarantee.

These proposals generally leverage existing processes for valuing insurance contracts, either under existing U.S. GAAP or regulatory requirements. This should minimize the costs involved and insure that the costs are less than the benefits of providing information that is substantially more transparent, relevant, and representationally faithful to the economics of insurance contracts for users of financial statements. Relative to the building block approach proposed in the exposure draft, implementation costs would be reduced significantly by the fact that all our proposals start with existing U.S. GAAP information, reducing transition costs.

Nevertheless, we continue to believe that the best approach to enhancing the financial reporting information for long duration insurance contracts would be to adopt the building block approach described in the exposure draft, modified by the suggestions in the Academy's comment letter.[7]

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We appreciate the opportunity to provide these comments. If you would like to discuss any of these further or if you have additional questions, please contact Heather Jerbi, the Academy's assistant director of public policy at 202.785.7869 or Jerbi@actuary.org.

Sincerely,

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

[7] See Academy letter to FASB on its insurance contracts exposure draft (Oct. 24, 2013): http://actuary.org/files/Academy_Response_to_FASB.pdf