AMERICAN ACADEMY of ACTUARIES

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March 25, 2020

Ms. Kim Kushmerick
Associate Director
AICPA
1345 Avenue of the Americas, 27th Floor
New York, NY 10105

Dear Ms. Kushmerick,

On behalf of the American Academy of Actuaries[1] Financial Reporting Committee, we would like to provide the following comments on the draft revisions to the *Audit and Accounting Guide: Life and Health Insurance Entities* for issues 1 (claim liabilities), 4AB (market risk benefits), 8 (updating cash flow assumptions), and 9ABC (DAC amortization).

While we have no substantive objections to the draft revisions as we understand them, we are concerned that the revisions may be misunderstood in ways that make them more prescriptive than intended or that conflict with the codified accounting standards. We believe that the understanding can be improved upon with modest changes to the drafts. Therefore, we respectfully request that the Financial Reporting Executive Committee (FinREC) take into consideration our comments as it finalizes these revisions to the guide.

We also note that some of this guidance interprets wording that is unchanged from current standards differently than it has been interpreted in the past. We do not disagree with these interpretations; they make sense in the overall context of the updated standards. We are concerned, however, that some will look at this guidance apart from the new context and conclude that the existing interpretations are wrong in any context. We recommend adding a statement to the guide to emphasize that the revisions made for ASU 2018-12 should not be used to judge practices employed under the standards as they exist before the updates.

[1] The American Academy of Actuaries is a 19,500-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.

<u>Issue #1: Claim liabilities associated with long-duration traditional insurance contracts</u>

Paragraph 8—potential for misunderstanding and unintended consequences

We believe that paragraph 8, as worded, could have unintended consequences, especially when seen in the wider context (beyond long-tail claims) of the guide. We believe the intent of this paragraph could be better expressed for this wider context.

The statement that "*FinREC believes that 'future benefits to be paid to or on behalf of policyholders and certain related expenses' represent all payments under the contract, including future expected claims and claims for which the disability, morbidity, or other insurance event has occurred but for which claims have not yet been paid, which obviates the need for a separate claim liability*" could easily be interpreted as including in "*future policy benefits*" amounts that are truly "*unpaid claims*," such as death benefits currently payable on life insurance contracts that terminated by death during or before the current reporting period.

We believe that FinREC intends for this paragraph to clarify the distinction between unpaid claims (ASC 944-40-25-1) and future policy benefits (ASC 944-40-25-8), not to eliminate the distinction. As worded, however, this paragraph seems to say that there is no such thing as an unpaid claim. We are also concerned that this could add unnecessary complexity to the valuation of products where truly unpaid claims dominate the reported claim liability.

To more accurately reflect the relevant provisions of subtopic 944-40, we recommend revising the first sentence of paragraph 8 with the following language:

> "8. *Based on the guidance in FASB ASC 944-40 as excerpted in paragraphs 3 through 7 above, FinREC believes that 'future benefits to be paid to or on behalf of policyholders and certain related expenses' represent all payments <u>expected to become due in the future</u> under the contract, including future expected claims and claims for which the disability, morbidity, or other insurance event has occurred but for which ~~claims have not yet been paid~~ <u>payment is not yet due</u>, which obviates the need for a separate claim liability <u>other than for amounts currently due but unpaid</u>.*"

Paragraph 13—potential for misunderstanding and unintended consequences

We are concerned that some will interpret the last sentence of paragraph 13 as permitting a company to apply the existing separate transition date discount rate to the incurred claim portion of all future liability calculations, including claims incurred after transition but before the respective reporting date. This would introduce a change in discount rate for projected cash flows when through the passage of time an expected (future) claim becomes an actual (prior) claim, with the effect of that discount rate change reported as part of the benefit expense in net income.

To prevent such changes in discount rates from affecting net income, we recommend revising the last sentence of paragraph 13 to the following:

"*As another alternative, an entity may retain the existing separate transition date discount rates when ~~measuring the liability~~ <u>discounting future cash flows on claims incurred prior to the transition date</u>.*"

Paragraph 13—potential for conflict between objectives

In paragraph 13, FinREC should also be aware that some claim liabilities are currently calculated without any discounting. As we read this paragraph, it would require applying a zero percent discount rate at transition of such liabilities. We also believe it to be consistent with the guidance in subtopic 944-40. If, however, FinREC believes that carrying forward what is effectively a zero percent discount rate to be inappropriate, then guidance may be added for how to best handle this situation.

Paragraphs 13 and 15—potential for misunderstanding

Paragraphs 13 and 15 both seem to assume that existing claim liabilities will be included in active life cohorts at transition, but nothing in these revisions state that as a requirement. Unless FinREC believes this is best determined under the specific facts and circumstances of each product for each entity, we recommend adding something to clarify FinREC's belief on appropriate handling of these balances at transition.

<u>Issue #4AB: Market Risk Benefits</u>

Paragraph 3—potential for misunderstanding

The second-to-last sentence of paragraph 3 ends with the phrase, "*under a fair value framework*." We are concerned that some will interpret this as including any fair value framework, which would be inconsistent with paragraph 2's emphasis on the current GAAP fair value framework in ASC topic 820.

To avoid such an interpretation, we recommend a simple clarifying revision to this phrase in paragraph 3, "*under <u>the FASB ASC 820</u> fair value framework*."

<u>Issue #8: Updating cash flow assumptions in the net premium ratio</u>

Paragraph 7—potential for misunderstanding and unintended consequences

Paragraph 7 states "*FinREC believes entities are not required to perform full experience studies outside of the regularly scheduled annual review, but should consider all information that is available in the interim period and have a reasonable basis to conclude all applicable assumptions are the entity's best estimate*."

We are concerned that this may potentially be interpreted as meaning that "*full experience studies*" are required as part of the regularly scheduled annual review. The use of the term "*experience studies*" may be too specific. Subtopic 944-40 does not specify experience studies as the method for performing the annual review. Actuarial standards of practice recognize other methods, such as trend analysis or actual-to-expected analysis, for determining whether a revision to certain assumptions is needed. Perhaps a term like "*a full review*" in place of "*full experience studies*" could be used in paragraph 7 to avoid any unintended implications.

Paragraph 9—potential for misunderstanding and unintended consequences

Paragraph 9 states "*FinREC believes if evidence suggests the cash flow assumption(s) for one cohort require an update, the entity should consider whether the updated assumption(s) suggest the need for assumption updates to other cohorts that share the same or similar assumption(s). For example, changes to the mortality assumptions for one cohort may suggest a similar change is needed for other cohorts, provided there is a degree of overlap in the mortality assumptions.*"

We are concerned that some may misunderstand the intent of this paragraph, particularly as it relates to paragraph 2.

We believe that the wording of paragraph 9 may be improved by emphasizing consistency among cohorts. Consistency is a common concern in both accounting and actuarial standards. Actuarial Standard of Practice No. 7 addresses this concern in the broader context of actuarial models. Its paragraph 3.10.3(b) states that "*The actuary should determine … that the actuarial assumptions … used for different segments of business are materially consistent….*" We recommend rewriting the first sentence of paragraph 9 to the following:

> "*FinREC believes that when a cash flow assumption is updated for one cohort, the entity should consider whether consistency among cohorts requires an assumption update for other cohorts, including those normally subject to annual review at a different time of year.*"

We also believe that a more specific example would help to clarify the intent of this paragraph. We recommend rewriting the second sentence of paragraph 9 with the following language:

> "*For example, updates to mortality assumptions for term life insurance products may suggest an immediate need to reconsider the mortality assumptions for permanent life insurance products that are subject to similar underwriting standards, even if the annual assumption review for the permanent products is normally performed at a different time.*"

Paragraph 13— incomplete guidance

Paragraph 13 addresses the reporting of the liability remeasurement gain separately in the statement of operations, as required in ASC paragraph 944-40-45-4. It points out that it should be reflected at the beginning of the current reporting period and that the liability remeasurement gain or loss for traditional and limited-payment contracts may be reported together with the liability remeasurement gain or loss related to additional universal life liabilities. It does not, however, address whether the remeasurement gain or loss of the limited-payment contracts deferred profit liability should be reported together with or separately from the remeasurement gain or loss of the corresponding liability for future policy benefits.

We believe that paragraph 13 would be more helpful if it were to address whether the deferred profit liability remeasurement gain or loss can or should be reported together with the gain or loss from remeasurement of the other liabilities.

Issue #9ABC: DAC amortization

Paragraph 9—inaccurate and misleading guidance

Paragraph 9 includes the sentence, "*FinREC believes that the rate used to amortize deferred acquisition costs for the current reporting period can be calculated either as of the beginning of the current reporting period (thereby excluding actual current reporting period experience) or as of the end of the current reporting period (thereby including actual current reporting period experience).*"

This description is inconsistent with the calculations shown elsewhere in the draft. We are concerned that some will misunderstand this guidance, possibly leading to a technique that fails to comply with the new requirements in some circumstances.

Under both alternatives, the amortization rate is recalculated as of the beginning of the current reporting period. They differ only with respect to the information used in the recalculation. The first approach updates the amortization rate as of the beginning of the current reporting period using information that was known at that time. The second approach updates the amortization rate as of the beginning of the current reporting period using information that is known at the end of the period (including actual experience and any assumption changes).

To better reflect the characteristics of these two methods, we recommend revising the second sentence of paragraph 9 with the following language:

> "*FinREC believes that the rate used to amortize deferred acquisition costs for the current reporting period can be calculated ~~either~~ as of the beginning of the current reporting period <u>using either information known at that time</u> (thereby excluding actual current reporting period experience) or ~~as of~~ <u>information known at</u> the end of the current reporting period (thereby including actual current reporting period experience <u>and any assumption updates</u>).*"

Paragraph 9—potential for misunderstanding

Paragraph 9 also includes the sentence, "*An entity should select one of these calculation methodologies and apply it consistently*."

We are concerned that this could be understood as either a one-time, entity-wide election (similar to the expense assumption option in paragraph 944-40-35-5(a)(2)) or as a separate election for each cohort (similar to the amortization method option in paragraph 944-30-35-3A). We believe the latter to be the better interpretation and recommend clarifying intent by replacing this sentence with something similar to the amortization method option:

> "*The experience adjustment method should be applied consistently over the remaining term of the related contracts.*"

Paragraphs 10 and 11—inaccurate and misleading guidance

Paragraphs 10 and 11 echo the inaccurate description in paragraph 9. Consistent with an improved description in paragraph 9, we recommend revising the first sentence in both paragraphs 10 and 11 to more accurately describe the methods, perhaps beginning them with:

> "10. *If the amortization rate for the current reporting period is calculated as of the beginning of the current reporting period ~~(thereby~~ excluding actual current reporting period experience (i.e., the current period amortization is based on expectations as of the beginning of the period) and actual terminations exceed expectations, a separate experience adjustment to further reduce the DAC balance would be needed.*"

> "11. *In contrast, if ~~the amortization rate for the current reporting period is calculated as of the end of the (thereby including~~ current reporting period experience~~)~~ is included in the calculation of the amortization rate for the current reporting period, no separate experience adjustment would exist.*"

Paragraph 11—inaccurate, incomplete, and misleading illustration

The illustrated schedules included with paragraph 11 contain a mistake and do not clearly indicate that the example includes both actual experience and an assumption change.

[If it weren't for the assumption change, the revised illustration would have shown no additional amortization in 20X2. The revised amortization rate would have been 74 divided by 2,800, or 2.64%. Applying that to the $700 actual amount in force would have produced amortization in 20X2 of 19, the same amount shown in the original Schedule Four.]

To provide accurate guidance, the mistake must be corrected, and we believe that clearly indicating the combination of actual experience and assumption change would help to avoid confusion.

The mistake is in Schedule Three's balance of insurance in force for 20X2. For DAC amortization, this should be the amount in force at the beginning of the year (1,000). Actual experience reduces the amount of insurance in force to 700 by the end of 20X2 (the beginning of 20X3) but does not affect the amount at the beginning of the year. The assumption change reduces projected in force for 20X4 and 20X5, respectively, to 400 and 200.

We recommend correcting Schedule Three to look like this:

<u>Schedule Three</u>
from FASB ASC 944-30-55-7A
revised to include actual terminations in 20X2
and an assumption change for projected in force after 20X3

Year	Balance of Insurance in Force
20X2 20X3 20X4 20X5	$ 1,000 700 400 200
Total	$ 2,300 (x)
Capitalized acquisition costs	$ 74 (y)
Amortization rate = (y)/(x)	3.22% (z)

Schedule Four also requires correction for the same mistake. We recommend:

<u>Schedule Four</u>
from FASB ASC 944-30-55-7A
revised to include current experience and assumption change

Capitalized costs, year two	$ 74
Amortization, year two Balance of insurance in force of $1,000 at rate (z) from revised Schedule Three	(32)
Experience adjustment, end of year two N/A	0
Balance, end of year two	$ 42

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We would welcome the opportunity to speak with you in more detail and answer any questions you have regarding these comments. If you have any questions or would like to discuss further, please contact Shera Evans, the Academy's risk management and financial reporting analyst, at niemirowski@actuary.org.

Sincerely,

Steven F. Malerich
Chairperson, Financial Reporting Committee
American Academy of Actuaries