October 30, 2002

Ms. Kim Hekker
Technical Manager
Accounting Standards, File 3162.LD
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Proposed Statement of Position: *Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts*

Dear Ms. Hekker:

The American Academy of Actuaries' (Academy) Life Financial Reporting Committee (LFRC) is pleased to have this opportunity to comment on the exposure draft of the proposed Statement of Position (SOP): *Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts*. We commend the Nontraditional Long-Duration Contracts Task Force (Task Force) for a very thoughtful proposal, and we appreciate the opportunity for Academy liaisons to participate in the Task Force's deliberations and drafting process.

In general, we are very supportive of the draft SOP. In this letter, we will generally limit our comments to certain of the conclusions that we find problematic or in need of further clarification.

Issue 5: Return Based on a Contractually Referenced Pool of Assets or Index

We would like a clarification that this provision applies only to general account business.

Issue 6: Annuitization Options

We disagree with the conclusion that no liability should be established during the accumulation phase related to the potential costs of annuitization incentives (defined as contract provisions that provide favorable treatment at annuitization via rights defined within the issued contract).

Our main concern is that in many instances this conclusion will result in an accounting treatment that does not appropriately reflect the economics of the product. Ignoring certain types of annuitization incentives could impede the fair presentation of liabilities and result in a distorted and aggressive pattern of earnings such as gains during the accumulation phase followed by potentially large losses or significantly reduced margins during the annuitization phase of the contract.

Examples of benefit designs that may exhibit such earnings patterns include: (1) two-tier annuities, which provide an upper tier account value that is only accessible for purposes of annuitization, and (2) guaranteed minimum income benefits on variable annuities, which depending upon separate account performance may provide similarly large economic benefits to policyholders that elect to annuitize the contract.

Attachments A1 through A4 provide sample illustrations of the earnings patterns that would result under the proposed SOP for the following types of situations:

Attachment	**Product Type**	**Payout Type**
A1	GMIB	Lifetime Income
A2	GMIB	Period Certain
A3	Two-Tier	Lifetime Income
A4	Two-Tier	Period Certain

A1 and A3 show the earnings pattern for an annuitization benefit that contains a significant mortality component, with the annuitization phase being reserved for as a Financial Accounting Statement (FAS) 97 limited pay contract subject to loss recognition at the point of annuitization. A2 and A4 show the earnings pattern for an annuitization benefit without a mortality component, with the annuitization phase being reserved for as a FAS 91 investment contract. As can be seen in the examples, a loss at annuitization occurs in the first case, and losses throughout the annuitization period occur in the second case. An additional reserve for annuitization incentives accrued during the accumulation phase of the contract would prevent either of these problematic earnings patterns.

We believe it is inappropriate to fail to recognize the anticipated costs of such annuitization incentives during the accumulation phase of the contract. The conclusion not to recognize such costs appears to be at odds with various fundamental principles of Generally Accepted Accounting Principles (GAAP) accounting – including the definition of a liability (probable and estimable), the matching principle, the concept of unearned revenue, and the concept of loss recognition that applies to insurance contracts.

Paragraph A22 indicates that annuitization benefits are not part of the accumulation phase of the contract. For contracts with significant annuitization incentives, we believe the distinction is not clear. The annuitization incentive may be viewed as a persistency bonus that is funded by revenues earned during the accumulation phase and serves as a bridge between the accumulation and payout phase of the contract. From this perspective, an annuitization incentive is integral to and should be recognized during the accumulation phase of the contract. In the case of Guaranteed Minimum Income Benefits (GMIBs) on variable annuities, there are generally explicit revenue charges assessed during the accumulation phase.

Paragraph A28 indicates that an annuitization guarantee is a price risk. This may be so for the minimum purchase rate guarantees on traditional annuity products (e.g., a 3 percent guarantee when prevailing settlement rates are 5 percent). On some products, however, the annuitization incentive is more than a price risk, it is an integral design element and a policyholder benefit with significant expected value when the policy is issued. Unlike traditional annuities, where the annuitization option is not heavily utilized, contracts with strong annuitization incentives generally do experience significant annuitization activity. We believe the cost of annuitization incentives, where significant, should be recognized during the accumulation phase when the associated revenues (*whether implicit or explicit)* are earned.

We note that the conclusion in FAS 97 indicating that the annuitization phase should be treated as a separate contract was premised on the fact that when FAS 97 was issued annuitization guarantees were generally of limited value, annuitization activity was rare, and the annuitization transaction itself was essentially priced for as a new sale that occurs at fair value. For certain contracts offered today with significant annuitization incentives, none of these underlying premises hold true.

In paragraph A30, the Task Force expresses concerns about the definition and measurement of the extra cost associated with annuitization bonuses. We believe it is possible and reasonable to define and measure the cost of such bonuses by comparing the present value of annuitization benefits, discounted using the portfolio earned rate less a suitable margin for profit and adverse deviation, to the greatest of the amounts available in cash (the benefit reserve under the proposed SOP).

In our view, it would be appropriate to accrue an additional reserve for the extra benefit costs arising from the annuitization incentives, with appropriate adjustments for expected persistency and utilization of the annuitization benefit. In other respects, the reserving for annuitization incentives could parallel that proposed by the SOP for persistency bonuses. In the case of GMIBs, the reserving mechanism should parallel the proposed reserving for Guaranteed Minimum Death Benefits (GMDBs). In the traditional deferred annuity case contemplated in FAS 97, the extra cost would be at or near zero since the present value of the annuitization benefits would approximate the amounts available in cash and expected annuitization rates would be low. Note that the annuitization itself would continue to be accounted for as a separate contract as indicated by FAS 97.

Issue 7: Accounting for Contracts That Contain Death or Other Insurance Benefit Features

I. Mortality Significance

We believe the guidance relating to the determination of the significance of mortality risk is too restrictive. The SOP refers to the present value of expected excess payments in relation to the present value of revenue. We have two concerns. First, focusing on the expected results does not allow for appropriate consideration of significant risks in the "tail" of the loss distribution – i.e., low probably but high severity losses as found in some variable annuity and other contracts. Low probability, high severity risks are the essence of insurance risk and should be taken into consideration when determining whether mortality or morbidity risk is significant. Second, we also note that using present values in the determination of mortality risk could inappropriately underweight the consideration of risks that arise in the later years of a policy.

We believe the determination of whether there is significant mortality or morbidity risk should reflect a broader range of considerations than just the expected present values of excess claims and revenues. In our view, the SOP should allow for consideration of low frequency, high severity risks as well as consideration of both discounted and undiscounted amounts.

II. Scope of Benefits Covered

Paragraph 26 of the draft SOP establishes an additional liability in situations where the amounts assessed in a period are not proportionate to the insurance coverage. Without further clarification and refinement, however, we believe the proposed SOP could unintentionally sweep in certain products and coverages and thereby require substantial unintended changes to current accounting.

Part of our concern with the SOP as drafted relates to the terms "proportionate" and "insurance coverage." Many Universal Life (UL) and Variable Universal Life (VUL) products have expected mortality costs that increase over time as a percentage of the cost of insurance charges (e.g., 50 percent grading to 90 percent). Typically, the decline in the mortality margin is offset by an increase in the interest margin such that the overall profit emergence is not unreasonable. Should an additional reserve be established so that mortality costs are directly proportionate to the insurance charges? We think this goes beyond the intent of the draft SOP, and FAS 97 already addresses situations involving excess front-end loads that are intended to compensate the insurer for benefits or services to be provided in future periods.

On the other hand, FAS 97 does not appropriately address the treatment of VUL plans with GMDB provisions. Variable universal life plans generally have GMDBs in the form of a no-lapse guarantee, i.e., contract is guaranteed to stay in force provided that minimum specified premiums are paid, even when the account value is depleted and the contract would otherwise lapse. Some VUL contracts have GMDB periods that extend for many years into the future. As the amounts assessed are generally not proportionate to coverage in periods where the GMDB comes into play, we believe that, if material, it would be appropriate to establish a reserve analogous to the reserve for GMDBs on variable annuities. In the case of VUL GMDBs, the excess benefits should be defined as the expected charges waived – i.e., the cost of insurance and expenses charges net of the premiums required to keep the contract in force during the period when the policy would otherwise lapse in the absence of a GMDB feature.

As the SOP is currently written, to reserve for a VUL GMDB it appears necessary to reserve for all benefits in excess of the account value, not just the GMDBs; this could radically change the recognition of mortality margins, which does not appear to be appropriate or the intent of the SOP.

Similar issues exist with universal life policies that contain no lapse guarantees.

We believe the potential unintended consequences of the draft SOP can be avoided by defining the scope of the additional liability requirements to apply to only those benefits, or portions thereof, that are deemed inherently non-periodic, i.e. are expected to be zero or insignificant in most periods but become significant under periods of specific economic conditions. In the case of a no-lapse guarantee, this benefit represents a partial waiver of assessments to the extent the account value plus premium are inadequate to fully cover the cost of insurance and other fund fees and charges. The waiver benefit would be considered non-periodic as it would be zero in most periods but there are economic scenarios where substantial benefits may arise, and would thus be subject to an additional liability. The base death benefits are periodic in nature with charges that are generally proportionate to the risk and would thus not be subject to any change in accounting.

III. Amortization of the Additional Liability

We believe the cost of excess benefits should be recognized in proportion to gross profits using the same methodology used for Deferred Acquisition Costs (DAC). Non-proportionate benefits would be excluded from gross profits consistent with the exclusion of all other non-level type items, i.e., acquisition costs, excess front-end loads, and sales inducements. This would result in the same estimated gross profit stream being used for amortizing all non-level items, i.e., DAC, unearned revenue, sales inducements and non-periodic benefits. Besides ensuring consistency, the calculations could be more readily done because they would follow established procedures for amortizing DAC and unearned revenue.

This proposed method would also solve some other technical problems that we have noted with the method described in the draft SOP. These problems are enumerated in Attachment A5.

Finally, the provision that the additional liability not be less than zero is appropriate. Although not specified in the draft SOP, our view is that, consistent with IAS groupings, this is appropriately applied at an aggregate grouping level.

Issues 9 & 10: Sales Inducements to Contract Holders

We agree with conclusions reached in the draft SOP regarding sales inducements to contract holders. Upon close review, we propose a small modification to the wording in Paragragh 33.

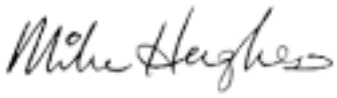
Paragraph 33 states that "…The insurance enterprise should demonstrate that such amounts are (a) incremental to amounts the enterprise credits on similar contracts without sales inducements…". We suggest adding the underlined wording to this paragraph:

> "…The insurance enterprise should demonstrate that such amounts are (a) incremental to amounts the enterprise credits or would credit on similar contracts without sales inducements…".

This additional wording is needed because companies may not have a similar product in their portfolio that does not have a sales inducement.

In closing, we again want to thank the American Institute of Certified Public Accountants for the opportunity to share our views on the proposed SOP. If you have any questions, or need additional clarification, please contact Steve English, the Academy's life insurance policy analyst (202-785-7880, english@actuary.org) or me (312-879-2122, michael.hughes@ey.com).

Sincerely,



Michael A. Hughes, Chairperson – Life Financial Reporting Committee
American Academy of Actuaries

****

The American Academy of Actuaries is the public policy organization for actuaries practicing in all specialties within the United States. A major purpose of the Academy is to act as the public information organization for the profession. The Academy is non-partisan and assists the public policy process through the presentation of clear and objective actuarial analysis. The Academy regularly prepares testimony for Congress, provides information to federal elected officials, comments on proposed federal regulations, and works closely with state officials on issues related to insurance. The Academy also develops and upholds actuarial standards of conduct, qualification and practice and the Code of Professional Conduct for all actuaries practicing in the United States.

Attachment A1
GMIB
Lifetime Annuitization

Assumptions:

Rollup interest rate is 5%
Waiting period for annuitization is 5 years
Ignore DAC impact on earnings

Year	SA Net Return	Accum Value	GMIB Rollup
0		100,000	100,000
1	7.0%	107,000	105,000
2	10.0%	117,700	110,250
3	-9.0%	107,107	115,763
4	3.0%	110,320	121,551
5	6.0%	116,939	127,628

Payout begins after 5 years
Payout period is lifetime payout with 5 year period certain
Annual payout based on the GMIB rollup of $127,628 is $14,400

Income Statement Results

Because there is a loss at annuitization, loss recognition requires setting a reserve so that no gains or losses are expected.
At annuitization, a yield rate of 6% is locked in for annuitization

Year	M&E Charges	Invest. Income	Reserve Increase	Payout	Net Income	EOY Reserve
1	1,620				1,620	107,000
2	3,371				3,371	117,700
3	3,372				3,372	107,107
4	3,261				3,261	110,320
5	3,409				3,409	116,939
6		7,016	(3,371)	14,400	(4,013)	113,569
7		6,814	(7,586)	14,400	-	105,983
8		6,359	(8,041)	14,400	-	97,942
9		5,877	(8,523)	14,400	-	89,419
10		5,365	(9,035)	14,400	-	80,385

Note: this example assumed that loss recognition is taken point of annuitization on an individual policy basis. In practice, loss recognition would be considered on a book of business basis.

Attachment A2
GMIB
Period Certain Annuitization

Assumptions:

Rollup interest rate is 5%
Waiting period for annuitization is 5 years
Ignore DAC impact on earnings

Year	SA Net Return	Accum Value	GMIB Rollup
0		100,000	100,000
1	7.0%	107,000	105,000
2	10.0%	117,700	110,250
3	-9.0%	107,107	115,763
4	3.0%	110,320	121,551
5	6.0%	116,939	127,628

Payout begins after 5 years; payout option is 5 year period certain
Payout interest rate is 5%
Annual payout based on the GMIB rollup of $127,628 is $29,479

Income Statement Results

The interest rate that equates $116,939 with a payout of $29,479 is 8.25%
Therefore valuation interest rate during payout is 8.25%
At annuitization, yield rate of 6% is locked in for annuitization period

Year	M&E Charges	Invest. Income	Reserve Increase	Payout	Net Income	EOY Reserve
1	1,620				1,620	107,000
2	3,371				3,371	117,700
3	3,372				3,372	107,107
4	3,261				3,261	110,320
5	3,409				3,409	116,939
6		7,016	(19,835)	29,479	(2,627)	97,104
7		5,826	(21,471)	29,479	(2,182)	75,633
8		4,538	(23,242)	29,479	(1,699)	52,391
9		3,143	(25,158)	29,479	(1,177)	27,233
10		1,634	(27,233)	29,479	(612)	(0)

Attachment A3
Two Tier Annuity
Lifetime Annuitization

Assumptions:

Interest accrues to the lower "cash" tier at guaranteed rate of 3%
Interest accrues to the upper "annuitization" tier at current rate of 5%
Earned interest rate is 6% all years
Ignore DAC impact on earnings

Year	Lower Tier Accum	Upper Tier Accum
0	100,000	100,000
1	103,000	105,000
2	106,090	110,250
3	109,273	115,763
4	112,551	121,551
5	115,927	127,628

Payout begins after 5 years
Payout period is lifetime payout with 5 year period certain
Annual payout based on the upper tier value of $127,628 is $14,400

Income Statement Results

Because there is a loss at annuitization, loss recognition requires setting a reserve so that no gains or losses are expected.

Year	Premium Income	Invest. Income	Reserve Increase	Payout	Net Income	EOY Reserve
1	100,000	6,000	103,000		3,000	103,000
2		6,180	3,090		3,090	106,090
3		6,365	3,183		3,183	109,273
4		6,556	3,278		3,278	112,551
5		6,753	3,377		3,377	115,927
6		6,956	(2,359)	14,400	(5,085)	113,569
7		6,814	(7,586)	14,400	-	105,983
8		6,359	(8,041)	14,400	-	97,942
9		5,877	(8,523)	14,400	-	89,419
10		5,365	(9,035)	14,400	-	80,385

Note: this example assumed that loss recognition is taken point of annuitization on an individual policy basis. In practice, loss recognition would be considered on a book of business basis.

Attachment A4
Two Tier Annuity
Period Certain Annuitization

Assumptions:

Interest accrues to the lower "cash" tier at guaranteed rate of 3%
Interest accrues to the upper "annuitization" tier at current rate of 5%
Earned interest rate is 6% all years
Ignore DAC impact on earnings

Year	Lower Tier Accum	Upper Tier Accum
0	100,000	100,000
1	103,000	105,000
2	106,090	110,250
3	109,273	115,763
4	112,551	121,551
5	115,927	127,628

Payout begins after 5 years; payout option is 5 year period certain
Payout interest rate is 5%
Annual payout based on the upper tier value of $127,628 is $29,479

Income Statement Results

The interest rate that equates $115,927 with a payout of $29.479 is 8.58%
Therefore valuation interest rate during payout is 8.58%

Year	Premium Income	Invest. Income	Reserve Increase	Payout	Net Income	EOY Reserve
1	100,000	6,000	103,000		3,000	103,000
2		6,180	3,090		3,090	106,090
3		6,365	3,183		3,183	109,273
4		6,556	3,278		3,278	112,551
5		6,753	3,377		3,377	115,927
6		6,956	(19,534)	29,479	(2,989)	96,393
7		5,784	(21,210)	29,479	(2,486)	75,184
8		4,511	(23,029)	29,479	(1,939)	52,155
9		3,129	(25,005)	29,479	(1,345)	27,150
10		1,629	(27,150)	29,479	(700)	(0)

Attachment 5
Non-periodic Benefits
Draft SOP Methodology for Additional Liability

To recap, the method proposed in the draft SOP for handling non-periodic benefits is to establish a liability such that the incurred benefits are reported as a level percent of the total assessments stream. This calculation is periodically unlocked to reflect actual experience and revised expected experience. The benefits net of changes in their liability, including unlocks, are fed into the gross profits stream used for DAC and unearned revenue. Following are certain technical issues with this method:

1. There is a circularity of calculation. Paragraph 26 notes:

   > "For contracts in which the assessments are collected over a period shorter than the period for which the contract is subject to mortality and morbidity risk, the assessment would be considered a front-end fee under FASB Statement No. 97 and accounted for under paragraph 20 of Statement No. 97. The amounts recognized in income should be considered assessments for purposes of this paragraph."

This leads to non-level assessments being deferred in proportion to gross profits that are dependent on changes in the non-proportionate benefits liability that is in turn dependent on changes in the non-level assessments, resulting in a circular calculation.

2. In order to maintain internal consistency, it can be mathematically demonstrated that it is necessary to deduct a component of interest earned from the changes in liability when calculating gross profits (if one wants to assure projected net profits maintain proportionality to gross profits under the assumption of earned interest rates equal to credited rates). This would further complicate the calculations.

The alternate method proposed by Academy addresses the above issues. In particular, the various non-proportionate items are removed from the gross profit stream; therefore a change in any one of these would not impact the gross profit stream and would thereby avoid requiring an unlocking in the other items.