



May 2, 2025

Jackson M. Day
Technical Director
Financial Accounting Standards Board

Alex Casas
Financial Accounting Standards Board

Tiffany Wyszowski
Financial Accounting Standards Board

Re: Agenda Request - Fixed Indexed Annuities

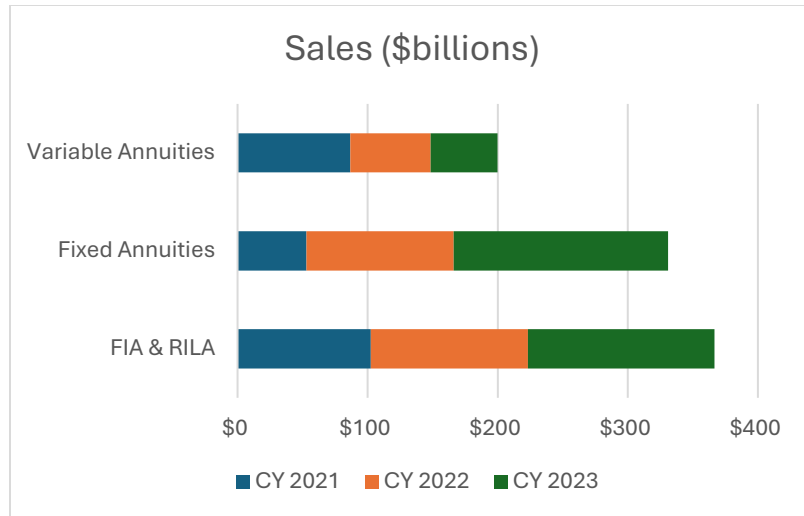
Dear Mr. Day, Mr. Casas, and Ms. Wyszowski,

On behalf of the Life GAAP Reporting Committee and the Financial Reporting Committee (Committees) of the American Academy of Actuaries,¹ we appreciate the opportunity to provide the following comments regarding indexed annuity and insurance products.

Indexed insurance products have gained popularity over the last several years. They include fixed indexed annuities (FIA), registered index linked annuities (RILA), indexed universal life contracts (IUL), and registered indexed universal life contracts (RIUL). Based on Life Insurance Management Research Association (LIMRA) information, indexed annuity sales have been larger than either traditional variable annuities (VA) or fixed deferred annuities (FDA) over the last three years. This trend continued in 2024 with record sales of these indexed annuity products. Indexed universal life products have also gained popularity.

LIMRA data through 2023:

¹ The American Academy of Actuaries is a 20,000+-member professional association whose mission is to serve the public and the U.S. actuarial profession. For 60 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.



From a policyholder investment risk and return perspective, these indexed products sit between variable products and fixed products. From an insurer perspective, indexed products risk and returns are generally consistent with fixed products. However, the current interpretation of the accounting guidance for these products creates significant non-economic income statement volatility. As a result, every insurer with material blocks of indexed products has introduced non-GAAP measures to remove this non-economic volatility, and these adjustments are not consistent.

The following introduces the background and explains why the accounting guidance creates significant problems for accounting for these products, explains how insurers manage the profitability of these products, and proposes an alternative measurement model that is consistent with how these products are managed. The committee believes the proposed measurement model would be more useful to users of these insurer financial statements and would address the adverse impacts of existing embedded derivative guidance. This analysis only refers to annuities, but the issues creating income statement volatility that drive insurers to create non-GAAP measures are the same for both annuity and life insurance products.

BACKGROUND

A deferred annuity is a contract with an insurance company that allows policyholders to earn fixed interest and/or realize equity gains with favorable tax treatment. In order to receive favorable tax treatment, these contracts must include an annuitization option to be classified as a life insurance contract. If these annuitization options contain other-than-nominal capital market risk, they are separately measured as market risk benefits (MRB). These MRBs are not a focus of this paper.

Policyholders can choose contracts with different risk and return profiles that determine how their contract can grow in value. VAs pass on equity gains or losses without adjustment. FDAs credit a fixed interest rate that is periodically declared. FIAs allow policyholders to participate in limited equity upside while protecting policyholders from equity downside risk. This is done with different strategies including a declared cap and 0% floor applied to the indexed equity return. RILAs provide higher equity upside returns than FIAs while limiting, but not eliminating, equity downside risk. Like FIAs, RILAs provide different strategies including a declared cap on indexed equity returns but only limit index losses through a buffer. For example, a 20% buffer would absorb the first 20% of losses, but all losses that exceed the buffer are passed onto the policyholder.

While VAs pass on equity returns (less fees) to policyholders, RILAs, FIAs, and FDAs provide guaranteed terms either as an interest rate, e.g., 1.5% per annum, or option value, e.g., 1% equity cap. Recent product designs allow policyholders to purchase a single annuity contract with the ability to reallocate their money between multiple variable, indexed, and fixed options over the contract's life.

The table below illustrates the insurer's costs for these different products. Numbers in parentheses are negative.

| | FDA | FIA | RILA |
|--|-------------------------|--|--|
| Illustrative declared rate/option | 3% for next policy year | S&P participation with 7% cap and 0% floor | S&P participation with 9% cap and (20%) buffer |
| Static hedging approach | | Sell 7% growth call and buy ATM call | Sell 9% growth call, buy ATM call, sell (20%) put |
| Current period cost to insurer | | Sell 7% call: (6.34%) Buy ATM call: 9.41% | Sell 9% call: (5.63%) Buy ATM call: 9.41% Sell (20%) put: (0.86%) |
| | Cost: 3% | Net cost: 3.07% | Net cost: 2.93% |
| Illustrative guaranteed rate/option | 1.5% | S&P participation with 1% cap and 0% floor | S&P participation with 2% cap and (20%) buffer |
| Guaranteed cost to insurer | | Sell 1% call: (8.92%) Buy ATM call: 9.41% | Sell 2% call: (8.44%) Buy ATM call: 9.41% Sell (20%) put: (0.86%) |
| | Cost: 1.5% | Net cost: 0.49% | Net cost: 0.11% |
| Guaranteed cost to insurer (stresses environment) | | Sell 1% call: (23.97%) Buy ATM call: 23.58% | Sell 2% call: (23.97%) Buy ATM call: 23.21% Sell (20%) put: (12.25%) |
| | Cost: 1.5% | Net cost: 0.38% | Net cost: (11.50%) |

“Cost” is the fixed interest credited for FDA and “Net cost” is the cost of the bundle of static hedges for FIA and RILA contracts. Those net costs assume 20% volatility and 3% discount rate for option pricing and 60% volatility and 1% discount rate for stressed option pricing.

| Policyholder return based on the following S&P returns | FDA | FIA | RILA |
|---|------------|--------------|--------------------|
| 10% | 3% | 7% (capped) | 9% (capped) |
| 8.5% | 3% | 7% (capped) | 8.5% |
| 3% | 3% | 3% | 3% |
| 6% loss | 3% | 0% (floored) | 0% (buffered) |
| 24% loss | 3% | 0% (floored) | 4% loss (buffered) |
| Insurer cost for all returns | 3% | 3.07% | 2.93% |

“Insurer cost” is the fixed interest credited for FDA and the net cost of the bundle of static hedges for FIA and RILA contracts.

As indicated in the tables above, while the benefits to the policyholder vary, the cost to insurers for RILA, FIA, and FDA are similar, since the insurance company has bought hedge assets.

They are all effectively interest costs. This is also how insurers manage and price these products. They are indifferent between crediting a declared interest rate in the fixed fund or using that same amount to purchase a bundle of options for the indexed fund.

ACCOUNTING GUIDANCE

These indexed products are discussed in Accounting Standards Codification (ASC) 815. Based on the following paragraphs in ASC 815, the current and future expected options within these contracts are a compound embedded derivative and are bifurcated from the host.

ASC 815-15-55-69: For the periodic ratchet design product, the insurer has committed to issue a series of options on the index over the duration of the contract. All of those forward-starting options meet the definition of a derivative instrument and require separate accounting under paragraph 815-15-25-1 from the perspective of the insurer unless a fair value election is made pursuant to paragraph 815-15-25-4. Paragraph 815-15-25-7 requires that the embedded feature with multiple components be separately accounted for as one compound embedded derivative.

ASC 815-15-55-70: In valuing those options, there are three main components to be considered:

- a. Future S&P 500 Index (or other index, as applicable) values will need to be estimated to determine both the future notional amounts at each ratchet date and the future strike prices of the future forward-starting options.
- b. Future annual cap and participation rates, which are often at the discretion of the contract issuer, subject to contractually specified minimums and maximums, will need to be estimated.
- c. Noneconomic factors related to policyholder-driven developments such as policy surrenders and mortality.

ASC 815-15-55-71: Given the three components, the forward-starting options should be valued using the expected future terms (that is, index values and cap and participation rates), but in no event should the value be less than the minimum amounts contractually agreed on in the contract. Expected terms represent management's estimates of cap and participation rates, rather than contractually guaranteed amounts. The estimated value reflects the notion that the contract provides for a level of equity-indexed return that can be estimated even when considering the issuer's options to adjust the policyholder's participation and cap rates. In subsequent periods when the terms of the forward-starting options become known, the actual terms should be substituted for the expected terms for purposes of valuation.

When this guidance was originally cleared by the board between 1999 and 2001, these equity-indexed product designs were in their infancy. RILA products, where policyholders are exposed to downside equity exposure, did not exist yet. Additionally, the "point-to-point" products mentioned in the original guidance are no longer offered. More importantly, "ratchet" products at that time only offered a single indexed option. Paragraph ASC 815-15-55-69 mentions that "the insurer has committed to issue a series of options on the index over the duration of the contract," because this "ratchet" product only offered the indexed feature. This is no longer true. Products now often offer multiple indexed, fixed, and variable investment options. Today's policyholders have the discretion to move their funds between these options, much like they move between different variable fund options within VAs.

Additionally, because these other investment options now exist, insurers generally have discretion to discontinue the indexed option at all anniversary dates. The option to move between the indexed funds offered, as well as between indexed and non-indexed funds, has been interpreted as other noneconomic factors that require estimates in ASC 815-15-55-70(c). That “commitment” as stated in ASC 815-15-55-69 is often no longer the case.

APPLICATION OF ACCOUNTING GUIDANCE

In practice, insurers break this embedded derivative into the current period option and future starting options (FSOs). The current option is marked to market and is straightforward. For the FSOs, insurers determine the embedded derivative based on what they expect to spend on those options. This practice is identical to how they determine future crediting rates for FDAs. For example, they may project a best estimate option cost of 3% of account value for each projected option reset period. The cost is typically based on projected portfolio or new money rates less a profit spread which is identical to the way insurers determine annual crediting rates for FDAs. While there are guaranteed minimum contractual amounts as described in ASC 815-15-55-71, these minimums result in costs that are near zero even in times of market stress. For RILA products, these minimums often result in a negative cost to the insurer as the value of the puts sold based on these minimum terms is worth more than the calls purchased.

To determine the projected notional amount (the account value), insurers generally assume a growth consistent with the option spend and reflect other policyholder behavior and demographic assumptions such as lapses, fund transfers, and mortality. Regarding fund transfers, insurers generally assume inertia and that the money does not transfer between funds. This is because the expected cost to insurers and the expected benefit to policyholders between the indexed and fixed funds are assumed to be the same so there is no incentive for policyholders to transfer nor any profitability impact to insurers if they do transfer. The cost of these FSOs is then discounted with the insurers’ own credit spread.

At the policy inception, the FSOs including the cost of the initial period option are defined as a compound embedded derivative and bifurcated from the host contract. A host accretion rate is then determined to accrete the host to the guaranteed minimum benefits for FIA and typically grow to the original deposit for RILA.

The following two tables show the expected income emergence at issue for an FDA and an FIA for a five-year product with some simplified assumptions. For example, all interest is assumed to be credited at the beginning of the period for FDAs to align with the timing of purchasing options at the beginning of the period. Despite the same expected lifetime profits, profit emergence for FIA differs from FDA. This is driven by the difference in the discount rate between the host and the value of the embedded derivative.

Table 1

| INCOME EMERGENCE FOR FIXED DEFERRED ANNUITY | | | | | | | | | | | |
|---|---------|-----------|----------------|-----------|---------------|------------------|--|--|--|--|--------|
| EOY | Premium | Port Rate | Crediting rate | Disc Rate | Account Value | Interest credits | | | | | Income |
| 0 | 1,000.0 | 4.0% | 3.0% | | 1,000.0 | 30.0 | | | | | - |
| 1 | | 4.0% | 3.0% | | 1,030.0 | 30.9 | | | | | 8.8 |
| 2 | | 4.0% | 3.0% | | 1,060.9 | 31.8 | | | | | 9.1 |
| 3 | | 4.0% | 3.0% | | 1,092.7 | 32.8 | | | | | 9.3 |
| 4 | | 4.0% | 3.0% | | 1,125.5 | 33.8 | | | | | 9.6 |
| 5 | | 4.0% | 3.0% | | 1,159.3 | | | | | | 9.9 |
| | | | | | | | | | | | 46.7 |

Table 2

| INCOME EMERGENCE FOR FIXED INDEXED ANNUITY | | | | | | | | | | 3.4% <-Host accretion rate | | | | | |
|--|---------|-----------|---------------|-----------|---------------|---------------|--------------------|----------------------|----------------------|----------------------------|---------|--------------|--------|---------|--|
| EOY | Premium | Port Rate | Option Budget | Disc Rate | Account Value | Option budget | PV (option budget) | Expired option Value | Fut starting options | Host | Resv | Resv less AV | Income | Income% | |
| 0 | 1,000.0 | 4.0% | 3.0% | 2.0% | 1,000.0 | 30.0 | 30.0 | | 153.0 | 847.0 | 1,000.0 | - | - | | |
| 1 | | 4.0% | 3.0% | 2.0% | 1,030.0 | 30.9 | 30.3 | 30.0 | 125.4 | 875.6 | 1,031.1 | 1.1 | 7.7 | 0.77% | |
| 2 | | 4.0% | 3.0% | 2.0% | 1,060.9 | 31.8 | 30.6 | 30.9 | 96.4 | 905.2 | 1,062.5 | 1.6 | 8.5 | 0.83% | |
| 3 | | 4.0% | 3.0% | 2.0% | 1,092.7 | 32.8 | 30.9 | 31.8 | 65.9 | 935.7 | 1,094.4 | 1.6 | 9.3 | 0.88% | |
| 4 | | 4.0% | 3.0% | 2.0% | 1,125.5 | 33.8 | 31.2 | 32.8 | 33.8 | 967.3 | 1,126.6 | 1.1 | 10.1 | 0.93% | |
| 5 | | 4.0% | 3.0% | 2.0% | 1,159.3 | | | 33.8 | | 1,000.0 | 1,159.3 | - | 11.0 | 0.98% | |
| | | | | | | | | 159.3 | | | | | 46.7 | | |

Below are descriptions of some of the terms and calculations in the tables above, as well in the subsequent examples:

- Port Rate – the projected earned rate on the assets backing these liabilities.
- Option Budget % and Crediting Rate % – the projected amounts either credited to the account value or used to buy options based on the portfolio earned rate and a target profit spread, beginning at 100 bps. As mentioned earlier, crediting to FDA is assumed to occur at the beginning of the period for simplicity and consistency with FIA.
- Disc Rate – the market consistent discount rate used to value the embedded derivative
- Option Budget – the option budget % x the Account Value.
- PV (option budget) – the present value of each future starting option at the Disc Rate.
- Expired options – the projected value of each purchased option. Time value of money for each of these was ignored for simplicity.
- Fut starting options – the sum of the PV (option budget) at each future period. This represents the FSO embedded derivative.
- Host – this equals the premium less the future starting options at issue then grows to the premium at a level “Host accretion rate.” Nonforfeiture guarantees were ignored for simplicity.
- Resv – host plus Fut starting options plus cumulative expired option values
- Income – interest earned on the reserve balance at the Port Rate less cost of Option Budget or Crediting Rate and other reserve changes.

VOLATILITY DUE TO ACCOUNTING MODEL

While the economics of FIAs and RILAs are very similar to FDAs, the GAAP reporting can be very different. The most frequent and largest financial statement difference arises in the way market changes affect the FSO valuation. Positive actual equity market performance leading to higher expected account value growth can increase GAAP reserves and reduce the current period income. Changes in forward interest rates also potentially change reserves and affect insurers’ current income in opposite ways, depending on their approach to updating their projected option budget. Earning emergence will also differ from FDAs, even when markets are stable.

The tables below continue the FIA example. As these products typically have much longer expected durations than the illustration, the real impacts of similar changes are often much larger than illustrated.

Table 3 shows the impact of an expired option after equity market appreciation. This results in higher assets under management, leading to more spread income over the expected life and higher expected

lifetime profits. This results in a higher projected option budget, which is recognized immediately. The expected additional spread is only recognized when it is earned, so the impact is a decrease in the current period income. In Tables 3, 4, and 5, the changes from the original expectations from Table 2 are highlighted in yellow.

Table 3

| EOY | Premium | Port Rate | Option Budget | Disc Rate | Account Value | Option budget | PV (option budget) | Expired option Value | Fut starting options | Host | Resv | Resv less AV | Income | Income% |
|-----|---------|-----------|---------------|-----------|---------------|---------------|--------------------|----------------------|----------------------|---------|---------|--------------|--------|---------|
| 0 | 1,000.0 | 4.0% | 3.0% | 2.0% | 1,000.0 | 30.0 | 30.0 | | 153.0 | 847.0 | 1,000.0 | - | - | |
| 1 | | 4.0% | 3.0% | 2.0% | 1,060.0 | 31.8 | 31.2 | 60.0 | 129.1 | 875.6 | 1,064.7 | 4.7 | 4.1 | 0.41% |
| 2 | | 4.0% | 3.0% | 2.0% | 1,091.8 | 32.8 | 31.5 | 31.8 | 99.2 | 905.2 | 1,096.2 | 4.4 | 9.6 | 0.91% |
| 3 | | 4.0% | 3.0% | 2.0% | 1,124.6 | 33.7 | 31.8 | 32.8 | 67.8 | 935.7 | 1,128.1 | 3.6 | 10.5 | 0.96% |
| 4 | | 4.0% | 3.0% | 2.0% | 1,158.3 | 34.7 | 32.1 | 33.7 | 34.7 | 967.3 | 1,160.4 | 2.1 | 11.4 | 1.01% |
| 5 | | 4.0% | 3.0% | 2.0% | 1,193.0 | | | 34.7 | | 1,000.0 | 1,193.0 | - | 12.3 | 1.06% |
| | | | | | | | | 193.0 | | | | | 47.8 | |

Table 4 shows the impact of a higher option budget discount rate with no changes to the expected portfolio rate or the option budget. While expected lifetime income does not change, income is accelerated due to the decrease in the present value of the option budget.

Table 4

| EOY | Premium | Port Rate | Option Budget | Disc Rate | Account Value | Option budget | PV (option budget) | Expired option Value | Fut starting options | Host | Resv | Resv less AV | Income | Income% |
|-----|---------|-----------|---------------|-----------|---------------|---------------|--------------------|----------------------|----------------------|---------|---------|--------------|--------|---------|
| 0 | 1,000.0 | 4.0% | 3.0% | 2.0% | 1,000.0 | 30.0 | 30.0 | | 153.0 | 847.0 | 1,000.0 | - | - | |
| 1 | | 4.0% | 3.0% | 3.0% | 1,030.0 | 30.9 | 30.0 | 30.0 | 123.6 | 875.6 | 1,029.2 | (0.8) | 9.6 | 0.96% |
| 2 | | 4.0% | 3.0% | 3.0% | 1,060.9 | 31.8 | 30.0 | 30.9 | 95.5 | 905.2 | 1,061.6 | 0.7 | 7.6 | 0.74% |
| 3 | | 4.0% | 3.0% | 3.0% | 1,092.7 | 32.8 | 30.0 | 31.8 | 65.6 | 935.7 | 1,094.0 | 1.3 | 8.7 | 0.82% |
| 4 | | 4.0% | 3.0% | 3.0% | 1,125.5 | 33.8 | 30.0 | 32.8 | 33.8 | 967.3 | 1,126.6 | 1.1 | 9.8 | 0.90% |
| 5 | | 4.0% | 3.0% | 3.0% | 1,159.3 | | | 33.8 | | 1,000.0 | 1,159.3 | - | 11.0 | 0.98% |
| | | | | | | | | 159.3 | | | | | 46.7 | |

Table 5 demonstrates a case where the insurer assumed a higher portfolio return and passes a portion of this higher yield on to the policyholder. In this case, the expected lifetime profits for the insurer increase. The change in the option budget results in a significant decrease to the current period income for the insurer.

Table 5

| EOY | Premium | Port Rate | Option Budget | Disc Rate | Account Value | Option budget | PV (option budget) | Expired option Value | Fut starting options | Host | Resv | Resv less AV | Income | Income% |
|-----|---------|-----------|---------------|-----------|---------------|---------------|--------------------|----------------------|----------------------|---------|---------|--------------|--------|---------|
| 0 | 1,000.0 | 4.0% | 3.0% | 2.0% | 1,000.0 | 30.0 | 30.0 | | 153.0 | 847.0 | 1,000.0 | - | - | |
| 1 | | 5.0% | 3.9% | 2.0% | 1,030.0 | 40.2 | 39.4 | 30.0 | 165.2 | 875.6 | 1,070.9 | 40.9 | (32.1) | -3.21% |
| 2 | | 5.0% | 3.9% | 2.0% | 1,070.2 | 41.7 | 40.1 | 40.2 | 127.6 | 905.2 | 1,102.9 | 32.7 | 17.4 | 1.69% |
| 3 | | 5.0% | 3.9% | 2.0% | 1,111.9 | 43.4 | 40.9 | 41.7 | 87.5 | 935.7 | 1,135.2 | 23.3 | 19.1 | 1.79% |
| 4 | | 5.0% | 3.9% | 2.0% | 1,155.3 | 45.1 | 41.6 | 43.4 | 45.1 | 967.3 | 1,167.7 | 12.4 | 21.0 | 1.88% |
| 5 | | 5.0% | 3.9% | 2.0% | 1,200.3 | | | 45.1 | | 1,000.0 | 1,200.3 | - | 22.9 | 1.98% |
| | | | | | | | | 200.3 | | | | | 48.3 | |

Many indexed products offer fixed as well as indexed options. In these cases, insurers must make assumptions regarding the transfer between these funds. Actual transfers differing from expected transfers can result in even greater accounting income volatility, even while the economic profitability has not changed.

As illustrated by the tables above, common updates to these products lead to unintuitive GAAP results. At best, these changes show spurious volatility. At worst, they result in misleading and contrary impacts between two otherwise identical companies.

NON-GAAP MEASURES TO REMOVE ACCOUNTING VOLATILITY

FDA and FIA products are often managed with similar profitability targets and objectives in mind. The volatility that can occur under current guidance for indexed products, generally related to the valuation of the future options, can make it difficult to measure and monitor the true performance of the business. As such, most companies have developed “non-GAAP measures” which look to remove the non-economic volatility and produce more stable and understandable financial statements for management and external stakeholders.

While there are some small differences, most insurers apply adjustments that align the FIA non-GAAP reporting to the reporting for FDAs. They recognize the spread they are earning on the current year. They also reflect the liability value of the current year’s option, which they also hedge with a matching asset. Since future starting options are discretionary, they only recognize these as they are purchased.

Table 6 includes examples, pulled from public company filings, that provide a high-level view of how GAAP Net Income numbers are being adjusted. The earnings after the non-GAAP adjustments are commonly called “core earnings,” “operating earnings,” “management earnings,” or “non-GAAP earnings.” In general, companies are either completely removing the impact of the fair value guidance from earnings, both on the asset and liability side by using book value for the options and account value as the liability reserve, or by including just the current period impact of the fair value calculation on the liabilities, thus removing the impact of the forward option valuation.

Table 6

| Lincoln (Q4 2024 Statistical Supplement, page 1) | Adjusted Gain (Loss) from Operations: “Items related to life insurance product features, which include...changes in the fair value of the embedded derivative liabilities of our indexed universal life insurance (“IUL”) contracts and the associated index options we hold to hedge them...” | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
|---|--|--------------|---------------------------------|--|--|------|------|--|------------------------|--|---|--|--|--|------------|--------------|--|--|--|--|--------|--------|--|-----------|---------|--|-----------|---------|-----------------------|---------|---------|---------------|-------|-------|--|-------|---|--------------|--------|----------|--|------------|------------|
| American National Group (Q1 2024 10-Q, page 48) | <table><tr><th></th><th colspan="2">Three Months Ended March 31,</th></tr><tr><th></th><th>2024</th><th>2023</th></tr><tr><th></th><th colspan="2">(Dollars in thousands)</th></tr><tr><td colspan="3">Reconciliation from net income (loss) available to common stockholders to non-GAAP operating income available to common stockholders:</td></tr><tr><td>Net income (loss) available to American Equity Investment Life Holding Company common stockholders</td><td>\$ 332,079</td><td>\$ (166,913)</td></tr><tr><td colspan="3">Adjustments to arrive at non-GAAP operating income available to common stockholders:</td></tr><tr><td>Net realized losses on financial assets, including credit losses</td><td>93,997</td><td>24,384</td></tr><tr><td>Change in fair value of derivatives and embedded derivatives</td><td>(173,388)</td><td>206,202</td></tr><tr><td>Capital markets impact on the change in fair value of market risk benefits</td><td>(169,535)</td><td>136,950</td></tr><tr><td>Net investment income</td><td>(1,622)</td><td>(2,491)</td></tr><tr><td>Other revenue</td><td>5,969</td><td>5,969</td></tr><tr><td>Expenses incurred related to acquisition</td><td>4,477</td><td>-</td></tr><tr><td>Income taxes</td><td>51,626</td><td>(79,765)</td></tr><tr><td>Non-GAAP operating income available to common stockholders</td><td>\$ 143,583</td><td>\$ 124,336</td></tr></table> | | Three Months Ended March 31, | | | 2024 | 2023 | | (Dollars in thousands) | | Reconciliation from net income (loss) available to common stockholders to non-GAAP operating income available to common stockholders: | | | Net income (loss) available to American Equity Investment Life Holding Company common stockholders | \$ 332,079 | \$ (166,913) | Adjustments to arrive at non-GAAP operating income available to common stockholders: | | | Net realized losses on financial assets, including credit losses | 93,997 | 24,384 | Change in fair value of derivatives and embedded derivatives | (173,388) | 206,202 | Capital markets impact on the change in fair value of market risk benefits | (169,535) | 136,950 | Net investment income | (1,622) | (2,491) | Other revenue | 5,969 | 5,969 | Expenses incurred related to acquisition | 4,477 | - | Income taxes | 51,626 | (79,765) | Non-GAAP operating income available to common stockholders | \$ 143,583 | \$ 124,336 |
| | Three Months Ended March 31, | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| | 2024 | 2023 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| | (Dollars in thousands) | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Reconciliation from net income (loss) available to common stockholders to non-GAAP operating income available to common stockholders: | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Net income (loss) available to American Equity Investment Life Holding Company common stockholders | \$ 332,079 | \$ (166,913) | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Adjustments to arrive at non-GAAP operating income available to common stockholders: | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Net realized losses on financial assets, including credit losses | 93,997 | 24,384 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Change in fair value of derivatives and embedded derivatives | (173,388) | 206,202 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Capital markets impact on the change in fair value of market risk benefits | (169,535) | 136,950 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Net investment income | (1,622) | (2,491) | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Other revenue | 5,969 | 5,969 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Expenses incurred related to acquisition | 4,477 | - | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Income taxes | 51,626 | (79,765) | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Non-GAAP operating income available to common stockholders | \$ 143,583 | \$ 124,336 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Athene (Q4 2023 10-K, page 71) | “Change in Fair Values of Derivatives and Embedded Derivatives – FIAs—Consists of impacts related to the fair value accounting for derivatives hedging the FIA index credits and the related embedded derivative liability fluctuations from period to period. The index reserve is measured at fair value for the current period and all periods beyond the current policyholder index term. However, the FIA hedging derivatives are purchased to hedge only the current index period. Upon policyholder | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |

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| | <p>renewal at the end of the period, new FIA hedging derivatives are purchased to align with the new term. The difference in duration between the FIA hedging derivatives and the index credit reserves creates a timing difference in earnings. This timing difference of the FIA hedging derivatives and index credit reserves is included as a non-operating adjustment.</p> <p>We primarily hedge with options that align with the index terms of our FIA products (typically 1–2 years). On an economic basis, we believe this is suitable because policyholder accounts are credited with index performance at the end of each index term. However, because the term of an embedded derivative in an FIA contract is longer-dated, there is a duration mismatch which may lead to mismatches for accounting purposes.”</p> |
| F&G (Q4 2023 10-K, page 84) | <p>“Adjusted net earnings should not be used as a substitute for net earnings (loss). However, we believe the adjustments made to net earnings (loss) in order to derive adjusted net earnings provide an understanding of our overall results of operations.</p> <p>“For example, we could have strong operating results in a given period, yet report net income that is materially less, if during such period the fair value of our derivative assets hedging the FIA and IUL index credit obligations decreased due to general equity market conditions but the embedded derivative liability related to the index credit obligation did not decrease in the same proportion as the derivative assets because of non-equity market factors such as interest rate and non-performance credit spread movements. Similarly, we could also have poor operating results in a given period yet show net earnings (loss) that is materially greater, if during such period the fair value of the derivative assets increased but the embedded derivative liability did not increase in the same proportion as the derivative assets. We hedge our index credits with a combination of static and dynamic strategies, which can result in earnings volatility, the effects of which are generally likely to reverse over time. Our management and board of directors review adjusted net earnings and net earnings (loss) as part of their examination of our overall financial results. However, these examples illustrate the significant impact derivative and embedded derivative movements can have on our net earnings (loss). Accordingly, our management performs a review and analysis of these items, as part of their review of our hedging results each period.</p> <p>“Amounts attributable to the fair value accounting for derivatives hedging the FIA and IUL index credits and the related embedded derivative liability fluctuate from period to period based upon changes in the derivative’s underlying index, changes in the interest rates and non-performance credit spreads used to discount the embedded derivative liability, and the fair value assumptions reflected in the embedded derivative liability. The accounting standards for fair value measurement require the discount rates used in the calculation of the embedded derivative liability to be based on risk-free interest rates adjusted for our non-performance as of the reporting date. The impact of the change in fair values of these derivatives and hedging costs has been removed from net earnings (loss) in calculating adjusted net earnings.”</p> |

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| Prudential (Q4 2024 Quarterly Financial Supplement, page 39): | “Adjusted operating income generally excludes realized investment gains and losses from products that contain embedded derivatives, and from associated derivative portfolios that are part of an asset-liability management program related to the risk of those products.” |
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THE REAL VALUE OF THESE PRODUCTS

These products allow policyholders to partially participate in equity markets with some form of downside protection. For insurers, these products are another spread product that are almost identical to FDAs. This is supported by the fact that many product designs now include an option for policyholders to move funds between fixed and indexed investments at each index renewal period.

Additionally, when blocks of these products are sold, they are fair valued in a manner similar to FDAs. The focus is on the expected interest spread earned between the assets backing the liabilities and the assumed cost of the future starting options. Apart from the current year’s options on these contracts, projected equity returns, and volatility have little to no bearing on this valuation.

Insurers do hedge the current period option. They do this either through dynamic or static hedging. Similarly, with some product designs that offer multi-year options, they also hedge the current multi-year declared option with matching derivatives.

While there are guaranteed minimum option rates similar to guaranteed minimum crediting rates for FDAs, they have very little to no value, even in distressed market environments. For example, the guaranteed minimum option rate on the indexed fund may be equal to the minimum credited rate on a fixed investment fund within the contract. Therefore, insurers do not hedge these expected costs. Furthermore, most indexed product designs today include at least a fixed investment option and allow for the insurer to discontinue offering the indexed options at the insurers’ discretion.

When this discretion to discontinue offering the indexed option exists for insurers, they will only choose to offer the index feature if they expect to earn a spread by offering it. Therefore, it is really an option the insurer chooses to exercise at each renewal date and cannot represent a cost to them before they choose to make that offer. Once they make the offer, it becomes an embedded derivative based on the terms of the offered index feature.

Therefore, the insurer has the right to offer the next indexed feature at market terms they set. The insurer will assess their expected net yield on assets backing the FIA and their target profit spread. If market terms are lower than the guarantees or imply a spread that is lower than the insurers’ target profit spread, the insurer has the right to not offer the indexed feature.

Finally, many of these products now include guaranteed minimum withdrawal benefits (GMWBs) but these are separately valued as MRBs.

ALTERNATIVE APPROACHES

We suggest the following two approaches, which would offer more useful information for users of financial statements:

1. Approach 1: A recognition that some “ratchet” products no longer include a commitment to offer future starting options
2. Approach 2: Valuing the current year option as well as any future index guarantees, if discontinuation of the index feature is not an option.

The real value of the forward starting options and the way they are managed is entirely consistent with future crediting for FDAs. Therefore, a valuation technique that doesn’t explicitly identify the value of the forward starting options would still be materially correct, so long as it appropriately values the current option(s) and any future index guarantees.

However, a valuation model based on the insurers’ target interest spread based on expected returns on investments would not be appropriate. Different asset investment decisions should not affect the market participant’s view of the liabilities. So, while every insurer expects to earn an interest spread on offering these indexed features and has the rights and ability to ensure this, such an insurer-specific valuation approach would not be consistent with fair value principles.

Approach 1 would only apply to contracts where offering options is at the discretion of the insurer. A common example is a product design with both a fixed and indexed investment option. For many of these designs, the insurer can discontinue offering the indexed feature at future policy anniversaries.

For these types of contracts, the insurer only offers the indexed feature at the policy anniversary if a profit is expected from offering the feature. Since the profit is based on real world returns expected at the anniversary date and is based on the insurer’s investment decisions, it would be inappropriate to include this projected earned rate in the embedded derivative. A more appropriate alternative would be for the insurer to value the FSO at zero for these types of policies and hold an embedded derivative for only the current period option.

In Approach 2, the insurer would fair value the current written option as well as the guaranteed minimum, rather than expected, option budget for FSOs. The approach to value the guaranteed minimum would follow techniques used for other embedded derivatives for guaranteed minimum account values. Expected costs would be valued based on market consistent assumptions and, in the absence of fees, this would be bifurcated from the host if other than nominal.

In both options, a host adjustment would remain necessary for the current period options. Since the current discretionary option is then purchased at the beginning of the term and not “credited” over the year like FDAs, another host adjustment would be made for just this one period. Such a method would start with the account value including settlement of the prior period expired option and deducting the cost of the new option when issued from the account value for the host. This host would then accrete back to the account value or nonforfeiture value over the term of the new current option.

RECOMMENDED CHANGES TO THE RELEVANT GUIDANCE

We believe both of our recommended approaches described above could be reflected by amending ASC 815-15-55-71, which applies solely to Equity-Indexed Annuity Contracts but is used for similar life insurance contracts, as follows:

ASC 815-15-55-71 Given the three components, the forward-starting options should be valued using the expected future terms (that is, index values and cap and participation rates) reflecting any discretion the entity has to discontinue to offer the options, but in no event should the value

be less than the minimum amounts contractually agreed on in the contract if that discretion does not exist. ~~Expected terms represent management's estimates of cap and participation rates, rather than contractually guaranteed amounts.~~ The estimated value reflects the notion that the contract provides for a level of equity-indexed return that can be estimated even when considering the issuer's options to adjust the policyholder's participation and cap rates. In subsequent periods when the terms of the forward-starting options become known, the actual terms should be substituted for the expected terms for purposes of valuation.

ASC 815-15-55-71A: If the entity had discretion to discontinue to offer the forward starting options, but the options are subsequently offered and accepted by the policyholder, paragraph 815-15-25-1 shall be applied at that time.

For insurers with contractual discretion to discontinue offering index features, this suggested change allows insurers to properly reflect the underlying economics of the future starting options. The changes would reflect economically the fact that offering these options is at the discretion of the insurer, with the choice of offering them as well as what they offer based on management's real-world view of the market and competitive conditions at that time.

If FASB would prefer not to amend ASC 815-15-55-71, an alternative solution would be to clarify that the newer "discretionary ratchet" products would not be held to the existing guidance. Current guidance discusses "ratchet" and "point-to-point" products, reflecting point-to-point products which were written at the time. They offered a single index period where ratchet products were committed to offer future starting options consistent with the language in ASC 815-15-55-69. That commitment leads to the valuation of the future starting options. The newer "discretionary ratchet" products do not have that commitment. We would be comfortable with additional clarification that confirms the guidance for "ratchet" products in ASC 815-15-55-71 does not apply to these newer "discretionary ratchet" products.

COMPARISON TO SIMILAR PRODUCTS

Comparable products relative to the Index-Linked credit features exist outside of the insurance industry. Worth noting are the following:

- Indexed Exchange-Traded Funds (ETFs) – These products are a type of investment fund that tries to replicate the performance of a selected equity index. Like regular stocks, they are traded on stock exchanges. Prices appear best aligned with the current period option value.
- Equity-Linked Notes – These products combine a fixed-income investment with an additional return tied to the performance of the underlying equity (e.g., a single security, a collection of stocks, or an underlying equity index).
- Structured Products – These products are pre-packaged yet highly customizable investment strategies, typically comprised of a bond with a derivative (i.e., option) component. They can be linked to a wide variety of underlying assets, such as equities, indices, commodities, interest rates, or currencies.
- Exchange-Traded Notes (ETNs) – These products are a type of unsecured, unsubordinated debt security that is traded on a stock exchange. Unlike a typical bond, there are no interest payments before maturity. At maturity, the issuer pays an amount based on the performance of the underlying index, less fees.

- Dollar Bond Index-Linked Securities (Dollar BILS) – These products are a type of bond with returns linked to a specific bond index. Interest payments occur at either a fixed or variable rate. Repayment at maturity is linked to the performance of the bond index.
- Index-Linked Certificates of Deposit (CDs) – These products have a return tied to the performance of the underlying index, rather than the fixed rate offered by more common traditional CD products.

While some of these products include discretion, we could find no examples where the issuer has both the discretion to discontinue offering the feature and currently value such features. None of these appear to be affected by the language changes we propose, thereby avoiding any potential contagion risk.

We appreciate the opportunity to offer these comments and recommendations. If you have any questions or would like to discuss further, please contact Amanda Barry-Moilanen, the Academy's policy project manager, life (barrymoilanen@actuary.org).

Sincerely,

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