Financial Security for Life

Michael Monahan
Senior Director, Accounting Policy
(202) 624-2324 t
mikemonahan@acli.com

November 18, 2020

Mr. Richard R. Jones, Chairman
Financial Accounting Standards
Board 401 Merritt 7, P.O. Box 5116
Norwalk, CT 06856-5116

Re: FASB Agenda Request — FASB ASU 2018-12 Annuitization Benefit Liability — Changes in the Upper-Medium Grade Rate

Dear Mr. Jones:

The American Council of Life Insurers ("ACLI") appreciates the opportunity to submit an Agenda Request to the FASB. Specifically, we ask that the Board consider an agenda topic on amending the guidance in Accounting Standards Update (ASU) 2018-12, Financial Services-Insurance (Topic 944) *Targeted Improvements to the Accounting for Long-Duration Contracts*, that addresses the effects of changes in the upper-medium grade rate.

Background

On May 29, 2019, ACLI sent a letter (attached) to FASB recommending that the guidance in ASU 2018-12, Financial Services-Insurance (Topic 944) *Targeted Improvements to the Accounting for Long-Duration Contracts,* be updated such that the effects of changes in the upper-medium grade rate should be classified in other comprehensive income ("OCI") for the annuitization benefit liability consistent with the accounting for the liability for future policy benefits ("FPB"). The rationale for this recommendation is described in the attached letter.

Issue

See our attached letter.

Thank you for your consideration. We welcome any questions you may have on our request.

Sincerely,

Mike Monahan
Senior Director, Accounting Policy

cc: Christine Botosan, Board Member
Hillary Salo, Technical Director
Alex Casas, Assistant Director
Jay Shah, Senior Project Manager

Attachment – ACLI May 19, 2019 Letter.

Financial Security...for Life.

Michael Monahan
Senior Director, Accounting Policy

May 29, 2019

Mr. Jay Shah, Senior Project Manager
Financial Accounting Standards Board
401 Merritt 7, PO Box 5116
Norwalk, CT 06856-5116

Re: FASB ASU 2018-12 Annuitization Benefit Liability - Changes in the Upper-Medium Grade Rate

Dear Mr. Shah:

In the review of ASU 2018-12, Financial Services-Insurance (Topic 944) *Targeted Improvements to the Accounting for Long-Duration Contracts,* The American Council of Life Insurers ("ACLI")[1] has identified several implementation issues that have been shared with The American Institute of Certified Public Account's ("AICPA") Insurance Experts Panel. In the course of those discussions, the decision was made for the ACLI to submit a letter that specifically relates to the application of changes in the upper-medium grade rate to the annuitization benefit liability and how those changes should be reported in the financial statements.

The purpose of this letter is to recommend that the guidance be updated such that the effects of changes in the upper-medium grade rate should be classified in other comprehensive income ("OCI") for the annuitization benefit liability consistent with the accounting for the liability for future policy benefits ("FPB"). The rationale for this recommendation is described below.

Paragraph 944-40-35-6A-b of the ASU states as follows:

Discount rate assumptions. Net premiums shall not be updated for discount rate assumption changes.

1. The difference between the updated carrying amount of the liability for future policy benefits (that is, the present value of future benefits and expenses less the present value of future net premiums based on updated cash flow assumptions) measured using the updated discount rate assumption and the original discount rate assumption shall be recognized directly to other comprehensive income (that is, on an immediate basis).

[1] The American Council of Life Insurers (ACLI) advocates on behalf of 280 member companies dedicated to providing products and services that promote consumers' financial and retirement security. 90 million American families depend on our members for life insurance, annuities, retirement plans, long-term care insurance, disability income insurance, reinsurance, dental and vision and other supplemental benefits. ACLI represents member companies in state, federal and international forums for public policy that supports the industry marketplace and the families that rely on life insurers' products for peace of mind. ACLI members represent 95 percent of industry assets in the United States. Learn more at www.acli.com.

2. The interest accretion rate shall remain the original discount rate used at contract issue date.

Paragraphs 944-40-35-12 through 944-40-35-16 provide revised guidance for annuitization benefits that includes the use of discounting at an upper-medium grade rate (944-40-35-15). As a result of the changes introduced in the ASU, we believe the effect is an inconsistency in application when a change in the discount rate occurs. Our analysis highlights this inconsistency.

ASC 944-40, as revised by ASU 2018-12, requires an additional liability to be accrued for certain annuitization benefits that do not meet the definition of market risk benefits or embedded derivatives under the guidance. Per ASC 944-40-25-26, this may include annuity purchase guarantees, guaranteed minimum income benefits that are not market risk benefits, and two-tiered annuities. The accounting model for this additional liability (hereafter referred to as the "ABL") is equivalent to the existing SOP 03-1 model except that the discount rate used to calculate the present value of expected annuitization payments at the expected annuitization date is to be the upper-medium grade fixed-income instrument yield (hereafter referred to as the "A-rate"), rather than the company-specific expected investment yield.

The change to using the A-rate aligns the discount rate for the payout phase with that required for FPB. However, unlike the FPB guidance, which requires the effect of changes in the A-rate to be recognized through OCI, the ASU requires the effect of changes in the A-rate on the ABL to be recognized in net income. The position articulated in the remainder of this paper is that aligning the classification of the effect of changes in the A-rate for the ABL with the OCI classification for FPB would result in a more conceptually sound accounting treatment.

Requiring the effect of changes in the A-rate to be recognized in net income would be the only instance in ASC 944 where the effect of changes in a prescribed rate impacts net income. The area for improvement being addressed by the introduction of the prescribed A-rate was that the discount rate being used to discount future cash flows was a company-specific, unobservable input. The FASB addressed this by prescribing a rate but allowing the effect of changes in that rate to be classified in OCI. There is no indication in the FASB's basis for conclusions that the effects of period-to-period changes in the prescribed rate were intended to impact net income. In particular, requiring it to impact net income in this one limited circumstance creates an accounting inconsistency that will be difficult for a financial statement user to understand.

There is also no indication that the FASB intended to make substantive changes to the SOP 03-1 model. The intention was to move certain types of benefits subject to capital market risk out of the SOP 03-1 model and into a fair value model. However, there is no indication that the features remaining in the SOP 03-1 model were intended to be accounted for in a substantially different way. It is not listed as one of the four major amendments to the standard, nor is there any discussion of it in the basis for conclusions. However, requiring the effect of changes in the A-rate to be recognized in net income would result in a significantly different earnings pattern than the current SOP 03-1 model. The existing model uses the expected investment yield to discount expected benefits, and, therefore, reflects company-specific investment strategies and asset-liability matching. Thus, near-term changes in market bond yields, which are relatively volatile, would not necessarily result in a change to management's long-term expected investment yields. As such, requiring the effect of changes in the A-rate to be recognized in net income will introduce accounting volatility that does not reflect the expected impact of economic volatility on a company's earnings.

Consistent with its goal to provide for an updating of a standard interest rate in the accounting for FPB, the FASB conformed the discount rate for the ABL. However, requiring the effect of changes in the A-rate to be recognized in net income divorces the accounting treatment from both the existing SOP 03-1 model (introducing significant earnings volatility due to changes in market bond yields) and the new FPB model (changes through OCI). Recording the impacts through OCI would retain a similar income statement recognition as the existing SOP 03-1 model, while also resulting in a consistent treatment with the FPB model.

Also, requiring the effect of changes in the A-rate to be recognized in net income creates a disconnect between the accounting immediately prior to and immediately following annuitization. Up until annuitization, the effect of changes in the A-rate will be recorded directly to net income, creating income statement volatility each period. Immediately upon annuitization, the resulting payout annuity becomes subject to the FPB guidance. Therefore, the A-rate at the date of annuitization is locked-in for purposes of interest accretion, and the ongoing volatility from changes in that rate is classified in OCI. In other words, despite the interest rate risk associated with the annuitization guarantee being virtually identical prior to and after annuitization, the accounting treatment differs significantly.

We believe a more conceptually sound approach would be to align with the FPB guidance, classifying the effect of changes in the A-rate in OCI. Under this alternative approach, at the time of annuitization, the ABL will be derecognized and that amount, adjusted for the removal of the amounts in accumulated other comprehensive income ("AOCI"), will be used in the calculation of the liability for the payout annuity. The discount rate used in the calculation of the liability for the payout annuity would be the original A-rate from the ABL calculation. Then, the entity would compare the FPB balance using the original A-rate and using the current A-rate. This difference would then replace the amount recorded in AOCI prior to annuitization. If an entity's assumption around the timing of annuitization and expected benefits were accurate, the reserve and AOCI balance would be unchanged prior to, and immediately after annuitization.

We welcome the opportunity to discuss our analysis and recommendation in greater detail should you have any questions.

Sincerely,

MMonahan

Mike Monahan
Senior Director, Accounting Policy

cc: Alex Casas, Assistant Director
FASB