AMERICAN ACADEMY *of* ACTUARIES

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November 23, 2020

Ms. Hillary H. Salo
Technical Director
Financial Accounting Standards Board (FASB)
401 Merritt 7, PO Box 5116
Norwalk, CT 06856-5116

Dear Ms. Salo,

On behalf of the American Academy of Actuaries[1], Financial Reporting Committee and Life Financial Reporting Committee we would like to provide comment relative to the AR-2020 Comment Letter No. 31 sent last month by the American Council of Life Insurers (ACLI) requesting that FASB revise the accounting for embedded derivatives related to equity indexing features and modified coinsurance/funds withheld reinsurance. Though not directly related to Accounting Standards Update (ASU) 2018-12, *Financial Services—Insurance (Topic 944): Targeted Improvements to the Accounting for Long-Duration Contracts,* the close relationship between these concerns and some aspects of ASU 2018-12 make this an especially good time to consider these concerns.

The Academy's mission is to provide policymakers and standards setters with objective and independent expertise and actuarial advice and therefore we believe FASB can benefit by our observations on ACLI's recommendations. As you are aware, the Academy's Financial Reporting Committee has on several occasions requested that FASB address the issues with accounting for these items, for example in our response to the scope question of the comment letter responding to the exposure draft *Targeted Improvements to the Accounting for Long-Duration Contracts*, and on other occasions as well.[2]

The Financial Reporting Committee and Life Financial Reporting Committee of the Academy continues to believe that it is important for FASB to address these issues in order to improve the relevance and representational faithfulness of insurance companies' US GAAP financial statements. We fully agree with the operational, risk management, and economic faithfulness points raised by the ACLI and hope that you will take up these issues.

Consistent with the ACLI letter and some additional points discussed below, these changes are necessary and the timing of these changes would ideally be aligned with the effective dates of ASU 2018-12 (i.e., January 1, 2023, for large public insurers and January 1, 2025, for others, assuming fiscal years aligned with calendar years). And we do not believe that this should impede the process of complying with the

[1] The American Academy of Actuaries is a 19,500+ member professional association whose mission is to serve the public on behalf of the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

[2] Examples include:

June 30, 2014; April 30, 2015; December 14, 2016 effective dates of ASU 2018-12. If FASB is concerned that the proposed changes could impede the ASU 2018-12 implementation efforts, a reasonable alternative would be to have a later mandatory effective date for these changes but permit early adoption aligned with a given company's ASU 2018-12 effective date.

We would like to note a few additional points that were not mentioned or emphasized in the ACLI letter:

1. While indexing features have been common in annuity contracts for more than 20 years, such features are becoming more common in universal life contracts. We understand that some indexed universal life (IUL) contracts are already applying accounting similar to that proposed in the ACLI letter. This is creating diversity in practice among IUL issuers as well as between similar features in certain IUL contracts and indexed annuities. It is thus urgent that FASB get ahead of this matter before the proliferation of IUL contracts creates even more diversity in practice, impeding comparability between similar features issued by different insurers.

2. Another concern making this an urgent matter is that insurers are currently enhancing the fair value models used for indexed products to address the market risk benefit requirements of ASU 2018-12 *Financial Services—Insurance (Topic 944): Targeted Improvements to the Accounting for Long-Duration Contracts.* It would be helpful to be able to make these valuation changes concurrently with the market risk benefit changes, allowing the two fair value calculations to be aligned and avoiding the need to revise the fair value models again at a later date.

3. When pricing indexed products, insurers are generally indifferent between crediting a fixed rate and crediting an indexed rate on the future balances since the economics are very similar. But the current accounting produces very different results. In addition, since Derivatives Implementation Group (DIG) Issue B29 was issued over 20 years ago, we have the benefit of observable information from merger and acquisition activity and we have not seen evidence from these transactions that fixed and indexed crediting generate differential valuations. Since fair value is supposed to reflect the price between a willing buyer and seller, the appropriate fair value would reflect this indifference between fixed crediting and indexed crediting under typical indexed product designs. The ACLI proposal would reflect this indifference. Product design has also evolved since DIG B29 such that the guarantees on the forward starting options ensure that the insurer has enough flexibility to retain the indifference between fixed crediting and indexed crediting.

4. Under current GAAP, the accounting for modified coinsurance/funds withheld forces an accounting mismatch between the passthrough of the investment income under the reinsurance agreement and the investment income earned on assets held by the ceding company for the large majority of situations where the assets are classified as available for sale. While the assets held by the ceding company are generally held at fair value, the changes in fair value of these assets (unrealized gain or loss) are reported through other comprehensive income (OCI) but the change in fair value of the modified coinsurance/funds withheld embedded derivative is reported through income. This is particularly problematic given the changes to accounting for future policy benefit liabilities under ASU 2018-12. Under current GAAP accounting there is a known accounting mismatch between assets and liabilities which is typically disregarded by investors. ASU 2018-12

addresses much of this mismatch by reporting changes in liability discount rates through OCI. But the embedded derivative under modified coinsurance/funds withheld precludes matched accounting between the OCI on the reinsured liabilities and the change in fair value of the assets. This will likely confuse investors. The ACLI proposal matches the accounting for modified coinsurance/funds withheld arrangements to economics of the reinsurance settlements since the reinsurance settlements simply pass the investment income through from the ceding company to the assuming company.

We recognize that FASB recently extended the effective date of ASU 2018-12 and that addressing these matters would generate some additional work. We do not believe that this additional work would impede efforts to implement ASU 2018-12 on time. The enhancements requested by the ACLI are simplifications to existing valuation processes, so the additional work would be limited.

For indexed annuities the major valuation changes from the ACLI proposal would be to stop utilizing budget method valuation models, and to introduce a re-bifurcation methodology into the valuation process. Ceasing to use the budget method would require minimal effort, and the re-bifurcation methodology would build on existing bifurcation practice, which would minimize the additional effort. Further, this could be done particularly efficiently now while indexed products' fair value models are already being enhanced to address market risk benefits.

For modified coinsurance and funds withheld, the ACLI proposal would be to stop utilizing existing fair value calculation models, and to replace the fair value calculation with information that the ceding and assuming companies already generally possess. Again, ceasing to use certain models and utilizing information that is already available would require minimal effort.

Of course, there would be some accounting work needed to effect these changes, such as adding general ledger accounts. But insurers are already working on adding general ledger accounts to comply with ASU 2018-12, so the additional effort here should be minimal as well.

If you would like to have a further discussion on our comments or if you have additional questions, please contact the Academy's risk management and financial reporting analyst Shera Niemirowski, at niemirowski@actuary.org.

Thank you for considering our input.

Sincerely,

Charles K. Chacosky, MAAA, FSA
Chairperson, Life Financial Reporting Committee
American Academy of Actuaries

Steven F. Malerich, MAAA, FSA
Chairperson, Financial Reporting Committee
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