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LETTER OF COMMENT NO. 13

October 10, 2008

Mr. Mark Trench
Project Manager
Financial Accounting Standards Board
401 Merritt, P. O. Box 5116
Norwalk, CT 06856-5116

Re: Insurer's Accounting for Separate Account Investments for Which the Insurer Holds a Majority Interest - Amendment to FAS 160

Dear Mr. Trench:

The American Council of Life Insurers ("ACLI") requests FASB consideration of a change in interpretation of current guidance relating to an insurer's accounting for separate account investments for which the insurer holds a majority interest. The ACLI requests that the FASB consider an interpretation that a separate account, while not a separate legal entity, be considered as such in the consolidated accounts of the insurer, and that the specialized investment company accounting rules followed by the separate account be carried forward in consolidation. Specialized industry accounting would include the non-consolidation of mutual funds or similar entities for which the insurer, through the separate account, holds a majority interest. This issue has become potentially more significant than in the past due to two recent FASB Statements, FASB Statement No. 157, *Fair Value Measurements*, due principally to the additional disclosure requirements, and FASB Statement No 160, *Noncontrolling Interests in Consolidated Financial Statements - An Amendment of ARB No. 51 ("SFAS 160")*.

The ACLI is a trade association with 353 member companies that account for 93 percent of the life insurance industry's total assets in the United States, 93 percent of the life insurance premiums and 94 percent of annuity considerations. ACLI member companies are leading providers of retirement and financial security products, including life, disability income, and long-term care insurance; annuities; reinsurance; IRAs; and pensions such as 401(k), 403(b), and 457 plans.

Background

Nature and Purpose of Separate Accounts

Separate accounts are a concept unique to insurance enterprises. The operational portion of the insurance enterprise (referred to as the general account) holds the policyholder liabilities (and the assets backing those liabilities) for those products where the insurance enterprise has assumed risks such as mortality, morbidity, and investment performance. The general account follows the appropriate U.S. GAAP accounting for the various assets and liabilities it holds.

A separate account is required, by law, if an insurance enterprise offers a variable product. The separate account is not a legal entity but is legally recognized. The insurance company sponsor is legally required to hold title to the assets and to segregate those assets from the general account so the assets and

performance of those assets can be attributed to the separate account product contractholder. Contractholders that have purchased a separate account product normally have a choice of a number of funds with differing investment objectives. The contractholders direct the allocation of their deposits across the investment options, with their allocation to the fund being represented by units of that separate account fund. The separate accounts are priced daily (certain funds might be priced less frequently) with the entire fair value net of fees allocated to the contractholder. The value of the fund, net of fees, is represented by the net asset value or NAV. This concept of pricing and allocation of value is consistent with a mutual fund.

The insurance company sponsor of the separate account earns an asset based fee for asset management and administrative expenses. These fees are deducted from the value of the separate account fund prior to striking the NAV.

Separate accounts invest in assets that match the investment objective of the separate account fund offering. Examples of investments are corporate bonds, real estate, stock, and mutual funds. While not true in all instances, it is common for the insurance enterprise to vote any equity share holdings. The insurance enterprise holds title to the assets in a fiduciary capacity and thus has the fiduciary responsibility to vote the shares in the best interest of the separate account contractholder.

Separate accounts may be either "registered" or "non-registered". If the separate account supports certain variable annuity or life contracts, that separate account must be registered with the Securities and Exchange Commission. Both types of separate accounts follow the same accounting policies, controls and procedures.

At inception of a new separate account, an insurance company sponsor may seed the fund to create an investment performance track record. The insurance company sponsor would have residual risks and rewards for the seed money ownership in the fund. The accounting for seed money follows the U.S. GAAP accounting based on the percentage of units held by the life company sponsor. The accounting for seed money is set forth in SOP 03-1 – *Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts* ("SOP 03-1") and is referenced briefly below but is outside the scope of this letter.

Accounting and Reporting of Separate Accounts by the Insurance Enterprise

The separate account arrangement creates challenges when determining the proper accounting because the insurance enterprise has title to the assets of the separate account but the separate accounts are segregated from the insurance enterprise's general account, therefore, the insurance enterprise receives no residual performance of the assets. The residual performance associated with the performance of the assets inure to the benefit of the contractholder.

The accounting for and reporting of separate accounts is addressed in SOP 03-1. SOP 03-1 outlines four criteria that must be met for a separate account arrangement to be afforded the summary line reporting under the provisions of the SOP. The four criteria are in paragraph .11 of the SOP and are as follows:

- a. The separate account is legally recognized. That is, the separate account is established, approved, and regulated under special rules such as state insurance laws, federal securities laws, or similar foreign laws.
- b. The separate account assets supporting the contract liabilities are legally insulated from the general account liabilities of the insurance enterprise (that is, the contract holder is not subject to insurer default risk to the extent of the assets held in the separate account).
- c. The insurer must, as a result of contractual, statutory, or regulatory requirements, invest the contract holder's funds within the separate account as directed by the contract holder in

designated investment alternatives or in accordance with specific investment objectives or policies.

- d. All investment performance, net of contract fees and assessments, must as a result of contractual, statutory, or regulatory requirements be passed through to the individual contract holder. Contracts may specify conditions under which there may be a minimum guarantee, but not a ceiling, as a ceiling would prohibit all investment performance from being passed through to the contract holder.

If the separate account meets all four criteria, the assets should be held at fair value and reported as a summary total in the insurance company sponsor's balance sheet. An equivalent summary total is reported in the liability section of the balance sheet. The performance of the assets and the corresponding amounts credited to the separate account contract holder should be offset within the same line of the statement of operations thus netting to zero with no income statement impact.

The following is an excerpt from the SOP 03-1 basis of conclusions, which provides rationale for the accounting guidance.

A-7 Collectively, the unique features of separate account arrangements warrant presentation distinct from an insurance enterprise's other assets and liabilities. AcSEC concluded that summary account totals in the statement of financial condition and the offsetting of investment performance and corresponding amounts credited to the contractholder provide the most meaningful presentation to the users of the financial statements for contracts meeting the four criteria specified in paragraph .11 of this SOP. In addition, that presentation allows financial statement users to more readily analyze investment returns of insurance enterprises by excluding amounts that are legally insulated from the general account and not available to shareholders.

SOP 03-1 provides limited discussion of the accounting by the insurer when the insurer, through the separate account, holds a majority interest in an investment such as a mutual fund. Appendix B, in describing the presentation in the financial statements of an insurance enterprise's proportionate interest in separate accounts (often referred to as general account "seed money"), notes that:

"Accounting for equity investments, including mutual funds, would depend on percentage ownership. If Subaccount XYZ owns more than 50 percent of the outstanding shares of a mutual fund, the accounting and classification of the items included in the column titled "Separate Account at General Account Value" would reflect consolidating the mutual fund into Subaccount XYZ. That is, if the mutual fund held debt and equity securities, those amounts would be included in the debt and equity securities lines of the table below."

The Appendix B guidance does not specifically address the existence of any minority interest in a less than wholly owned equity investment and whether and how any minority interest would be presented in the insurer's financial statements. Some believe that the majority investment, including any minority interest, would be subject to the same rules as general GAAP. Others believe that the special nature of separate accounts would allow the minority interest to be included in separate account liabilities, while others believe that the specialized investment company non-consolidation accounting would follow through to the consolidated accounts of the insurer, obviating the need for minority interest accounting.

Accounting and Reporting by the Separate Account

Certain separate accounts are subject to stand alone reporting ("stand alone separate account financial statements"). Registered separate accounts are required to produce stand alone audited GAAP financial statements filed with the SEC annually. In some cases, non-registered separate account financial statements are prepared for institutional separate account contractholders (e.g. pension plans). In both

cases the stand alone separate account financial statements are prepared in accordance with the guidance provided in the *Audit and Accounting Guide: Audits for Investment Companies* ("the Guide"). Separate accounts are specifically identified as within the scope of the Guide as they are considered akin to investment funds. Where applicable, financial statement requirements were developed to be consistent with those of investment funds.

Accounting and Reporting Issue

For purposes of this accounting issue, a separate account is defined as those that meet the GAAP definition of a separate account under SOP 03-1 (including both registered and non-registered separate accounts).

As previously discussed, separate accounts invest in assets that match the investment objective of the separate account fund offering. Examples of investments are corporate bonds, real estate, stock, and mutual funds. Our issue is limited to instances when a separate account invests in a mutual fund or similar entities where the separate account holds more than 50% of the mutual fund shares. For example, an insurance enterprise that has a mutual fund operation may establish a mutual fund to serve both the separate account contractholders and the retail mutual fund customer base. In this scenario it is possible for the separate account to own greater than 50% of the mutual fund with the retail customers owning the remainder. Ownership of greater than 50% requires an assessment of whether or not the mutual fund should be consolidated using a voting interest model by either/both the insurance enterprise or the separate account for its stand alone reporting.

Separate account assessment – For stand alone separate account financial statements, the separate account would not consolidate the mutual fund under paragraph 7.04 of the Guide. According to paragraph 7.04, consolidation or use of the equity method of accounting by an investment company of a non-investment company investee is not appropriate. SEC Regulation S-X, rule 6-03(c)(1)(i) states that statements of the registrant may be consolidated only with the statements of subsidiaries which are investment companies. The Guide and the SEC regulations indicate the registrant may consolidate, but consolidation is not required. Industry practice related to this area has developed not to consolidate. Given that the residual risks and rewards of the entire fund do not inure to the separate account contractholders, the decision to not consolidate is appropriate. As a result, the separate account reflects its ownership of the fund in its stand alone separate account financial statements, similar to a master-feeder fund or funds of funds presentation per paragraphs 5.34 – 5.54 of the Guide.

Insurance enterprise assessment – the insurance enterprise follows the accounting for a voting interest entity in Accounting Research Bulletin No. 51, *Consolidated Financial Statements* (As amended) ("ARB 51"). As noted above, the insurance company sponsor does not have the residual rights to the net assets of the separate account nor does the insurance entity have the residual rights to the net assets of the mutual fund. The residual risks and rewards to the mutual fund are allocated to the separate account contractholders and the retail customer base. We think this allocation is critical and should be the basis for no consolidation but so far have not been able to overcome the fact that the insurance enterprise holds title to the separate account's mutual fund shares and votes the shares in matters of corporate governance over the mutual fund. While there is voting control of the mutual fund, the voting control does not result in the benefit of ownership, which we believe is a key element for consolidation.

In addition, the insurance enterprise general account is not able to apply the guidance in EITF 85-12, *Retention of Specialized Accounting for Investments in Consolidation* ("EITF 85-12") because the separate account is not a legal entity as required by the guidance. EITF 85-12 would otherwise indicate that in the consolidation by the insurance enterprise the non-consolidation accounting by the separate account should be retained.

The accounting objective of SOP 03-1, as described in A-7 above, is preserved after the consolidation of the mutual fund by the insurance enterprise if the noncontrolling interest share of the mutual fund is reported in the separate account assets and separate account liabilities items on the balance sheet. The income statement offset is also applied. Consequently the only impact is a balance sheet gross up for the noncontrolling interest. While we do not support the consolidation, we can accept such a conclusion, recognizing it may not be the only possible presentation, because the usefulness of the insurance enterprise's financial statements is not negatively impacted.

SFAS 160 Application

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements – an amendment of ARB No. 51* ("SFAS 160") which is effective January 1, 2009. Under SFAS 160, noncontrolling interests are reported as a separate component of equity. In addition, upon adoption of SFAS 160, consolidated net income will include amounts attributable to both the parent and the noncontrolling interest. We have concerns with the application of SFAS 160 to the accounting issue described above.

If SFAS 160 is interpreted to reflect the noncontrolling interest in equity, it is presumed the net assets of the noncontrolling interest would be consolidated in the general account. This reporting of net assets would be necessary to meet the accounting objective of SOP 03-1. In addition to the balance sheet impact of the consolidation, there would be related impacts on the remaining financial statements. We respectfully contend that the reporting of the noncontrolling interest of these mutual funds on the financial statements of the insurance enterprise is not meaningful or useful to the financial statement users for the following reasons:

- Assets (or portions of assets) owned through a noncontrolling interest would be combined with the general account. This presentation in the statement of financial position gives more prominence in the financial statements to the assets the life insurance company does not hold title to (i.e. noncontrolling interest) compared to the assets that it does (i.e. contractholder funds in a separate account). This does not seem to be useful information for the financial statement user.
- The assets of the noncontrolling interest would be pro-rata amounts of the mutual fund assets. Pro-rata portions of assets for which the company does not have title commingled with assets of the general account further diminishes the usefulness of the consolidated financial statements.
- The change in net assets of the noncontrolling interest will be reflected in the revenue section of the insurance enterprise. The change would be offset in "net income attributable to noncontrolling interest". The increase in revenue may be mistakenly interpreted as available to support the operation of the consolidated general account. It is likely that the revenue will need to be removed for the reporting of a non-GAAP revenue measure to ensure the enterprise's growth and ability to meet its obligations is misunderstood by financial statement users.
- If cash flows are reported in cash and cash equivalents and is not identified as restricted cash, the following problem arises. The cash flows from the separate accounts are not included in the statement of cash flows of the insurance enterprise since those cash flows are not available to meet the obligations of the general account. With the adoption of SFAS 160, the cash flows related to the noncontrolling interest will be included in the statement since those flows will be commingled in the balance sheet of the enterprise. Similar to the revenue, this information is not useful as the cash flows are not available to meet the obligations of the general account.
- The equity of the noncontrolling interest does not support the general account operations.
- Fluctuating mutual fund ownership levels will result in mutual funds moving in and out of the financial statements (i.e. consolidating/deconsolidating) over time. The movement of funds in and out of the financial statements will make the analysis of the results more difficult for the users. We question relevance, understandability and comparability of such a presentation where the fluctuating ownership could result in a different presentation period to period.

Recommendation/Request

We request the FASB extend the application of specialized accounting as permitted by EITF 85-12 to separate account arrangements that meet the criteria in SOP 03-1. Therefore, not requiring consolidation of the underlying mutual funds but rather recognizing the fair value of the investment in the mutual fund per the Guide. This would be a narrow application that recognizes that while a separate account is not a separate legal entity, it is like a legal entity in many ways such as:

- *Separate accounts have financial statement reporting requirements that are separate from the insurance entity.* The financial statements are prepared in accordance with the guidance provided in U.S. GAAP and the Guide.
- A separate account is legally recognized. That is, the separate account is established, approved, and regulated under special rules such as state insurance laws, federal securities laws, or similar foreign laws.
- Separate account assets must be insulated from the general account liabilities to satisfy contractholder obligations.

We believe the application of EITF 85-12 to the separate account arrangement is a logical extension of the guidance that would reflect that while a separate account is not a legal entity, it has substantially similar economics to a separate legal entity. The end result would be a principle based approach that reflects the substance over form of the separate account arrangement.

We recognize the fundamental desire for increased consolidations, especially given the current turmoil in the financial markets. We support consolidation when the nature of the arrangements among entities is such that the majority of the economic upside and downside rests with the owner, sponsor or variable interest holder. As articulated throughout this document, the separate account arrangement results in a situation where the insurance company, while holding title to the assets, does not receive the residual rewards. As such consolidation does not seem appropriate and is misleading to the financial statement user. Furthermore, since the mutual fund typically does not have debt on its balance sheet, it is not comparable to many entities where consolidation is currently being debated. The insurance company already reports its obligation to the contractholder so the insurance enterprise's obligations related to this arrangement are fully recognized without the need to consolidate these mutual funds.

We respectfully request your attention to this issue. If you have any questions or comments concerning our accounting and reporting issue, please contact Mike Monahan at mikemonahan@acli.com, 202-624-2324.

Sincerely,



Michael M. Monahan
Director, Accounting Policy