October 25, 2013

Technical Director – File Reference No. 2013-290
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: FASB Exposure Draft – Insurance Contracts (Topic 834)

The Principal Financial Group ("The Principal") appreciates the opportunity to offer our views on the Financial Accounting Standards Board's ("FASB") Exposure Draft – Insurance Contracts ("ED"). The Principal is a leader in offering businesses, individuals, and institutional clients a wide range of financial products and services, including retirement services, asset management, and insurance solutions, through its diverse family of financial services companies. A member of the Fortune 500, the Principal Financial Group has $466.2 billion in assets under management and serves some 19.0 million customers worldwide from offices in Asia, Australia, Europe, Latin America and the United States.

Executive Summary

We generally support the FASB’s objective of developing a single, high-quality, principles-based accounting model for insurance contracts. At a high level, we feel that the building blocks approach described in the Exposure Draft provides a reasonable foundation for a high-quality accounting model for long-term insurance contracts. However, we have significant concerns with the proposed guidance, and we believe that the proposed guidance would result in the following negative impacts for the users of insurers’ financial statements and the insurance industry:

- **Complexity** - We feel that the proposed guidance has become so complex that the resulting financial statements will not be understandable or meaningful to users. Furthermore, we do not believe that it will improve the availability of decision-useful information to the users of our financial statements.
- **Cost vs. Benefit** - We anticipate that the proposed guidance will result in substantial additional costs for the preparers, users, and auditors of financial statements. We do not believe that the proposed changes in accounting guidance provide sufficient benefits to justify the significant costs of initial implementation and on-going compliance.
- **Cost of Capital** - The added complexity of the proposed accounting guidance and resulting volatility in our presentation of earnings and equity will make it more difficult for analysts and investors to understand the financial results of insurance companies. We believe this will lead to a reduction in the pool of potential investors, decreased valuations for insurance companies and an increased cost of capital for insurers.
Based on these concerns, we are unable to support the proposed guidance in its current form.

High-level Concerns

The Principal participated in the drafting of the Exposure Draft response by the American Council of Life Insurers ("ACLI"), and we generally agree with the concerns expressed in the ACLI’s response. In addition to signing the ACLI letter, we wanted to take the opportunity to highlight our areas of concern. At a high level, our concerns fall into four key categories: (1) complexity, (2) volatility, (3) cost, and (4) convergence, as described below.

Complexity of the accounting model

We believe the proposed guidance is very complex and will be difficult to implement and maintain. This proposal will significantly increase insurers’ reliance on actuarial models to calculate liability balances, income statement items and related disclosures. Specifically, the following aspects of the guidance will add significantly to the complexity of insurers’ financial statements:

- Revenue recognition – Reported revenue will be based on “earned premium” which is an actuarially derived value rather than an observable amount. Earned premium does not relate to the cash inflows measured under the building blocks model nor does it correlate with the timing of activities that generate insurance contract revenue, such as sales.
- Discount rates – The calculation of discount rates will require the use of significant inputs that are not observable in the market. Accordingly, financial statement users may be skeptical of these inputs and the resulting financial statements.
- Estimated returnable amounts – The exclusion of estimated returnable amounts from revenue and expenses adds unneeded complexity and is not reflective of the manner in which insurers price and manage their business.
- Separation of results between other comprehensive income ("OCI") and net income – While we believe that reporting the impact of changes in the discount rate in OCI (rather than net income) produces an appropriate result, this requirement will add significantly to the complexity of the calculations.
- Disclosures – The proposed guidance will result in a significant increase in the volume of required disclosures, making it difficult for the users of financial statements to focus on the information that is truly important.

We have discussed the proposed guidance with members of the insurance analyst community. Based on these discussions, the complexity of the proposed accounting guidance will make it more difficult for analysts and investors to understand the financial results of insurance companies. We believe this will lead to a reduction in the pool of potential investors, decreased valuations for insurance companies and an increased cost of capital for insurers.

In addition, we note that the building blocks approach focuses on the measurement of insurance liabilities, which ultimately places more emphasis on the balance sheet and less emphasis on the income statement. We believe this de-emphasis of the income statement coupled with the added complexities noted above may lead analysts and investors to increase their reliance on non-GAAP measures as a means of understanding insurers’ results.
Volatility of earnings and equity
Based on our initial testing, we anticipate that the proposed guidance will significantly increase the volatility of reported earnings and equity, due to the requirement for insurers to update discount rates and cash flow assumptions on each reporting date. Due to the long-term nature of insurance liabilities, a small change in assumptions can result in a significant change in the present value of the fulfillment cash flows, even if the long-term profitability of the business has not changed significantly. In many cases, the resulting change in the liability balance may dominate the insurer’s reported earnings for the period, making it difficult for financial statement users to assess the insurer’s performance. We do not believe that this type of period-to-period volatility provides a faithful representation of the economics of the business.

To the extent that insurers back their liabilities with assets that are measured at fair value through OCI ("FV-OCI"), income statement volatility will be mitigated by the FASB’s decision to recognize changes in the liability due to changes in the discount rate in OCI. However, for the portion of insurers’ assets that are measured at fair value through net income and amortized cost, the resulting accounting mismatch will create volatility in the income statement and equity. To address this issue, we recommend the FASB allow an election to use FV-OCI measurement for the assets that back insurance liabilities. Furthermore, the exclusion of portfolio credit spreads from the liability discount rate will create an additional accounting mismatch between an insurer’s assets and liabilities, which will create balance sheet volatility that does not reflect the economics of the business.

Lastly, products such as universal life and deferred annuities often utilize dynamic lapse rate assumptions or other assumptions that are directly dependent on current and/or future interest rates. Under the proposed guidance, changes in the liability resulting directly from changes in the discount rate will be reported in OCI, but changes in the liability resulting from changes in interest rate-dependent assumptions will flow through net income. As a result, short-term fluctuations in interest rates may lead to income statement volatility for products that utilize dynamic lapse rate assumptions. Splitting the impacts of interest rate changes between OCI and net income will likely add to difficulties in interpreting and communicating the financial results of the company.

Cost of implementation and maintenance
We anticipate that the proposed guidance will create significant additional costs – both initial and ongoing – for the preparers, auditors, and users of financial statements. The proposed guidance represents a complete overhaul of the financial reporting framework for insurance contracts. As a result, insurers will need to invest significant resources to create new actuarial models to perform the required calculations. Significant changes to systems and processes will be required to track and retain the additional data needed in the actuarial models. For example, insurers will need to collect and retain a large amount of granular data in order to calculate margins and track unearned premiums for in-force contracts. Extensive education will be needed for both internal and external stakeholders. Further, additional resources will be needed to establish appropriate internal controls and oversight over the calculation, reporting and disclosure processes. We have not yet performed a full estimate of the costs of the proposed guidance. However, based on work completed to date and our preliminary analysis of the remaining work effort, we anticipate that the initial implementation costs of the proposed guidance will exceed $50 million.
In addition, we anticipate that complying with the guidance will create significant on-going incremental costs that are not reflected in the estimate above. Post implementation, the complexity of the calculations, the effort to analyze and explain the periodic results and the large volume of required disclosures will result in the need for additional actuarial and accounting staff. Complying with the proposed requirements will substantially increase the amount of time required for insurers to prepare their financial statements. As a result, insurers may be forced to either significantly lengthen their close cycles or prepare financial statements on a lagged basis. Both of these solutions would adversely impact the timeliness and relevance of the financial statements.

**Convergence between the FASB and the IASB**

We note that the FASB originally undertook this project in an effort to achieve convergence with the International Accounting Standards Board’s (IASB’s) emerging standard on Insurance Contracts. However, the Boards have not achieved convergence, as evidenced by the lengthy list of significant differences between the FASB’s decisions and the IASB’s decisions (included in Appendix B of the FASB ED). While the FASB and IASB frameworks are similar at a high level, we believe that the significant differences between the two proposed standards will make it difficult for users to compare the results of insurers in the United States to the results of insurers in other jurisdictions.

In the early stages of the project, we believed that convergence with international standards would be one of the key benefits of overhauling the United States framework for insurance contracts accounting. However, the lack of convergence between the FASB and the IASB raises serious questions as to whether the costs of the new guidance outweigh the benefits. In the event the FASB decides to move forward with the proposed changes to insurance contracts accounting, we urge the FASB and IASB to consider the feedback received on their respective proposals and work together to resolve differences and develop a converged standard.

**Recommendations**

In light of the concerns noted above, we believe that a thorough cost-benefit analysis is warranted. We urge the FASB to carefully consider the cost estimates from the field testing participants and to weigh the costs against the perceived benefits of the new guidance. We also encourage the FASB to carefully consider the input received from investors, analysts, and other users of insurers’ financial statements.

We note that the United States already has robust and comprehensive financial reporting standards for insurance contracts. We believe that two of the key objectives of accounting standards for insurance contracts should be to ensure that (1) the recorded liabilities are sufficient to cover our obligations under the contract and (2) the profit emergence is reasonable relative to the economics of the contract. While the existing guidance is not perfect, we believe that it achieves these objectives, is generally understood by both the preparers and users of financial statements, and has served its purpose well for many years. Therefore, we urge the FASB to exercise appropriate caution in overhauling the existing standards. In the event that the benefits of the proposed guidance are not deemed to outweigh the cost, we recommend that the FASB consider making targeted improvements to the existing US GAAP guidance for insurance contracts. Areas the FASB could consider, with appropriate field testing and preparer and user outreach, include unlocking certain assumptions for all insurance contracts each reporting period and exploring alternative amortization methodologies for deferred acquisition costs.
In addition to the general concerns outlined above, the attachment provides a summary of our key concerns with specific aspects of the proposed guidance.

We appreciate your consideration of our comments. If you would like to discuss this letter, please contact me at (515) 247-4885 or lillis.terry@principal.com.

Sincerely,

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ATTACHMENTS
Specific Concerns - FASB Exposure Draft – Insurance Contracts (Topic 834)

Below is a summary of our key concerns with specific aspects of the proposed guidance.

Scope (Question #1)
We generally support the scope of the proposed guidance. However, we believe that a practical expedient should be offered for contracts that fall within the scope of the guidance yet contain de minimis insurance risk. In particular, deferred annuity products generally contain a guaranteed annuitization option, which gives the customer the right to use the accumulated account value to purchase a stream of life income payments, based on guaranteed factors specified within the contract. The presence of a guaranteed annuitization option causes deferred annuities to fall within the scope of the proposed guidance, because there is at least one scenario where the company could experience a significant loss due to longevity risk after annuitization.

However, in practice, deferred annuity products are often used primarily to accumulate assets for retirement, and utilization of the annuitization option is often very low. Applying the Insurance Contracts guidance to such products may produce anomalous results not reflecting the true economics of the product, because the expected value of cash flows relating to insurance risk would be very low. For products that contain de minimis insurance risk, we recommend that the FASB allow a practical expedient that would give companies the option of accounting for these products fully under the financial instruments guidance. This would allow for an amortized cost approach, which we believe is more in line with the risks of these types of products.

Further, we are concerned that the scope of the proposed guidance is very broad and may include transactions the FASB did not intend to include. For example, it is not clear to us whether the proposed guidance includes standard representations and warranties used in the sale of commercial loans. These representations and warranties confirm data at a point in time such as the fact that the seller has clear title and other information such as the occupancy status or specific tenants in a property. These representations and warranties represent that the information provided is accurate and do not guarantee the performance of the asset in future periods. We believe that such representations and warranties where there is no guarantee in the event of loss should not be included in the scope of the proposed guidance. We recommend that the FASB review the scope of the proposed guidance and better clarify the transactions that should be accounted for under the proposed guidance.

Separation of noninsurance components (Question #2)
While we are generally supportive of the criteria for unbundling distinct performance obligations to provide goods or services, it is not clear to us whether asset management services need to be unbundled and accounted for separately. We do not support unbundling these services because they are closely related to the insurance contract. We recommend that the FASB clarify that asset management fees should not be separated for contracts such as variable annuities, where fees are the principle source of revenue and an integrated component of the insurance contract.

Portfolio definition (Question #8)
We have several concerns with the FASB definition of a portfolio of insurance contracts. The FASB defines a portfolio of insurance contracts as:
A group of insurance contracts that (a) Are subject to similar risks and priced similarly relative to the risk assumed and (b) Have similar duration and similar expected patterns of release from risk, that is, reduction in variability in cash flows.

We are concerned that the proposed definition could be interpreted to require an excessive amount of granularity in the definition of portfolios. For example, a single premium deferred annuity (SPIA) issued to a 40-year-old would likely have a different duration – and possibly a different level of profitability – than an otherwise similar SPIA issued to an 80-year-old. Based on a literal reading of the FASB’s definition of a portfolio, one could conclude that these contracts are required to be placed in separate portfolios. We do not believe that this conclusion is appropriate, as these contracts are priced and managed as a single pool, and there is no practical reason to put them in separate portfolios.

We recommend that the FASB adopt the following definition, which would alleviate the concerns described above while still meeting the Board’s objective:

A group of insurance contracts that (a) provide coverage for similar insurance risks (e.g., mortality, morbidity, etc.), (b) are priced to reflect the risk undertaken, and (c) are managed together as a single pool.

Discount rate (Questions #14, 18, and 24)

Under the proposed guidance, fulfillment cash flows are discounted using a yield curve that reflects the characteristics of the insurance contract liability. While this approach may be appealing from a theoretical standpoint, it creates several practical difficulties. Because insurance liabilities are not traded in liquid markets, the discount rate applicable to an insurance liability is not directly observable. The Implementation Guidance (paragraphs 834-10-55-93 to 55-95) indicates that insurers may use one of two methods to determine the discount rate:

- The “top-down” approach starts with the yield curve for the actual portfolio or a reference portfolio, and then removes factors that are not relevant to the insurance liability, such as credit risk premiums for expected and unexpected credit losses.
- The “bottom-up” approach starts with the risk-free yield curve, and then adds factors that are relevant to the insurance liability, such as an illiquidity premium.

Both approaches require the use of significant unobservable inputs (the credit risk premium for the top-down approach and the illiquidity premium for the bottom-up approach). As a result, the determination of the discount rate will involve significant judgment and subjectivity.

In addition, credit risk premiums are generally excluded from the liability discount rate, except to the extent that the amount, timing, or uncertainty of the cash flows arising from the insurance contract depends on the performance of specified assets. The exclusion of the credit risk premium from the liability discount rate will create an accounting mismatch relative to the assets backing the insurance liabilities. Changes in market credit risk premiums will result in changes in the reported value of the insurer’s assets, without a corresponding change in the reported value of the insurer’s liabilities. This accounting mismatch will lead to volatility in reported comprehensive income and equity due to short-
term fluctuations in market credit risk premiums; this volatility does not accurately reflect the economics of the business.

Furthermore, the exclusion of the credit risk premium from the liability discount rate may cause insurers to report a loss at inception on certain long-duration products, even if the products are expected to be profitable over the long term. This artificial accounting loss will likely make the products less attractive for insurers to sell, and may prompt some insurers to stop offering certain long-duration products. Credit spreads are an integral component of an insurer’s pricing assumptions; excluding credit spreads from the discount rate does not reflect the economics of the business.

In order to address these concerns, we recommend that the FASB allow the use of discount rates that reflect the anticipated yields on the assets backing the insurance contract liabilities. We acknowledge that the resulting yield curve will include elements (such as a credit risk premium) that are not directly related to the characteristics of the insurance contract liability. However, this approach would reduce the reliance on unobservable inputs in the determination of the discount rate, and it would reduce or eliminate the accounting mismatches described above. We believe that the elimination of artificial accounting mismatches should take precedence over the desire to construct a yield curve that reflects only the characteristics of the insurance contract liability.

Lastly, under the proposed guidance, the initial yield curve is locked in for the purpose of interest accretion. We believe that the requirement to use the entire yield curve—rather than a single discount rate—adds unnecessary complexity to the interest accretion calculation. In addition, the use of a full yield curve will make it more difficult to explain interest-related changes in the liability from one period to the next. Therefore, we recommend that the FASB allow companies to translate the initial yield curve into an equivalent single discount rate for the purpose of interest accretion.

Unlocking of the service margin (Question #23)
While we support the FASB’s use of a single margin, we disagree with the FASB’s view that the margin should be calculated at contract inception and then locked in for the life of the contract. We believe that it would be more appropriate to use an approach similar to the IASB’s proposed approach for the contractual service margin, wherein the margin is updated for changes in the estimates of future cash flows.

The initial margin represents an estimate of the profits that are expected to be earned over the life of the contract. The estimated profitability of a contract will change over time as the insurer updates its estimates of future cash flows. We believe that updating the margin to reflect current estimates would provide a more faithful representation of the unearned profit embedded in the contract and would be consistent with the Board’s balance sheet approach. We acknowledge that unlocking the margin will add slightly to the complexity of the calculations. However, we believe that the added complexity is justified, because unlocking the margin would provide more decision-useful information to financial statement users.

Deferred acquisition costs (Questions #29 and 30)
The proposed guidance requires insurers to track qualifying acquisition costs separately from other cash flows and report them as an offset against the margin. We believe that this requirement adds unnecessary complexity to the calculation and presentation of the liability. We note that acquisition costs are
similar to other fulfillment cash flows, in that the insurer incurs these costs as a direct result of issuing the contract and fulfilling the obligations associated with the contract. In addition, acquisition costs are an integral part of insurers’ pricing models, and the premium charged for a contract is intended to cover the acquisition costs, as well as the other fulfillment cash flows. Therefore, we recommend that acquisition costs be included in the measurement of fulfillment cash flows as part of the liability.

**Earned premium approach (Questions #31 and 34)**

The proposed guidance uses an “earned premium” approach, wherein insurance contract revenue is recognized in proportion to the value of coverage and services provided during the period. Under this approach, the revenue recognized in a given period is an actuarially derived value rather than an observable amount. While the earned premium approach meets the narrow objective of aligning presentation with the revenue recognition principles, it does not relate to the cash inflows measured under the building blocks model, nor does it provide useful information about the growth and future earnings potential of the company.

In some cases, the earned premium approach may produce misleading results that will make it difficult for the users of financial statements to assess the insurer’s growth. In the “Implementation Guidance and Illustrations” section of the ED, the FASB provides an example of the calculation of insurance contract revenue for a closed block of 25-year term life contracts (paragraphs 834-10-55-162 to 55-169). Because claims are expected to increase over the course of the 25-year coverage period, the reported revenue steadily increases over the course of the coverage period. The pattern of reported revenue creates the impression that the block of business has grown steadily during the coverage period, despite the fact that the example represents a closed block with no new sales after the inception date. Therefore, we do not believe that the earned premium approach provides meaningful information to the users of financial statements.

We recommend the use of a premium due approach, similar to the current approach for traditional long-term insurance contracts. Premium due is an objective, observable amount that is easily understood by the users of financial statements and provides investors useful information about the growth and future earnings potential of the company. We recognize the premium due approach is not completely consistent with the revenue recognition principles. However, by removing insurance contracts from the scope of the expected revenue recognition standard, the FASB recognized that the economics of insurance contracts are fundamentally different from other types of contracts and should be accounted for and presented differently than other contracts. We believe the departure from the principle is warranted to provide the most decision-useful information to the financial statement users and avoid unnecessary complexities in the preparation of the financial statements.

**Estimated returnable amounts (Question #32)**

We disagree with the FASB’s decision to exclude estimated returnable amounts from revenue and expenses. We believe that presentation should flow from measurement. Thus, the revenues and expenses reported in the income statement should be consistent with the fulfillment cash flows included in the measurement model. For contracts measured using the building blocks approach, the measurement model includes all fulfillment cash flows, including amounts that meet the FASB’s proposed definition of estimated returnable amounts. In order to exclude the estimated returnable amounts from revenue and expenses, the insurer would be required to perform additional calculations outside of the measurement model; these calculations add unneeded complexity and do not enhance the availability of
decision-useful information to financial statement users. Furthermore, the exclusion of estimated returnable amounts is not reflective of the manner in which insurers price and manage their business. Therefore, we recommend that the FASB eliminate the requirement to exclude estimated returnable amounts from reported revenue and expenses.

**Disclosure requirements (Question #41)**

We support the stated objective of “enabling users of the financial statements to understand the amount, timing, and uncertainty of future cash flows arising from insurance contracts.” However, we have concerns regarding the volume and content of disclosures required by the Exposure Draft. The guidance in the Exposure Draft represents a significant increase in the volume of required disclosures. We believe that the additional disclosure requirements will generate significant costs for the preparers of financial statements, while providing little if any additional benefit to the users of financial statements. Furthermore, the sheer volume of required disclosures may diminish the usefulness of the disclosures by making it difficult for users to pick out the truly important information. Complying with the proposed measurement model and related disclosure requirements will substantially increase the amount of time required for insurers to prepare their financial statements. As a result, insurers may be forced to either significantly lengthen their close cycles or prepare financial statements on a lagged basis. Both of these solutions would adversely impact the timeliness and relevance of the financial statements.

We note that many of the disclosures are complex and detailed, and they require forward-looking assumptions and significant management judgment. We question whether disclosures including this information will be auditable, posing challenges for both preparers and auditors. Further, we note that many of the disclosures, including those related to risks, inputs, judgments, and assumptions, are similar to those already required for public companies in their quarterly and annual filings with the Securities and Exchange Commission (“SEC”). We suggest partnering with the SEC to establish appropriate principles for disclosures outside the audited financial statements. This would allow preparers the freedom to appropriately discuss management judgments and other forward-looking items in Management’s Discussion and Analysis in a manner consistent with the way the business is monitored and managed. We believe this would provide more decision-useful information to users of the financial statements.

**Effective date and transition (Question #42)**

In the event that the FASB decides to move forward with the framework proposed in the ED, we believe that the effective date should be no earlier than the first quarter of the first calendar year beginning four years after the issuance of a final standard. For example, if the standard is finalized in 2014, the standard should become effective no sooner than the quarter ending March 31, 2019.

As noted in our previous comments, the proposed guidance represents a complete overhaul of the financial reporting framework for insurance contracts. As a result, insurers will need to create new actuarial models to perform the required calculations. Significant changes to systems and processes will be required to track and retain the additional data needed in the actuarial models. Extensive education will be needed for both internal and external stakeholders. Further, additional time will be needed to develop appropriate internal controls and oversight over the calculation, reporting and disclosure processes. It is imperative that the FASB allow adequate time for preparers to develop the necessary systems and processes to perform the required calculations. Failure to do so will increase the likelihood of financial reporting errors and reduce the quality and reliability of the reported results.
Due to the complexity of the proposed guidance and the significant judgment required to interpret and apply the guidance, we anticipate that numerous issues and questions will arise as insurers work to implement the new accounting standard. In the event that the FASB decides to move forward with the proposed guidance, we urge the Board to consider the formation of a group consisting of preparers, auditors, analysts, and staff to address the issues and questions that arise during the implementation process.