December 15, 2016

Technical Director – File Reference No. 2016-330
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: Exposure Draft – Insurance Contracts (Topic 944)

The Principal Financial Group (“Principal”) appreciates the opportunity to offer our views on the Financial Accounting Standards Board’s (“FASB”) Exposure Draft on Targeted Improvements to the Accounting for Long-Duration Contracts (“Exposure Draft”). Principal helps people and companies around the world to build, protect and advance their financial well-being with our retirement, insurance and asset management expertise. With innovative ideas and real-life solutions, we make financial progress possible for clients of all income and portfolio sizes. A member of the Fortune 500®, Principal has $595.8 billion\(^1\) in assets under management and offices in 18 countries throughout Asia, Australia, Europe, Latin America and North America.

**Executive Summary**

We participated in drafting 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 share Principal’s views on the proposed guidance.

Below is a high-level summary of our key recommendations and areas of concern. For additional detail on each of these issues, please see our detailed responses to the Questions for Respondents and Other Considerations.

**Cost/benefit analysis**

We appreciate the FASB’s efforts since the 2013 exposure draft to address preparer and user concerns and to limit the scope of the insurance contracts project to focus on improvements to U.S. GAAP. However, we still question whether the expected benefits of this proposal exceed

\(^1\) As of September 30, 2016
the cost of complying with the proposed guidance. The changes proposed in the Exposure Draft represent more than targeted improvements to the current accounting model for long-duration contracts. We anticipate that the proposed guidance will create significant additional costs – both initial and on-going – for the preparers, auditors, and users of financial statements. While we have not yet performed a full estimate of the costs of the proposed guidance, based on work completed to date and our preliminary analysis of the remaining work effort, we anticipate that the proposed guidance will result in implementation costs of $30 to 50 million.

The proposed guidance represents a complete overhaul of the financial reporting framework for traditional and participating insurance contracts. As a result, we will need to invest significant resources to create new actuarial models, systems, and processes to perform the required calculations, as described in our response to Question 23. We will also need to develop a new framework and models to calculate the fair value of market risk benefits not currently recorded at fair value. 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.

In addition, we anticipate that complying with the guidance will create significant on-going incremental costs that are not reflected in the estimate above. Specifically, we believe the ongoing costs related to accounting for traditional and participating contracts, including periodic updates of assumptions and discount rates; tracking of historical experience data; and the effort to analyze and explain the reserve balances, as well as additional work for the large volume of required disclosures for all insurance contracts will require significant resources.

The most significant drivers of these increased costs (both one-time and ongoing) relate to the requirement to retrospectively update cash flow assumptions for traditional and participating insurance contracts, the proposed accounting framework for participating contracts (which represents a complete overhaul of the existing model), and the substantial volume of new disclosures required. We believe the FASB could significantly reduce costs in these areas by eliminating the requirement to update cash flow assumptions retrospectively, providing a scope-out for closed blocks of participating contracts, and reducing the volume and complexity of the proposed disclosures by modifying the disaggregation requirement and providing companies with flexibility to disclose information most meaningful to their financial statement users.

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.

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. If the FASB changes the Exposure Draft to provide relief for the areas we’ve noted in this comment letter, 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. If the FASB
does not provide relief in the areas we’ve noted in our comment letter, we believe we would need significantly longer to implement the new guidance given the complexities involved in the Exposure Draft and the resource overlap with other initiatives.

**Liability for non-participating contracts**
We recommend that FASB retain the existing guidance on accounting for the liability for future policy benefits. As explained in our response to Question 2, we do not believe that the benefits of updating cash flow assumptions and discount rates justify the costs. In addition, due to the long-term nature of many insurance contracts, a small change in assumptions may result in a large change in the reserve balance if assumptions are updated on a retrospective basis. These changes may create significant volatility in current period earnings, and we do not believe that this volatility accurately reflects current period performance. We believe that loss recognition testing, which is based on revised assumptions that reflect expected experience as of the valuation date, ensures that the liability is adequate based on current assumptions. We believe that the FASB could meet their objectives by clarifying existing guidance in this area.

If the FASB decides to move forward with the proposal to require insurers to update cash flow assumptions, we recommend that the effects of updating cash flow assumptions be calculated on a prospective basis, rather than a retrospective basis. We believe that a prospective approach would significantly improve the cost-benefit tradeoffs of the proposed guidance.

**Liability for participating contracts**
We recommend the FASB remove participating contracts held in a Closed Block from the scope of this project and continue to account for these contracts under existing GAAP. The proposed accounting for these contracts will take a significant investment of resources to create the necessary information systems, processes and controls to implement the proposed guidance. Given the nature of the Closed Block, which is a legally segregated group of assets and liabilities in a run-off status for products that are no longer offered to customers, we do not believe the financial statement users will get any significant benefit from applying the proposed amendments to these contracts. Scoping out the participating contracts in a Closed Block would significantly improve the cost-benefit relationship.

If the FASB decides not to remove participating contracts held in a Closed Block from the scope of this proposal, we recommend the FASB provide a practical expedient for determining the liability for these contracts, as described in our response to Question 7.

**Deferred acquisition costs**
We applaud the FASB’s efforts to simplify the amortization of deferred acquisition costs (“DAC”). We view the amortization approach described in the Exposure Draft as an improvement over the current approach. We believe that the proposed DAC amortization approach will result in greater transparency and will be easier for the users of financial statements to understand. In addition, it will result in a reduction in effort for preparers, and it will eliminate the non-intuitive financial results that can result from the retrospective aspect of the current amortization method based on estimated gross profits (“EGPs”).
Disclosures
We support the stated objective of disclosing information “in a manner that allows users to understand the amount, timing, and uncertainty of future cash flows arising from liabilities.” 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, particularly due to the level of disaggregation required. We believe that the additional disclosure requirements will generate significant costs for the preparers of financial statements, and we question whether the cost of providing the disclosures on a disaggregated basis is worth any additional benefit to the users of financial statements. We are also concerned that some of the required disclosures, such as those around earned and crediting rates, will result in the disclosure of proprietary information (in part due to the level of disaggregation required) that will provide an advantage to competing companies. 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.

We recommend the FASB consider ways to reduce the disclosure overload that we believe will occur if the FASB moves forward with the proposal. We believe the FASB should consider (1) removing the explicit requirement to disaggregate the disclosures; (2) focusing the disclosures on quantitative and qualitative information that has the most significant impact on our financial statements each period rather than disclosing all disaggregated balances, inputs, judgements and assumptions in any period if they did not significantly impact the period results; and (3) only requiring the disclosures in interim periods if there has been a significant change during the year.

We also recommend that FASB partner with the Securities and Exchange Commission (“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.

We appreciate your consideration of our comments. If you would like to discuss this letter, please contact Terry at (515) 247-4885 or Lillis.Terry@principal.com or Angie at (515) 248-2292 or Sanders.Angie@principal.com.

Sincerely,

Terrance J. Lillis
Executive Vice President and
Chief Financial Officer

Angela R. Sanders
Senior Vice President and
Controller

ATTACHMENT:
Responses to FASB Questions for Respondents and Other Considerations
Principal’s Responses to FASB Questions for Respondents and Other Considerations

Liability for Future Policy Benefits—Contracts Other Than Participating Contracts

Question 1—Scope: Do you agree with the scope of the proposed amendments on the accounting for the liability for future policy benefits for contracts other than participating contracts? If not, what types of contracts, contract features, or transactions should be included in or excluded from the scope and why?

Response: We believe that the proposed scope is appropriate.

Question 2—Cash flow assumption update method and presentation: Do you agree that the effect of updating cash flow assumptions should be calculated and recognized on a retrospective basis in net income? If not, what other approach or approaches do you recommend and why?

Response: We recommend that the FASB retain the existing guidance on accounting for the liability for future policy benefits. We acknowledge that updating cash flow assumptions and discount rates would provide a more faithful representation of the company’s current obligation. However, the result would diminish the value of the statement of operations due to the distortion of current period earnings, as discussed below. In addition, updating cash flow assumptions and discount rates will significantly increase complexity and will result in substantial incremental costs, both initially and on an ongoing basis. (Please see our response to Question 23 for a description of the incremental costs.) Therefore, we do not believe that the benefits justify the costs.

In addition, due to the long-term nature of many insurance contracts, a small change in assumptions may result in a large change in the reserve balance if assumptions are updated on a retrospective basis. These changes may create significant volatility in current period earnings, and we do not believe that this volatility accurately reflects current period performance. The proposed method for updating cash flow assumptions is similar to the method that is currently used for updating the assumptions for estimated gross profits, which are used in the amortization of DAC for universal life-type contracts. In the Basis for Conclusions, the FASB noted that “Assumption updates [for estimated gross profits] can result in periodic adjustments that are challenging to calculate, understand, and explain” (paragraph BC29.c.). We believe that the proposal to simplify DAC amortization – and eliminate the income statement volatility that arises from assumption updates – is a significant improvement. However, we are concerned that updating assumptions for the liability for future policy benefits will result in periodic adjustments that are similarly challenging to calculate, understand, and explain.

In the Basis for Conclusions, the FASB noted that “Financial statement users raised concerns about the use of out-of-date assumptions or ‘locked-in’ assumptions to calculate the liability for traditional insurance contracts” (paragraph BC29.a.). We note that insurers are required to perform loss recognition testing in order to ensure that the current liability, along with future gross premiums, will be sufficient to cover future benefits and expenses. Loss recognition testing is based on revised assumptions that reflect expected experience as of the valuation date. So although the valuation assumptions are locked in at contract inception, the loss recognition testing process ensures that the liability is adequate based on current assumptions. We believe
that the FASB could better address investors’ concerns about locked-in assumptions by clarifying the existing loss recognition testing guidance.

If the FASB decides to move forward with the proposal to require insurers to update cash flow assumptions, we recommend that the effects of updating cash flow assumptions be calculated on a prospective basis, rather than a retrospective basis. Under a prospective approach, the revised net premium ratio would be calculated by comparing (1) the present value of future benefits, less the carrying amount of the liability to (2) the present value of future gross premiums.

Under the proposed retrospective approach, insurers would be required to update the net premium “using actual historical experience and updated future cash flow assumptions” (proposed Accounting Standards Update (“ASU”) 944-40-35-6A.a). We interpret this requirement to mean that insurers would need to track actual experience at the cohort level (for contracts that are still in force, as well as contracts that have terminated) over the life of the policies. We believe that this requirement is operationally burdensome and would not result in more decision-useful information. Some insurance contracts can remain in force for up to 100 years or more. Therefore, insurers would be required to retain detailed records of historical experience over a very long period of time. Tracking and retaining data at this level would create significant costs and operational challenges. Updating the net premium ratio on a prospective basis would eliminate the need to track historical experience, thus significantly reducing the costs and operational challenges of applying the proposed guidance.

In addition, updating the net premium to reflect actual experience would create a “cushioning” effect, which would partially offset the current period’s experience. Consider the example of a term life insurance product. Suppose that actual mortality experience in the current period is higher than the mortality rates assumed in the reserve calculation. If the insurer updates the net premium calculation to reflect actual experience, this will result in an increase in the net premium ratio, leading to a reduction in the reserve (all else being equal). The reduction in the reserve will increase current period earnings, partially offsetting the impact of the higher-than-expected mortality experience in the current period. We have a similar situation with the current amortization approach for DAC on universal life-type contracts, where adverse experience in the current period can result in a reduction in current period DAC amortization. In the Basis for Conclusions, the FASB noted that users have expressed concerns with reflecting these “offsetting effects in net income, which complicates the evaluation of an insurance entity’s financial performance” (paragraph BC69). Likewise, updating the net premium ratio for actual experience would result in offsetting effects in net income, and we believe that this would complicate the evaluation of the insurer’s current period performance. We have included an example to demonstrate this effect in the Appendix of this letter. Updating the net premium ratio on a prospective basis would eliminate this cushioning effect.

Furthermore, updating the net premium ratio on a retrospective basis would result in a one-time “unlocking” impact when future cash flow assumptions are updated. As noted above, small changes in assumptions may result in significant volatility in current period earnings, and we do not believe that this volatility accurately reflects current period performance. We have a similar situation with the current amortization approach for DAC on universal life-type contracts, where cash flow assumptions are updated on a retrospective basis. In the Basis for Conclusions, the
FASB noted that users have expressed concerns that the resulting DAC unlocking adjustments “complicate financial statement analyses, can be unintuitive or counterintuitive, and are difficult to model” (paragraph BC71). Likewise, we believe that updating the net premium ratio on a retrospective basis would complicate financial statement analyses and lead to unintuitive or counterintuitive results. Updating the net premium ratio on a prospective basis would eliminate the one-time unlocking impacts when cash flow assumptions are updated.

Due to the concerns noted above, we recommend that the net premium ratio be updated on a prospective basis to reflect changes in future cash flow assumptions. We believe that this approach would significantly improve the cost-benefit tradeoffs of the proposed guidance. Eliminating the requirement to reflect actual experience in the net premium calculation would significantly reduce the work effort, while updating forward-looking assumptions would address concerns with locked-in assumptions.

Question 3—Cash flow assumption update frequency: Do you agree that cash flow assumptions should be updated on an annual basis, at the same time every year, or more frequently if actual experience or other evidence indicates that earlier assumptions should be revised? If not, what other approach or approaches do you recommend and why?

Response: If the FASB moves forward with the proposal to update cash flow assumptions, we agree that assumptions should be updated on an annual basis, at the same time every year, or more frequently if needed.

The assumptions used in valuing insurance contracts are long-term assumptions, which are not expected to change significantly from one quarter to the next. Therefore, we believe that an annual review schedule is generally reasonable. We also believe that it is appropriate to give preparers the option of updating assumptions more frequently if evidence suggests that an update is needed.

We support the FASB’s decision not to prescribe that assumption updates be made in a specific quarter (e.g. 4th quarter). We believe that it is appropriate to allow preparers to select the timeframe that works best for them in light of other workflow demands of both preparers and external auditors.

Question 4—Discount rate assumption: Do you agree that expected future cash flows should be discounted on the basis of a high-quality fixed-income instrument yield that maximizes the use of current market observable inputs? If not, what other approach or approaches do you recommend and why?

Response: As noted in our response to Question 2, we do not believe that the benefits of updating cash flow assumptions and discount rates justify the costs. In addition, we note that the current loss recognition testing requirements ensure that the liability is adequate based on current assumptions and discount rates. Therefore, we recommend that the FASB retain the existing guidance on accounting for the liability for future policy benefits.
If the FASB decides to move forward with the proposal to require insurers to update discount rates, we have concerns with the use of a “high-quality fixed-income instrument yield.” This language has generally been interpreted to mean bonds rated AA or higher. However, the population of “high-quality” bonds has declined significantly in recent years. According to Barclays2 “US Investment Grade Corporate Update” (September 2016), 58% of the bonds in the Barclays Credit Index were rated AA or higher in 1973. By 2013, only 22% of the bonds in the index were rated AA or higher. The reduction in the proportion of bonds rated AA or higher can be attributed to multiple factors. Credit rating agencies have tightened their standards since the financial crisis, leading to a significant reduction in the population of bonds rated AA or higher. In addition, many companies have made strategic decisions to no longer pursue or maintain an AA credit rating. To the extent that this trend continues in the future, the supply of bonds rated AA or higher may continue to decline. In addition, we believe that the current definition of “high-quality” may be problematic for companies operating in non-US markets, where the supply of bonds rated AA or higher may be extremely small, or even non-existent.

The lack of a deep and liquid market for bonds rated AA or higher will lead to difficulties in selecting an appropriate discount rate, as well as anomalies in the movement of discount rates from one period to the next. As the universe of “high-quality” bonds shrinks, the discount rate will be more heavily influenced by changes in the credit spreads of individual companies. In order to address these concerns, we recommend that the FASB clarify the definition of “high-quality fixed-income instrument” to include a broader universe of investments, such as bonds rated A or higher.

Question 5—Discount rate assumption update method and presentation: Do you agree that the effect of updating discount rate assumptions should be recognized immediately in other comprehensive income? If not, what other approach or approaches do you recommend and why?

Response: If the FASB moves forward with the proposal to update discount rates, we agree that the effect of updating the discount rate should be recognized immediately in other comprehensive income (“OCI”).

If the effect of discount rate changes were recognized in net income, this would create significant income statement volatility in response to short-term fluctuations in interest rates. Given the long-term nature of insurance contracts, we do not believe that it is appropriate to reflect this volatility in net income. Therefore, we agree that the effect of discount rate changes should be reflected in OCI.

Furthermore, insurance liabilities are typically backed primarily by assets that are measured at fair value through OCI. Therefore, reflecting the effect of discount rate changes in OCI will better align the accounting for insurance liabilities with the accounting for the assets supporting those liabilities.

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**Question 6**—Discount rate assumption update frequency: Do you agree that discount rate assumptions should be updated at each reporting date? If not, what other approach or approaches do you recommend and why?

**Response:** If the FASB moves forward with the proposal to update discount rates, we agree that discount rates should be updated at each reporting date.

Insurance liabilities are typically backed primarily by assets that are measured at fair value. The fair value of these assets is updated at each reporting date. In order to avoid an accounting mismatch between insurance liabilities and the assets supporting those liabilities, we believe that the discount rate should be updated at each reporting date.

**Liability for Future Policy Benefits—Participating Contracts**

**Question 7**—Scope (participating contracts): Do you agree with the scope of the proposed amendments on the accounting for the liability for future policy benefits for participating contracts, including closed block contracts issued by a demutualized insurance entity? If not, what types of contracts, contract features, or transactions should be included in or excluded from the scope and why?

**Response:** No, we do not agree with the scope of the proposed amendments for participating contracts. We recommend the FASB remove participating contracts held in a Closed Block from the scope of this project and continue to account for these contracts under existing GAAP.

The Closed Block we are referring to in our recommendation is established in the process of a company converting from a mutual ownership to a stock ownership. Closed Blocks are established through agreement with the state regulator to protect the dividend rights of participating policyholders. Assets are allocated to the Closed Block at the outset and are solely for the benefit of holders of the policies included in the Closed Block. Policy dividends are managed to reflect changes in experience. A policyholder dividend obligation is required to be established for earnings in the Closed Block that are not available to shareholders. There are no policies added to the Closed Block after it is established and thus the block is in a run-off status. The products included in our Closed Block are no longer offered to customers and would be particularly difficult to model under the proposed amendments.

The proposed accounting for these contracts will take a significant investment of resources to create the necessary information systems, processes and controls to implement the proposed guidance. Given the nature of the Closed Block, which is a legally segregated group of assets and liabilities in a run-off status for products that are no longer offered to customers, we do not believe the financial statement users will get any significant benefit from applying the proposed amendments to these contracts. Updating the interest rate and cash flow assumptions will not more accurately reflect the obligation of the Closed Block, which ultimately will be the assets and returns of the Closed Block. Scoping out the participating contracts in a Closed Block would significantly improve the cost-benefit relationship.
If the FASB decides not to remove participating contracts held in a Closed Block from the scope of this proposal, we recommend the FASB provide a practical expedient for determining the liability for these contracts. We support the approach recommended by the ACLI where the liability would equal the sum of (1) the carrying value of the assets in the Closed Block; (2) an additional liability for any contractual guarantees that cannot be funded from the Closed Block assets; and (3) at transition, an accrual for the difference between (a) the reserve, deferred acquisition costs, policyholder dividend obligation and any other asset or liability backing the contract immediately before transition; and (b) the sum of items (1) and (2). This approach significantly reduces the cost of providing an updated liability for participating contracts in Closed Blocks and explicitly takes into account our obligation under the Closed Block to pay policyholders the value and returns of the Closed Block assets while covering any guaranteed benefits within the contracts.

**Question 8—Cash flow assumption update method and presentation (participating contracts):** Do you agree that the effect of updating cash flow assumptions should be calculated and recognized on a retrospective basis in net income? If not, what other approach or approaches do you recommend and why?

**Response:** As noted in our response to Question 7, we do not believe that updating the interest rate and cash flow assumptions will more accurately reflect the obligation of the Closed Block. However, if the FASB decides to move forward with the proposal to update cash flow assumptions for participating contracts, we recommend that the effects of updating cash flow assumptions should be calculated on a prospective basis. Please see our response to Question 2 for further information.

**Question 9—Cash flow assumption update frequency (participating contracts):** Do you agree that cash flow assumptions should be updated on an annual basis, at the same time every year, or more frequently if actual experience or other evidence indicates that earlier assumptions should be revised? If not, what other approach or approaches do you recommend and why?

**Response:** If the FASB decides to move forward with the proposal to update cash flow assumptions for participating contracts, we believe that cash flow assumptions should be updated at the same frequency as the discount rate. Please see the ACLI’s response to this question for further information.

**Question 10—Discount rate assumption (participating contracts):** Do you agree that expected future cash flows should be discounted on the basis of a high-quality fixed-income instrument yield that maximizes the use of current market observable inputs? If not, what other approach or approaches do you recommend and why?

**Response:** We do not believe a high-quality fixed-income instrument yield is appropriate for participating contracts, because we believe the discount rate should consider the relationship between dividends paid on participating contracts and investment returns. If the Board proceeds with updating cash flow assumptions and discount rates for participating contracts, we believe the discount rate used to calculate the net premium ratio should be based on the investment yield which is used to determine the dividends we pay. The proposed guidance does not take into
account that participating contracts have adjustable crediting rates that depend on investment returns. Accordingly, the proposed guidance will produce anomalous results that do not reflect the economics of the contract.

Please see the ACLI’s response to this question for further information.

**Question 11—Discount rate assumption update method and presentation (participating contracts):** Do you agree that the effect of updating discount rate assumptions should be recognized immediately in other comprehensive income? If not, what other approach or approaches do you recommend and why?

**Response:** If the FASB moves forward with the proposal to update the discount rate for participating contracts, we support recognizing the effect of updating the discount rate assumptions immediately in OCI. Please see the ACLI’s response to this question for further information.

**Question 12—Discount rate assumption update frequency (participating contracts):** Do you agree that discount rate assumptions should be updated at each reporting date? If not, what other approach or approaches do you recommend and why?

**Response:** If the FASB moves forward with the proposal to update the discount rate for participating contracts, we agree that discount rates should be updated at each reporting date. Please see our response to Question 6 for further information.

**Market Risk Benefits**

**Question 13—Scope:** Do you agree with the scope of the proposed amendments on the accounting for market risk benefits? If not, what types of contracts or contract features should be included in or excluded from the scope and why?

**Response:** We generally agree with the scope of the proposed amendments on the accounting for market risk benefits. However, we believe that guaranteed minimum death benefits (“GMDBs”) should not be included as a market risk benefit and should continue to be accounted for as an additional insurance liability. While we acknowledge that GMDBs have “more than nominal” market risk as defined in the Exposure Draft, GMDBs are only accessible by the policyholder upon the death of the insured and do not have the optionality found in other market risk benefits. As such, GMDBs more closely resemble long-term insurance benefits than market risk benefits. Because of the long-term nature and absence of optionality of GMDBs, we do not believe the short-term fair value fluctuations that would result from the proposed market risk benefit accounting accurately represent the economics of the GMDBs in our financial statements. We recommend that the FASB consider revising the definition of market risk benefits to exclude contract features where insurance risk is more prevalent than market risk.

**Question 14—Measurement:** Do you agree that all market risk benefits should be measured at fair value, with fair value changes attributable to a change in the instrument-specific credit risk recognized in other comprehensive income? If not, what other alternative or alternatives do you recommend and why?
Response: We believe that the FASB’s decision to recognize changes in the instrument-specific credit risk in OCI is an improvement over the current accounting where changes are recognized in net income. However, we question, as we do with current GAAP, whether it is appropriate to include instrument-specific credit risk in the fair value measurement of market risk benefits as it may create anomalous results. For example, an increase in an issuer’s own credit risk will also result in an increase in the interest rate associated with the underlying market risk benefit since an investor would expect a greater return for assuming that risk. This increased interest rate will reduce the calculated liability for the market risk benefit with the offset recorded as an increase in the issuer’s equity. We do not believe it is appropriate for an issuer to record an increase in equity due to an increase in own credit risk, and this could result in financial statements that do not properly reflect an issuer’s financial position. We recommend that the FASB define the value of market risk benefits to exclude own credit risk.

Deferred Acquisition Costs

Question 15—Scope: Should the scope of the proposed amendments be expanded to include investment contract acquisition costs currently amortized using the interest method in Subtopic 310-20, Receivables—Nonrefundable Fees and Other Costs?

Response: We recommend that the FASB expand the scope of the proposed amendments to include investment contract acquisition costs currently amortized using the interest method. While we believe that the interest method is a reasonable amortization basis, we would prefer to make the amortization approach for investment contracts consistent with the amortization approach for insurance contracts.

Question 16—Amortization: Do you agree with the proposed amendments that would simplify the amortization of deferred acquisition costs? If not, what other simplified and reasonably estimable amortization approach or approaches do you recommend and why?

Response: We applaud the FASB’s efforts to simplify the amortization of DAC. We believe that the amortization approach described in the Exposure Draft represents an improvement over the current approach.

Under current guidance, DAC and related balances for universal life-type contracts are amortized in proportion to EGPs. The amortization schedule is updated on a retrospective basis to reflect actual experience, as well as any changes in future assumptions. This process – known as truing up and unlocking – may result in non-intuitive results. Due to the long-term nature of many insurance contracts, a small change in assumptions can result in a large change in the DAC balance. These changes can create significant volatility in current period earnings, and we do not believe that this volatility accurately reflects the economics of the underlying business. Furthermore, changes in the amortization schedule may result in a write-up of the DAC balance, essentially causing companies to re-establish DAC that has previously been amortized.
The current EGP-based approach also requires significant effort and resources on the part of financial statement preparers. In addition to developing and maintaining detailed models to project EGPs, preparers also spend a significant amount of time analyzing changes in the DAC balance and explaining these changes to the users of financial statements.

We believe that the proposed DAC amortization approach will result in greater transparency and will be easier for the users of financial statements to understand. In addition, it will result in a reduction in effort for preparers, and it will eliminate the non-intuitive financial results that can result from the retrospective aspect of the current EGP-based amortization.

**Question 17—Impairment:** Do you agree that deferred acquisition costs should not be subject to impairment testing? If not, what alternative or alternatives do you recommend and why?

**Response:** We believe that DAC should still be subject to impairment testing. Under the approach proposed in the Exposure Draft, DAC amortization will no longer be tied to the profitability of the underlying contracts. This may occasionally result in situations where the underlying contracts do not have sufficient profits to support the DAC asset. In these cases, losses would emerge in future periods, when the DAC amortization expense exceeds the profits from the underlying contracts.

If the DAC asset cannot be recovered from profits on the underlying business, we believe that it would be appropriate to recognize a loss immediately by writing down the DAC asset, rather than allowing the losses to emerge in future periods. Therefore, we recommend that companies be required to evaluate the recoverability of DAC by comparing the current DAC balance to the undiscounted sum of the future projected profits from the block of business. Because the DAC asset will no longer accumulate interest under the proposed guidance, we believe that the comparison should be based on an undiscounted sum of future profits, rather than a present value measure. In addition, our proposed approach is similar to the impairment testing approach that is currently used for other intangible assets. We recommend that the impairment analysis be performed on an annual basis, or more frequently if circumstances change or events occur that may impact the recoverability of the DAC asset. We believe that impairment testing would help to ensure that the DAC balance is reasonable and appropriate relative to the projected profits on the underlying business.

**Presentation and Disclosure**

**Question 18—Proposed requirements:** Do you agree that the presentation and disclosure requirements included in the proposed amendments would provide decision-useful information? If not, which presentation and/or disclosure requirement or requirements would you change and why?

**Response:** We support the stated objective of disclosing information “in a manner that allows users to understand the amount, timing, and uncertainty of future cash flows arising from liabilities.” 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, particularly due to the level of disaggregation required and the requirement to include all of the disclosures in our interim financial statements. We believe
that the additional disclosure requirements will generate significant costs for the preparers of financial statements, and we question whether the cost of providing the disclosures on a disaggregated basis is worth 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 identify the truly important information.

On a quarterly basis, we publish a financial supplement to our financial statements that contains additional detailed information for our financial statement users. The supplemental information is in response to additional data requested by external financial analysts who closely review our financial results. In the Basis for Conclusions, the FASB acknowledges users’ reliance on such supplemental information (paragraph BC78). However, we note that much of the information in our financial supplement has resulted from discussions with and requests by these users. Given that the users of our financial statements have not requested the disclosures required by this proposal, we believe the disclosures are excessive and we are uncertain of their benefit to users.

We also note that providing these disclosures in a meaningful way for entities with international operations may be very difficult because certain information relevant to foreign entity operations may not be comparable to products in other countries. This could force companies to evaluate preparing disclosures at the country level which we believe is not in the spirit of the proposed guidance in proposed ASU 944-40-50-5A where “useful information [should] not be obscured by…the inclusion of insignificant detail”.

We recommend the FASB consider ways to reduce the disclosure overload that we believe will occur if the FASB moves forward with the proposal. We believe the FASB should consider (1) removing the explicit requirement to disaggregate the disclosures; (2) focusing the disclosures on quantitative and qualitative information that has the most significant impact on our financial statements each period rather than disclosing all disaggregated balances, inputs, judgments and assumptions in any period if they did not significantly impact the period results; and (3) only requiring the disclosures in interim periods if there has been a significant change during the year.

We note that many of the disclosures related to risks, inputs, judgments, and assumptions are complex and detailed, and 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 these disclosures are similar to those already required for public companies in their quarterly and annual filings with the SEC. We believe that including these disclosures in the audited financial statements instead of Management’s Discussion and Analysis will result in significant costs for preparers for establishing additional internal controls and auditing of the relevant information with little additional benefit to users. 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.
Should the FASB move forward with the proposed disclosures, we have the following comments related to specific disclosure requirements in the Exposure Draft.

- Proposed ASU 944-40-55-13H states that an insurance entity should not aggregate amounts from different reportable segments. We also note that proposed ASU 944-40-50-5A indicates the level of disaggregation should be done so that “useful information is not obscured by either the inclusion of a large amount of insignificant detail or the aggregation of items that have significantly different characteristics.” We recommend removing the language in proposed ASU 944-40-55-13 prohibiting disclosures from crossing segments to allow companies to determine an appropriate level of aggregation in the spirit of the disclosure principle noted in proposed ASU 944-40-50-5A. We have certain products with similar characteristics that we offer to customers across segments, and we believe there could be benefit to financial statement users in disclosing them together. Further, we note that the disaggregation guidance in the new revenue recognition standard uses the same principles and concepts as included in the Exposure Draft, but does not contain the specific language prohibiting disclosures from crossing segments (see Accounting Standards Codification (“ASC”) 606-10-55-89 through 91).

- Proposed ASU 944-40-45-3 requires that market risk benefits be presented separately on the statement of financial position and that changes in fair value (except for the changes related to the instrument-specific credit risk) be presented separately in net income. We believe companies should be allowed to determine based on their business model if this information is significant enough to be disclosed on the face of their financials. We recommend the proposal be modified to allow companies the option of including this information on the face of the financial statements or in the related disclosures to the financial statements.

- Proposed ASU 944-40-50-7A requires disaggregated disclosures for earned rates and crediting rates. We believe these disclosures could explicitly reveal pricing strategies for many products and result in the disclosure of proprietary information that will provide an advantage to competing companies. We are not aware of any other industry required to disclose this type of information at the proposed level of detail required by the Exposure Draft. We recommend that the disclosure requirements be modified to ensure that companies are not required to disclose propriety information.

- Proposed ASU 944-40-50-6 requires disclosure at a disaggregated level of ranges and weighted averages of significant inputs, judgments and assumptions used in measurement of the liability. We do not believe disclosure of ranges and weighted averages for certain assumptions such as mortality and lapse rates provides meaningful information to users because the range can be as wide as 0 to 100%. We recommend the disclosure requirements clarify that companies should focus on disclosures that provide relevant and meaningful information to financial statement users.

- The example DAC rollforward in proposed ASU 944-30-55-2 contains line items for capitalizations, amortization expense and terminations. We believe that the terminations line item would only include unexpected lapses in any period since expected lapses would be included in amortization expense. If our interpretation is correct, we question whether splitting lapses in this manner provides decision useful information. We recommend the FASB clarify the intent of this line item.
Question 19—Additional requirements: Are there any additional presentation or disclosure requirements that would provide decision-useful information? If so, please describe them and explain why.

Response: If the FASB moves forward with the proposed model, we would not propose any additional disclosure requirements

Effective Date and Transition
Question 20—Implementation date: The Board is interested in understanding the key drivers affecting the timing of implementation. What are those key drivers, and how do they affect the time it will take to implement the proposed amendments? Should the effective date be the same for both public entities and nonpublic entities?

Response: The proposed guidance represents a complete overhaul of the financial reporting framework for traditional and participating 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. In particular, under the proposal, we would need to maintain information to track actual historical experience at the cohort level (for contracts that are still in force, as well as contracts that have terminated) over the life of the policies. Because insurance contracts can remain outstanding for 100 years or more, this would require us to retain large amounts of experience data for a very long period of time which would create significant costs and operational challenges. We will also need to create new processes and models to determine and record the fair value of our GMDBs as well as significantly change our ledger systems to accumulate data for disclosures, some of which we do not track today. These new processes and models will require partnering with our software vendors, who, like other vendors in our industry, will not make changes to their systems until the new guidance is final. 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. Further, we expect this guidance to be implemented at the same time we are implementing other significant initiatives in our industry, including the new Department of Labor regulations, statutory principles based reserving, and new GAAP accounting guidance for financial instruments and leases. All of these initiatives require significant systems, internal controls and resources to implement and could produce competition for available resources.

If the FASB changes the Exposure Draft to provide relief for the areas we’ve noted in this comment letter, 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 2017, the standard should become effective no sooner than the quarter ending March 31, 2022. If the FASB does not provide relief in the areas we’ve noted in our comment letter, we believe we would need significantly longer to implement the new guidance given the complexities involved in the Exposure Draft and the resource overlap with other initiatives.
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.

**Question 21—Transition methods:** Are the proposed transition provisions operable and do they provide decision-useful information? If not, what would you recommend and why?

**Response:** We have concerns with the proposed transition guidance related to the liability for future policy benefits and DAC.

We interpret the proposed transition guidance for the liability for future policy benefits as follows:

- If we have actual historical information or can estimate historical information from other objective information back to the contract issue date for a specific cohort, we would apply the guidance retrospectively back to the contract issue date for that cohort.
- If data at this level is not available and cannot be estimated, we would apply the guidance prospectively as of the transition date.

This will result in the guidance being applied to newer cohorts retrospectively (because data is readily available from contract issue) and older cohorts prospectively (because data will not be readily available from contract issue). We believe that applying the guidance in this manner will produce financial results that are not intuitive and are difficult to explain due to the two different transition methods applied across different cohorts of the same product. We recommend that the FASB apply the changes related to the liability for future policy benefits for all cohorts prospectively as of the transition date. This will increase the comparability across cohorts within a company and across companies and reduce the operational burden of implementing the new guidance. Should the FASB continue to support retrospective adoption, we recommend the FASB use the guidance already in place in ASC 250, which would allow companies to use all available data in determining whether the guidance can be applied retrospectively.

We recommend that the proposed guidance for cohorts that currently have DAC be applied retrospectively in accordance with ASC 250. We believe that applying the DAC guidance retrospectively produces a result more representative of the economics of our business and produces greater comparability between cohorts, which would have different amortization patterns if the guidance was applied prospectively. While we understand that the FASB’s proposal was intended to simplify the transition for DAC, we believe that many companies have the data necessary to apply the guidance retrospectively and that doing so would not be burdensome given our relatively recent implementation of ASU 2010-26, *Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts*. Additionally, we expect certain products, such as payout annuities, to have deferred acquisition cost balances under the new guidance that they do not have today due to the proposed change to amortize on a straight line
basis. We recommend the FASB simplify transition for cohorts that do not currently have DAC by not requiring entities to establish deferred acquisition cost balances at transition. This is similar to relief provided in ASC 944-10-65-1(d) when implementing ASU 2010-26.

We acknowledge a perceived inconsistency in recommending prospective transition for the liability for future policy benefits and retrospective transition for DAC. However, we note that the proposed guidance for the liability for future policy benefits is significantly more complex than current GAAP due to the substantial additional data and resources that would be required for implementation. Conversely, the proposed amortization approach for DAC is a simplification of current GAAP that does not require substantial data or resources.

Question 22—Transition disclosure: Do the proposed transition disclosure requirements provide decision-useful information? If not, what would you recommend and why?

Response: We note that many of the metrics covered by the transition disclosures are only relevant at the total company level (e.g. net income and earnings per share). Accordingly, requiring the proposed transition disclosures “on a disaggregated basis consistent with that which will be used for recurring disclosures” is overly burdensome and will not provide meaningful information to financial statement users. We recommend that the transition disclosures not be required at a disaggregated level.

Further, for areas with retrospective adoption, we believe ASC 250-10-50-1(b)(2) requires that, in the period of adoption, an entity determine and disclose the amounts that would have been reported under the “old” accounting guidance if it had not made the accounting change. ASC 250-10-50-3 further requires this disclosure for subsequent interim periods in the fiscal year of an accounting change. As previously noted, the process and systems changes required to implement this guidance will be significant and we believe it would be overly burdensome to run parallel systems during the year of implementation to provide financial statement results under both old and new guidance. We recommend that the FASB remove this requirement for any implementation area with retrospective adoption and grant relief similar to that provided in previously issued accounting guidance, including ASU 2016-12 on revenue recognition (see ASC 606-10-65-1(e)) and ASU 2010-26 on DAC (see ASC 944-10-65-1(a)(2)).

Costs and Complexities

Question 23—Costs and complexities: Describe the nature of the incremental costs of adopting the proposed amendments, distinguishing between one-time costs and ongoing costs. Explain which aspects of the proposed amendments are driving those costs and include ideas to make the proposals more cost effective.

Response: We anticipate that the proposed guidance will create significant additional costs – both initial and on-going – for the preparers, auditors, and users of financial statements. 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 proposed guidance will result in implementation costs of $30 to 50 million. The proposed guidance represents a complete overhaul of the financial reporting framework for traditional and participating insurance contracts. As a result, we will need to invest significant
resources to create new actuarial models to perform the required calculations, including developing processes for updating cash flow assumptions, calculating and updating discount rates, and tracking experience at the cohort level. We will also need to develop a new framework and models to calculate the fair value of market risk benefits not currently recorded at fair value. Significant changes to our systems and processes will be required to track and retain the additional data needed for the new disclosures. These updates to our models, systems and processes will require a joint effort with our software vendors, who, like other vendors in our industry, will not make changes to their systems until the new guidance is final. 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 also expect this guidance to be implemented at the same time we are implementing other significant initiatives in our industry, including the new Department of Labor regulations, statutory principles based reserving, and new GAAP accounting guidance for financial instruments and leases. All of these initiatives require significant systems, internal controls and resources to implement and could produce competition for available resources.

In addition, we anticipate that complying with the guidance will create significant on-going incremental costs that are not reflected in the estimate above. While we acknowledge that the simplification of deferred acquisition cost amortization will provide some cost savings, we believe that the additional work in other areas post implementation will exceed these cost savings and will result in the need for additional actuarial and accounting staff. Specifically, we believe the ongoing costs related to accounting for traditional and participating contracts, including periodic updates of assumptions and discount rates; tracking of historical experience data; and the effort to analyze and explain the reserve balances, as well as additional work for the large volume of required disclosures for all insurance contracts will require significant resources.

The most significant drivers of these increased costs (both one-time and ongoing) relate to the requirement to retrospectively update cash flow assumptions for traditional and participating insurance contracts, the proposed accounting framework for participating contracts (which represents a complete overhaul of the existing model), and the substantial volume of new disclosures required. We believe the FASB could significantly reduce costs in these areas by eliminating the requirement to update reserve calculations to reflect historical experience, providing a scope-out for closed blocks of participating contracts, and reducing the volume and complexity of the proposed disclosures by modifying the disaggregation requirement and providing companies with flexibility to disclose information most meaningful to their financial statement users.

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.
Other Considerations

Reinsurance assets and liabilities
We currently amortize reinsurance assets and liabilities based on EGPs in accordance with ASC 944-605-35-15, which states “the assumptions used in accounting for reinsurance costs shall be consistent with those used for the reinsured contracts”. We note that this guidance does not specifically state that we should amortize reinsurance costs based on EGPs, but based on how we account for the underlying contract. Under the proposed guidance, amortization of amounts related to the reinsured contract will change to be based on either insurance in force or straight line and the guidance in ASC 944-605-35-15 will not change. If we change our method of amortizing reinsurance costs from EGPs to insurance in force or straight line to align with the new guidance, it is not clear to us whether we would be required to perform a preferability assessment in accordance with ASC 250 or if this is an indirect change related to the new guidance that would not require a preferability assessment. We would not want to amortize our reinsurance assets/liabilities based on EGPs if amortization of amounts related to the underlying contract will no longer be amortized in that manner. We recommend that the FASB clarify that we could change our amortization method for our reinsurance assets and liabilities to be consistent with how we amortize DAC on the underlying contracts without performing a preferability assessment.

Additional liability for profits followed by losses
We have concerns with the proposed guidance on additional liabilities for profits followed by losses. Under the proposed guidance, the “determination of whether profits are followed by losses shall be performed at contract inception and as assumptions are updated in subsequent periods” (proposed ASU 944-40-25-27A). If the insurer concludes that an additional liability is needed, the liability shall be equal to (a) the benefit ratio multiplied by cumulative assessments, from contract inception through the balance sheet date, (b) less cumulative excess payments, (c) plus accreted interest (ASC 944-40-35-10).

We have two key concerns with this guidance. First, the proposed guidance will create a “cliff effect” if an insurer is required to establish an additional liability after contract inception. Upon determining that an additional liability is required, the insurer would be required to establish a liability that reflects accruals relating to all past assessments, dating back to the inception of the cohort. For cohorts that have been in-force for several years, this may result in the establishment of a large additional liability where none previously existed. In some cases, the additional liability may exceed the present value of the eventual loss that the liability is intended to fund. Conversely, if an insurer determines that an additional liability is no longer required, there may be a similar discontinuity (albeit in the opposite direction) when the existing additional liability is derecognized.

Second, the proposed guidance will create the need for insurers to keep track of actual assessments on all in-force business. Even for cohorts where an additional liability is not currently required, there is a possibility that the insurer may be required to establish an additional liability in the future, due to changes in assumptions. In this case, the insurer would be required to establish a liability reflecting cumulative assessments and cumulative excess payments dating back to contract inception. Therefore, we believe that insurers would need to track this information on all in-force business, in order to prepare for the possibility that an additional liability may be required in the future. The components of assessments are similar to the
components that are currently included in estimated gross profits. Therefore, if insurers are required to track actual assessments on in-force business, this will eliminate many of the practical benefits that insurers would otherwise realize from the simplification of the DAC amortization model.

The FASB could address these concerns by either (1) retaining the existing guidance for profits-followed-by-losses testing or (2) accruing the additional liability on a prospective basis (i.e. accruing based on future assessments, rather than immediately accruing for all past assessments). Please see the ACLI’s response to Question 2 for additional information.
Appendix

Illustration of “cushioning” effect from updating net premium ratio to reflect actual experience

In our response to Question 2, we noted that updating the net premium to reflect actual experience would create a “cushioning” effect in scenarios where actual experience differs from expected experience. Below is a numerical example illustrating the cushioning effect.

The illustration builds off of Example 6, found on page 105 of the Exposure Draft. Example 6 illustrates the calculation of the original net premium ratio at the issue date of a portfolio of contracts, based on the following assumptions (proposed ASU 944-40-55-29I):

- The Entity expects a majority of policyholder benefits to be paid in Year 10.
- A discount rate of 4 percent is used to compute the net premiums and the liability for future policy benefits.
- For simplicity, benefit payments and premiums receipts are made at the end of the year.

In proposed ASU 944-40-55-29K, the net premium ratio as of the issue date is calculated as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Benefits &amp; Expenses</th>
<th>Gross Premiums</th>
<th>Net Premiums</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td></td>
<td>$81,340</td>
<td>$59,937</td>
</tr>
<tr>
<td>1</td>
<td>$8,300</td>
<td>$81,340</td>
<td>$59,937</td>
</tr>
<tr>
<td>2</td>
<td>8,600</td>
<td>76,710</td>
<td>56,526</td>
</tr>
<tr>
<td>3</td>
<td>10,220</td>
<td>72,380</td>
<td>53,335</td>
</tr>
<tr>
<td>4</td>
<td>11,530</td>
<td>68,330</td>
<td>50,351</td>
</tr>
<tr>
<td>5</td>
<td>13,500</td>
<td>64,530</td>
<td>47,550</td>
</tr>
<tr>
<td>6</td>
<td>14,240</td>
<td>60,950</td>
<td>44,912</td>
</tr>
<tr>
<td>7</td>
<td>17,020</td>
<td>57,570</td>
<td>42,422</td>
</tr>
<tr>
<td>8</td>
<td>19,620</td>
<td>54,370</td>
<td>40,064</td>
</tr>
<tr>
<td>9</td>
<td>22,070</td>
<td>51,320</td>
<td>37,816</td>
</tr>
<tr>
<td>10</td>
<td>425,000</td>
<td>48,430</td>
<td>35,687</td>
</tr>
<tr>
<td>Total</td>
<td>$550,100</td>
<td>$635,930</td>
<td>$468,599</td>
</tr>
<tr>
<td>Present value</td>
<td>$387,114</td>
<td>$525,348</td>
<td>$387,114</td>
</tr>
</tbody>
</table>

Net premium ratio 73.69%

We’ve extended Example 6 to include (1) a baseline scenario, where actual experience is equal to expected experience and (2) an alternative scenario, where actual benefits exceed expected benefits in year 5.

Baseline scenario (actual experience = expected experience)

In the baseline scenario, we assume that actual experience is equal to expected experience in all years. We further assume that there are no updates to the original cash flow assumptions. (Note that this differs from the example in the Exposure Draft, which assumes that cash flow assumptions are updated at the end of year 3.)
Based on these assumptions, the liability at the end of year 5 is calculated as follows:

<table>
<thead>
<tr>
<th></th>
<th>End of Year 5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Present value of future benefits and expenses (for years 6-10)</td>
<td>$ 415,055</td>
</tr>
<tr>
<td>Less: Present value of future net premiums (for years 6-10)</td>
<td>179,680</td>
</tr>
<tr>
<td>Liability for future policy benefits</td>
<td>$ 235,375</td>
</tr>
</tbody>
</table>

In the calculations above, the present value of future net premiums is based on the original net premium ratio of 73.69%. In this scenario, it is appropriate to continue using the original net premium ratio, because actual cash flows up to time 5 have been equal to expected cash flows, and we have not updated any of our future cash flow assumptions.

**Alternative scenario (actual benefits > expected benefits in year 5)**

In the alternative scenario, actual experience is equal to expected experience in years 1-4. However, in year 5, actual benefits and expenses are 10% higher than expected. The higher-than-expected benefits in year 5 are assumed to be a one-time event, so no changes are made to future cash flow assumptions.

Based on the proposed guidance, we update the net premium ratio retrospectively to reflect actual historical experience. The calculation below reflects actual experience for years 1-5 and expected experience for years 6-10.

<table>
<thead>
<tr>
<th>Year</th>
<th>Benefits &amp; Expenses</th>
<th>Gross Premiums</th>
<th>Net Premiums</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>$ 8,300</td>
<td>$ 81,340</td>
<td>$ 59,937</td>
</tr>
<tr>
<td>2</td>
<td>8,600</td>
<td>76,710</td>
<td>56,526</td>
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<tr>
<td>3</td>
<td>10,220</td>
<td>72,380</td>
<td>53,335</td>
</tr>
<tr>
<td>4</td>
<td>11,530</td>
<td>68,330</td>
<td>50,351</td>
</tr>
<tr>
<td>5</td>
<td><strong>14,850</strong></td>
<td>64,530</td>
<td>47,550</td>
</tr>
<tr>
<td>6</td>
<td>14,240</td>
<td>60,950</td>
<td>44,912</td>
</tr>
<tr>
<td>7</td>
<td>17,020</td>
<td>57,570</td>
<td>42,422</td>
</tr>
<tr>
<td>8</td>
<td>19,620</td>
<td>54,370</td>
<td>40,064</td>
</tr>
<tr>
<td>9</td>
<td>22,070</td>
<td>51,320</td>
<td>37,816</td>
</tr>
<tr>
<td>10</td>
<td>425,000</td>
<td>48,430</td>
<td>35,687</td>
</tr>
<tr>
<td>Total</td>
<td>$ 551,450</td>
<td>$ 635,930</td>
<td>$ 468,599</td>
</tr>
<tr>
<td>Present value</td>
<td>$ 388,224</td>
<td>$ 525,348</td>
<td>$ 388,224</td>
</tr>
</tbody>
</table>

Net premium ratio 73.90%

Due to the higher-than-expected benefits and expenses in year 5, the net premium ratio has increased from 73.69% to 73.90%.
Using the revised net premium ratio, the liability at the end of year 5 is calculated as follows:

<table>
<thead>
<tr>
<th>End of Year 5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Present value of future benefits and expenses</td>
</tr>
<tr>
<td>(for years 6-10)</td>
</tr>
<tr>
<td>Less: Present value of future net premiums</td>
</tr>
<tr>
<td>(for years 6-10)</td>
</tr>
<tr>
<td>Liability for future policy benefits</td>
</tr>
</tbody>
</table>

Below is a comparison of the benefits, expenses, liabilities, and net income in year 5:

<table>
<thead>
<tr>
<th></th>
<th>Alternative Scenario</th>
<th>Baseline Scenario</th>
<th>Change in Line Item</th>
<th>Change in Net Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Benefits and expenses in year 5</td>
<td>14,850</td>
<td>13,500</td>
<td>1,350</td>
<td>(1,350)</td>
</tr>
<tr>
<td>Liability for future policy benefits (end of</td>
<td>234,860</td>
<td>235,375</td>
<td>(515)</td>
<td>515</td>
</tr>
<tr>
<td>year 5)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total change in net income</td>
<td></td>
<td></td>
<td>(835)</td>
<td></td>
</tr>
</tbody>
</table>

In the alternative scenario, actual benefits and expenses in year 5 are $1,350 higher than in the baseline scenario. However, the increase in benefits and expenses is partly offset by a $515 decrease in the liability relative to the baseline scenario. Note that we did not update any of our future cash flow assumptions; the $515 decrease in the liability is a direct result of updating the net premium ratio to reflect actual experience in year 5. After reflecting the reduction in the liability, pre-tax net income in the alternative scenario will only be reduced by $835 relative to the baseline scenario. (The $835 reduction in earnings is based on a $1350 increase in benefits and expenses, offset by a $515 reduction in the liability.) Thus, updating the net premium ratio to reflect actual experience will result in a “cushioning” effect, which prevents the full impact of experience deviations from being reflected in current period earnings.