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Via E-mail to jerichter@fasb.org



LETTER OF COMMENT NO. 33

Mr. Lawrence W. Smith, Chairman
Emerging Issues Task Force
Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856-5116

Re: Comment Letter Regarding EITF Issues Summary No. 1, Supplement No. 1, on Issue 06-4, Accounting for Deferred Compensation and Post-Retirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements (May 31, 2006)

Dear Mr. Smith:

This letter is in response to “EITF Issues Summary No. 1, Supplement No. 1, on Issue 06-4, Accounting for Deferred Compensation and Post-Retirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements (May 31, 2006).” As a Fellow of the Society of Actuaries (FSA), a Member of the American Academy of Actuaries (MAAA) and a CFA Charterholder who has been involved in this market for a decade, I would like to comment upon the decision as issued by the Emerging Issues Task Force (EITF).

Background

The use of various forms of split-dollar insurance have been prevalent in the corporate markets for many years, providing financial security for individuals and corporations alike in a win-win relationship between employer and employee. In general terms, a split-dollar insurance arrangement involves the purchase of an insurance policy (or policies) upon the life of an employee, and involves the sharing of risks and benefits between an employer and an employee.

It is clear that if a corporation contractually provides a post-retirement benefit for an employee, then Generally Accepted Accounting Principles dictate under FAS 106 or APB 12, as applicable, that the expense of that post-retirement benefit be accrued in a rational and systematic method over the expected working lifetime of the employee.

The question that the EITF has attempted to address in this Decision is whether an insurance policy that has been purchased in conjunction with a split-dollar insurance benefit that extends post-retirement should be considered to “effectively settle” the obligation to provide that post-retirement insurance benefit, thereby mitigating or eliminating the need to accrue any expense for the post-retirement life insurance benefit.

Format of Comment Letter

The balance of this comment letter follows the following structure:

Discussion

Summary of Position A Assertions

Point by Point Comment/Response to Position A

View C - The Logical Conclusion

Other Factors That Support View C

Summary

As you will determine from this comment letter, while I agree with some of the assertions posited by those who hold View A, I strenuously object to the EITF's decision as a whole based upon View A.

However, I also agree with enough of the EITF's assertions in View A that I do not agree on the whole with View B either. I believe that the real answer lies somewhat between View A and View B. Enter View C.

View C is not based upon any sort of attempt at reconciliation or compromise between the divergent viewpoints held by proponents of View A and View B. Rather, it is attempt to directly address the issue in a rational and logical manner that is consistent with Generally Accepted Accounting Principles.

As someone who has practiced in this market exclusively for many years from multiple perspectives and has a unique combination of expertise in this market, I believe that I can deliver in this comment letter an objective viewpoint.

Discussion

Insurance Product Performance Drivers

There are different types of insurance policies that may be utilized for a split-dollar insurance arrangement. The performance of an insurance carrier's policies are dependent upon the actual performance of various aspects of the product(s) that have been purchased. For General Account insurance products, such aspects include, but are not limited to;

- The general account investment performance of the issuing carrier
- The expense controls and performance of the issuing carrier
- The mortality expense controls and performance of the issuing carrier
- The underwriting controls and performance of the issuing carrier
- The pricing methodology, capital, tax and return requirements of the issuing carrier

In addition to, or in lieu of, the above aspects for a General Account product, other factors affecting the performance of Separate Account products include, but are not limited to:

- The investment performance of the underlying investment portfolio(s)
- The expense controls and performance of the investment manager
- The cost and performance of any additional product features (such as Stable Value Wraps, Credit Enhancements, etc.)

Projected Policy Performance

In projecting the performance of a policy, assumptions are made that are based upon the current conditions at the time of the projection. The only thing that can be known a priori is that the future will not perfectly match the assumptions. A policy could over- or under- perform the projections based upon the factors noted above.

Contractually Guaranteed Policy Performance

All insurance policies also provide contractual guarantees with respect to the performance of their products. For Universal Life types of policies, there are typically guarantees with respect to the minimum rate of interest that will be credited to a policy, as well as the maximum amount of charges that can be deducted from a policy's cash values for mortality and other expenses. These contractual guarantees provide the minimum cash values and death benefits that the product is contractually bound to provide to the policy owner.

Summary of Position A Assertions

This section summarizes every assertion that is posited by the proponents of View A.

Assertion:

An obligation to provide a benefit is a liability and therefore must be recorded.

Assertion:

Purchasing a policy is not a settlement by definition because settlement requires irrevocable action. Irrevocability is defined as “unalterable, committed beyond recall.” Position A posits that since the owner can surrender the policy, it is not irrevocable.

Assertions:

A settlement eliminates significant risks related to the obligation and the assets used to effect the settlement.

A settlement requires a nonparticipating policy.

Assertions:

UL policies are “participating” because they allow the policy owner to share with the insurer in the risks of investment performance and other experience (such as mortality and expense).

UL policies give the insurer the right to recover unexpected increases in mortality or expense.

If the policy owner is exposed to experience losses of the insurer (via possible future required additional premiums or if the purchaser retains most or all of the related risks and rewards), then a settlement has not occurred.

Assertion:

The owner has not transferred most of the risks and rewards associated with the assets used to effect the settlement. Because the employer books the asset, the employer demonstrates that it is sharing in the benefits of the insurance arrangement.

Assertion:

The owner is subject to the risk of default by the insurance company in the event of default (for a general account product).

Assertion:

The view is that this is a pre-funding vs. a settlement, therefore pre-funding should not affect the recognition of the liability.

Assertion:

Employer has clearly given a value to the employee. By entering into a post retirement split-\$ agreement, the employer is providing benefits to the employee that the employer would have otherwise been entitled to and has therefore sacrificed the right to future economic benefits.

Point by Point Comment/Response to Position A

This section takes every assertion that is posited by the proponents of View A and addresses each one directly.

View A Assertion:

An obligation to provide a benefit is a liability and therefore must be recorded.

Response:

By the same token, if a corporation holds a contractually guaranteed life insurance benefit, then the present value of that contractually guaranteed asset should also be recorded. If the obligation in question is a death benefit for a retired employee, then the recognition of said benefit assumes that the person will die post-retirement and that the benefit must be paid by the corporation or its assignee(s). If the corporation owns a contractually guaranteed death benefit, then by the same reasoning the corporation should book the value of that contractually guaranteed death benefit as an asset. Many corporate insurance policies issued for split dollar purposes have contractually guaranteed death benefits that are guaranteed regardless of the performance of the insurance company (or nonparticipating, as the EITF appears to define it) with respect to investments, expenses, mortality, or other factors. It is important to note that this should involve contractually guaranteed payments, not projections based upon performance, but the minimum guaranteed payments that are contractually guaranteed to be paid by the insurance company. This is no less certainty of the payment of this asset than there is for the repayment of the principal on a corporate bond.

View A Assertion:

Purchasing a policy is not a settlement by definition because settlement requires irrevocable action. Irrevocability is defined as “unalterable, committed beyond recall.” Position A posits that since the owner can surrender the policy, it is not irrevocable.

Response:

The purchase of a policy creates an irrevocable benefit to the owner through the guaranteed cash values and guaranteed death benefits. The definition of irrevocable as cited does not make clear whether irrevocability must be symmetrical or whether it may be asymmetrical. An insurance policy is, by definition, irrevocable on the part of the obligor, that is, the insurance company. It is true that if a guaranteed death benefit insurance policy is purchased to assume the risk of a death benefit and then is subsequently surrendered without a release of the obligation, then *at that point* the corporation would be exposing itself to an unfunded obligation and would have to account for the future unfunded benefit obligation. But as long as the corporation holds a guaranteed benefit that is in excess of the benefit obligation then the obligation has been effectively settled as the insurance company has an irrevocable obligation of payment.

View A Assertions:

A settlement eliminates significant risks related to the obligation and the assets used to effect the settlement.

A settlement requires a nonparticipating policy.

Response:

Many corporate insurance policies issued for split dollar purposes have contractually guaranteed cash values and death benefits that are guaranteed regardless of the performance of the insurance company or policy (or nonparticipating, as the EITF appears to define it) with respect to investments, expenses, mortality, or other factors. *It is this contractually guaranteed value that should be evaluated.* This contractually guaranteed benefit is nonparticipating, using the EITF's definition, because it is not impacted by the results of the insurance company's experience on investments, mortality, expenses or any other factor. The insurance company has no ability to recover any unexpected costs or unfavorable experience beyond said contractual guarantees on a prospective basis.

View A Assertions:

UL policies are "participating" because they allow the policy owner to share with the insurer in the risks of investment performance and other experience (such as mortality and expense).

UL policies give the insurer the right to recover unexpected increases in mortality or expense.

If the policy owner is exposed to experience losses of the insurer (via possible future required additional premiums or if the purchaser retains most or all of the related risks and rewards), then a settlement has not occurred.

Response:

This is a valid point in evaluating whether an insurance contract is effectively a settlement. While "participating" is not being used in the traditional sense with respect to the insurance industry, this position and/or definition of "participating" is reasonable and accurate within the scope of this paper. When an insurance contract is valued based upon non-guaranteed elements, it is true that the policy owner is exposed, to a certain extent, to some of the experience losses of the insurer. However, when the contract is valued based upon contractually guaranteed conditions, this is no longer true. The insurer is contractually limited to the right of recovery via required guaranteed minimum credited interest rates and required guaranteed maximum cost of mortality charges and expense charges. *It is under these contractual guarantees that an insurance policy should be evaluated when determining its value as a settlement.*

View A Assertion:

The owner has not transferred most of the risks and rewards associated with the assets used to effect the settlement. Because the employer books the asset, the employer demonstrates that it is sharing in the benefits of the insurance arrangement.

Response:

In order to qualify as insurance for tax purposes according to Internal Revenue Code, there must exist a “transfer of risk.” The Internal Revenue Service has repeatedly demonstrated the ability and willingness to pursue insurance arrangements that do not accomplish the transfer of risk in corporate insurance. The IRS has never challenged the transfer of risk associated with policies purchased for simple split-dollar arrangements. The employer is “participating” only in the sense that it has a secured claim upon the cash value of the insurance policy that is providing the insurance death benefit. The value of this cash value is typically the premium plus the accrued net income of the policy to date. The risk of mortality is clearly transferred in this insurance arrangement.

The value of the split dollar benefit obligation to the employee should be measured against the “Net Amount at Risk” (NAR) on a contractually guaranteed basis. The fact that the policy owner maintains the right to the insurance asset’s cash value simply represents a cost recovery device for the premium plus interest and does not necessarily mean that the owner is materially sharing in the net benefit of the insurance policy, i.e. participating in the insurance risk, unless the split dollar arrangement provides for some of the Net Death Benefit to be distributed to the policy owner, and some to the Insured.

Furthermore, as long as 1) the benefit obligation to the employee is effectively covered by the guaranteed death benefit provided within the NAR, and 2) the policy owner’s portion of the NAR, if any, does not reduce the value of the death benefit below that which is needed to cover the obligation, then 3) the fact that the policy owner may participate in any of the excess NAR proceeds does not mean that a settlement has not occurred. A settlement does not appear to be limited by definition to a 2 party transaction, but could certainly include multiple parties – in this case policy owner, insured and insurance company. Each party benefits from the settlement in their own right.

View A Assertion:

Additionally the owner is subject to the risk of default by the insurance company in the event of default.

Response:

This is in direct opposition to the task force’s own assertion above that “The owner has not transferred most of the risks and rewards associated with the assets...” One cannot argue that

two opposing assertions are both in support of one's own position. That should be enough to refute at least one of these two assertions.

The owner of any financial instrument is subject to the risk of default, whether significant or de minimus. The insurance contract, valued under the contractually guaranteed benefits, provides a clearly defined minimum series of cash values and death benefits that the insurer must contractually provide. This contractually guaranteed benefit of cash values and death benefits is no more or less likely to be paid than any other asset on a corporation's balance sheet that holds an equal credit rating. As an example, banks hold outstanding mortgage loans as assets in spite of the fact that they may not be repaid. Also, corporations hold debt instruments of other corporations even though they could default.

The owner of an asset books the value of that asset until there is a change in the likelihood of the principal and/or interest being paid on time and/or in full. Only when an asset becomes impaired does the owner adjust the value of the asset. Insurance companies are heavily regulated by 50 state insurance departments and stringently rated by multiple ratings agencies such as S&P, Moody's, Fitch, A.M. Best, etc. There is perhaps no other industry as heavily regulated by multiple entities with the purpose of ensuring the full and timely payment of obligations than the insurance industry. To go so far as to demand that the guaranteed values of an insurance policy be discounted due to a risk of default would logically require that ALL non-U.S. government-backed assets on a corporate balance sheet be likewise discounted, which obviously will never happen based upon GAAP.

View A Assertion:

The view is that this is a pre-funding vs a settlement, therefore pre-funding should not affect the recognition of the liability.

Response:

This assertion is consistent with the EITF's very first point in this section. If this position is allowed, then it would only be reasonable, rationale and consistent to allow the corporation to book the value of the *contractually guaranteed death benefit as an asset* as well. Ultimately, this would not necessarily be the optimal course of action for the committee to pursue, as it could have unintended consequences such as the recognition of assets that are not matched to split dollar benefit obligations, but are simply corporate insurance policies purchased as assets to informally fund employee benefit expenses and/or key man insurance. In the bank market alone, the cash values of Bank Owned Life Insurance (BOLI) are estimated at over \$70 billion dollars. On the other hand, to require the recognition of a benefit obligation and not allow for the recognition of an asset by using the same assumptions would defy the basic tenets of Generally Accepted Accounting Principles.

View A Assertion:

Employer has clearly given a value to the employee. By entering into a post retirement split-\$ agreement, the employer is providing benefits to the employee that the employer would have otherwise been entitled to and has therefore sacrificed the right to future economic benefits.

Response:

This assertion is a stretch, at best. This assertion assumes that the employer first purchased an insurance policy on the employee, is the full beneficiary of the policy, and then subsequently decided to “give away” the death benefit of the insurance that the employer originally bought by entering into a split-\$ agreement. Virtually all split dollar policies are purchased with the benefit in mind for both the policy owner and the Insured from the outset.

View C – The Logical Conclusion

For a split dollar arrangement, a corporation should evaluate the insurance policy's "Net Amount at Risk" (NAR) on a contractually guaranteed basis (e.g. minimum guaranteed credited interest rates and maximum guaranteed cost of insurance charges in the case of Universal Life policies and Variable Universal Life Insurance policies, and contractually stated guaranteed values for Whole Life policies) to determine if the contractually guaranteed death benefit from the insurance policy is sufficient to settle the benefit obligation. If the contractually guaranteed net death benefit from the insurance policy is sufficient to settle the benefit obligation, then no additional benefit expense accrual is required because the benefit obligation has been effectively settled and the insurance company who has provided the guarantee has no latitude to deliver anything less than the contractual guarantees. If the contractually guaranteed death benefit from the insurance policy is NOT sufficient to settle the benefit obligation, then some additional benefit expense accrual is required for the shortfall. The topic of how to calculate that value would be the topic of a separate comment letter, but in the end, would not pose any significant barriers in terms of the effort required to accomplish.

This position would also have the benefit of being consistent with TB 85-4, and would not require any reconsideration of currently adopted standard practices in the recognition of insurance assets.

In addition, if the split-dollar arrangement defines the limit of the benefit obligation to be equal to the actual NAR paid out by the insurance policy at the death of the insured with a floor of zero, then there is, by definition, no benefit obligation that is not effectively settled by the contractual guarantees of the insurance policy since it is the actual NAR benefit payment that defines the benefit. There are many split dollar arrangements that define the benefit in this manner.

Other Factors That Support View C

Yield to Worst Analogy: Valuing an insurance policy based upon contractual guarantees could be considered analogous to evaluating a debt security on a “Yield to Worst” basis. Taking this conservative approach to valuing the contractually guaranteed death benefit provided by the insurance policy provides the floor of the benefit that is expected to be paid.

Benefits Limited to NAR: If the split-\$ arrangement is defined as the actual “Net Amount at Risk” (NAR) that is actually paid out by the insurance company, with no liability for any additional benefit, then the employer has by definition completely transferred any and all risks associated with the benefit obligation directly to the insurance policy.

Benefit Severability: If employer can terminate the death benefit obligation at any time without recourse, then it could be argued that no benefit obligation exists on the part of the employer.

Ease of Evaluation on Guaranteed Basis: The fact that insurance policies can be easily evaluated on a contractually guaranteed basis makes it easy to implement View C. NAIC (National Association of Insurance Commissioners) Model Illustration Law provides for the uniform evaluation of insurance policies based upon both “current” and “guaranteed” assumptions. Such illustration systems and methodology must be verified and “signed off” upon by an insurance company’s designated “Illustration Actuary.” At policy issue, an illustration is delivered to the policy owner that shows both “Guaranteed” and “Current” illustrated values from the date of issue to maturity. In addition, policy owners may request from the issuing insurance company an “In Force” illustration at any time (typically annually) that illustrates both the “Guaranteed” and “Current” illustrated values from the actual current values of the policy (the then-current actual cash value and death benefit at the time of request) from that actual point-in-time going forward to maturity. Therefore, each year, the policy owner could easily re-evaluate the guaranteed cash values and death benefits in order to see if the benefit obligation continues to be covered by the insurance policy.

Prospectively, as long as the insurance policy has historically credited more interest than is contractually guaranteed, and/or has charged cost of insurance charges that are less than the contractually guaranteed maximums, then the current “In Force” illustrations that are run in the future will always demonstrate an improvement in the then-current guaranteed benefits vs. the original guaranteed benefits. This is because any changes to the interest rate and/or cost of insurance charges may only be applied prospectively, not retroactively.

Summary

View C is the correct answer and is in the middle ground, so to speak. The non-guaranteed aspect of an insurance policy has given some on the committee reasonable pause with respect to consideration as a settlement of an obligation. However, the task force has not appeared to take into consideration the dual aspects of insurance policy performance – that is “current” vs. “guaranteed” cash values and death benefits.

In order to be considered a settlement, the obligation from the insurance company must be guaranteed irrevocably without any considerations of “participation.” When this bifurcation of “current” vs. “guaranteed” policy values is evaluated, then it becomes clear that an insurance contract should be considered a settlement if the guaranteed minimum cash values and death benefits are sufficient to support the total obligation. It is an irrevocable guarantee that the insurer can not change. However, if the guaranteed minimum values are insufficient to cover the obligation, then the difference between the present value of the benefit vs. the present value of the guaranteed asset should be accrued as a liability on some basis (which I have not addressed in this comment letter, as it is a separate discussion which would need to be addressed after a final position has been taken upon this primary issue.)

Fortunately, View C also presents a solution in which the evaluation is relatively easy to make on an annual basis. The NAIC (National Association of Insurance Commissioners) Model Law provides guidelines on illustrating the cash value and death benefit performance of insurance policies which are widely adhered to in form and in practice. All insurance companies illustrate their insurance policy performance on both a current and a guaranteed basis. In-force illustrations are available to policy owners upon request. The mechanism already exists and is in place to effect the valuation of insurance policies on a guaranteed basis.

Thank you for your consideration of these comments. If you have any questions or desire further dialogue, please do not hesitate to contact me.

Sincerely,



Richard K. Bratten CFA, FSA, MAAA