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2016-330
Comment Letter No. 7

December 14, 2016

Technical Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: Exposure Draft, *Targeted Improvements to the Accounting for Long-Duration Contracts* (File Reference No. 2016-330)

Dear Technical Director:

We appreciate the opportunity to comment on the proposed Accounting Standards Update (ASU), *Targeted Improvements to the Accounting for Long-Duration Contracts*. We support the Board's objective to make targeted improvements to the recognition, measurement, presentation, and disclosure requirements for long-duration contracts issued by an insurance entity.

We generally believe that the proposed amendments would result in meaningful improvement to financial reporting by an insurance entity. However, we believe the Board should consider modifying certain aspects of the proposal to achieve its objectives.

Our observations and views on key aspects of the proposed ASU are summarized in this cover letter. Our responses to the Board's specific questions are described in more detail in Appendix A. In view of the nature and extent of the proposed changes, and the different types of long-duration insurance contracts, we strongly recommend that the Board formally field test the proposal before it issues a final ASU.

Method to update cash flow assumptions

We support the Board's proposal to retain the net premium reserving model and agree that a liability measured with updated assumptions provides more decision-useful information when those assumptions reflect an entity's current view of the expected cash flows. The proposed ASU would require an insurance entity to use a retrospective method to measure the effect of changes in cash flow assumptions. We acknowledge the theoretical merits of this method because changes in estimates would not be entirely attributed to future period results. However, we believe the Board should consider a prospective method for updating the cash flow assumptions because it also would improve financial reporting without introducing the complexity and cost of the retrospective method.

Discount rate for non-participating contracts

We agree with the Board's proposal for a company to discount expected future cash flows using a rate adjusted for liquidity that reflects the characteristics of the insurance liability. This rate would maximize the use of current, market observable inputs. However, during periods of market dislocation, the use of a high-quality fixed-income yield, interpreted in U.S. GAAP to be AA, may result in discount rates that are not representative of the economics of the transaction between the insurance entity and its customers. A

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fixed-income instrument yield that is less than high-quality or a reference rate of a diversified fixed-income portfolio, could more faithfully represent a long-duration insurance liability discount rate.

We recommend that the Board perform additional analysis and outreach to identify an index or other objectively determined rate that more closely aligns with the characteristics of the insurance liability.

Participating Contracts

We have a general concern about the accounting model proposed for participating contracts. We believe that using the same accounting model for participating contracts as non-participating contracts does not reflect the unique characteristics and underlying economics of participating contracts. We recommend that the Board perform additional work and outreach to develop a model for participating contracts that will better reflect the underlying economics and characteristics of those contracts.

Market Risk Benefits

Scope

The proposed ASU defines *market risk benefits* by referring to product types. Rather than defining market risk benefits as those linked to only variable products, we believe the Board should develop a principle that would cover similar features on all insurance and investment contracts. A broad principle also would be useful to address future change and evolution in insurance products.

Measurement

We suggest that the Board consider whether fully life-contingent market risk benefits (guaranteed minimum death benefits or GMDBs) should be considered market risk benefits. Because these benefits are payable only on death and the policyholder cannot choose to trigger the benefit, it is not clear that the accounting for these benefits should change from what it is today (under SOP 03-1).

Transition

We believe the Board should provide a practical expedient for an insurance entity to apply at transition if it is impracticable for an entity to adopt the fair value accounting model on a retrospective basis. It may be difficult, or in some cases impossible, without using hindsight, to determine the assumptions at contract issuance that would be the inputs into the fair value calculation at transition.

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If you have questions about our comments or wish to discuss the matters addressed in this comment letter, please contact Kimber Bascom at (212) 909-5664 or kbascom@kpmg.com, or Alan Goad at (212) 872-3340 or agoad@kpmg.com.

Sincerely,

Handwritten signature in black ink that reads "KPMG LLP". The letters are bold and slightly slanted, with a stylized 'K' and 'P'.

KPMG LLP

Appendix – Responses to Selected Questions for Respondents

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?

Yes. We agree with the scope of the proposed guidance.

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?

We agree that the effect of updating cash flow assumptions should be recognized in net income. We also acknowledge that a retrospective method to calculate the effect of updating the cash flow assumptions has theoretical merit because changes in estimates would not be entirely attributed to future period results. However, we believe the Board should consider a prospective method because:

- It may be difficult for users to understand the results under a retrospective method, similar to the difficulty users have today with the retrospective unlocking of deferred acquisition costs.
- A prospective method would reflect actual experience in the period in which it occurs rather than partially offsetting that experience by a retrospective adjustment at the time cash flow assumptions are updated.
- The retrospective method would introduce complexities into the reserving model since a significant amount of historical information would be needed to apply this approach. A prospective method would be operationally less complex and less costly to use, both in transition and in future reporting periods.
- A prospective method would be consistent with the methods under the forthcoming IFRS standard.

A prospective method also is consistent with the current guidance for income amortization for certain beneficial interests (ASC 325-40-35-4a). We believe a prospective method applied to traditional, limited payment and participating contracts could improve financial reporting by reporting in earnings the effect of assumption changes. Furthermore, it would provide users with decision-useful information without introducing the significant complexity and additional costs associated with the retrospective method.

Additional Liability for Death and Annuity Benefits

The current accounting model for the additional liability for death and annuity benefits (formerly SOP 03-1) requires the assessment of profits followed by losses only at the inception of the contract. The proposed ASU would require an insurance entity to perform this assessment *at each reporting period* and, if there are projected profits followed by losses, to calculate an additional reserve using a retrospective method

(i.e., back to the inception of the contract). We suggest that the Board consider requiring a prospective method for determining the additional reserve needed when profits followed by losses are first identified. A prospective method would not require entities to maintain significant amounts of historical data and would recognize experience in the period in which it occurs.

The proposed ASU would not allow the benefit ratio to exceed 100%, with a goal of requiring immediate loss recognition. By contrast, the SOP 03-1 model accumulates reserves as assessments are earned. Capping this ratio does not appear to achieve the Board's goal of requiring immediate loss recognition. One way to require immediate loss recognition would be to modify the liability definition for additional benefits to be based on discounting of future cash flows, consistent with the determination of future policy benefit reserves, rather than use a roll-forward accumulation definition. We suggest that the Board perform additional work and outreach in this area as there may be other ways to achieve the goal of immediate loss recognition.

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?

Yes. We agree that an insurance entity should update the cash flow assumptions 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. We do believe that the evaluation of assumptions annually, with or without a corresponding change if evidence indicates, is consistent with this requirement.

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?

Yes. We agree that a company should discount expected future cash flows using a rate adjusted for liquidity that reflects the characteristics of the insurance liability. This rate would maximize the use of current market observable inputs. However, during periods of market dislocation, the use of a high-quality fixed-income yield, interpreted in U.S. GAAP to be AA, would frequently result in discount rates that are not representative of the economics of the transaction between the insurance entity and its customers. A fixed-income instrument yield that is less than high-quality, or a reference rate of a diversified fixed-income portfolio, could more faithfully represent a long-duration insurance liability discount rate and its corresponding illiquidity.

Measuring long-duration contracts using a discount rate curve that is significantly lower than the rate implicit in setting premiums could result in recognizing losses at the inception of contracts that are expected to be profitable. This may not be representative of the economics of the transaction between the parties for certain interest spread products like single premium immediate annuities.

We suggest that the Board perform additional analysis and outreach to identify an index or other objectively determined rate that more closely aligns with the principle implicit in the proposed guidance that the discount rate should reflect the characteristics of the insurance liability.

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?

Yes. We agree that an insurance entity should immediately recognize in other comprehensive income the effect of updating discount rate assumptions.

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?

Yes. We agree that that an insurance entity should update the discount rate assumptions at each reporting period.

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?

We agree with the scope of the proposed amendments for the liability for future policy benefits for participating contracts, except for participating contracts in a closed block issued by a demutualized insurance entity. We believe that by its nature, a closed block is different from other participating contracts. A closed block comprises a defined, limited group of policies and a defined set of assets, and is governed by a set of operating rules agreed upon with the insurance entity's regulator.

We recommend that the Board consider simplifying the accounting for a closed block issued by a demutualized insurance entity. For example, a closed block's defined set of assets, including the future return on those assets, inure to the benefit of the policyholders in the closed block, not to the stockholders of the insurance entity. Therefore, we recommend that the future policy benefit reserve be equal to the assets that support the closed block contracts. In addition, because the insurance entity is required to fund shortfalls in assets based on the demutualization agreement, the analysis for an additional reserve (similar to a reserve under SOP 03-1) would be needed to ensure that the liability reflects the obligations of the insurance entity to the closed block 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?

As discussed in our response to Question 2, we believe a prospective method could improve financial reporting by reporting in earnings the effect of assumption changes. A prospective method would provide

users of the financial statements with decision-useful information without introducing into the reserve calculation significant complexity and additional costs.

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?

Yes. We agree that cash flow assumptions, other than interest-sensitive cash flows, 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.

We have a general concern about the accounting model proposed for participating contracts. We believe that using the same accounting model for participating contracts as for non-participating contracts does not recognize the unique characteristics and underlying economics of participating contracts. Our main concern with the proposed model is the requirement to discount the projected cash flows related to policyholder dividends using a high-quality fixed-income instrument yield and accrete interest based on the discount rate determined at the inception of the contract. Insurance entities would adjust expected cash flows related to policyholder dividends in response to interest rate changes; however, a significant change to net income would not be expected (i.e., the expected changes in investment earnings generally would offset the future expected policyholder dividends). However, because the proposed model uses a high-quality fixed-income instrument yield to discount the estimated cash flows and accretes interest based on the original discount rate, the effect on other comprehensive income and net income would be inconsistent with the economics of the participating contract.

We suggest that the Board perform additional outreach and work to develop a model for participating contracts that will reflect the underlying economics and characteristics of those contracts.

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?

As discussed in our responses to Questions 4 and 9, we agree that expected future cash flows should be discounted using a rate adjusted for liquidity that reflects the characteristics of the insurance liability, including participating contract interest-sensitive cash flows. This rate should maximize the use of current, market observable inputs. However, during periods of market dislocation, using a high-quality fixed-income yield, interpreted in current GAAP to be AA, may result in discount rates that are not representative of the economics of the transaction between the insurance entity and its customers. A fixed-income instrument yield that is less than high-quality or a reference rate of a diversified fixed-income portfolio, could more faithfully represent a long-duration insurance liability discount rate. Additionally, characteristics unique to a participating contract (e.g., interest-sensitive assumptions like expected policyholder dividends) should be considered when determining an appropriate discount rate to apply to the expected future cash flows in a participating contract.

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?

Yes. We agree that an insurance entity should recognize immediately in other comprehensive income (OCI) the effect of updating discount rate assumptions, other than interest-sensitive cash flows (e.g., the policyholder dividend assumption).

We understand that there is a potential mismatch in earnings and OCI when updates to interest-sensitive cash flow assumptions are recognized in net income and the effect of the change in discount rates is recognized in OCI. We suggest that the Board perform further outreach to determine whether financial statement users would be concerned about a mismatch.

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?

Yes. We agree that an insurance entity should update the discount rate assumptions at each reporting period.

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?

No. Rather than defining market risk benefits as those linked to only variable products, we believe the Board should develop a principle that would cover similar features on all insurance and investment contracts. For example, an annuity writer may offer guaranteed lifetime withdrawal benefits on both variable annuities and fixed annuities. Under the proposed guidance, only the lifetime withdrawal benefit on the variable annuity would be considered a market risk benefit although the contract holder may have a loss potential under either contract, depending on the benefit definition.

A principles-based approach would be useful because insurance products continue to change and evolve. In addition, we believe that the Board should consider whether fully life-contingent market risk benefits (guaranteed minimum death benefits or GMDBs) should be considered market risk benefits. Because this benefit is payable only on death and the policyholder cannot choose to trigger the benefit, it could be that it should not be considered a market risk benefit and should be accounted for under the current model. The current model requires an insurance entity to update assumptions each period and is consistent with the Board's proposal to require entities to update assumptions 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. In addition, we are not aware of diversity in practice related to the accounting for these benefits. All other benefit features that meet the definition of market risk benefits on all insurance and investment contracts should follow the Board's proposed fair value accounting model.

We believe the Board should consider alternative wording for the reinsurance guidance proposed in ASC 944-40-25-40. Under the proposed language in that paragraph, an entity would evaluate whether the underlying contract and benefit meet the criteria to be a market risk benefit (ASC 944-40-25-25C). If the underlying contract and benefit meet the criteria, the reinsurance contract also would be considered a market risk benefit under the proposal. However, if an entity assumes only the mortality risk and not capital market risk, the assuming entity would have to measure the fair value of this benefit even though it does not assume capital market risk related to the benefit. Rather than linking the conclusion to the benefits in the underlying contracts, we suggest revising the wording to require the reinsurer to evaluate the risk assumed and if that risk meets the definition of a market risk benefit.

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?

Yes. We agree that an insurance entity should measure all market risk benefits, after considering our suggested scope changes discussed in Question 13, at fair value, and should recognize in other comprehensive income the changes in fair value that are attributable to a change in the instrument-specific credit risk.

Deferred Acquisition Costs (DAC)

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?

No. We do not believe that the Board should expand the proposed scope of the amendments to include investment contract acquisition costs currently amortized using the interest method in ASC Subtopic 310-20.

The Board proposed that the amortization of sales inducement assets and the recognition of the unearned revenue liability should follow the proposed DAC amortization method. However, there are other balances that entities have historically recognized in net income using the current DAC amortization model. Examples of these balances are the present value of future profits for acquisitions before January 1, 2008 (pre-FAS 141R), the costs of reinsurance, and intangible assets or liabilities resulting from the difference between the fair value of the insurance contract and the insurance contract calculated under ASC 944-805-30-1. We suggest that the Board evaluate and clarify whether entities should use the proposed DAC amortization model or another amortization method for these other balances.

We do not agree that the unearned revenue liability should follow the new DAC amortization method and suggest that the Board require insurance entities to apply the guidance for the deferred profit liability for limited-payment contracts. This model would allow the accretion of interest and would include an estimate for future estimated deferrals, which will result in a model consistent with revenue recognition.

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?

Yes. We believe that the proposed amendments would simplify the amortization of deferred acquisition costs. However, we recommend that the Board consider providing companies with an option of defining an appropriate amortization driver when in-force amounts cannot be readily determined. The use of a straight line method when contracts are aggregated into cohorts of similar risks but varying sizes can produce amortization patterns that are inconsistent with the economics of the underlying contracts when contracts lapse at rates different from expected rates.

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?

Yes. We agree that deferred acquisition costs should not be subject to impairment testing.

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?

Yes. We agree with the proposed presentation requirements. We generally agree with the proposed disclosure requirements, which would provide decision-useful information. However, the proposal includes extensive disclosure requirements about interim periods that we believe may reduce the effectiveness of communicating financial results. We recommend that the proposed disclosures should only be required for annual reporting periods and entities should rely on the existing requirements in ASC 270-10-50-1 for interim disclosures.

Liability for Future Policy Benefits and Additional Liability for Annuitization, Death, or Other Insurance Benefits

The proposed guidance would require an entity to disclose undiscounted expected future net premiums and expected future benefits. It is not clear why this information provides decision useful information. Also, quantitative information about certain assumptions, such as mortality and lapses, may not provide decision useful information to users since the ranges for these assumptions could be very wide (for example, 0 to 100).

Market Risk Benefits

Because the proposal would require market risk benefits to be measured at fair value, we believe that an insurance entity should follow the guidance for fair value disclosures in ASC 820-10-50 for all of these benefits, rather than creating specific requirements that are different from those that apply to other fair value measurements.

Deferred Acquisition Costs

The Board should consider the usefulness of the requirement to present disaggregated rollforwards of deferred acquisition costs in a manner consistent with the disaggregation of the related liability. Under the proposed guidance, the amortization of deferred acquisition costs no longer is linked to the profitability of the contracts or the measurement of the liability. Therefore, disaggregated DAC information may not provide decision useful information to financial statement users. As an alternative, we suggest requiring the disclosures in ASC 944-30-50-2A at a consolidated level, which we believe would provide users with relevant decision-useful information.

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.

No. We do not believe that additional presentation or disclosure requirements are needed, unless the Board decides to use a prospective method for updating cash flow assumptions. We suggest that the Board work with users to understand what additional disclosures would provide decision-useful information when using a prospective method to update cash flow assumptions.

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?

There is an extensive amount of accounting change facing entities that would be subject to the proposed ASU, e.g., new U.S. GAAP standards about revenue recognition (ASU 2014-09 as amended), recognition and measurement of financial instruments (ASU 2016-01), leases (ASU 2016-02), and credit losses (ASU 2016-13), and new regulatory requirements with Principles Based Reserving. In addition, entities subject to IFRS reporting expect to be required to adopt IFRS 17, *Insurance Contracts*, on January 1, 2021. Implementing these changes will require significant resources. In addition, the proposed insurance guidance would be a significant change to current practice and implementing the new requirements, specifically the retrospective method to update cash flow assumptions, would require changes to systems, processes, and controls. We recommend that the Board take these factors into consideration when deciding on the effective date of the proposed ASU.

We believe nonpublic entities should be given additional time to implement the proposed amendments; however we suggest that nonpublic entities should be allowed to early adopt the proposed guidance.

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?

Liability for Future Policy Benefits

We agree that retrospective application is operable and provides decision-useful information.

Market Risk Benefits

If information dating back to the issuance of the contract is available, we agree with the Board's proposal for retrospective application and recognition of the difference between fair value and carrying value, excluding the effect of changes in the instrument-specific credit risk between contract issue date and transition date. However, it may be difficult, or in some cases impossible without using hindsight (which is not allowed in ASC 250 for retrospective application), to determine the assumptions at the issuance of the contracts that are the inputs into the fair value calculation at transition. We believe the Board should explore practical expedients for transition in situations where it is impracticable for entities to use retrospective application.

Deferred Acquisition Costs

We agree with the Board's proposal to apply the proposed guidance to the existing carrying amounts at the transition date, adjusted for the removal of any related amounts in other comprehensive income. See earlier discussion in Question 15 about the need for transition guidance for balances other than DAC and sales inducements that have historically been recognized in net income using the DAC amortization guidance.

Question 22:

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

We do not believe that additional presentation or disclosure requirements are needed.

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.

We believe preparers are best able to comment about the nature of the incremental costs of adopting the proposed amendments.