Via Email: director@fasb.org

December 15, 2016

Technical Director
File Reference No. 2016-330
Financial Accounting Standards Board
401 Merrit 7
Post Office Box 5116
Norwalk, CT 06856-5116

Re: FASB Exposure Draft, Insurance Contracts

Dear Technical Director,

Lincoln National Corporation ("LNC" or "we") appreciates the opportunity to comment on the FASB Exposure Draft, Financial Services – Insurance (Topic 944), Targeted Improvements to the Accounting for Long-Duration Contracts ("FASB ED"). LNC is a holding company which operates multiple insurance and retirement businesses in the United States through subsidiary companies. Through our business segments, we sell a wide range of insurance, wealth protection, accumulation and retirement income products and solutions. As of September 30, 2016, we had consolidated assets of $266.6 billion.

The life insurance industry fills a critical role in ensuring the financial and retirement security of millions of Americans. As such, it is important to have high quality accounting standards that produce results that reflect the economics and long-term nature of life insurance and annuity contracts. Any changes to existing U.S. GAAP should be consistent with this view and should result in an improvement to the reliability and understandability of financial statements.

We believe that existing U.S. GAAP has a well-established set of standards that has served the industry and investors well over many years. However, we concur that modifications to existing U.S. GAAP are warranted, but believe targeted changes should generally be focused on unlocking assumptions for measuring traditional life insurance benefit liabilities.

We have been actively monitoring the FASB's Insurance Contracts project and have significant concerns with the following views expressed in the FASB ED.

- *Market risk benefit*
  We have the following concerns regarding the valuation for market risk benefits, as proposed in the FASB ED. These concerns are summarized as follows:
  - First, we do not believe that all market risk benefits should be measured at fair value. However, for those benefits measured at fair value under existing U.S. GAAP, we agree the changes in fair value attributable to a change in the

instrument-specific credit risk should be recognized in other comprehensive income.

- Second, we believe portions of the fair value standard require revision to ensure consistency with other proposed valuation standards – specifically by adopting the discount rate for long-dated fixed-rate liabilities for cash flows within market risk benefits with long-dated fixed-rate characteristics. Failure to ensure consistency will lead to unacceptable accounting distortions as the U.S. Variable Annuity (VA) industry matures and VA policies shift standards from market risk benefits to long-dated fixed-rate liabilities.
- Third, we believe assumptions for long-dated equity market volatility should be based on historical volatility plus a margin for prudence – as the market simply is too thin to support either reliable estimates of fair valuation or prudent risk management via hedging.

The proposed definition of market risk benefits scopes in different types of guaranteed benefit features including those that are fully life-contingent (e.g., GMDB), those that are fully non-life-contingent (e.g., GMWB), and those with elements of both life- and non-life contingent features (e.g. GLWB). The features are typically associated with variable annuity products, however GMDBs are also offered on certain variable life contracts as well.

We believe that the FASB should not group all market risk benefits together for the sake of consistency and require the related reserves to be valued at fair value. Such treatment would account for market risk benefits with life-contingent benefit features differently than other long duration contracts with life-contingent benefit features (i.e. traditional life insurance contracts).

We believe it is more appropriate for contracts with life-contingent features to be accounted for similarly, which can be achieved through established U.S. GAAP.

We believe that the proposed definition of market risk benefits in the FASB ED does not adequately recognize the differences in the life-contingent and non-life contingent nature of the various types of benefits provided by these contract features. We therefore support retaining U.S. GAAP based on the accounting principal of maintaining consistent accounting for life-contingent benefits and non-life contingent benefits, which can be accomplished through existing U.S. GAAP.

It is our view that the existing guidance for benefit features that are fully life-contingent such as GMDBs and for benefit features that are fully non-life contingent such as GMWBs is consistently applied by preparers and well understood by users and that the diversity in practice is primarily attributed to the application of the guidance in ASC paragraph 815-15-55-61 to benefit features with elements of both life- and non-life contingent features (i.e. GLWBs).

We recommend the FASB focus on providing clarifying guidance related to the interpretation of ASC paragraph 815-15-55-61 rather than focusing accounting changes on all market risk benefits.

- *Deferred Acquisitions Costs*
  We support retaining the current U.S. GAAP guidance which results in the amortizing of deferred acquisition costs in proportion to a measure of profitability such as estimated gross profits. We believe the following benefits exist under existing U.S. GAAP:
  - Amortization of DAC in proportion to a measure of profitability is reasonable and consistent with the emergence of product earnings.
  - Existing amortization is accepted by users and is theoretically sound in that it ensures future earnings reported in U.S. GAAP income statements are consistent with long-term expected margins.
  - Existing method has accommodated changing product features and weathered the financial crisis when assets and liability valuations were undergoing significant changes.

- *Discount rate*
  We believe that discount rates used by the insurance entity should reflect the asset-liability management business model and the interdependence between the assets and liabilities. As such, we believe the discount rate should be based on the expected return of the assets backing the liability. We support retaining the existing discount rate under U.S. GAAP, which is based on the estimated pre-tax investment yields (net of related investment expenses) expected at the contract issue date (or claim incurral date for amounts reclassified as unpaid claim liabilities), less expected credit losses.

  While theoretically we are not opposed to long-duration insurance contracts being discounted based on a portfolio of high-quality fixed-income investments, we do not believe the interpretation of Aa as high-quality is consistent with the characteristics of the liability. As an alternative, we would recommend a risk-adjusted expected investment yield as used by insurers in new business pricing. It is our view that new business pricing best represents the price at which a marginal shareholder is willing to deploy capital to support issuance of liabilities with long-dated fixed rate characteristics. Subsequent analysis contained in this letter demonstrates that the yields on newly issued long-dated fixed rate liabilities are most often between A and Bbb – and well above Aa. We therefore propose use of ‘A rated’ investment yields as a prudent basis for the discount rate if a rate based on existing U.S. GAAP is not to be retained.

  Moreover, under existing U.S. GAAP, the discount rate used in fair value calculations is the risk-free rate and the discount rate used to calculate additional liabilities under the benefit ratio approach in ASC 944-40-25-27A is the contract rate. The FASB ED retains these discount rates. However, a shortcoming in existing U.S. GAAP is the inconsistency with the guidance noted above and the discount rate for long-dated fixed rate liabilities. For example, the moment before a GLWB or GMIB contract converts into a payout annuity, its U.S. GAAP reserve will be substantially larger than the U.S. GAAP reserve for the payout annuity simply because of the difference in discount rates used under the

two valuations. As a result, we believe the discount rate for GLWB or GMIB claim cash flows should be harmonized with the discount rate for long-dated fixed rate liabilities. The failure to harmonize these discount rates will result in substantial non-economic U.S. GAAP reserve release over time as the over $800 billion[1] of U.S. GMIB and GMWB contracts mature into payout annuities over the next 5-20 years.

We further recommend that when a claim occurs, any amounts reclassified from the Liability for Future Policy Benefits to the Liability for Unpaid Claims and Claim Adjustment Expenses, the Liability for Unpaid Claims and Claim Adjustment Expenses should be accounted for as a derecognition of the amounts reflected in the Liability for Future Policy Benefits and related AOCI. A current rate at the time of the reclassification should then be used as the discount rate for the establishment of the Liability for Unpaid Claims and Claim Adjustment Expenses liability.

Our positions on the other areas of targeted changes proposed in the FASB ED are summarized as follows:

- *Assumptions used to measure the liability for future policy benefits*
  We support the unlocking of assumptions for traditional, limited-payment, and participating long-duration contracts. We agree with the FASB that a liability measured with updated assumptions would provide more decision-useful information and would more faithfully represent the insurance entity's obligation, because it gives users a more current view of an insurance entity's expected future cash flows, as opposed to a historical view that includes a provision for risk of adverse deviation.

- *Presentation and disclosure*
  We agree users of financial statements will benefit from a separate presentation of the carrying amount of GMXBs measured at fair value on the statement of financial position, a separate presentation of the portion of the change in the carrying amount of GMXBs measured at fair value not attributable to the change in own credit risk in net income, and the portion of the change in the carrying amount of GMXBs measured at fair value attributable to the change in own credit risk in other comprehensive income.

  We are concerned with the granularity of the new disclosures included in the proposed amendments in the FASB ED, including both the disclosures required at transition and the required ongoing disclosures. Our concern is that the required disaggregated disclosures of earned rates and credited rates would result in an insurance entity effectively disclosing proprietary product pricing information and strategies that would then be readily available to competing companies.

- *Effective date and transition*
  We recommend that the effective date of the proposed amendments in the FASB ED should be at least four years from the issuance of the final guidance. If the Accounting Standards Update containing the proposed amendments in the FASB ED were to be

[1] Source: Oliver Wyman

issued by end of 2017, this would suggest a January 1, 2022 effective date. Our rationale supporting this timing includes the following:

- Significant changes to processes, systems and internal controls in order to collect and verify the accuracy of historical data required to update assumptions used in the measurement of the liability for traditional, limited-payment and participating contracts will be a significant change in practice for insurance entities;

- Significant changes to processes, systems and internal controls in order to collect and verify the accuracy of historical fair value measurement inputs for those market risk benefits not currently valued at fair value;

- Significant changes to processes, systems and internal controls in order to collect and verify the accuracy of the data required for the enhanced disclosures including the numerous disaggregated rollforwards and qualitative and quantitative information in order to provide useful information.

We further recommend that the proposed amendments in the FASB ED related to the transition methods for the Liability for Future Policy Benefits be modified to allow insurance entities to apply the prospective transition method without having to demonstrate that the full retrospective transition application is impracticable.

- *Cost and complexities*
  We have significant concerns about the costs associated with implementation of the proposed amendments, including the impact on people, process and systems as well as the resulting complexity introduced. In addition to the potential significant and costly impacts on systems and processes, the proposed amendments would have significant impacts on performance reporting, and could impact product design and capital management. In order to manage through the significant change that will be required of an implementation of the proposed amendments, companies will have to consider additional hiring, outsourcing to third parties, internal training costs, and redeploying existing resources within the organization. It is likely there will not be sufficient actuarial and accounting resources to accommodate the demand by companies.

We believe that any changes made to existing U.S. GAAP should result in an improvement to the reliability and understandability of financial statements. The stated objectives of the targeted improvements to the accounting for long-duration insurance contracts are to improve the timeliness of recognizing changes in the liability for future policy benefits by requiring that updated assumptions be used to measure the liability for future policy benefits (that is, that assumptions be “unlocked”) and modify the rate used to discount future cash flows, to simplify and improve the accounting for certain options or guarantees embedded in variable contracts, to simplify the amortization of deferred acquisition costs, and to improve the effectiveness of the required disclosures. While we are supportive of some of the proposed amendments in the FASB ED, there are others that we do not support.

We have provided answers to selected questions in the FASB ED that are related to our key areas of concern and the recommendations discussed herein. We appreciate the opportunity to express our views on issues related to the FASB ED. If you have any questions regarding our comments please contact me at (484) 583-1798.

Sincerely,

Christine A. Janofsky
Senior Vice President and Chief Accounting Officer

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?

Response: Our response to this question is mixed.

The proposed amendments will combine the guidance for Limited-Payment Contracts and Traditional Long-Duration Contracts. We agree that this combination is appropriate.

The proposed amendments included in the Claim Costs and Liabilities for Future Policy Benefits Section add wording in paragraph 944-40-25-9 requiring that when a claim occurs, any amounts reclassified from the Liability for Future Policy Benefits to the Liability for Unpaid Claims and Claim Adjustment Expenses, the Liability for Unpaid Claims and Claim Adjustment Expenses is to be discounted at the interest accretion rate previously used for the Liability for Future Policy Benefits with the corresponding amount recognized in accumulative other comprehensive income (AOCI) as a result of updating the discount rate assumption being carried over. Therefore this type of transaction falls within the scope of the proposed amendments. We believe this proposed amendment would essentially require a seriatim calculation for each individual claim as claims incurred in any one accounting period would likely relate to contracts which were written at different times and therefore have different from inception discount rates and different rate changes reflected in AOCI. These seriatim based calculations will be voluminous and difficult to manage. We therefore recommend that the transfer instead be accounted for as a derecognition of the amounts reflected in the Liability for Future Policy Benefits and related AOCI. A current rate at the time of the reclassification should then be used as the discount rate for the establishment of the Liability for Unpaid Claims and Claim Adjustment Expenses.

The proposed amendments will also scope in changes to Universal Life-Type contracts including changes for Universal Life–Type contracts with Death or Other Insurance Benefits and Contracts with Annuitization Benefits. The proposed amendments will also scope in added guidance on Market Risk Benefits. As discussed further in our responses to questions 13 and 14 below, we do not agree with the scope of the proposed amendments related to Market Risk Benefits. Further, we do not agree with the proposed changes covering both Universal Life-Type Contracts and Nontraditional Contract Benefits and Reinsurance Contracts which would require an insurance entity to first determine whether a contract feature that provides for potential benefits in addition to the account balance should be accounted for as a Market Risk Benefit before then determining whether such contract features should be accounted for under the provisions of Subtopic 815-10 or 815-15. Please see our responses to Questions 13 and 14 for a further discussion of our recommendations as to the scope of targeted changes for these types of contract features.

For the Additional Liability for Death or Other Insurance Benefits, the wording in paragraph 944-40-35-9 in the proposed amendments has been modified to require that "An insurance entity shall regularly evaluate estimates used and establish or adjust the additional liability balance ... ." Similarly, for the additional liability for annuitization benefits, the wording in paragraph 944-40-35-12 in the proposed amendments has been modified to require that "The insurance entity shall regularly evaluate estimates used and establish or adjust the additional liability balance ... ." Paragraph 944-40-50-6e in the proposed amendments further requires disclosures for annual and interim periods: "For contracts described in paragraphs 944-40-25-26 [i.e. death or other insurance benefits] through 25-27A [i.e., annuitization benefits] for which an entity did not recognize a liability because no future losses are expected, qualitative and quantitative information (that is, the range, weighted average, and actual experience) about significant inputs, judgements, and assumptions used to conclude that no losses are expected." This new requirement to continually assess whether future losses are expected and if so, to establish a liability, along with the related disclosures will be costly for insurance entities to implement. This is due not only to the additional recordkeeping which will be required in order to maintain the historical data necessary to implement the establishment of the additional liability on a retrospective basis, but also due to the incremental ongoing cost of having this data audited for footnote disclosure purposes.

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 agree that the effect of updating cash flow assumptions for traditional and limited-payment long duration contracts should be calculated and recognized on a retrospective basis in net income. Although retrospectively adjusting the net premium ratio for changes in cash flow assumptions will result in more volatility in the measurement of the Liability for Future Policy Benefits for traditional and limited-payment contracts than today's model, we agree that this methodology will give financial statement users a more current view of expected cash flows and result in a more faithful representation of an insurance entity's obligations.

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: While we agree in concept that cash flow assumptions should be updated, we do not 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." We believe that the proposed wording could be interpreted to suggest that it would be mandatory to update cash flow assumptions each year. Rather than requiring mandatory annual assumption updates, we recommend that the proposed amendment follow the existing U.S. GAAP for universal life-type contracts whereby management exercises quarterly judgment in determining whether there are significant, sustainable trends requiring an unlocking and resetting of assumptions before required annual unlocks. Applying this approach to

traditional life insurance products would report changes in assumptions that are materially off trend and sustained in current earnings but not reflect in the financial statements changes in assumptions such as mortality or lapses with no apparent pattern. We therefore suggest that the wording be modified to read as follows: "cash flow assumptions should be evaluated for adjustment at least 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."

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: Our response to this question has two parts: first, we prefer the current method to establish the discount rate assumption – estimated pre-tax investment yields, adjusted for adverse deviation – as it best reflects the buy-and-hold business model employed by life insurers in these business lines. Second, to the extent FASB pursues development of a discount rate informed by market observable inputs, we suggest deriving the discount rate assumption based on a curve comprised of A rated bonds rather than Aa. Our analysis shows the A curve better reproduces insurer new business pricing, which we think is the most objective measure of investor valuation of liabilities with the long-dated fixed-rate characteristics. The market for A rated bonds is also deeper and consequently less likely to exhibit idiosyncratic volatility than Aa bonds, providing a more stable and economic measure of GAAP equity.

First, as noted above we do not agree that a high-quality fixed-income instrument yield that maximizes the use of current market observable inputs should be used to discount expected future cash flows. The discount rate under current U.S. GAAP is based on the estimated pre-tax investment yields (net of related investment expenses) expected at the contract issue date, adjusted for adverse deviation. By referring to expected investment yields to derive a discount rate at inception, U.S. GAAP reflects the integrated management of long-term asset and liability cash flows at the core of the life insurance business model and minimizes material accounting mismatches.

Second, while theoretically we are not opposed to a discount rate based on a high-quality fixed-income instrument yield that attempts to reflect the characteristics of the liability, the interpretation of Aa as high-quality is not reflective of the economics of the underlying insurance contracts and is not consistent our asset-liability business model. Use of such a rate would result in volatility that is inconsistent with the long-term nature of these contracts. Furthermore, we do not believe the re-measurement of changes in the discount rate through other comprehensive income mitigates the volatility in the measurement of the Liability for Future Policy Benefits that is introduced by using a market-based rate.

Our concern about Aa as the measure arises from paragraph BC 51 of the FASB ED which notes that "The Board also observed that pension obligations are discounted at a high-quality rate under current U.S. GAAP." We understand that the Securities and Exchange Commission has suggested that fixed-income investments rated Aa or better are considered to meet the high-quality rate requirement. Following the most recent financial crisis, the market for bonds with a

rating of Aa or above has contracted and is currently very thinly traded. This may be problematic for insurance entities as they implement the proposed amendments to the discount rate guidance going forward and is a potential flaw associated with the use of such a rate.

Moreover, we think the selection of Aa bond yields lacks an objective basis in the insurance marketplace for long-dated fixed-rate liabilities. It is our view that the most objective basis to measure the current value of liabilities are yields observable in insurer new business pricing. Yields on new business represent the yield at which a marginal shareholder is willing to commit capital to support issuance of liabilities with long-dated fixed rate characteristics. Application of this yield signals to investors the value of their liability portfolio with similar characteristics valued in current conditions – which we believe is a central objective of the FASB proposed modifications.

We think the ideal framework would apply observed new business liability yields directly in order to produce the most accurate measure of investor value. However, we recognize the lack of reliable published measures of liability yields at present and the consequent desire for FASB to use rated bond yields as a proxy.[2] Our analysis of new business yields in competitive markets for long-dated fixed rate liabilities, the results of which are shown in the figure below, supports the use of yields for bonds rated A instead of Aa.[3] The analysis reflects pricing of 20-year period certain annuities, a liability type with long-dated fixed-rate characteristics (and which simplifies this analysis given the yields do not reflect insurer judgments on actuarial characteristics such as mortality rates). The analysis compares the duration-matched spread-over-US Treasuries of new business liability pricing with corporate bond spreads of equivalent duration at different rating levels (Aa, A, Bbb).

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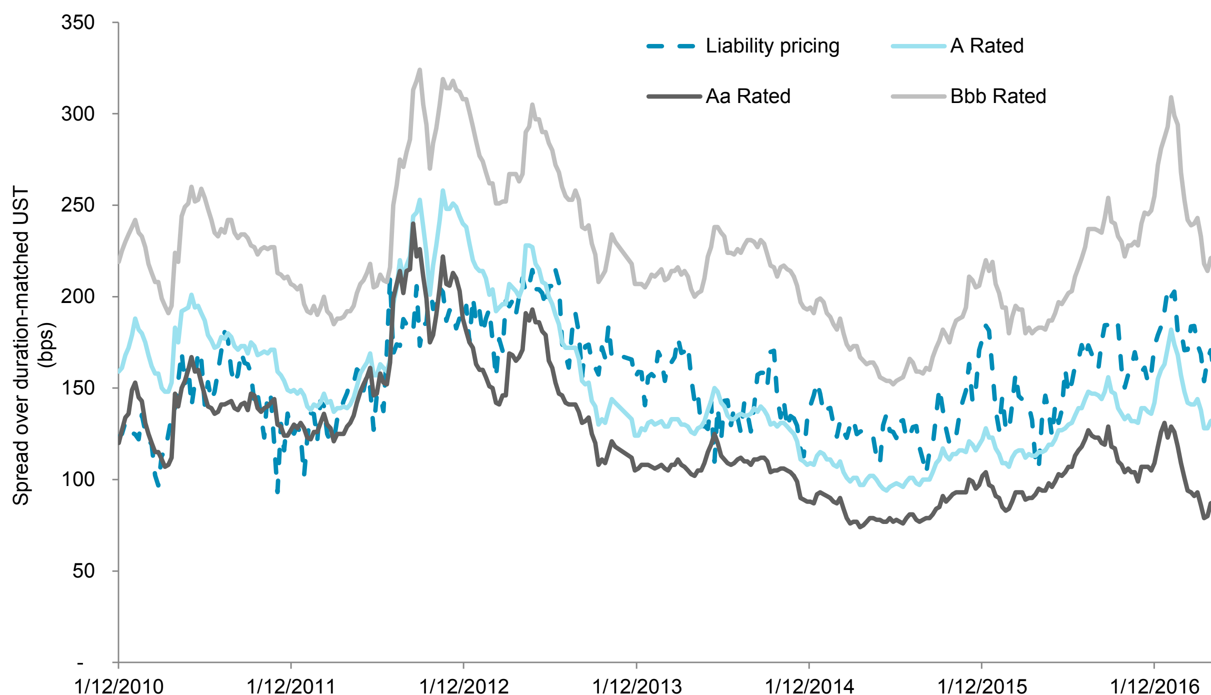
[2] LNC contends a reliable index of liability yields could be constructed with relative ease should FASB wish to pursue development of such a construct.

[3] Liability yields were obtained by determining the spread over US Treasuries required to equal the net premium for the top three price quotes from providers of period certain annuities with a 20-year term. The net premium reflects the gross premium less 4% of premium for policy acquisition expenses and 1% for policy maintenance expenses. Source of price quotes is CANNEX. Corporate bond spreads are obtained from Bank of America Merrill Lynch Global Index system and reflect maturities of 7-10 years, consistent with the duration of a 20-year term certain annuity.



The comparison supports several important observations:

- *Liability spread is closer to A rated bonds than Aa rated bonds almost all of the time*: True in 72% of observations since 2010 and 94% since 2012
- *Majority of instances when Aa corporate bond spreads exceed liability spreads is in 2011*: Period when Aa and A bond spreads converged well within historical norms (and reflect a lack of depth in the Aa bond market)
- *Liability spread sits between the A and Bbb rated spreads more often than between A and Aa*: Indicates selection of a curve based on A ratings includes a degree of prudence in reserves consistent with a view of adverse deviation in expectations
- *Strong majority of observed liability spreads exceed the Aa spread:* Liability spread exceeds Aa corporate bond spread in 83% of data points since 2010 and 98% since 2012

Beyond their descriptive power, the last set of statistics carries important implications for insurer new business profitability. An excess of the liability spread beyond the discount rate would result in a *de facto* U.S. GAAP 'loss at issue' – and use of Aa would implies insurers destroyed shareholder value in these markets during the strong majority of the past six years.

We encourage the FASB to undertake further analysis of new business pricing as our analysis indicates the A rated basis for the discount rate holds across all long-dated fixed-rate liabilities.

For these reasons we propose use of 'A rated' investment yields as a prudent basis for the discount rate should the FASB decide to modify existing U.S. GAAP and wish to designate a single index of market observable spreads as the basis for the discount rate for long-dated fixed-rate liabilities.

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: We agree that, when deemed necessary (see our response to Question 6), recognizing the effect of updating discount rate assumptions immediately in other comprehensive income is preferable to recognizing the effect of updating discount rate assumptions immediately in net income.

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: No, we do not agree that discount rate assumptions should be updated at each reporting date. Requiring the discount rate assumptions to be updated at each reporting date introduces unnecessary volatility in the measurement of the Liability for Future Policy Benefits. We believe that discount rate assumptions should only be updated if rates have materially moved off pricing or previously updated discount rate assumptions and appear persistent at those new levels.

Liability for Future Policy Benefits – Participating Contracts

Questions 7 through 12 – Although LNC does have blocks of participating contracts, such contracts are not material to our financial statements and therefore we have not responded to these questions. However, we encourage the FASB to take into consideration the responses provided by insurance entities for whom such contracts are material.

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 do not agree with the scope of the proposed amendments on the accounting for market risk benefits as we believe the FASB's scope is too broad and goes beyond the FASB's objective of reducing diversity in practice related to GMXBs. We believe an appropriate accounting principle is to maintain consistent accounting for life-contingent benefits and non-life-contingent benefits, which would not be accomplished through the proposal in the FASB ED, but may be achieve by clarifying the interpretation of FASB ASC paragraph 815-15-55-61.

GMXBs provide for different types of guaranteed benefit features including those that are fully life-contingent, those that are fully non-life contingent, and those with elements of both life- and non-life contingent features. The features are typically associated with variable annuity products, however GMDBs are also offered on certain variable life contracts as well. The

discussion that follows is generally applicable to the features associated with our variable annuity guarantees based on the existing accounting, but there will also be impacts on our variable life contracts that offer guaranteed death benefits.

A discussion of common examples of each of these types of guaranteed benefit features is as follows.

Guaranteed Minimum Death Benefit (GMDB) – A GMDB is a feature in an annuity, life insurance, or similar contract that:

- For annuities, provides that, in the event of an insured's death, the beneficiary (or insurer in the case of a reinsurance contract) will receive the higher of the current account balance of the contract or another amount defined in the contract.
- For life contracts, provides for the payment of a death benefit in the event that the account balance is zero, contingent on the payment of certain required premiums.

The difference between the guaranteed amount defined in the contract and the account balance is referred to as the net amount at risk.

The guaranteed benefit payment is a single payment, the timing of which is driven entirely by mortality. The benefit amount specified by the guarantee is only paid if the insured event (death) occurs while the insurance contract / rider is in force. Therefore the payment of the benefit is fully life contingent and the benefit cannot be net settled. The total amount to be paid out under the benefit feature, as well as the insurance entity's net amount at risk is known with certainty once the insured event has occurred.

The reserves for GMDBs are established using the benefit ratio reserve methodology described in ASC paragraph 944-40-30-20 (originally promulgated via AICPA Statement of Position 03-1 (SOP 03-1)). We are not aware of any diversity in practice in applying the required benefit ratio reserving process.

Guaranteed Minimum Withdrawal Benefit (GMWB) – A GMWB is a benefit that provides a contract holder a guarantee that a minimum amount (usually stated as a percentage of premiums) will be available for withdrawal over a specific period. Regardless of the contract account balance, the contract holder is guaranteed the right to periodic withdrawals from the contract until the amount of premiums deposited into the contract is withdrawn.

The guaranteed benefit payments are periodic in nature and are not driven by mortality. The benefit amount specified by the guarantee is paid out regardless of whether the covered life lives or dies. Therefore the benefit is fully non-life contingent and the benefit is net settled via the periodic withdrawal payments. The total amount to be paid out under the benefit feature is known with certainty; however, the insurance entity's net amount at risk will fluctuate depending on the account balance of the underlying variable annuity.

The reserves for GMWBs are established using the fair value guidance. We are not aware of any diversity in practice in applying the required fair value reserving methodology.

<u>Guaranteed Lifetime Withdrawal Benefit (GLWB)</u> – A GLWB is a contract feature or rider on a variable annuity contract that allows minimum withdrawals from the invested amount without having to annuitize the investment. The amount that can be withdrawn is based on a percentage of the total amount invested in the annuity.

The guaranteed benefit payments are periodic in nature and are impacted by mortality. The benefit amount specified by the guarantee is paid out only as long as the covered life is living. The benefit is net settled via the periodic withdrawal payments. The total amount to be paid out under the benefit feature is not known with certainty (the amount of the periodic payments are defined by the benefit feature, however the total number of payments to be made is not known due to the life-contingent aspect of the feature). Issuers of these types of benefits often conclude that these benefits include elements of both life- and non-life- contingent features.

ASC paragraphs 815-15-55-57 through 55-61 (originally DIG B25) discuss the application of the guidance to various payment alternatives for variable annuity contracts. ASC paragraph 815-15-55-61 includes an example of a variable-payout annuity contract that includes a period-certain benefit plus a life-contingent variable payout. The guidance indicates that "For a period-certain-plus-life-contingent variable-payout annuity contract, the embedded derivative related only to the period-certain guaranteed minimum periodic payments would be required to be separated under paragraph 815-15-25-1, whereas the embedded derivative related to the life-contingent guaranteed minimum periodic payments would not be separated under that paragraph."

Diversity in practice has arisen as to the proper application of this guidance as it relates to the bifurcation of the cash flows between the period-certain cash flows included in the fair value reserve calculation and the life-contingent cash flows included in the benefit ratio reserve calculation. It should be noted that the guidance provided in ASC paragraphs 815-15-55-57 through 55-61 (DIG B25) was well grounded in the scope guidance for derivatives found in ASC paragraphs 815-10-15-83 through 15-123 and the recognition guidance for embedded derivatives found in ASC paragraphs 815-15-25-1 through 25-3.

Acknowledging that GMXBs include benefit features that are fully life-contingent (e.g., GMDB), benefit features that are fully non-life-contingent (e.g., GMWB), and benefit features with elements of both life- and non-life contingent features (e.g. GLWB), we believe that the FASB should not group all GMXBs together for the sake of consistency and require the related reserves to be valued at fair value. Such treatment would account for GMXB's with life-contingent benefit features differently than other long duration contracts with life-contingent benefit features. We believe it is more appropriate for contracts with life contingent features to be accounted for similarly, which would be consistent with established U.S. GAAP, including the derivative guidance noted above. It should be noted that the basis for conclusions for SOP 03-1 clearly indicates in paragraph A-35 that the AcSEC believed the additional liability required by the SOP (the benefit ratio reserve) is in substance a FAS 60 policyholder benefit liability, but with the unlocking of assumptions each period as required under FAS 97 to recognize the variability of the insurance benefit payments and contract assessments. Thus the reserving guidance specified in ASC Topic 944 is already consistent with the periodic unlocking of assumptions required for universal life-type contracts and with the FASB ED proposed amendment to require insurance entities to annually update all assumptions used in calculating

the liability for future policy benefits for traditional long-duration contracts, limited payment contracts, and participating life insurance contracts.

It is our view that the existing guidance for benefit features that are fully life-contingent such as GMDBs and for benefit features that are fully non-life-contingent such as GMWBs is consistently applied by preparers and well understood by users and that the diversity in practice is primarily attributed to the application of the guidance in ASC paragraph 815-15-55-61 to benefit features with elements of both life- and non-life contingent features (i.e. GLWBs).

In accounting for GLWBs, LNC follows a hybrid accounting policy that considers the fact that certain features of these guarantees have elements of both insurance benefits (accounted for as benefit ratio reserves) and embedded derivatives (accounted for at fair value). We calculate the value of the embedded derivative reserve and the benefit ratio reserve based on the specific characteristics of each GLWB feature, utilizing a bifurcation variable to determine the boundary of the embedded derivative reserve and the benefit ratio reserve. This accounting policy is consistent with the accounting principal outlined above, where benefit features that are life-contingent are accounted for similarly (as insurance) and benefit features that are non-life-contingent are accounted for similarly (at fair value). We believe the FASB should clarify existing U.S. GAAP to indicate that life contingent benefits should be accounted for under ASC 944 as insurance contracts and non-life contingent benefits should be accounted for at fair value under ASC 815.

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: Our response has several parts to reflect the nuances of the application of fair value to market risk benefits.

- First, we do not believe that all market risk benefits should be measured at fair value. However, for those benefits measured at fair value under existing U.S. GAAP, we agree the changes in fair value attributable to a change in the instrument-specific credit risk should be recognized in other comprehensive income.
- Second, we believe portions of the fair value standard require revision to ensure consistency with other proposed valuation standards – specifically by adopting the discount rate for long-dated fixed-rate liabilities for cash flows within market risk benefits with long-dated fixed-rate characteristics. Failure to ensure consistency will lead to unacceptable accounting distortions as the U.S. VA industry matures and VA policies shift standards from market risk benefits to long-dated fixed-rate liabilities.
- Third, we believe assumptions for long-dated equity market volatility should be based on historical volatility plus a margin for prudence – as the market simply is too thin to support either reliable estimates of fair valuation or prudent risk management via hedging.

The above bullet points are discussed further as follows:

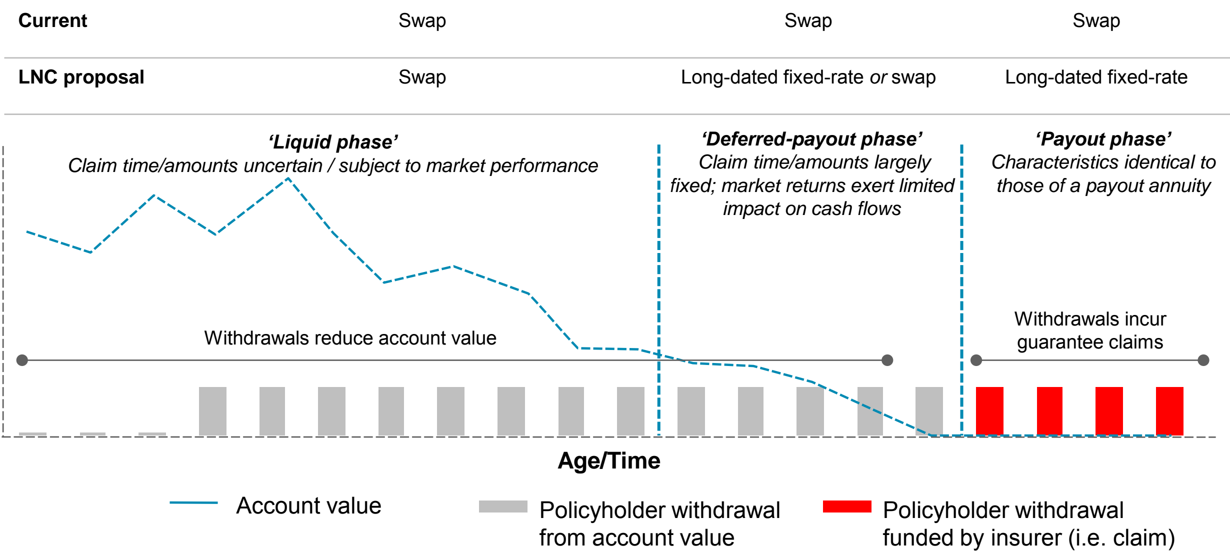
Part 1. Not all market risk benefits should be measured at fair value

As discussed in our response to Question 13, we support an accounting principle that values life-contingent benefits as insurance and non-life contingent benefits at fair value. To appropriately value life-contingent benefits on a market consistent basis (i.e. at fair value) is challenging as there is not a very deep market and valuations become more difficult at the longer durations; furthermore, the liability becomes very sensitive to small changes in market assumptions. Life-contingent benefits cannot be settled other than through death (for GMDBs) or by continuing to live (for GLWBs), and therefore to account for all GMXBs at fair value would ignore the differences between life-contingent and non-life contingent benefits. Since there is no real market to trade GMXB's, there is likely significant divergence in practice around how companies would calculate fair value (due to things like liquidity premiums, margins, long dated volatility assumptions, etc.). We acknowledge that diversity in practice exists today in accounting for these features, but believe that there is unlikely to be true consistency among companies even with a move to fair value for all GMXB's for the reasons noted.

We believe the FASB should clarify existing U.S. GAAP to indicate that life contingent benefits should be accounted for as insurance contracts and non-life contingent benefits should be accounted for at fair value. However, we further note the following regarding fair valuations of non-life contingent benefits.

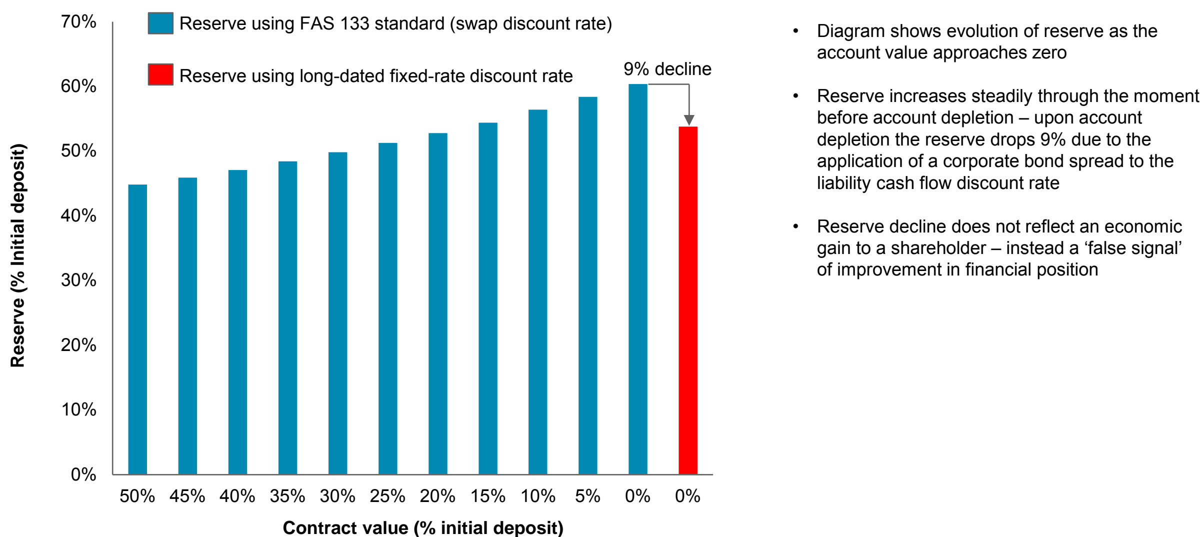
Part 2. Market risk benefit standard must be harmonized with long-dated fixed-rate liabilities

Under existing U.S. GAAP, the discount rate used in fair value calculations is the risk-free rate and the discount rate used to calculate additional liabilities under the benefit ratio approach in ASC 944-605-25-8 (which would be amended and moved to 944-40-25-27A) is the contract rate. The guidance proposed in the second sentence of paragraph 944-40-35-8B in the FASB ED reads: "For annuitization or withdrawal benefits, on the date of annuitization or extinguishment of the account balance, the balance related to the market risk benefit will be zero and the amount deducted will be used in the calculation of the liability for the payout annuity." This results in an inconsistency with the discount rate for long-dated fixed rate liabilities. The figure below shows the phases of a GMWB contract, and specifically how the liability characteristics approach and eventually become identical to a long-dated fixed-rate liability as the contract nears exhaustion of the account value. As noted in the figure, LNC proposes use of the same long-dated fixed-rate discount rate during the 'payout phase' and potentially during the 'deferred-payout phase' shortly before exhaustion when the GMWB claim cash flows achieve a high degree of certainty (i.e. are largely fixed).



The failure to harmonize the discount rates will lead to results counter to FASB objectives as the VA industry matures and contracts enter the 'payout phase'. For example, the moment before a GLWB contract converts into a payout annuity, the U.S. GAAP reserve will be substantially larger than the U.S. GAAP reserve for the payout annuity simply because of the difference in discount rates used under the two valuations. Insurers with GMWB contracts exhausting their account value and converting to a payout annuity will therefore report a U.S. GAAP profit from the reserve release. LNC analysis shows the reserve release will be significant – approximately 9% of the pre-depletion GMWB reserve per 100bps of spread in the long-dated fixed-rate liability discount rate. This phenomenon is illustrated in the figure below, which shows the U.S. GAAP reserve profile in the period leading up to and immediately after exhaustion of the account value.[4]

[4] For simplicity, this example assumes the U.S. GAAP reserve consists of all living benefit cash flows (full rider charges and claims)



The effect of the non-economic reserve release will be significant; Oliver Wyman estimates US life insurers carry over $800 billion of contracts with either a GMWB or GMIB rider.[5] To avert such a substantial accounting distortion we believe the discount rate for GMWB and GMIB claim cash flows should be consistent with the discount rate for long-dated fixed rate liabilities.

Part 3. Equity implied volatility should not use market implied as a basis for longer tenors

Existing fair value guidance requires the use of current assumptions that a market participant would use to value the asset or liability. Among other inputs, we use observable capital market information including risk free rates derived from the swap curve and implied equity index volatility. The implied volatility assumption becomes significant as more benefits are measured at fair value and would result in significant cost as companies attempt to hedge the additional volatility. Based on the volume of market risk benefits in the industry and the related volatility, the capital markets today do not supply adequate volatility-sensitive instruments in the marketplace to hedge the risk of changes in long-term implied volatility ('Vega') over time.

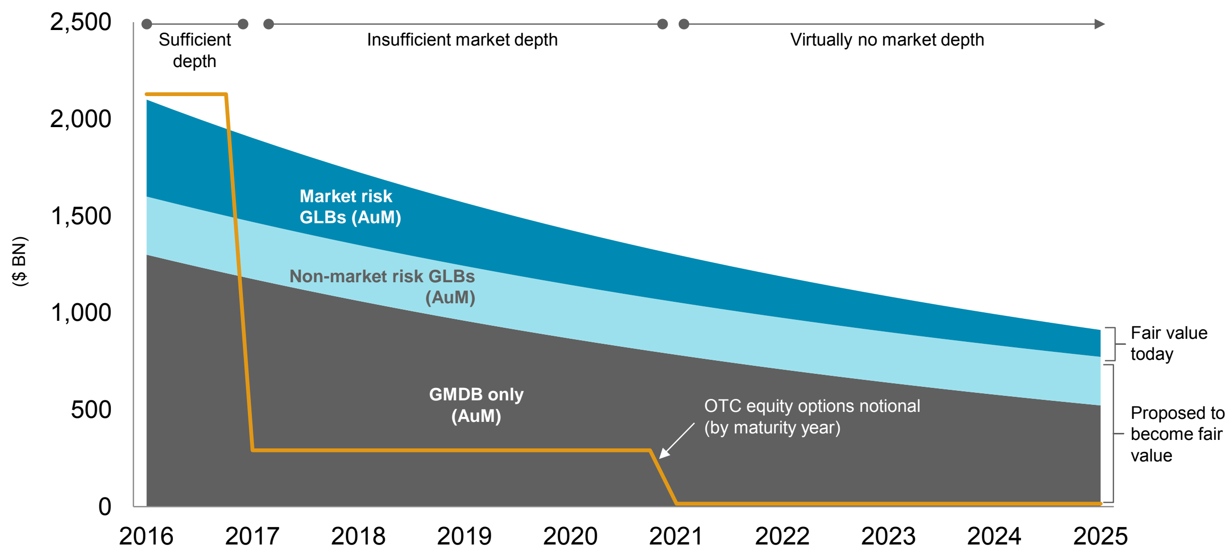
The exhibit below illustrates the mismatch between variable annuity industry exposure and market depth for volatility-sensitive instruments. The exhibit compares the projected variable annuity Assets Under Management (AuM) – a proxy of the VA industry exposure to equity volatility – by the current accounting designation against the volume of Over the Counter (OTC) options by year of maturity.[6] Two principal observations about the depth of equity-linked option markets are supported by the exhibit:

- Market depth is sufficient to value and/or risk manage all VA equity volatility exposure within a year after the valuation date

[5] "A question of legacy: Measuring and managing policyholder behavior risk in variable annuities", December 2016

[6] Option maturity by year is estimated by dividing the total outstanding notional volume by the length of periods provided by the BIS. For maturities beyond 5 years we assumed a 10-year period of option maturities.

- Market depth *arguably* is sufficient to value and/or risk manage the portion of VA equity volatility exposure under the market risk benefit standard today – estimated by Oliver Wyman to be 15-20% of VA AuM – up to five years after the valuation date
- Market depth is insufficient to value or risk manage any material segment of VA equity exposure beyond five years
- The expansion of scope of the market risk benefit standard to all VA guarantees would overwhelm market depth in all but the first year after the valuation date



Source: Bank of International Settlements "Options Sold Gross Basis" (1H2016 OTC Derivatives by Maturity), Oliver Wyman

Should the FASB wish to expand the market risk benefits measured at fair value to life-contingent guarantees, an alternative source for equity volatility valuation parameters would be an historical view of volatility. This would result in less volatility of the liability and would enable a stable valuation in light of limited option market depth. A margin to the historical volatility could be added to represent a fair value risk premium. A method common in the variable annuity industry used in internal economic valuations is to apply a margin to historical consistent with the long-run difference between realized and implied equity return volatility at short tenors.

* * *

Given the facts and circumstances discussed above LNC recommends that the Board retain existing U.S. GAAP based on the accounting principal of maintaining consistent accounting for life-contingent benefits and non-life-contingent benefits. We suggest that companies could provide additional disclosure, such as fair value disclosures, for those life contingent benefit features that are not reported at fair value. This would enable users of financial statements to compare applicable companies' results across the industry, where differences in accounting

interpretation exist. At a minimum, we believe that GMDBs should be scoped out of the proposed amendments.

In addition, we make the following comments on the market risk benefits sections of the FASB ED:

- The guidance proposed in the first sentence of paragraph 944-40-35-8B reads: "Upon derecognition of a market risk benefit, an insurance entity shall derecognize any related amount included in accumulated other comprehensive income and shall include in net income any gain or loss that is realized as a result of changes in the instrument-specific credit risk." We are concerned that this sentence will effectively require insurance entities to track amounts included in AOCI at a seriatim level (that is, by individual contract) rather than at a cohort level. This will require significant modifications to administrative systems in order to track and record the amounts related to individual contracts. We are further concerned that including any such gain or loss immediately in net income will create non-economic volatility in net income.

- The guidance proposed in the second sentence of paragraph 944-40-35-8B reads: "For annuitization or withdrawal benefits, on the date of annuitization or extinguishment of the account balance, the balance related to the market risk benefit will be zero and the amount deducted will be used in the calculation of the liability for the payout annuity." We suggest that this wording be modified to read "For annuitization benefits, on the date of annuitization, and for withdrawal benefits, on extinguishment of the account balance, the balance related to the market risk benefit will be zero and the amount deducted will be used in the calculation of the liability for the payout annuity." The design of many GLWB products allows for the contract owner to initiate withdrawals without actually annuitizing the contract. The design may allow a contract owner to stop taking withdrawals for a period of time and then begin taking withdrawals again at a later time. We believe that the suggested wording change will be more straightforward to apply to GLWB products. We further note that the requirement to adjust the market risk benefit reserve to zero and use the amount deducted to calculate a liability for the payout annuity will result in the ongoing obligation no longer meeting the definition of a market risk benefit. Once the account value has been extinguished, the guarantee essentially becomes a fully life contingent obligation, a liability that is no longer impacted by capital market risk, and warrants use of a discount rate consistent with the characteristics of this liability.

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: No, we do not believe the scope of the proposed amendments should be expanded to include investment contract acquisition costs currently amortized using the interest method in Subtopic 310-20, Receivables—Nonrefundable Fees and Other Costs.

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: Although the proposed amendments could simplify the amortization of deferred acquisition costs, we do not agree with the FASB's proposal. We support amortizing deferred acquisition costs in proportion to a measure of profitability, e.g. Estimated Gross Profits (EGPs), and are concerned that the FASB's proposed amendment is in contradiction with this view. Under the existing DAC amortization method amortization is based on revenues for traditional products and EGPs for non-traditional products.

We believe the following benefits exist under existing U.S. GAAP:

- Amortization of DAC in proportion to a measure of profitability is reasonable and consistent with the emergence of product earnings.
- Existing amortization is accepted by users and is theoretically sound in that it ensures future earnings reported in U.S. GAAP income statements are consistent with long-term expected margins.
- Existing method has accommodated changing product features and weathered the financial crisis when assets and liability valuations were undergoing significant changes.

We would encourage the FASB to reconsider this proposed amendment and explore disclosure alternatives that would enhance the transparency regarding the existing accounting methods, rather than change the accounting.

As we understand it, one of the factors the Board considered in making the decision to move away from an amortization methodology for deferred acquisition costs which is linked to the emergence of earnings to one which is based on insurance in force, is that the acquisition cost does not represent a cash flow with the policyholder. While this is true, the pricing of insurance products is such that it takes into consideration the earnings that are necessary to recover the acquisition costs. Products are typically priced to be profitable and to provide a minimum return to the company after taking into consideration the costs to acquire and maintain the policy. It is common for life insurance policies and annuity contracts to include a provision for a surrender charge (also referred to as a contingent deferred sales charge) or an initiation fee, or both. These

pricing features help ensure that in the event the policy or contract is terminated before sufficient earnings emerge to recover the acquisition costs, the company will be adequately compensated via the surrender charge or initiation fee.

We also understand that the Board's decision on the amortization methodology of deferred acquisition costs will also be applicable for the amortization of other intangibles such as deferred sales inducements (DSI), and deferred initiation fees (sometimes referred to as deferred front-end loads (DFEL)). Under current guidance, the amortization methodology for these intangibles follows the deferred acquisition cost amortization methodology. We view the delinking of the amortization of these intangibles from the emergence of earnings from the underlying products as being problematic.

Unlike acquisition costs, the cash flows associated with DSI and DFEL are between the insurance company and the policyholder and we believe that the thinking of the AcSEC and FASB during their deliberations of these items prior to the issuance of SOP 03-1 and FAS 97, respectively, (included for reference in Appendix A) continues to be relevant and sound.

Lastly, in a business combination involving the acquisition of a life insurance company, the Value Of Business Acquired (VOBA) represents the difference between (1) the fair value of the contractual insurance and reinsurance assets acquired and liabilities assumed and (2) the value of the assets and liabilities measured in accordance with the acquirer's accounting policies for insurance and reinsurance contracts that it issues or holds. As such, VOBA is often thought of as the present value of future profits, representing the present value of estimated cash flows embedded in the existing contracts acquired. Many companies analogize to the current EGP based DAC amortization guidance as a reasonable amortization methodology. Given that this intangible represents the present value of future profits embedded in the existing contracts, we believe that guidance should continue to allow an amortization pattern based on the emergence of earnings from those contracts.

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: As indicated in our response to Question 16, we support retaining the existing U.S. GAAP guidance which calls for amortizing deferred acquisition costs in proportion to a measure of profitability.

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 do not agree with the presentation and disclosure requirements included in the proposed amendments. We have the following specific concerns and recommendations:

- We have an overarching concern with disclosure overload, both from the perspective of the preparers of financial statements and from the perspective of the users of financial statements. Providing numerous disaggregated rollforwards on an interim and annual basis along with voluminous qualitative and quantitative information, ranges and weighted-averages may in concept appear to provide meaningful information, however we question whether providing such information will provide decision useful information for audiences other than the most sophisticated analysts and financial statement users.

- We are concerned about the additional cost to audit information required by the enhanced disclosures (i.e., disaggregated rollforwards of the liability for future policy benefits, liability for policyholders' account values, DAC, and separate accounts) that may already be included in other sections of annual and quarterly reports filed by public companies with the SEC that would be required in the footnotes as a result of the proposed disclosure guidance. The additional cost of moving this information to the footnotes would not be justified, as users of financial statements already have access to this information for public companies.

- As stated in our response to Question 1 above, we do not agree with the requirement to regularly assess contracts with death or other insurance benefits and annuitization benefits for which an additional liability had not been established at contract issuance because future losses were not expected. Further, we believe the requirement in paragraph 944-40-50-6e in the proposed amendments to disclose for annual and interim reporting periods which reads: "For contracts described in paragraphs 944-40-25-26 through 25-27A for which an entity did not recognize a liability because no future losses are expected, qualitative and quantitative information (that is, the range, weighted average, and actual experience) about significant inputs, judgements, and assumptions used to conclude that no losses are expected," will be costly for insurance entities to implement. This is due not only to the additional recordkeeping which will be required, but also due to the incremental ongoing cost of having this data audited for footnote disclosure purposes.

- For the liability for policyholders' account balances we are concerned that the required disaggregated disclosures of earned rates and credited rates would result in an insurance entity effectively disclosing proprietary product pricing information and strategies that would then be readily available to competing companies.

- For market risk benefits, for each disaggregated rollforward presented disclosures are to include the guaranteed benefit amounts in excess of the current account balance. The proposed amendments include that the net amount at risk for a variable annuity contract would be an example of the guaranteed benefit amount in excess of the current account balance. The term net amount at risk is defined as: "The guaranteed benefit in excess of the current account balance. For guarantees in the event of death, the net amount at risk is the minimum guaranteed amount available to the contract holder upon death in excess of the contract holder's account balance at the balance sheet date. For guarantees of amounts at annuitization, the net amount at risk is defined as the present value of the minimum

guaranteed annuity payments available to the contract holder determined in accordance with the terms of the contract in excess of the current account balance." The net amount at risk for a death benefit compares known amounts as of a specific period in time (the balance sheet date). The net amount at risk for an annuitization benefit considers the present value of the minimum guaranteed annuity payments. Both of these concepts are easily understood and relatively easy to apply. The guaranteed benefit amounts in excess of account value for certain types of guarantees which meet the definition of a market risk benefit is less obvious. For instance, a component of the fair value calculation for a GMWB or GLWB includes projections of both the future benefits and future fees which would include projections of long-term lapse rates, utilization of guaranteed withdrawals, a projection of inefficient withdrawal behavior (including taking less than or more than the maximum guaranteed withdrawal), mortality, and volatility. We are concerned that individual insurance entities will develop their own measure of the amount to be disclosed as the net amount at risk for these types of benefits, thus resulting in diversity in practice and the disclosure of potentially non-comparable information. We therefore recommend that the proposed amendments should not require the disclosure of the net amount at risk for guaranteed benefits measured at fair value.

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: As indicated in our response to Question 13 above, we suggest that companies could provide additional disclosure, such as fair value disclosures, for those life contingent benefit features that are not reported at fair value. Our recommendation would be for the FASB to amend ASC 825 to require that the fair value disclosures required in ASC 825-10-50-10 for financial assets and liabilities, be extended to include the GMXB life contingent benefit features that are not carried at fair value under existing U.S. GAAP. This would provide users of financial statements with fair value information for all GMXBs.

Effective Date and Transition

Question 20 – Implementations 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 amendments in the FASB ED requiring the annual updating of assumptions used in the measurement of the liability for traditional, limited-payment and participating contracts insurance contracts will be a significant change in practice for insurance entities. This will require significant changes to processes, systems and internal controls in order to collect and verify the accuracy of both the historical actual cash flows and the projected future cash flows used in the measurement of the liability for future policy benefits.

The proposed amendments in the FASB ED requiring market risk benefits to be valued at fair value and the related retrospective application thereof will also require significant changes to processes, systems and internal controls in order to collect and verify the accuracy of historical fair value measurement inputs for those market risk benefits not currently valued at fair value.

The proposed amendments in the FASB ED requiring enhanced disclosures including the numerous disaggregated rollforwards and qualitative and quantitative information will require time and effort to determine the appropriate level of aggregation or disaggregation in order to provide useful information.

Insurance entities will further require significant lead time to adopt the proposed amendments including time related to the following:

- Updating actuarial models;
- Upgrading systems to ensure that they can handle new requirements (e.g. to collect and store data, track and adjust discount rates);
- Completing modelling necessary to understand the new emergence of earnings resulting from the proposed amendments and how the earnings emergence will fluctuate with changing economic conditions;
- Evaluating and updating key performance indicators, rules of thumb and sensitivity guidance will need to be;
- Developing, testing and implementing processes and controls throughout the organization;

In order to manage through the significant change that will be required to implement the proposed amendments, companies will have to consider additional hiring, outsourcing to third parties, internal training costs, and redeploying existing resources within the organization. It is likely there will not be sufficient actuarial and accounting resources to accommodate the demand by companies.

Based on the factors above, we believe that the effective date for any proposed amendments, once finalized, should be no earlier than fiscal years and interim periods therein beginning after December 15 of the year four years after the proposed amendments are finalized. If the Accounting Standards Update containing the proposed amendments in the FASB ED were to be issued by end of 2017, this would suggest a January 1, 2022 effective date.

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: Our response to this question is mixed.

DAC

The proposed transition provisions requiring a prospective approach for updating DAC and similar balances are operable and will provide decision-useful information.

Liability for Future Policy Benefits

We find the transition provisions related to the liability for future policy benefits as being problematic. Under the existing accounting guidance, insurance entities are not required to collect and maintain information related historical actual cash flows and therefore it is likely that most insurance entities have not put in place and maintained systems and the related internal controls thereon to accurate collect such information. Therefore collecting and validating actual historical cash flow information will be both costly and time consuming. We therefore recommend that the proposed amendments in the FASB ED related to transition for the liability for future policy benefits be further amended to allow for the prospective transition methodology provided for in paragraph 944-40-65-2(d)(2) without having to demonstrate that the full retrospective transition application is impracticable.

Market Risk Benefits

For market risk benefits, the FASB has not provided any practical expedients and we have significant concerns with the retrospective application of the guidance on market risk benefits as proposed. Our concerns are in the areas of hedging and transition as further discussed below.

Hedging:

We utilize a dynamic hedging strategy designed to mitigate selected risk and income statement volatility of the GLWB's caused by changes in the equity markets, interest rates, and market-implied volatilities. To accomplish this, we utilize: options and total return swaps on U.S.-based equity indices, futures on U.S.-based and international equity indices, interest rate futures, interest rate swaps, and currency futures. Our hedge program also has a long-term goal of accumulating assets that could be used to pay claims under these benefits. We acknowledge that companies have adopted different hedging strategies and it is our view that most companies have tailored their hedging programs around company specific applications of the embedded derivative guidance in ASC Topic 815 cited above.

For GMDB's, although not 100% efficient, many companies use a delta hedging strategy that helps mitigate much of the economic risk and income statement volatility.

Should the FASB continue to move forward with the proposed amendments on accounting for all market risk benefits at fair value, there is a practical issue associated with the individual company hedging practices. One of our primary concerns of moving from our existing accounting policy to a full fair value accounting policy is the impact such a change could have on our financial statements based purely on the market conditions that exist at the date of adoption and beyond. While the transition adjustment related to re-measuring the liability would likely be recorded to retained earnings, the company would now be forced to decide whether to modify the hedge program to hedge the incremental U.S. GAAP income statement volatility (related to life contingent insurance benefits) in addition to the existing economic hedge strategy (which hedges

non-life contingent benefits). This would add costs and potential marketplace capacity issues for derivatives required to hedge. Such dynamics would be detrimental to both shareholders and customers.

From a practical perspective, if a company chooses to hedge all or a portion of the additional U.S. GAAP volatility that will result from the proposed amendments, the company would have the following options:

> Option A: Purchase derivatives as of the date of adoption to align with the new accounting guidance. Under this option, it is likely that the market would not be able to handle the demand for derivatives by the industry and/or would drive up the cost of derivative assets, resulting in a significant increased cost for companies.
>
> Option B: A company could proactively build up their hedge portfolio in anticipation of the accounting change. However, this would cause U.S. GAAP volatility in the periods leading up to the accounting change, which could have negative consequences on the investor's understanding of the financial results.
>
> Option C: Similar to Option B, a company could decide to build up their hedge portfolio in periods subsequent to the adoption of the new accounting guidance. This would cause a period of volatility in the financial statements until companies can build up their hedge portfolio to align with revised hedge strategies.
>
> Option D: Companies who may not choose to hedge certain benefits today (i.e. GMDBs) could choose to implement hedge programs based on the U.S. GAAP volatility that will arise from fair value accounting and this would result in increased cost to companies.

Each Option presents challenges to companies at the time of transition and may not be practical to implement.

Transition:

Recognizing that each of the four Options noted above introduces non-economic P&L volatility as companies are forced to adjust their hedge programs to mitigate non-economic accounting volatility, should the FASB continue with its proposed amendments, we would propose the following possible Transition Alternatives:

> Alternative A: Prospective adoption for new guarantees. The pricing (and profitability) of in-force products depended on assumptions of hedge costs at issue. Adopting the new accounting prospectively for new product issuances would enable companies to revise hedge strategies real time and mitigate income statement volatility. It would also mitigate changes to product profitability resulting from changing accounting. However, we recognize this would further

the diversity in practice that exists today by introducing diversity in accounting practices within companies for the same or similar features.

Alternative B: Modified retrospective adoption with initial impact of adoption recorded to retained earnings with a phase in approach to recording the impact of non-economic volatility through the P&L. Allow companies the option to calculate the fair value of the GMXBs at the date of adoption, record the impact of the change in accounting to retained earnings. In combination with Option C noted above, as companies adjust their hedge programs prospectively, allow companies to bifurcate the inforce GMXB business and amortize the impact of the unhedged liabilities into the P&L over some reasonable period of time, i.e. 5-10 years, as companies adjust their hedge programs over time. New product issuances would not require this treatment as companies would be in a position to implement their hedge strategy real time. This approach would minimize the non-economic P&L volatility and minimize the cost to adjust the companies' hedge programs. This alternative introduces complexity for both the preparer and user, and would have to be further developed if it is determined to be a viable alternative.

As noted in our response to Question 13, we disagree with a mandatory approach that all market risk benefits should be measured at fair value. Should the Board decide to move forward with the proposed changes, we have concern with the proposed transition guidance for market risk benefits. A "retroactive application to all periods" means that insurers would be expected to go back to the inception date of the contract and value the market risk benefit in accordance with the initial measurement guidance outlined in ASC 944-40-30-19B, and then effectively use those terms (e.g. ascribed fee) to determine the fair value as of the transition date. This must be performed without using "hindsight". Market risk benefit transition also does not offer a practical expedient as does the transition for the Liability for Future Policy Benefits.

We believe a practical expedient should be developed as:

1. The retroactive application would not come without undue cost and effort as:
    a. These products have been in the market place since the 1980's. Since then the accounting and reserving platforms have changed. As a result, accessing data is near impossible especially where operating systems are no longer available.
    b. Many of the Funds that these products invested in since the 1980's no longer exist, so are not available to map into the valuation

2. The retroactive approach requirement is to not use hindsight in developing the fair value from issue date. We believe developing the fair value on past dates will require the use of hindsight. In fact the Board has recognized this difficulty in ASU 2016-13 Financial Instruments—Credit Losses:

    - BC115. The Board decided that the amendments in this Update should be applied on a modified-retrospective transition approach that would require a cumulative-effect adjustment to the opening retained earnings in the statement of financial

position as of the date of adoption. The Board rejected other methods, including methods that would have required full retrospective transition. The Board acknowledges that retrospective transition methods generally provide the most useful information. However, the Board determined them to be impracticable to apply in prior periods because the use of hindsight would be necessary in making estimates of expected credit losses. Stakeholders generally agreed with a modified-retrospective transition approach.

- BC116. Stakeholders requested additional transition guidance for certain debt securities and those financial assets that would meet the criteria of purchased financial assets with credit deterioration. For example, questions were raised about whether an allowance would be recorded for a debt security that had an OTTI before the effective date, which may result in a reversal of a previous write-down that was in accordance with previous GAAP. In addition, if an allowance was recorded, preparers would have to use hindsight to determine the write-down amount, if applicable. In response to stakeholders' feedback, the Board provided transition relief to debt securities that had OTTIs in accordance with previous GAAP and for purchased financial assets that were within the scope of Subtopic 310-30, including those that applied Subtopic 310-30 by analogy.

We do not believe our situation is any less challenging than faced with the Board on credit impairments. In fact, we are even more challenged given the length of time these products have been outstanding.

3. We have precedent in US GAAP of adopting fair value measure, other than on a retrospective basis
   - Statement 133 Implementation Issue No. B-23 Embedded Derivatives: Terms of a Separated Non Option Embedded Derivative When the Holder *Has Acquired the Hybrid Instrument Subsequent to Its Inception*

     - In separating a non-option embedded derivative from the host contract under paragraph 12 of Statement 133 when the holder has acquired the hybrid instrument in a secondary market *subsequent* to the inception of the hybrid instrument, the terms of the embedded derivative should be determined by the holder so as to result in the derivative having a fair value generally equal to zero at the date the holder enters into (that is, acquires) the hybrid instrument. The initial accounting by the holder of the hybrid instrument should not be impacted by whether it purchased the hybrid instrument at inception or subsequent to inception in a secondary market.

     - The above guidance should also be applied at the date an entity adopts Statement 133 (if the entity has not elected the grandfathering provisions in paragraph 50) such that the terms of the non-option embedded derivative should be determined by the entity so as to result in the derivative having a fair value generally equal to zero at the date that entity enters into the hybrid instrument regardless whether that date is the inception of the hybrid instrument or a later point in time.

We recommend a prospective or a modified retrospective transition for market risk benefits as full retrospective transition is not practicable. We are exploring various prospective and modified retrospective transition options. We would expect that the Board would also perform outreach to preparers, users and the audit community to gain a further understanding of the issues and needs of the various constituents.

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

Response: While the proposed transition disclosure requirements would provide decision-useful information, we are concerned that the cost of complying with certain transition disclosures will out-weigh the decision usefulness of the disclosures. Specifically, where retrospective adoption applies, we believe ASC 250-10-50-1(b)(2) requires that, in the period of adoption, an entity would be required to disclose the amounts that would have been reported under the prior accounting guidance and further, that under ASC 250-10-50-3 this disclosure would also be required for subsequent interim periods in the fiscal year of the accounting change. We recommend that the Board provide language consistent with the ASC 606-10-65-1(e) in ASU 2016-12, *Revenue from Contracts with Customers (Topic 606)*, which specifically removes this requirement for any implementation area with retrospective adoption.

To address the issue of the non-economic P&L volatility identified in our response to Question 13 above, if the transition alternatives for Market Risk Benefits which we propose in our response to Question 13 are not included in the amended guidance when issued, we recommend that companies be allowed to make optional unaudited supplemental disclosures. The optional supplemental disclosures would reflect the hypothetical value of hedge assets the company would have purchased at the transition date, consistent with the company's existing hedging practice. The change in the fair value of these hypothetical hedge assets from transition date would then be reported so that financial statement users could assess the hypothetical fully hedged results. The optional supplemental disclosures would be unaudited due to the hypothetical nature of these disclosures.

Cost 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: Insurance entities will incur significant incremental one-time and ongoing costs to adopt the proposed amendments including cost related to the following:

• Actuarial models would need to be updated;	Initial and ongoing cost

• Systems would need upgrading to ensure that they can handle new requirements (e.g. to collect and store data, track and adjust discount rates);	Initial cost
• Significant modelling would be necessary to understand the new emergence of earnings resulting from the proposed amendments and how the earnings emergence will fluctuate with changing economic conditions;	Initial and ongoing cost
• Key performance indicators, rules of thumb and sensitivity guidance will need to be evaluated and updated;	Initial and ongoing cost
• Significant time would be needed to develop, test and implement processes and controls throughout the organization;	Initial cost
• Increased pressure on timelines for preparing financial information, because reported results would be dependent on current estimates and as a result of the significant expansion of disclosures including disaggregated rollforwards and expanded qualitative and quantitative information;	Initial and ongoing cost
• We will need to determine the expected durations of our insurance obligations in order to construct the hypothetical high-quality fixed-income instrument portfolio that would be of similar duration. Since many long-duration contracts exceed the duration of available high-quality fixed-income instrument assets, we will need to apply judgements when observable inputs are not available to cover the duration of the liability;	Initial and ongoing cost
• For the disaggregated rollforwards and disclosures, we will need to capture, accumulate and evaluate on a timely basis significantly more data. Will require changes to processes, systems and controls to prepare disclosures;	Initial and ongoing cost
• Audit fees will be substantial.	Initial and ongoing cost

The following systems will also be impacted by the implementation of the proposed measurement model:

- Policy administration / product maintenance systems;
- Reinsurance systems;
- Claims systems;
- Actuarial valuation systems;
- General ledger;
- Consolidation system;

- Business intelligence / reporting systems.

In addition to the potential significant and costly impacts on systems and processes, the proposed amendments would have significant impacts on performance reporting, and could impact product design and capital management.

Finally, we anticipate that our human capital will be impacted significantly:

- Compensation arrangements and performance targets may be changed, requiring involvement of our human resource departments;
- Additional resources may be needed to manage the transition;
- Actuarial and accounting resources will be in high demand, increasing the cost to companies;
- Information technology resources will be needed to address changing actuarial valuations and systems developments.

In order to manage through the significant change that will be required to implement the proposed amendments, companies will have to consider additional hiring, outsourcing to third parties, internal training costs, and redeploying existing resources within the organization. It is likely there will not be sufficient actuarial and accounting resources to accommodate the demand by companies.

The permanent increase in the cost of doing business will put entities that issue insurance contracts at a disadvantage relative to financial services companies that do not issue such contracts and will impair the ability of such entities to compete for capital and, most importantly, to provide needed accumulation and protection products to consumers.

Appendix A – Excerpts Regarding AcSEC and FASB Considerations – Amortization of Deferred Sales Inducements and Amortization of DFEL

In concluding that the amortization of DSI should be linked to the emergence of profits, the AcSEC considered the following:

> Appendix A Basis for Conclusions of Statement of Position 03-1, *Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts*, includes the following discussion (**emphasis added**):
>
> > **A-58.** Amortization of deferred sales inducements. For contracts accounted for under FASB Statement No. 97, the asset arising from sales inducements should be amortized using methodology and assumptions consistent with those used for deferred acquisition costs under FASB Statement No. 97, which is effectively the expected life of the accumulation phase of the contract. Because FASB Statement No. 97 requires that the annuitization phase be viewed as a separate contract, the annuitization phase should not be combined with the accumulation phase. AICPA Practice Bulletin No. 8, Application of FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments, to Insurance Enterprises, states:
> >
> > > The amortization method described in FASB Statement No. 97 for universal life-type contracts should be used for investment contracts that include significant surrender charges or that yield significant revenue from sources other than the investment of contract holders' funds. This method matches amortization of deferred policy acquisition costs (DPAC) with the recognition of gross profits. Otherwise, DPAC on investment contracts should be amortized using an accounting method that recognizes acquisition and interest costs as expenses at a constant rate applied to net policy liabilities and that is consistent with the interest method under FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated With Originating or Acquiring Loans and Initial Direct Costs of Leases (interest method).
> >
> > This guidance is provided for the amortization of deferred acquisition costs, which in this context is similar to debt issuance costs.
> >
> > **A-59.** AcSEC considered, but rejected, the view that a qualifying sales inducement should be amortized over the shorter of the expected life of the contract or the period during which the sales inducement is effectively operating to incent persistency. **As the recovery of sales inducements is through future**

income streams [such as fees charged against the assets, investment margins, cost of insurance charges, reduction of other cost components (such as commissions), or surrender charges] during the expected contract life, AcSEC concluded that qualifying sales inducements should be amortized over the expected life of the contract. In addition, amortization of deferred sales inducements will include an expected lapse assumption that is updated each period.

In concluding that the amortization of DFEL should be linked to the emergence of profits, the FASB considered the following:

Appendix A: Background Information and Basis for Conclusions of FAS 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, includes the following discussion (**emphasis added**):

Initiation Fees and Surrender Charges

68. Universal life-type contracts typically include an amount assessed against policyholders on inception of contracts (initiation fee) or an amount assessed against policyholders when contracts are terminated (surrender charge), or both. **The Exposure Draft reflected the Board's conclusion that both initiation fees and surrender charges are assessed primarily to recover capitalized acquisition costs**. …

69. **After considering the nature of amounts assessed against policyholders under universal life-type contracts, the Board concluded that all such amounts contribute proportionately to the profitability of a book of contracts.** The fact that a particular event, for example, surrender of a contract, may trigger realization of an amount assessed does not alter that conclusion. The Board also concluded that some amounts are collected before being earned and that an initiation fee is one such amount. A surrender charge, on the other hand, is collected when the relationship between policyholder and insurer has been severed. The insurance enterprise has no remaining obligation, and, therefore, the surrender charge is earned when realized.