Statutory Accounting Principles (E) Working Group
Hearing Agenda
October 15, 2020
10:30 A.M. – 12:00 P.M. Central

ROLL CALL

Dale Bruggeman, Chair	Ohio	Judy Weaver	Michigan
Carrie Mears / Kevin Clark, Co-Vice Chairs	Iowa	Doug Bartlett	New Hampshire
Richard Ford	Alabama	Bob Kasinow	New York
Kim Hudson	California	Melissa Greiner	Pennsylvania
Kathy Belfi / William Arfanis	Connecticut	Jamie Walker	Texas
Dave Lonchar	Delaware	Doug Stolte / David Smith	Virginia
Eric Moser	Illinois	Amy Malm	Wisconsin
Caroline Fletcher / Stewart Guerin	Louisiana		

NAIC Support Staff: Julie Gann, Robin Marcotte, Jim Pinegar, Fatima Sediqzad, Jake Stultz

Note: Webex Meetings may be recorded for future use.

ACA Risk Corridors Update: As a result of the Supreme Court decision, CMS has exposed draft guidance regarding how issuers must treat new recoveries of the risk corridor payments related to the 2014-2016 program in their medical loss ratio (MLR) and rebate calculations. CMS welcomes comments on this proposed guidance which has a comment deadline of Oct. 21. The exposure draft can be found at:

https://www.cms.gov/files/document/MLR-Guidance-RC-Recoveries-and-MLR.pdf

Ref #	Title	Attachment #	Agreement with Exposed Document?	Comment Letter Page Number
2019-24 SSAP No. 71 (Robin)	**Levelized and Persistency Commission**	**A-Agenda Item**	**No**	**AICPA- 1 IP – 4**

Summary:

The Working Group has been discussing agenda item 2019-24: Levelized and Persistency Commission since August 2019. During the Summer 2020 National Meeting (July), the Working Group exposed nonsubstantive revisions to *SSAP No. 71—Policy Acquisition Costs and Commissions* (SSAP No. 71) to clarify levelized commission guidance and provide additional direction regarding commissions that are based on policy persistency. The revisions also clarify that the recognition of commission expense is based on experience-to-date. The revisions exposed in July 2020 were consistent with the 2019 Fall National Meeting exposure, with the inclusion of guidance to clarify that reporting entities that have not complied with the original intent shall reflect the change as a correction of an error in the year-end 2020 financial statements.

Some insurers have entered into third-party arrangements with the intent to defer the recognition of commission costs. This goes against long-standing statutory accounting guidance and results in those insurers presenting a better financial position than actual results based on existing in-force insurance policies.

The proposed revisions are intended to clarify the original guidance in SSAP No. 71 regarding levelized commissions. The statutory accounting guidance in SSAP No. 71 has been in place since 1998, which is even before codification. The guidance requires full liability recognition of commission funding agreements. The exposure requires reporting entities that have not complied with the original intent of the statement to reflect the change as a correction of an error (as a mistake in the application of an accounting principle) pursuant to *SSAP No. 3—Accounting Changes and Corrections of Errors* in the December 31, 2020 financial statements. In accordance with SSAP No. 3, correction of all accounting errors in previously issued financial statements, for which an amended financial statement was not filed, are to be reported as an adjustment to unassigned funds (surplus) in the period in which the error was detected. Disclosure shall also occur in accordance with SSAP No 3.

Interested Parties' Comments:

Interested parties would like to propose the following edits to SSAP No. 71, similar to those sent in January 2020.

SUMMARY CONCLUSION

2. Acquisition costs are those costs that are incurred in the acquisition of new and renewal insurance contracts and include those costs that vary with and are primarily related to the acquisition of insurance contracts (e.g., agent and broker commissions, certain underwriting and policy issue costs, and medical and inspection fees). Acquisition costs and commissions shall be expensed as incurred. Determination of when acquisition costs and commissions have been incurred shall be made in accordance with SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets. For example, when commissions are paid directly to an agent based upon renewal such as in traditional trail commission arrangements, commission expense would be recognized when the obligating event (i.e., the renewal) occurs and the related premium revenue is recognized.

3. Contingent commission liabilities shall be determined in accordance with the terms of each individual commission agreement. Commission liabilities determined on the basis of a formula that relates to loss experience shall be established for the earned portion. Assumptions used to calculate the contingent commission liability shall be consistent with the terms of the policy contract and with the assumptions made in recording other assets and liabilities necessary to reflect underwriting results of the reporting entity such as retrospective premium adjustments and loss reserves, including incurred but not reported. Other than the commission arrangements discussed in Paragraph 2, commission contracts that include persistency (or other such components) shall not use these clauses to defer recognition of commission expense. If a commission is based on annual policy persistency (or other similar components), the commission shall be accrued ratably over each annual period based on experience to date for which the persistency commission will be paid.~~the policy period that the commission relates~~. In regard to persistency commission, it is inappropriate to wait until the amount is fully earned and/or unavoidable to accrue experience to date commission expenses. Actual policy cancellation would reverse the accrual of the related persistency commission.

4. Levelized commissions occur in situations where agents receive normal (non-level) commissions with payments made by a third party. It is intended, but not necessarily guaranteed, that the amounts paid to the agents by the third party would ultimately be repaid (with interest explicit or implied) to the third party by levelized payments (which are less than the normal first year commissions but exceed the normal renewal commissions) from the reporting entity. (Note: levelized repayments made by the reporting entity extend the repayment period but might not be a straight-line repayment.) These transactions are, in fact, funding agreements between a reporting entity and a third party, A funding agreement is an agreement whereby a third party provides a lump sum of money in return for a stream of payments over a predetermined time period. The payment stream is fixed without regard to the traditional elements of continued premium payments or policy persistency. The continuance of the stream of payments specified in the levelized commission contract is a mechanism to bypass recognition of those expenses which are ordinarily charged to expense in the first year of the contract. Consequently, the normal link between the persistency of the policy, the continuance of the premium payment or the maintenance of the agent's license with the reporting entity is not maintained with respect to the payment stream.

5. The use of an arrangement such as a levelized commission arrangement where commission payments are not linked to traditional elements such as premium payments and policy persistency, but rather are linked to the repayment of an advance amount paid by a third party to the agents requires the establishment of a liability by the reporting entity for the full amount of the unpaid principal and accrued interest which is payable to a third party related to levelized commissions ~~FN~~.

~~New Footnote – The guidance in this paragraph notes that levelized commissions which use a third party to pay agents that are linked to traditional elements require establishment of a liability for the amounts that have been paid to the agents and any interest accumulated to date.~~

Effective Date and Transition

7. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*. ~~The nonsubstantive revisions adopted ________ regarding levelized commission intend to clarify the original intent of this statement. Reporting entities that have not complied with the original intent of the statement shall reflect the change as a correction of an error (as a mistake in the application of an accounting principle) pursuant to SSAP No. 3 in the December 31, 2020 financial statements. In accordance with SSAP No. 3, correction of all accounting errors in previously issued financial statements, for which an amended financial statement was not filed, shall be reported as an adjustment to unassigned funds (surplus) in the period in which the error was detected. Disclosure shall also occur in accordance with SSAP No. 3.~~

We request that the above edits be incorporated into the proposed Ref #2019-24.

In addition, we believe that what have been deemed non-substantive clarifications to the original intent of SSAP No. 71 proposed by the SAPWG in Ref #2019-24 are in fact **substantive modifications** that materially change accounting practices that were established long before the 2001 codification, and that continue today in many different forms

Per the SAPWG process, substantive statutory accounting revisions introduce original or modified accounting principles. Substantive revisions can be reflected in an existing Statement of Statutory Accounting Principles (SSAP) or a new SSAP. Nonsubstantive statutory accounting revisions are characterized as language clarifications that do not modify the original intent of a SSAP. SSAPs are considered the highest authority (Level 1) in the statutory accounting hierarchy.

The proposed accounting treatment in Ref #2019-24 is significantly different than the current interpretation of the original SSAP and general statutory principles, specifically, full recognition of an expense at the time the policy is issued versus incremental recognition of commission costs over time as the policy persists and they become legal obligations. The current proposed language does not address the many varying product/distribution compensation arrangements in the industry and IP believe this will cause unintended consequences. The link between the traditional elements such as policy persistency and the accrual of commissions is a long-standing principle. Eliminating the link to the policy persistency is not a clarification, it is a substantive change that modifies the original intent of SSAP No. 71, thus requiring further evaluation.

Interested parties believe that the exposure as written will also unintentionally impact the accounting for certain types of traditional trail commission arrangements that are commonplace in the market for life and annuity products. Although funding agreements can also have elements that are based upon policy persistency, there exists in the industry a longstanding practice of compensating agents directly based upon policy persistency. In these scenarios, the reporting entity has an agreement in place with agents that requires commission payment if and only if a policy persists (for example, at each annual renewal). If a policyholder opts not to renew, the reporting entity has no obligation to pay further commissions to the agent.

As written, interested parties believe this exposure would require the reporting entity to accrue these trail commissions at policy inception, which would be counter to the principles contained in SSAP No. 5R - *Liabilities, Contingencies and Impairment of Assets*. These commissions are not liabilities until the policy persists, and, until that time, the transaction obligating the entity has not occurred. Language added to paragraph 2 is intended to distinguish the scope of the guidance in paragraphs 3-5 from these traditional trail commission arrangements.

Further, interested parties strongly disagree with the modifications to paragraph 7. Reporting entities have filed annual statements based on the current interpretation of SSAP No. 71 with unqualified opinions from their external auditors. Regulatory examinations have also been completed by various states of domicile insurance departments without adjustment. IP believe that if the proposed revisions are adopted and result in an accounting change, these should be reflected as a change in accounting principle. Per SSAP No. 3, "A change in accounting principle results from the adoption of an accepted accounting principle, or method of applying the principle, which differs from the principles or methods previously used for reporting purposes." Reporting entities that in good faith applied a particular method by following SSAP No. 71 and were not required to adjust statements as a result of audits or regulatory examinations, should not be considered to have made an **accounting error**. As such, interested parties disagree with the modifications in paragraph 7. As noted above, the proposed revisions to SSAP No. 71 substantially change the interpretation that has been followed for years, and therefore, the original text would apply for a reporting entity that must change its method of applying the revised SSAP No. 71.

In summary, we recommend that the NAIC consider the changes contained in the current Ref #2019-24 exposure be reclassified as **substantive, that an issue paper be drafted, and that this be re-exposed and processed accordingly.**

AICPA Comments:
The American Institute of Certified Public Accountants' NAIC Task Force (Task Force) appreciates the opportunity to discuss our comments on Form A: Issue 2019-24, Levelized and Persistency Commission.

Our comments are in response to the proposed transition language in paragraph 7 related to the nonsubstantive revisions regarding levelized commissions:

> Effective Date and Transition
>
> 7. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*. The nonsubstantive revisions adopted ________ regarding levelized commission intend to clarify the original intent of this statement. Reporting entities that have not complied with the original intent of the statement shall reflect the change as a correction of an error (as a mistake in the application of an accounting principle) pursuant to SSAP No. 3 in the December 31, 2020 financial statements. In accordance with SSAP No. 3, correction of all accounting errors in previously issued financial statements, for which an amended financial statement was not filed, shall be reported as an adjustment to unassigned funds (surplus) in the period in which the error was detected. Disclosure shall also occur in accordance with SSAP No. 3.

We believe that the requirement to account for this clarification as a correction of an error pursuant to SSAP No. 3 in the year-end 2020 financial statements would be a departure from how the NAIC has traditionally adopted clarifications to statutory accounting as changes in accounting principle. (We are not aware of any other examples of revisions to SSAPs being considered an error correction since the adoption of the revised NAIC *Accounting Practices and Procedures Manual* in 2001.) We believe that resolving the diversity in practice that currently exists in the accounting for levelized commission programs as the correction of an error would be inconsistent with the NAIC's recent treatment of other nonsubstantive revisions that were adopted to promote the uniform application of statutory accounting guidance. For example, any change in income tax balances that resulted from the comprehensive revisions to the SSAP No. 101 Q&A that were adopted in 2019 to clarify the application of the deferred tax admissibility calculation for year-end 2019 reporting purposes were allowed to be reported as a change in accounting principle in accordance with SSAP No. 3. (Since changes in DTAs only affect surplus, the issue of the income statement needing to be adjusted due to the year-end adoption of new accounting guidance did not exist in this instance, as discussed further below.)

We recommend that the NAIC consider revising the transition language in Issue 2019-24 to allow companies to account for the change as a change in accounting principle, in accordance with SSAP No. 3. Paragraphs 3 through 5 of SSAP No. 3 discuss the characteristics and application of a change in accounting principle,

> A change in accounting principle results from the adoption of an accepted accounting principle, or method of applying the principle, which differs from the principles or methods previously used for reporting purposes. A change in the method of applying an accounting principle shall be considered a change in accounting principle.
>
> A characteristic of a change in accounting principle is that it concerns a choice from among two or more statutory accounting principles. However, a change in accounting principle is neither (a) the initial adoption of an accounting principle in recognition of events or transactions occurring for the first time or previously immaterial in their effect, nor (b) the adoption or modification of an accounting principle necessitated by transactions or events that are clearly different in substance from those previously occurring.
>
> The cumulative effect of changes in accounting principles shall be reported as adjustments to unassigned funds (surplus) in the period of the change in accounting principle. The cumulative effect is the difference between the amount of capital and surplus at the beginning of the year and the amount of capital and surplus that would have been reported at that date if the new accounting principle had been applied retroactively for all prior periods.

We believe the proposed change meets the definition of a change in accounting principle, as we believe the alternative interpretation of the levelized commission guidance in SSAP No. 71 has been accepted in practice. Specifically, we are aware from comments received from industry that some regulators (as part of periodic financial examinations) have not objected to the classification of levelized commission programs with commission payments linked to persistency as allowable in accordance with paragraph 5 of SSAP No. 71.

In addition, we believe that treating the proposed change as a correction of an error will potentially result in challenges for certain reporting entities. For example, reporting entities that have followed the alternative interpretation of the levelized commission guidance in SSAP No. 71 would have previously expensed a portion of this adjustment in their quarterly financial statements filed throughout 2020. If the guidance is adopted for year-end 2020, this expensed portion would need to be identified and reversed in order to properly report the adjustment to the opening (i.e., January 1, 2020) balance of surplus for year-end 2020 reporting purposes, which would increase the complexity of adopting the change. An option to avoid these complications would be to account for the change in accounting principle as of January 1, 2021, which is consistent with the guidance in SSAP No. 3 to adopt new accounting principles at the beginning of the year.

We also wanted to bring it to the Working Group's attention that requiring this clarification to be accounted for as a correction of an error could result in the independent auditor being required to express a qualified opinion on the prior year audited statutory basis financial statements in accordance with AICPA standards. This consideration exists in situations where the misstatements are material but not pervasive to the financial statements unless the prior year financial statements are restated, regardless of the statutory account treatment provided by SSAP No. 3 to recognize the correction of the error.

Summary of key points from commenters and NAIC staff recommendations:

1) The revisions should be reclassified as substantive and IPs recommend an issue paper.)
2) The revisions are too extensive regarding renewal commission and would require premature liability recognition at policy inception of traditional persistency commission. The comments assert this is contrary to longstanding practice.
3) They object to treating the revisions as a correction of an error and instead prefer a "change in accounting principle." (Both IPs and AICPA)

The July 2020 and December 2019 Working Group exposures were essentially the same with the addition of the correction of error guidance. In September 2020, the interested parties provided comments reflecting the similar themes as prior comments, but also provided new tracked revisions. (The IPs characterize these as similar, but they are not identical to the prior changes.)

Detailed review of the Interested parties proposed revisions.

a. **Paragraph 2 & 3 -** Interested parties propose adding new language that directly paid trailing commission is recognized on renewal in the acquisition cost paragraph 2. The interested parties proposed paragraph 2 revisions, shown as shaded text below, are intended to distinguish the scope of the guidance in paragraphs 3-5 from these traditional trail commission arrangements. Interested parties noted a concern that the exposure would require the reporting entity to accrue these trail commissions at policy inception, which would be counter to the principles contained in SSAP No. 5R— *Liabilities, Contingencies and Impairment of Assets*.

> For example, when commissions are paid directly to an agent based upon renewal such as in traditional trail commission arrangements, commission expense would be recognized when the obligating event (i.e., the renewal) occurs and the related premium revenue is recognized.

NAIC Staff does not recommend the revisions for the following reasons:

While NAIC staff agree that the intent of the agenda item is not to require accrual of traditional persistency commission on day one. NAIC staff note that there is diversity in practice regarding the use of commission terms and we are hesitant to recommend using the term trailing because people have mislabeled some of the funding agreements as persistency or trailing commissions.

The term "directly paid" trailing commission does not clarify if it is a street level agent or a third-party funding agent involved in a levelized commission arrangement agent being paid.

b. **Paragraph 3** – Interested parties propose to revise the following exposed language:

> Commission contracts that include persistency (or other such components) shall not use these clauses to defer recognition of commission expense. If a commission is based on annual policy persistency (or other similar components), the commission shall be accrued based on experience to date for the policy period that the commission relates. In regard to persistency commission, it is inappropriate to wait until the amount is fully earned and/or unavoidable to accrue experience to date commission expenses. Actual policy cancellation would reverse the accrual of the related persistency commission.

Interested parties suggested revisions are shaded:

> Other than the commission arrangements discussed in Paragraph 2, commission contracts that include persistency (or other such components) shall not use these clauses to defer recognition of commission expense. If a commission is based on annual policy persistency (or other similar components), the commission shall be accrued ratably over each annual period based on experience to date for which the persistency commission will be paid.~~the policy period that the commission relates.~~ In regard to persistency commission, it is inappropriate to wait until the amount is fully earned and/or unavoidable to accrue experience to date commission expenses. Actual policy cancellation would reverse the accrual of the related persistency commission.

NAIC staff does not recommend the interested parties' proposed revisions as the use of the word "paid" introduces confusing elements. NAIC staff notes that the intent of the exposed guidance is not to require day 1 accrual of traditional persistency commission. We note that commission terminology varies among insurers and recommends remaining as principle based as possible regarding types of commission.

NAIC staff cautions that some of the entities employing funding agreements were characterizing the repayment as persistency commission, even though the commission payments to the writing agents were owed (and typically paid by the funding agent) with the initial sale of the policy.

NAIC staff recommends deleting the exposed guidance in paragraph 3 and expanding the proposed guidance in paragraphs 4 and 5 as the issue is identifying funding agreements which have been mischaracterized as commission (including in some cases, renewal and persistency commission).

c. **Paragraph 4** – Interested parties propose a new more restrictive definition of a funding agreement, noting that a funding agreement payment stream is a lump sum of money in return for a stream of payments over a predetermined time period and the payments are fixed without regard to the traditional elements of continued premium or policy persistency. interested parties' suggested revisions are as follows:

> A funding agreement is an agreement whereby a third party provides a lump sum of money in return for a stream of payments over a predetermined time period. The payment stream is fixed without regard to the traditional elements of continued premium payments or policy persistence.

NAIC Staff does not recommend the revisions for the following reasons:

- The existing guidance in SSAP No. 71 notes that accrual of the levelized commission arrangement is required even if repayment is not guaranteed.

- The existing guidance does not require a fixed repayment or fixed time period of repayment. It specifically requires accrual even if repayment is not guaranteed.

NAIC staff recommends adding "which attempts" in paragraph 4 as shown as shaded text below:

4. Levelized commissions occur in situations where agents receive normal (non-level) commissions with payments made by a third party. It is intended, but not necessarily guaranteed, that the amounts paid to the agents by the third party would ultimately be repaid (with interest explicit or implied) to the third party by levelized payments (which are less than the normal first year commissions but exceed the normal renewal commissions) from the reporting entity. (Note: levelized repayments made by the reporting entity extend the repayment period but might not be a straight-line repayment.) These transactions are, in fact, funding agreements between a reporting entity and a third party, regardless of how the payment to the third party is characterized. The continuance of the stream of payments specified in the levelized commission contract is a mechanism which attempts to bypass recognition of those expenses which are ordinarily charged to expense in the first year of the contract. Consequently, the normal link between the persistency of the policy, the continuance of the premium payment or the maintenance of the agent's license with the reporting entity is not maintained with respect to the payment stream.

d. **Paragraph 5 -** Interested parties propose to remove the footnote regarding the link to traditional elements with comments that eliminating the link to the policy persistency is not a clarification, but a substantive change. Interested parties note that the link between the traditional elements such as policy persistency and the accrual of commissions is a long-standing principle.

> Exposed New Footnote – The guidance in this paragraph notes that levelized commissions which use a third party to pay agents that are linked to traditional elements require establishment of a liability for the amounts that have been paid to the agents and any interest accumulated to date~~.~~

NAIC staff notes that the funding agreement guidance is focused on noting that a levelized commission arrangement is an attempt to disconnect the relationship between traditional elements and indicates that a levelized commission arrangement should not be used to avoid recognizing the funding agreement (levelized commission) obligations.

NAIC staff proposes being more explicit regarding the implicit assumptions about levelized commission.

NAIC staff agree that there is a longstanding link to traditional elements with directly paid agents who write the policies and NAIC staff believes that most reporting entities are consistent on this point when there is not a funding agreement.

However, NAIC staff cautions that the footnote was an attempt to address a reporting entity mislabeling a funding agreement structure as a persistency commission.

NAIC staff recommends that the Working Group make the following revisions which are illustrated as shaded text below:

- **Delete the exposed new footnote and**

- **Expose additional guidance for paragraph 5 that is more descriptive of what the substance of a funding agreement.**

5. The use of an arrangement such as a levelized commission arrangement where commission payments are not linked to traditional elements such as premium payments and policy persistency, but rather are linked to the repayment of an advance amount paid by a third party to the direct selling agents requires the establishment of a liability by the reporting entity for the full amount of the unpaid principal and accrued interest which is payable to a third party related to levelized commissions ~~FN~~. Arrangements that use a third party to pay agents who write policies for the reporting entity and the insured can be an attempt to de-link the relationship between the insurer and those agents and defer or levelize the acquisition commissions. The insurance reporting entity is required to recognize the full amount of earned commission costs to the direct policy writing agents even if those costs are paid indirectly to the agents by a third party through the use of levelized commission, or similar arrangement, which is in substance a funding arrangement. Having a third party pay commission costs to the selling agent is strong evidence of a potential funding arrangement which shall be recognized as a liability because the substance of the arrangement indicates that repayment is reasonable and probable, even if a contingency has been incorporated into the funding arrangement, unless the underlying policy has been cancelled. A third-party structure cannot recharacterize (e.g. by referencing policy persistency) and delay recognition of liabilities for initial sales commission owed from the writing of policies regardless of how a third-party arrangement is structured with regards to the timing of payment from the insurer. The amount owed for full initial sales commission shall be recognized immediately as the writing of an insurance contract is the event that obligates the insurer, and such action shall occur consistently among insurers. As such, this recognition is required regardless if the insurer owes a selling agent directly or if a third-party has been contracted to provide payment to the selling agent.

~~New Footnote – The guidance in this paragraph notes that levelized commissions which use a third party to pay agents that are linked to traditional elements require establishment of a liability for the amounts that have been paid to the agents and any interest accumulated to date.~~

e. **Paragraph 7- Change in accounting** - Both interested parties and the AICPA disagree with correction of an error treatment and prefer classification as a change in accounting. (It is noted that referring as a correction in error could result with issues in previously filed financial statements, prior exams, prior unqualified audit the accounting approach.

NAIC staff recommends modifying the exposed revisions to remove the language on correction of an error and specify the nonsubstantive revisions have an effective date of Jan. 1, 2021.

f. More granular guidance - Interested parties believe not being more granular on types of commission will cause unintended consequences, and the following themes from their letter are noted:

- Concerns that a reporting entity would be required to accrue trail commissions at policy inception.
- Significantly different than the current interpretation, full recognition of an expense at the time the policy is issued versus incremental recognition of commission costs over time as the policy persists and they become legal obligations.
- Although funding agreements can also have elements based upon policy persistency, there exists in the industry a longstanding practice of compensating agents directly based upon policy persistency. In these

scenarios, the reporting entity has an agreement in place with agents that requires commission payment if and only if a policy persists (for example, at each annual renewal). If a policyholder opts not to renew, the reporting entity has no obligation to pay further commissions to the agent.

Because companies employ a large variety of commission structures, NAIC staff recommends remaining high level and continuing to reference SSAP No. 5 regarding liability recognition. NAIC staff also recommends remaining as principles based as possible regarding the types of commission and their recognition. Therefore the proposed revisions have less guidance on types of commission and more guidance on funding agreements.

NAIC staff notes that the issue is clearly distinguishing between persistency commission and funding agreements masquerading as persistency commission.

g. Substantive change – Interested parties recommend that the revisions be reclassified from nonsubstantive to substantive. These comments requests revisions and an issue paper asserting it is a material change to established practices:

   - Materially change established accounting practices

   - Significantly different than the current interpretation, full recognition of an expense at the time the policy is issued versus incremental recognition of commission costs over time as the policy persists and they become legal obligations.

NAIC staff asserts that the goal of this agenda item is to be consistent with the principles of what is a funding agreement. NAIC staff still believe that the proposed revisions are nonsubstantive and focused on clarifying existing guidance.

NAIC staff believes that if the SAP guidance is modified in ways that permit a delay in recognition of acquisition costs, that more companies will be compelled to enter these contracts to prevent competitive disadvantages. Such deferral would fundamentally change the underlying principle of expensing acquisition costs as incurred. This principle is a primary difference from GAAP capitalization of acquisition costs. If this occurs, the Working Group may want to undertake a project to reconsider the recognition of DAC.

Summary of Recommended Action:
NAIC staff recommends that the Working Group exposed the shaded revisions shown on the following page under the heading "Shaded SSAP No. 71 Revisions for October 2020 Working Group Discussion" with a shortened comment deadline of Oct. 30 to allow for discussion on the Nov. 12 call of the Working Group.

The key points of the proposed revisions are as follows:
- **Improved description of the funding agreements.**
- **Deletes some of the previously proposed revisions regarding of other types of commission to address the comments received regarding unintended impacts on traditional renewal commission.**
- **Modify the exposed revisions to remove the language on correction of an error; and**
- **Proposes the nonsubstantive revisions have a Jan. 1, 2021 effective date.**

The following pages contain:
1) Shaded SSAP No. 71 Revisions for October 2020 Working Group Discussion

2) July 2020 Previously Exposed SSAP No. 71 Revisions

3) A brief overview of GAAP treatment, which notes third party paid acquisition costs are also accrued in GAAP deferred acquisition costs.

The comment letters are included in Attachment B (19 pages).

Shaded SSAP No. 71 Revisions for October 2020 Working Group Discussion

2. Acquisition costs are those costs that are incurred in the acquisition of new and renewal insurance contracts and include those costs that vary with and are primarily related to the acquisition of insurance contracts (e.g., agent and broker commissions, certain underwriting and policy issue costs, and medical and inspection fees). Acquisition costs and commissions shall be expensed as incurred. Determination of when acquisition costs and commissions have been incurred shall be made in accordance with SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets.

3. Contingent commission liabilities shall be determined in accordance with the terms of each individual commission agreement. Commission liabilities determined on the basis of a formula that relates to loss experience shall be established for the earned portion. Assumptions used to calculate the contingent commission liability shall be consistent with the terms of the policy contract and with the assumptions made in recording other assets and liabilities necessary to reflect underwriting results of the reporting entity such as retrospective premium adjustments and loss reserves, including incurred but not reported. ~~Commission contracts that include persistency (or other such components) shall not use these clauses to defer recognition of commission expense. If a commission is based on annual policy persistency (or other similar components), the commission shall be accrued based on experience to date for the policy period that the commission relates. In regard to persistency commission, it is inappropriate to wait until the amount is fully earned and/or unavoidable to accrue experience to date commission expenses. Actual policy cancellation would reverse the accrual of the related persistency commission.~~

4. Levelized commissions occur in situations where agents receive normal (non-level) commissions with payments made by a third party. It is intended, but not necessarily guaranteed, that the amounts paid to the agents by the third party would ultimately be repaid (with interest explicit or implied) to the third party by levelized payments (which are less than the normal first year commissions but exceed the normal renewal commissions) from the reporting entity. (Note: levelized repayments made by the reporting entity extend the repayment period but might not be a straight-line repayment.) These transactions are, in fact, funding agreements between a reporting entity and a third party, regardless of how the payment to the third party is characterized. The continuance of the stream of payments specified in the levelized commission contract is a mechanism which attempts to bypass recognition of those expenses which are ordinarily charged to expense in the first year of the contract. Consequently, the normal link between the persistency of the policy, the continuance of the premium payment or the maintenance of the agent's license with the reporting entity is not maintained with respect to the payment stream.

5. The use of an arrangement such as a levelized commission arrangement where commission payments are not linked to traditional elements such as premium payments and policy persistency, but rather are linked to the repayment of an advance amount paid by a third party to the direct selling agents requires the establishment of a liability by the reporting entity for the full amount of the unpaid principal and accrued interest which is payable to a third party related to levelized commissions ~~FN~~. Arrangements that use a third party to pay agents who write policies for the reporting entity and the insured can be an attempt to de-link the relationship between the insurer and those agents and defer or levelize the acquisition commissions. The insurance reporting entity is required to recognize the full amount of earned commission costs to the direct policy writing agents even if those costs are paid indirectly to the agents by a third party through the use of levelized commission, or similar arrangement, which is in substance a funding arrangement. Having a third party pay commission costs to the selling agent is strong evidence of a potential funding arrangement which shall be recognized as a liability because the substance of the arrangement indicates that repayment is reasonable and probable, even if a contingency has been incorporated into the funding arrangement, unless the underlying policy has been cancelled. A third-party structure cannot recharacterize (e.g. by referencing policy persistency) and delay recognition of liabilities for initial sales commission owed from the writing of policies regardless of how a third-party arrangement is structured with regards to the timing of payment from the insurer. The amount owed for full initial sales commission shall be recognized immediately as the writing of an insurance contract is the event that obligates the insurer, and such action shall occur consistently among insurers. As such, this recognition is required regardless if the insurer owes a selling agent directly or if a third-party has been contracted to provide payment to the selling agent.

~~New Footnote – The guidance in this paragraph notes that levelized commissions which use a third party to pay agents that are linked to traditional elements require establishment of a liability for the amounts that have been paid to the agents and any interest accumulated to date.~~

Effective Date and Transition

7. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*. The nonsubstantive revisions adopted ________ regarding levelized commission ~~intend~~are to clarify the original intent of this statement and are effective January, 2021. ~~Reporting entities that have not complied with the original intent of the statement shall reflect the change as a correction of an error (as a mistake in the application of an accounting principle) pursuant to SSAP No. 3 in the December 31, 2020 financial statements. In accordance with SSAP No. 3, correction of all accounting errors in previously issued financial statements, for which an amended financial statement was not filed, shall be reported as an adjustment to unassigned funds (surplus) in the period in which the error was detected. Disclosure shall also occur in accordance with SSAP No. 3.~~

July 2020 Previously Exposed SSAP No. 71 Revisions

2. Acquisition costs are those costs that are incurred in the acquisition of new and renewal insurance contracts and include those costs that vary with and are primarily related to the acquisition of insurance contracts (e.g., agent and broker commissions, certain underwriting and policy issue costs, and medical and inspection fees). Acquisition costs and commissions shall be expensed as incurred. Determination of when acquisition costs and commissions have been incurred shall be made in accordance with SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets.

3. Contingent commission liabilities shall be determined in accordance with the terms of each individual commission agreement. Commission liabilities determined on the basis of a formula that relates to loss experience shall be established for the earned portion. Assumptions used to calculate the contingent commission liability shall be consistent with the terms of the policy contract and with the assumptions made in recording other assets and liabilities necessary to reflect underwriting results of the reporting entity such as retrospective premium adjustments and loss reserves, including incurred but not reported. Commission contracts that include persistency (or other such components) shall not use these clauses to defer recognition of commission expense. If a commission is based on annual policy persistency (or other similar components), the commission shall be accrued based on experience to date for the policy period that the commission relates. In regard to persistency commission, it is inappropriate to wait until the amount is fully earned and/or unavoidable to accrue experience to date commission expenses. Actual policy cancellation would reverse the accrual of the related persistency commission.

4. Levelized commissions occur in situations where agents receive normal (non-level) commissions with payments made by a third party. It is intended, but not necessarily guaranteed, that the amounts paid to the agents by the third party would ultimately be repaid (with interest explicit or implied) to the third party by levelized payments (which are less than the normal first year commissions but exceed the normal renewal commissions) from the reporting entity. (Note: levelized repayments made by the reporting entity extend the repayment period but might not be a straight-line repayment.) These transactions are, in fact, funding agreements between a reporting entity and a third party, regardless of how the payment to the third party is characterized. The continuance of the stream of payments specified in the levelized commission contract is a mechanism to bypass recognition of those expenses which are ordinarily charged to expense in the first year of the contract. Consequently, the normal link between the persistency of the policy, the continuance of the premium payment or the maintenance of the agent's license with the reporting entity is not maintained with respect to the payment stream.

5. The use of an arrangement such as a levelized commission arrangement where commission payments are not linked to traditional elements such as premium payments and policy persistency, but rather are linked to the repayment of an advance amount paid by a third party to the agents requires the establishment of a liability by the reporting entity for the full amount of the unpaid principal and accrued interest which is payable to a third party related to levelized commissions [FN].

New Footnote – The guidance in this paragraph notes that levelized commissions which use a third party to pay agents that are linked to traditional elements require establishment of a liability for the amounts that have been paid to the agents and any interest accumulated to date.

Effective Date and Transition

7. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*. The nonsubstantive revisions adopted ________ regarding levelized commission intend to clarify the original intent of this statement. Reporting entities that have not complied with the original intent of the statement shall reflect the change as a correction of an error (as a mistake in the application of an accounting principle) pursuant to SSAP No. 3 in the December 31, 2020 financial statements. In accordance with SSAP No. 3, correction of all accounting errors in previously issued financial statements, for which an amended financial statement was not filed, shall be reported as an adjustment to unassigned funds (surplus) in the period in which the error was detected. Disclosure shall also occur in accordance with SSAP No. 3.

Comparison to U.S. GAAP and SAP:

- It has been a long-standing practice for both U.S. GAAP and SAP to recognize acquisition costs as they are incurred.

- Under U.S. GAAP, acquisition costs from successful contracts are recognized as intangible assets (known as deferred acquisition costs - DAC) and amortized into expense overtime. This amortization occurs consistently over the expected term of the contract. If the contract is terminated early, the deferred acquisition cost is written off and immediately expensed. U.S. GAAP follows this process as it allows for a matching of revenues and expenses – which is a U.S. GAAP concept.

- The immediate expensing of acquisition costs has been a key difference between SAP / GAAP since inception of SAP. This treatment is intentional because these are not "assets" that can be used to pay policyholder claims. Rather, these are incurred costs that are just deferred for expense recognition under GAAP for timing purposes.

- In 2010, U.S. GAAP moved closer to SAP with requiring immediate expense recognition for some "acquisition costs" that companies had previously been recognizing as DAC assets. This was because of discrepancies in practice regarding which acquisition costs should be recognized as assets under U.S. GAAP and amortized overtime into expense. With this guidance, U.S. GAAP stipulated that only certain acquisition costs from successful contracts are permitted to be recognized as assets and amortized into expense. (Commission costs from successful contracts are permitted to be capitalized as assets and amortized under U.S. GAAP – so those are still different between GAAP/SAP, but we include this information to highlight that if it wasn't for the U.S. GAAP intent to match revenues and expenses, then immediate expense recognition would occur as these expenses have been incurred and often paid.)

- With the issuance of the 2010 guidance, the Financial Accounting Standards Board (FASB) discussed independent third parties. With this discussion, the FASB confirmed that direct costs of contract acquisition that are incurred in transactions with both independent third parties and employees are deferrable in their entirety if the capitalization criteria are met. As such, the FASB does not have different treatment based on the inclusion of third parties. ASU 2010-26. The BOC paragraphs BC8-BC11 address third-party involvement:

> BC11. On August 19, 2010, the staff posted the staff draft to the FASB website. The staff draft did not formally seek comments; however, it welcomed input from interested parties. As a result, 10 comment letters were received. A number of constituents raised concerns with the staff draft, including concerns that the proposed guidance would result in economically similar acquisition costs (for example, commissions) receiving different accounting treatment depending on whether the person performing the acquisition activity was an independent third party or an employee. Concerns also were raised about the operationality of the model and the costs associated with applying it because many insurance agents might not qualify as independent third parties as defined but also are not employees. Others were concerned that the proposal would significantly differ from the direction of the Board's joint insurance project. In light of those concerns, at the September 16, 2010 meeting, **the Task Force decided to reverse its previous tentative decision and reached a final consensus that incremental direct costs of contract acquisition that are incurred in transactions with both independent third parties and employees are deferrable in their entirety if the capitalization criteria are met.**

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Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A

Issue: Levelized and Persistency Commission

Check (applicable entity):

	P/C	Life	Health
Modification of existing SSAP	☒	☒	☒
New Issue or SSAP	☐	☐	☐
Interpretation	☐	☐	☐

Description of Issue:
NAIC staff has received regulator inquiries on the application of the levelized commissions guidance in *SSAP No. 71—Policy Acquisition Costs and Commissions.* This agenda item is to recommend clarifications to the existing levelized commissions guidance and provide additional guidance regarding commission that is based on policy persistency. SSAP No. 71 describes that levelized commissions occur in situations in which a third party pays agents non-levelized commissions and the reporting entity pays a third party by levelized payments. The statement notes that it is intended, but not necessarily guaranteed, that the amounts paid to the agents by the third party would ultimately be repaid to the third party from the reporting entity. SSAP No. 71 identifies such arrangements as funding agreements between the reporting entity and the third party. SSAP No. 71 then identifies that the use of a commission arrangement where commission payments are not linked to traditional elements (such as premium payments and policy persistency) requires the establishment of a liability for the full amount of the unpaid principal and accrued interest which is payable to a third party related to levelized commissions is required.

The questions received by NAIC staff relate to the use of levelized commission arrangements and when the liability for commission based on annual persistency is required to be recorded as a liability in accordance with *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets*.

Levelized Commission

For the example in question, a third party is paying agent commissions and receiving periodic payments. Consistent with the guidance in SSAP No. 71, paragraph 4, the third party (funding agent) is paying the agents on behalf of the reporting entity and receiving levelized payments from the reporting entity which include additional fees or interest in excess of the commissions. The agreement between the reporting entity and the funding agent specifies that the funding agent will not be reimbursed by the reporting entity if the policies that generate the commission are cancelled prior to the policy anniversary date. The regulator noted that the reporting entity was not accruing the liability to the third-party funding agent, asserting that the payments to the funding agent were theoretically avoidable until the policy had passed the anniversary year-end date.

The accounting issue is whether levelized commission arrangements that are linked to traditional elements (such as premium payments and policy persistency) requires the establishment of a liability for the full amount of the unpaid principal and accrued interest which is payable to a third party related to levelized commissions.

Persistency Commission

Also, in the noted example, the reporting entity was also asserting that the levelized commission obligations related to policy persistency commission were not required to be accrued until the policy anniversary year end had been passed. The reporting entity asserts that the liability is not required until the persistency commission was fully earned by the agent and therefore unavoidable.

The accounting issue is if the persistency commission expense should be accrued proportionately over the policy period to which the commission relates, or if it is accrued only when fully earned and unavoidable.

Existing Authoritative Literature:

Preamble provides the following (**bolding added for emphasis**):

> 37. Liabilities require recognition as they are incurred. Certain statutorily mandated liabilities may also be required to arrive at conservative estimates of liabilities and probable loss contingencies (e.g., interest maintenance reserves, asset valuation reserves, and others).
>
> 38. Revenue should be recognized only as the earnings process of the underlying underwriting or investment business is completed. **Accounting treatments which tend to defer expense recognition do not generally represent acceptable SAP treatment.**

SSAP No. 5 – Revised—Liabilities, Contingencies and Impairments of Assets

> **Liabilities**
>
> 2. A liability is defined as certain or probable1 future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or to provide services to other entities in the future as a result of a past transaction(s) or event(s).
>
> 3. A liability has three essential characteristics: (a) it embodies a present duty or responsibility to one or more other entities that entails settlement by probable1 future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand, (b) the duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice, and (c) the transaction or other event obligating the entity has already happened. This includes, but is not limited to, liabilities arising from policyholder obligations (e.g., policyholder benefits, reported claims and reserves for incurred but not reported claims). Liabilities shall be recorded on a reporting entity's financial statements when incurred.
>
> 4. Estimates (e.g., loss reserves) are required in financial statements for many ongoing and recurring activities of a reporting entity. The mere fact that an estimate is involved does not of itself constitute a loss contingency. For example, estimates of losses utilizing appropriate actuarial methodologies meet the definition of liabilities as outlined above and are not loss contingencies.
>
> **Loss Contingencies or Impairments of Assets**
>
> 6. For purposes of implementing the statutory accounting principles of loss contingency or impairment of an asset described below, the following additional definitions shall apply:
>
> a. Probable—The future event or events are likely to occur;
>
> b. Reasonably Possible—The chance of the future event or events occurring is more than remote but less than probable;
>
> c. Remote—The chance of the future event or events occurring is slight.
>
> 7. A loss contingency or impairment of an asset is defined as an existing condition, situation, or set of circumstances involving uncertainty as to possible loss to an enterprise that will ultimately be resolved when one or more future event(s) occur or fail to occur (e.g., collection of receivables).
>
> 8. An estimated loss from a loss contingency or the impairment of an asset shall be recorded by a charge to operations if both of the following conditions are met:
>
> a. Information available prior to issuance of the statutory financial statements indicates that **it is probable that an asset has been impaired or a liability has been incurred** at the date of the statutory financial statements. It is implicit in this condition that it is probable

that one or more future events will occur confirming the fact of the loss or incurrence of a liability; and

b. The amount of loss can be reasonably estimated.

SSAP No. 71—Policy Acquisition Costs and Commissions provides the following (**bolding added for emphasis**):

SUMMARY CONCLUSION

2. Acquisition costs are those costs that are incurred in the acquisition of new and renewal insurance contracts and include those costs that vary with and are primarily related to the acquisition of insurance contracts (e.g., agent and broker commissions, certain underwriting and policy issue costs, and medical and inspection fees). **Acquisition costs and commissions shall be expensed as incurred. Determination of when acquisition costs and commissions have been incurred shall be made in accordance with SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets.**

3. Contingent commission liabilities shall be determined in accordance with the terms of each individual commission agreement. Commission liabilities determined on the basis of a formula that relates to loss experience shall be established for the earned portion. **Assumptions used to calculate the contingent commission liability shall be consistent with the terms of the policy contract and with the assumptions made in recording other assets and liabilities necessary to reflect underwriting results of the reporting entity such as retrospective premium adjustments and loss reserves, including incurred but not reported.**

4. **Levelized commissions occur in situations where agents receive normal (non-level) commissions with payments made by a third party.** It is intended, but not necessarily guaranteed, that the amounts paid to the agents by the third party would ultimately be repaid (with interest explicit or implied) to the third party by levelized payments (which are less than the normal first year commissions but exceed the normal renewal commissions) from the reporting entity. These transactions are, in fact, funding agreements between a reporting entity and a third party. **The continuance of the stream of payments specified in the levelized commission contract is a mechanism to bypass recognition of those expenses which are ordinarily charged to expense in the first year of the contract. Consequently, the normal link between the persistency of the policy, the continuance of the premium payment or the maintenance of the agent's license with the reporting entity is not maintained with respect to the payment stream.**

5. **The use of an arrangement where commission payments are not linked to traditional elements such as premium payments and policy persistency, but rather are linked to the repayment of an advance amount requires the establishment of a liability for the full amount of the unpaid principal and accrued interest which is payable to a third party related to levelized commissions**.

Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups): None

Information or issues (included in *Description of Issue*) not previously contemplated by the Working Group: None

Convergence with International Financial Reporting Standards (IFRS): Not applicable

Staff Review Completed by:
Robin Marcotte, NAIC Staff – July 2019

Staff Recommendation:
NAIC Staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive and expose revisions to SSAP No. 71 as illustrated below. NAIC Staff recommends that revisions to the guidance clarify the following:

1. A levelized commission arrangement (whether linked to traditional or nontraditional elements) require the establishment of a liability for the full amount of the unpaid principal and accrued interest payable to a third party at the time the policy is issued.

2. The persistency commission is accrued proportionately over the policy period in which the commission relates to and is not deferred until fully earned.

These recommendations are consistent with the original intent of SSAP No. 71 as well as the Statutory Statement of Concepts focusing on Recognition (excerpts from Preamble, paragraphs 37 and 38):

- Liabilities require recognition as they are incurred.

- Accounting treatments which tend to defer expense recognition do not generally represent acceptable SAP treatment.

Proposed Revisions to SSAP No. 71:

SUMMARY CONCLUSION

2. Acquisition costs are those costs that are incurred in the acquisition of new and renewal insurance contracts and include those costs that vary with and are primarily related to the acquisition of insurance contracts (e.g., agent and broker commissions, certain underwriting and policy issue costs, and medical and inspection fees). Acquisition costs and commissions shall be expensed as incurred. Determination of when acquisition costs and commissions have been incurred shall be made in accordance with SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets. The recognition of commission expense for new and renewal insurance contracts meets the definition of a liability under SSAP No. 5R when the policy is issued or renewed. The issuance of the policy is the obligating event under SSAP No. 5R.

3. Contingent commission liabilities shall be determined in accordance with the terms of each individual commission agreement. Commission liabilities determined on the basis of a formula that relates to loss experience shall be established for the earned portion. Assumptions used to calculate the contingent commission liability shall be consistent with the terms of the policy contract and with the assumptions made in recording other assets and liabilities necessary to reflect underwriting results of the reporting entity such as retrospective premium adjustments and loss reserves, including incurred but not reported. Commission contracts that include persistency (or other such components) shall not use these clauses to defer recognition of commission expense. If a commission is based on annual policy persistency (or similar components), the commission is accrued based on experience to date for the policy period (it is inappropriate to wait until the amount is fully earned and/or unavoidable). Actual policy cancellation would reverse the accrual of the related persistency commission.

4. Levelized commissions occur in situations where agents receive normal (non-level) commissions with payments made by a third party. It is intended, but not necessarily guaranteed, that the amounts paid to the agents by the third party would ultimately be repaid (with interest explicit or implied) to the third party by levelized payments (which are less than the normal first year commissions but exceed the normal renewal commissions) from the reporting entity. These transactions are, in fact, funding agreements between a reporting entity and a third party. The continuance of the stream of payments specified in the levelized commission contract is a mechanism to bypass recognition of those expenses which are ordinarily charged to expense in the first year of the contract. Consequently, the normal link

between the persistency of the policy, the continuance of the premium payment or the maintenance of the agent's license with the reporting entity is not maintained with respect to the payment stream.

5. The use of an arrangement where commission payments are not linked to traditional elements such as premium payments and policy persistency, but rather are linked to the repayment of an advance amount requires the establishment of a liability for the full amount of the unpaid principal and accrued interest which is payable to a third party related to levelized commissions[FN].

New Footnote – The guidance in this paragraph does not imply that levelized commissions that are linked to traditional elements do not require establishment of a liability. Rather, such levelized commissions are captured in paragraphs 3-4.

Status:
On August 3, 2019, the Statutory Accounting Principles (E) Working Group moved this agenda item to the active listing, categorized as nonsubstantive, and exposed revisions to *SSAP No. 71—Policy Acquisition Costs and Commissions*, as illustrated above, to clarify levelized commissions guidance and provide additional direction regarding commissions that are based on policy persistency. The revisions also clarify that the recognition of commission expense is based on experience to date.

For Fall 2019 Discussion NAIC staff has proposed updates for exposure.

Paragraph 2 - Removed previously exposed revisions as unneeded.
Paragraph 3 - Added clarifying phrases regarding persistency commission accrual. The concept is that normal persistency commission is accrued for the period it relates to unless the policy is cancelled.
Paragraph 4 - Added two clarifying phrases to assist with identifying levelized commission funding agreements.
Paragraph 5 - Added clarifying phrases regarding funding agreements.
Footnote 1 - Redrafted to remove double negative wording.

SSAP No. 71:

SUMMARY CONCLUSION

2. Acquisition costs are those costs that are incurred in the acquisition of new and renewal insurance contracts and include those costs that vary with and are primarily related to the acquisition of insurance contracts (e.g., agent and broker commissions, certain underwriting and policy issue costs, and medical and inspection fees). Acquisition costs and commissions shall be expensed as incurred. Determination of when acquisition costs and commissions have been incurred shall be made in accordance with SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets.

3. Contingent commission liabilities shall be determined in accordance with the terms of each individual commission agreement. Commission liabilities determined on the basis of a formula that relates to loss experience shall be established for the earned portion. Assumptions used to calculate the contingent commission liability shall be consistent with the terms of the policy contract and with the assumptions made in recording other assets and liabilities necessary to reflect underwriting results of the reporting entity such as retrospective premium adjustments and loss reserves, including incurred but not reported. Commission contracts that include persistency (or other such components) shall not use these clauses to defer recognition of commission expense. If a commission is based on annual policy persistency (or other similar components), the commission shall be accrued based on experience to date for the policy period that the commission relates. In regard to persistency commission, it is inappropriate to wait until the amount is fully earned and/or unavoidable to accrue experience to date commission expenses. Actual policy cancellation would reverse the accrual of the related persistency commission.

4. Levelized commissions occur in situations where agents receive normal (non-level) commissions with payments made by a third party. It is intended, but not necessarily guaranteed, that the amounts paid

to the agents by the third party would ultimately be repaid (with interest explicit or implied) to the third party by levelized payments (which are less than the normal first year commissions but exceed the normal renewal commissions) from the reporting entity. (Note: levelized repayments made by the reporting entity extend the repayment period but might not be a straight-line repayment.) These transactions are, in fact, funding agreements between a reporting entity and a third party, regardless of how the payment to the third party is characterized. The continuance of the stream of payments specified in the levelized commission contract is a mechanism to bypass recognition of those expenses which are ordinarily charged to expense in the first year of the contract. Consequently, the normal link between the persistency of the policy, the continuance of the premium payment or the maintenance of the agent's license with the reporting entity is not maintained with respect to the payment stream.

5. The use of an arrangement such as a levelized commission arrangement where commission payments are not linked to traditional elements such as premium payments and policy persistency, but rather are linked to the repayment of an advance amount paid by a third party to the agents requires the establishment of a liability by the reporting entity for the full amount of the unpaid principal and accrued interest which is payable to a third party related to levelized commissions[FN].

New Footnote – The guidance in this paragraph notes that levelized commissions which use a third party to pay agents that are linked to traditional elements require establishment of a liability for the amounts that have been paid to the agents and any interest accumulated to date.

On December 7, 2019, the Statutory Accounting Principles (E) Working Group exposed revisions to *SSAP No. 71—Policy Acquisition Costs and Commissions*, as illustrated above, to include additional NAIC staff modifications regarding persistency commission and levelized commission arrangements to address certain comments received and to allow for further discussion. With this exposure, the Working Group directed a notification of the exposure to be sent to the Life Actuarial (A) Task Force.

On March 18, 2020, the Statutory Accounting Principles (E) Working Group deferred discussion of this item for a subsequent call or meeting.

On July 30, 2020, the Statutory Accounting Principles (E) Working Group exposed revisions to *SSAP No. 71—Policy Acquisition Costs and Commissions*, as illustrated below. Exposed revisions clarify existing levelized commissions guidance which requires full recognition of the funding liabilities incurred to date for commission expenses prepaid on behalf of an insurer. The exposed revisions are consistent with the 2019 Fall National Meeting exposure, with the inclusion of guidance to clarify that reporting entities that have not complied with the original intent shall reflect the change as a correction of an error, in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*, in the year-end 2020 financial statements.

SUMMARY CONCLUSION

2. Acquisition costs are those costs that are incurred in the acquisition of new and renewal insurance contracts and include those costs that vary with and are primarily related to the acquisition of insurance contracts (e.g., agent and broker commissions, certain underwriting and policy issue costs, and medical and inspection fees). Acquisition costs and commissions shall be expensed as incurred. Determination of when acquisition costs and commissions have been incurred shall be made in accordance with SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets.

3. Contingent commission liabilities shall be determined in accordance with the terms of each individual commission agreement. Commission liabilities determined on the basis of a formula that relates to loss experience shall be established for the earned portion. Assumptions used to calculate the contingent commission liability shall be consistent with the terms of the policy contract and with the assumptions made in recording other assets and liabilities necessary to reflect underwriting results of the reporting entity such as retrospective premium adjustments and loss reserves, including incurred but not reported. Commission contracts that include persistency (or other such components) shall not use these clauses to defer recognition of commission expense. If a commission is based on annual policy persistency (or other similar components), the commission shall be

accrued based on experience to date for the policy period that the commission relates. In regard to persistency commission, it is inappropriate to wait until the amount is fully earned and/or unavoidable to accrue experience to date commission expenses. Actual policy cancellation would reverse the accrual of the related persistency commission.

4. Levelized commissions occur in situations where agents receive normal (non-level) commissions with payments made by a third party. It is intended, but not necessarily guaranteed, that the amounts paid to the agents by the third party would ultimately be repaid (with interest explicit or implied) to the third party by levelized payments (which are less than the normal first year commissions but exceed the normal renewal commissions) from the reporting entity. (Note: levelized repayments made by the reporting entity extend the repayment period but might not be a straight-line repayment.) These transactions are, in fact, funding agreements between a reporting entity and a third party, regardless of how the payment to the third party is characterized. The continuance of the stream of payments specified in the levelized commission contract is a mechanism to bypass recognition of those expenses which are ordinarily charged to expense in the first year of the contract. Consequently, the normal link between the persistency of the policy, the continuance of the premium payment or the maintenance of the agent's license with the reporting entity is not maintained with respect to the payment stream.

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New Footnote – The guidance in this paragraph notes that levelized commissions which use a third party to pay agents that are linked to traditional elements require establishment of a liability for the amounts that have been paid to the agents and any interest accumulated to date.

Effective Date and Transition

7. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*. The nonsubstantive revisions adopted regarding levelized commission intend to clarify the original intent of this statement. Reporting entities that have not complied with the original intent of the statement shall reflect the change as a correction of an error (as a mistake in the application of an accounting principle) pursuant to SSAP No. 3 in the December 31, 2020 financial statements. In accordance with SSAP No. 3, correction of all accounting errors in previously issued financial statements, for which an amended financial statement was not filed, shall be reported as an adjustment to unassigned funds (surplus) in the period in which the error was detected. Disclosure shall also occur in accordance with SSAP No. 3.

Shaded SSAP No. 71 Revisions for October 2020 Working Group Discussion

2. Acquisition costs are those costs that are incurred in the acquisition of new and renewal insurance contracts and include those costs that vary with and are primarily related to the acquisition of insurance contracts (e.g., agent and broker commissions, certain underwriting and policy issue costs, and medical and inspection fees). Acquisition costs and commissions shall be expensed as incurred. Determination of when acquisition costs and commissions have been incurred shall be made in accordance with SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets.

3. Contingent commission liabilities shall be determined in accordance with the terms of each individual commission agreement. Commission liabilities determined on the basis of a formula that relates to loss experience shall be established for the earned portion. Assumptions used to calculate the contingent commission liability shall be consistent with the terms of the policy contract and with the assumptions made in recording other assets and liabilities necessary to reflect underwriting results of the reporting entity such as retrospective premium adjustments and loss reserves, including incurred but not reported. ~~Commission contracts that include persistency (or other such components) shall not use these clauses to defer recognition of commission expense. If a commission is based on annual policy persistency (or other similar components), the commission shall be accrued based on experience to date for the policy period that the commission relates. In regard to persistency commission, it is inappropriate to wait until the amount is fully earned and/or unavoidable to accrue experience to date commission expenses. Actual policy cancellation would reverse the accrual of the related persistency commission.~~

4. Levelized commissions occur in situations where agents receive normal (non-level) commissions with payments made by a third party. It is intended, but not necessarily guaranteed, that the amounts paid to the agents by the third party would ultimately be repaid (with interest explicit or implied) to the third party by levelized payments (which are less than the normal first year commissions but exceed the normal renewal commissions) from the reporting entity. (Note: levelized repayments made by the reporting entity extend the repayment period but might not be a straight-line repayment.) These transactions are, in fact, funding agreements between a reporting entity and a third party, regardless of how the payment to the third party is characterized. The continuance of the stream of payments specified in the levelized commission contract is a mechanism which attempts to bypass recognition of those expenses which are ordinarily charged to expense in the first year of the contract. Consequently, the normal link between the persistency of the policy, the continuance of the premium payment or the maintenance of the agent's license with the reporting entity is not maintained with respect to the payment stream.

5. The use of an arrangement such as a levelized commission arrangement where commission payments are not linked to traditional elements such as premium payments and policy persistency, but rather are linked to the repayment of an advance amount paid by a third party to the direct selling agents requires the establishment of a liability by the reporting entity for the full amount of the unpaid principal and accrued interest which is payable to a third party related to levelized commissions ~~FN~~. Arrangements that use a third party to pay agents who write policies for the reporting entity and the insured can be an attempt to de-link the relationship between the insurer and those agents and defer or levelize the acquisition commissions. The insurance reporting entity is required to recognize the full amount of earned commission costs to the direct policy writing agents even if those costs are paid indirectly to the agents by a third party through the use of levelized commission, or similar arrangement, which is in substance a funding arrangement. Having a third party pay commission costs to the selling agent is strong evidence of a potential funding arrangement which shall be recognized as a liability because the substance of the arrangement indicates that repayment is reasonable and probable, even if a contingency has been incorporated into the funding arrangement, unless the underlying policy has been cancelled. A third-party structure cannot recharacterize (e.g. by referencing policy persistency) and delay recognition of liabilities for initial sales commission owed from the writing of policies regardless of how a third-party arrangement is structured with regards to the timing of payment from the insurer. The amount owed for full initial sales commission shall be recognized immediately as the writing of an insurance contract is the event that obligates the insurer, and such action shall occur consistently among insurers. As such, this recognition is required regardless if the insurer owes a selling agent directly or if a third-party has been contracted to provide payment to the selling agent.

~~New Footnote – The guidance in this paragraph notes that levelized commissions which use a third party to pay agents that are linked to traditional elements require establishment of a liability for the amounts that have been paid to the agents and any interest accumulated to date.~~

Effective Date and Transition

7. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*. The nonsubstantive revisions adopted regarding levelized commission ~~intend~~are to clarify the original intent of this statement and are effective January, 2021. ~~Reporting entities that have not complied with the original intent of the statement shall reflect the change as a correction of an error (as a mistake in the application of an accounting principle) pursuant to SSAP No. 3 in the December 31, 2020 financial statements. In accordance with SSAP No. 3, correction of all accounting errors in previously issued financial statements, for which an amended financial statement was not filed, shall be reported as an adjustment to unassigned funds (surplus) in the period in which the error was detected. Disclosure shall also occur in accordance with SSAP No. 3.~~

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Attachment B

Statutory Accounting Principles (E) Working Group
Oct. 2020
Comment Letters Received

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AICPA

September 14, 2020
Mr. Dale Bruggeman
Statutory Accounting Principles Working Group
National Association of Insurance Commissioners
2301 McGee Street, Suite 800
Kansas City, MO 64108-2662

Ref: 2019-24 - Levelized and Persistency Commission

Dear Mr. Bruggerman:

The American Institute of Certified Public Accountants' NAIC Task Force (Task Force) appreciates the opportunity to discuss our comments on Form A: Issue 2019-24, Levelized and Persistency Commission.

Our comments are in response to the proposed transition language in paragraph 7 related to the nonsubstantive revisions regarding levelized commissions:

> **Effective Date and Transition**
>
> 7. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*. The nonsubstantive revisions adopted ________ regarding levelized commission intend to clarify the original intent of this statement. Reporting entities that have not complied with the original intent of the statement shall reflect the change as a correction of an error (as a mistake in the application of an accounting principle) pursuant to SSAP No. 3 in the December 31, 2020 financial statements. In accordance with SSAP No. 3, correction of all accounting errors in previously issued financial statements, for which an amended financial statement was not filed, shall be reported as an adjustment to unassigned funds (surplus) in the period in which the error was detected. Disclosure shall also occur in accordance with SSAP No. 3.

We believe that the requirement to account for this clarification as a correction of an error pursuant to SSAP No. 3 in the year-end 2020 financial statements would be a departure from how the NAIC has traditionally adopted clarifications to statutory accounting as changes in accounting principle. (We are not aware of any other examples of revisions to SSAPs being considered an error correction since the adoption of the revised NAIC *Accounting Practices and Procedures Manual* in 2001.) We believe that resolving the diversity in practice that currently exists in the accounting for levelized commission programs as the correction of an error would be inconsistent with the NAIC's recent treatment of other nonsubstantive revisions that were adopted to promote the uniform application of statutory accounting guidance. For example, any change in income tax balances that resulted from the comprehensive revisions to the SSAP No. 101 Q&A that were adopted in 2019 to clarify the application of the deferred tax admissibility calculation for year-end 2019 reporting purposes were allowed to be reported as a change in accounting principle in accordance with SSAP No. 3. (Since changes in DTAs only affect surplus, the issue of the income

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statement needing to be adjusted due to the year-end adoption of new accounting guidance did not exist in this instance, as discussed further below.)

We recommend that the NAIC consider revising the transition language in Issue 2019-24 to allow companies to account for the change as a change in accounting principle, in accordance with SSAP No. 3. Paragraphs 3 through 5 of SSAP No. 3 discuss the characteristics and application of a change in accounting principle,

> A change in accounting principle results from the adoption of an accepted accounting principle, or method of applying the principle, which differs from the principles or methods previously used for reporting purposes. A change in the method of applying an accounting principle shall be considered a change in accounting principle.
>
> A characteristic of a change in accounting principle is that it concerns a choice from among two or more statutory accounting principles. However, a change in accounting principle is neither (a) the initial adoption of an accounting principle in recognition of events or transactions occurring for the first time or previously immaterial in their effect, nor (b) the adoption or modification of an accounting principle necessitated by transactions or events that are clearly different in substance from those previously occurring.
>
> The cumulative effect of changes in accounting principles shall be reported as adjustments to unassigned funds (surplus) in the period of the change in accounting principle. The cumulative effect is the difference between the amount of capital and surplus at the beginning of the year and the amount of capital and surplus that would have been reported at that date if the new accounting principle had been applied retroactively for all prior periods.

We believe the proposed change meets the definition of a change in accounting principle, as we believe the alternative interpretation of the levelized commission guidance in SSAP No. 71 has been accepted in practice. Specifically, we are aware from comments received from industry that some regulators (as part of periodic financial examinations) have not objected to the classification of levelized commission programs with commission payments linked to persistency as allowable in accordance with paragraph 5 of SSAP No. 71.

In addition, we believe that treating the proposed change as a correction of an error will potentially result in challenges for certain reporting entities. For example, reporting entities that have followed the alternative interpretation of the levelized commission guidance in SSAP No. 71 would have previously expensed a portion of this adjustment in their quarterly financial statements filed throughout 2020. If the guidance is adopted for year-end 2020, this expensed portion would need to be identified and reversed in order to properly report the adjustment to the opening (i.e., January 1, 2020) balance of surplus for year-end 2020 reporting purposes, which would increase the complexity of adopting the change. An option to avoid these complications would be to account for the change in accounting principle as of January 1, 2021, which is consistent with the guidance in SSAP No. 3 to adopt new accounting principles at the beginning of the year.

We also wanted to bring it to the Working Group's attention that requiring this clarification to be accounted for as a correction of an error could result in the independent auditor being required to express a qualified opinion on the prior year audited statutory basis financial statements in accordance with AICPA standards. This consideration exists in situations where the misstatements are material but not pervasive to the financial statements unless the prior year financial statements are restated, regardless of the statutory account treatment provided by SSAP No. 3 to recognize the correction of the error.

We appreciate the opportunity to express our views. If you should have any questions regarding our comments, please contact me at (440) 893-0010 or Kim Kushmerick, AICPA at (212) 596-6160.

Sincerely,

Jean Connolly
Chair - AICPA NAIC Task Force

CC:
Bob Dohrer, AICPA Chief Auditor
Tracy Harding, Chair - ASB
Angela Newell, Chair – FinREC
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September 18, 2020

Mr. Dale Bruggeman, Chairman
Statutory Accounting Principles Working Group
National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

RE: Items Exposed for Comment by the Statutory Accounting Principles Working Group on July 30 with Comments due September 18

Dear Mr. Bruggeman:

Interested parties appreciate the opportunity to comment on the exposure drafts released for comment by the NAIC Statutory Accounting Principles (E) Working Group (the Working Group). We offer the following comments:

Ref #2019-24: Levelized and Persistency Commission

The Working Group moved this agenda item to the active listing, categorized as nonsubstantive, and exposed revisions to *SSAP No. 71—Policy Acquisition Costs and Commissions* (SSAP No. 71) to clarify levelized commissions guidance and provide additional direction regarding commissions that are based on policy persistency. The revisions also clarify that the recognition of commission expense is based on experience to date. The revisions are intended to clarify the original intent of SSAP No. 71 regarding levelized commissions. Reporting entities that have not complied with the original intent of the statement are to reflect the change as a correction of an error (as a mistake in the application of an accounting principle) pursuant to SSAP No. 3 in the December 31, 2020 financial statements. In accordance with SSAP No. 3, correction of all accounting errors in previously issued financial statements, for which an amended financial statement was not filed, are to be reported as an adjustment to unassigned funds (surplus) in the period in which the error was detected. Disclosure shall also occur in accordance with SSAP No. 3.

Interested parties would like to propose the following edits to SSAP No. 71, similar to those sent in January 2020.

SUMMARY CONCLUSION

2. Acquisition costs are those costs that are incurred in the acquisition of new and renewal insurance contracts and include those costs that vary with and are primarily related to the acquisition of insurance contracts (e.g., agent and broker commissions, certain underwriting and policy issue costs, and medical and inspection fees). Acquisition costs and commissions shall be expensed as incurred. Determination of when acquisition costs and commissions have been incurred shall be made in accordance with SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets. For example, when commissions are paid directly to an agent based upon renewal such as in traditional trail commission arrangements, commission expense would be recognized when the obligating event (i.e., the renewal) occurs and the related premium revenue is recognized.

3. Contingent commission liabilities shall be determined in accordance with the terms of each individual commission agreement. Commission liabilities determined on the basis of a formula that relates to loss experience shall be established for the earned portion. Assumptions used to calculate the contingent commission liability shall be consistent with the terms of the policy contract and with the assumptions made in recording other assets and liabilities necessary to reflect underwriting results of the reporting entity such as retrospective premium adjustments and loss reserves, including incurred but not reported. Other than the commission arrangements discussed in Paragraph 2, commission contracts that include persistency (or other such components) shall not use these clauses to defer recognition of commission expense. If a commission is based on annual policy persistency (or other similar components), the commission shall be accrued ratably over each annual period based on experience to date for which the persistency commission will be paid.~~the policy period that the commission relates~~. In regard to persistency commission, it is inappropriate to wait until the amount is fully earned and/or unavoidable to accrue experience to date commission expenses. Actual policy cancellation would reverse the accrual of the related persistency commission.

4. Levelized commissions occur in situations where agents receive normal (non-level) commissions with payments made by a third party. It is intended, but not necessarily guaranteed, that the amounts paid to the agents by the third party would ultimately be repaid (with interest explicit or implied) to the third party by levelized payments (which are less than the normal first year commissions but exceed the normal renewal commissions) from the reporting entity. (Note: levelized repayments made by the reporting entity extend the repayment period but might not be a straight-line repayment.) These transactions are, in fact, funding agreements between a reporting entity and a third party,. A funding agreement is an agreement whereby a third party provides a lump sum of money in return for a stream of payments over a predetermined time period. The payment stream is fixed without regard to the traditional elements of continued premium payments or policy persistency. The continuance of the stream of payments specified in the levelized commission contract is a mechanism to bypass recognition of those expenses which are ordinarily charged to expense in the first year of the contract. Consequently, the normal link between the persistency of the policy, the continuance of the premium payment or the maintenance of the agent's license with the reporting entity is not maintained with respect to the payment stream.

5. The use of an arrangement such as a levelized commission arrangement where commission payments are not linked to traditional elements such as premium payments and policy persistency, but rather are linked to the repayment of an advance amount paid by a third party to the agents requires the establishment of a liability by the reporting entity for the full amount of the unpaid principal and accrued interest which is payable to a third party related to levelized commissions ~~FN~~.

~~New Footnote – The guidance in this paragraph notes that levelized commissions which use a third party to pay agents that are linked to traditional elements require establishment of a liability for the amounts that have been paid to the agents and any interest accumulated to date.~~

Effective Date and Transition

7. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*. ~~The nonsubstantive revisions adopted ________ regarding levelized commission intend to clarify the original intent of this statement. Reporting entities that have not complied with the original intent of the statement shall reflect the change as a correction of an error (as a mistake in the application of an accounting principle) pursuant to SSAP No. 3 in the December 31, 2020 financial statements. In accordance with SSAP No. 3, correction of all accounting errors in previously issued financial statements, for which an amended financial statement was not filed, shall be reported as an adjustment to unassigned funds (surplus) in the period in which the error was detected. Disclosure shall also occur in accordance with SSAP No. 3.~~

We request that the above edits be incorporated into the proposed Ref #2019-24.

In addition, we believe that what have been deemed non-substantive clarifications to the original intent of SSAP No. 71 proposed by the SAPWG in Ref #2019-24 are in fact **substantive modifications** that materially change accounting practices that were established long before the 2001 codification, and that continue today in many different forms

Per the SAPWG process, substantive statutory accounting revisions introduce original or modified accounting principles. Substantive revisions can be reflected in an existing Statement of Statutory Accounting Principles (SSAP) or a new SSAP. Nonsubstantive statutory accounting revisions are characterized as language clarifications that do not modify the original intent of a SSAP. SSAPs are considered the highest authority (Level 1) in the statutory accounting hierarchy.

The proposed accounting treatment in Ref #2019-24 is significantly different than the current interpretation of the original SSAP and general statutory principles, specifically, full recognition of an expense at the time the policy is issued versus incremental recognition of commission costs over time as the policy persists and they become legal obligations. The current proposed language does not address the many varying product/distribution compensation arrangements in the industry and IP believe this will cause unintended consequences. The link between the traditional elements such as policy persistency and the accrual of commissions is a long-standing principle. Eliminating the link to the policy persistency is not a clarification, it is a substantive change that modifies the original intent of SSAP No. 71, thus requiring further evaluation.

Interested parties believe that the exposure as written will also unintentionally impact the accounting for certain types of traditional trail commission arrangements that are commonplace in the market for life and annuity products. Although funding agreements can also have elements that are based upon policy persistency, there exists in the industry a longstanding practice of compensating agents directly based upon policy persistency. In these scenarios, the reporting entity has an agreement in place with agents that requires commission payment if and only if a policy persists (for example, at each annual renewal). If a policyholder opts not to renew, the reporting entity has no obligation to pay further commissions to the agent.

As written, interested parties believe this exposure would require the reporting entity to accrue these trail commissions at policy inception, which would be counter to the principles contained in SSAP No. 5R - *Liabilities, Contingencies and Impairment of Assets*. These commissions are not liabilities until the policy persists, and, until that time, the transaction obligating the entity has not occurred. Language added to paragraph 2 is intended to distinguish the scope of the guidance in paragraphs 3-5 from these traditional trail commission arrangements.

Further, interested parties strongly disagree with the modifications to paragraph 7. Reporting entities have filed annual statements based on the current interpretation of SSAP No. 71 with unqualified opinions from their external auditors. Regulatory examinations have also been completed by various states of domicile insurance departments without adjustment. IP believe that if the proposed revisions are adopted and result in an accounting change, these should be reflected as a change in accounting principle. Per SSAP No. 3, “A change in accounting principle results from the adoption of an accepted accounting principle, or method of applying the principle, which differs from the principles or methods previously used for reporting purposes.” Reporting entities that in good faith applied a particular method by following SSAP No. 71 and were not required to adjust statements as a result of audits or regulatory examinations, should not be considered to have made an **accounting error**. As such, interested parties disagree with the modifications in paragraph 7. As noted above, the proposed revisions to SSAP No. 71 substantially change the interpretation that has been followed for years, and therefore, the original text would apply for a reporting entity that must change its method of applying the revised SSAP No. 71.

In summary, we recommend that the NAIC consider the changes contained in the current Ref #2019-24 exposure be reclassified as **substantive, that an issue paper be drafted, and that this be re-exposed and processed accordingly.**

Ref #2019-34: Related Parties, Disclaimers of Affiliation and Variable Interest Entities

The Working Group exposed proposed changes to SSAP No. 25 as described below:

- Based on the comments from the Group Solvency Issues (E) Working Group, NAIC staff added a new disclosure that provides information on minority ownership interests, as well as significant relationships between minority owners and other U.S. domestic insurers/groups. This new disclosure is not intended to include passive fund owners, such as ETFs and mutual funds. This is in paragraph 22 in the exhibit to this agenda item.

- NAIC staff removed the direct references to U.S. GAAP and SEC guidance that was included in the initial draft revisions. It was not intended to incorporate by reference the guidance from these sources but was instead intended to show that the revisions were going to be more consistent with the U.S. GAAP and SEC guidance. The language that was added to the description of related parties in paragraph 4 in the original exposure draft are all language from either U.S. GAAP or from laws and regulations related to the SEC.

- With the proposed rejection of the U.S. GAAP VIE guidance for statutory accounting, our intention is to rely on SSAP No. 25, including the proposed revisions, to capture related parties for reporting. These updates are not intended to change reporting in Schedule BA or Schedule D for any investments.

Based upon a call with NAIC staff and our understanding of the objective of the changes to SSAP No. 25, interested parties marked up SSAP No. 25 with edits that are directed at ownership interests in insurers (the reporting entity) of greater than 10% where the investor (owner) has filed and received a disclaimer of control, but leaves the requirements for investments of the insurer unchanged, except for the proposed additions to certain of the sub-paragraphs of paragraph 4 (see attached).

Also, we reviewed the two approaches for reporting shared by SAPWG staff with interested parties on September 1 regarding the proposed disclosure of ownership interests in insurers of greater than 10%. We believe the Schedule Y approach is the better of the two as it allows for the capture of more information regarding complex ownership arrangements; however, we believe that the development of instructions to go along with the new part of Schedule Y is needed before concluding on that approach.

Ref #2020-17: Updating the SCA Review Process

The Working Group moved this item to the active listing, categorized as nonsubstantive, and exposed revisions to *SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities* to provide updated descriptive language regarding SCA reviews. Additionally, this agenda item proposes a more streamlined method for communicating SCA review results.

Interested parties offer the following comments:

- We have no comments on the Form A.
- On the 2 additional files (see attached mark-up versions) which provide filing procedures for filing a Sub-1 form and a Sub-2 form, we suggest changing the following in the 'Note

to filer' paragraph on the first page of each document, which is consistent with changes adopted by SAPWG 2017-08 (Extension of SCA Filing Deadlines):

- ✓ A Sub-1 form is required to be filed within ~~30~~ 90 days of the acquisition or formation of the investment. A Sub-2 form is required to be filed annually for any existing investment~~, by June 30th of the next calendar year~~ by August 31st or one month after the audit report date.

- On page 8 of the Sub-2 document, there is reference to 'Sub-1' when it appears that it should be 'Sub-2'. This change has been reflected as a mark-up in the Sub-2 document.

Ref #2020-18: SSAP No. 97 Update

The Working Group moved this item to the active listing, categorized as nonsubstantive, and exposed revisions to *SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities*, removing the statement that guarantees or commitments from the insurance reporting entity to the SCA can result in a negative equity valuation of the SCA. This update reflects recently adopted guidance from agenda item 2018-27 which states that reported equity losses of an SCA shall not go negative (thus the reported basis will stop at zero), however to the extent there is a financial guarantee or commitment, that liability would be recognized in accordance with *SSAP No. 5R—Liabilities, Contingencies and Impairment of Assets.*

As stated in the Exposure, earlier this year SAPWG adopted item 2018-26 – SCA Loss Tracking – Accounting Guidance, which updated the accounting guidance provided under SSAP No. 97—*Investments in Subsidiary, Controlled and Affiliated Entities* (SSAP No. 97). Item 2018-26 stated that reported equity method losses of an investment in a subsidiary controlled or affiliated entity ("SCA") would not create a negative value in the SCA investment, thus stopping the reporting of the equity method losses at zero. However, to the extent there was a financial guarantee or commitment, it would require appropriate recognition under *SSAP No. 5R—Liabilities, Contingencies and Impairment of Assets.* These updates were made to paragraph 14e of SSAP No. 97.

The Exposure intends to further clarify paragraph 9 of SSAP No. 97, which describes all the adjustments that must be recorded by the insurer when recording its equity pick up in 8.b.ii and 8.b.iv entities (8.b.iv entities will be referred to herein as "foreign insurance subsidiaries"). Per the Exposure, the last sentence in paragraph 9 is being modified as shown below to make the sentence consistent with the guidance that was issued under item 2018-26:

> "Note that the outcome of these adjustments, ~~as well as guarantees or commitments of the parent entity to provide additional funding,~~ can result in a negative equity valuation of the investment."

This change suggests that SSAP No. 97 requires negative equity valuation of foreign insurance subsidiaries. If that was always the intent, we would point out that there are substantive reasons to differentiate foreign insurance subsidiaries from 8.b.ii entities and floor their equity at zero, including the fact that foreign insurance entities have a true business purpose, independent from the parent insurer, and are subject to significant regulations in the foreign jurisdiction in which they operate.

In addition to these reasons, requiring negative equity valuation of foreign insurance subsidiaries would also appear to be a change from our prior understanding, which was based in part upon question 7 of the SSAP No. 97 Q&A. Question 7 of the SSAP No. 97 Q&A only refers to 8.b.ii entities as the type of entities for which negative equity would be required to be recorded. Since question 7 does not mention foreign insurance subsidiaries, we historically interpreted that to mean that negative equity would not be recorded for those entities, regardless of whether the negative equity was due to operating losses or paragraph 9 adjustments.

Interested parties request clarification from the SAPWG on whether the intent of the Exposure's modifications to the paragraph 9 adjustments is intended to cause an insurer's equity investment in a foreign insurance subsidiary to fall below zero. We are also seeking clarification on whether question 7 of the SSAP No. 97 Q&A was only meant to apply to operating losses and not paragraph 9 adjustments. (On a related note, we suggest that question 7 of the SSAP No. 97 Q&A itself be updated to reflect this Exposure since question 7 of the Q&A makes reference to 8.b.ii entities being reported with negative equity. However, we understand that Ref #2018-26 changed that so that negative equity would only be tracked and not reported unless there was a guarantee issued by the insurance reporting entity on the subsidiary.)

In regard to the potential intent of paragraph 9 adjustments requiring an insurance reporting entity to report its equity investment in a foreign insurance subsidiary or an 8.b.ii. subsidiary at an amount below zero, we offer a few comments and observations.

- We agree that with respect to 8.b.ii entities, the statutory accounting guidance would require an insurer to report negative equity since 8.b.ii entities are considered an extension of the insurance company. 8.b.ii entities may own assets that would not be admitted if owned by the insurer, so it is reasonable to require the insurer to report negative equity in those subsidiaries to prevent such assets from becoming admissible simply because they are owned by an 8.b.ii subsidiary and not owned directly by the insurer.
- We, however, do not agree that the application of the paragraph 9 adjustments should ever result in the insurer's investment in a foreign insurance subsidiary being reported at an amount less than zero. Prior to applying the SSAP No. 97 paragraph 9 adjustments, the GAAP equity of a foreign insurance subsidiary is subject to the following recoverability and impairment tests on the net assets inherent in its GAAP equity:
  - ✓ GAAP loss recognition testing of DAC and reserves, for which additional liabilities would be established for expected future losses beyond recovery of any GAAP assets (including recoverability of deferred acquisition costs, or DTAs),
  - ✓ GAAP impairment testing of asset balances (e.g. – goodwill, DTA's, investment other-than-temporary losses)

The application of the paragraph 9 adjustments to a foreign insurance subsidiary's GAAP equity results in a valuation of these entities that is in some cases more conservative than U.S. statutory accounting and that does not reflect the foreign insurance subsidiary's valuation. (For example, deferred acquisition costs that have been deemed recoverable under GAAP are non-admitted, while holding the higher gross GAAP reserve that has no implicit credit for acquisition expenses that is inherent in statutory reserves).

Furthermore, foreign insurance companies are more akin to 8.b.iii entities as they are independent business entities that sell insurance products to customers. In addition, foreign insurance subsidiaries are subject to significant regulations, including capital requirements, by their local insurance regulators. As such, unlike 8.b.ii SCA entities, these foreign insurance companies are stand-alone operations and not an extension of the domestic insurance company. Therefore, we believe these entities should be treated consistently as an 8.b.iii SCA entity, and only recognize a negative equity value (in the form of an SSAP No. 5R liability) to the extent the parent insurance company has guaranteed obligations of the foreign insurance company or is otherwise committed to provide further financial support for the investee.

Finally, not all foreign insurance companies receive audited GAAP financial statements. In these situations, the investment in the foreign insurance subsidiary (cost basis) is non-admitted, and no results are reflected in surplus until the foreign insurance company distributes earnings to the parent insurance company. If a parent insurance company does decide to obtain an audit of its foreign insurance company, it should not result in an impact to surplus that is worse than non-admitting the investment.

Ref #2020-19: Clarification Edits - Mortgage Loan Participations

The Working Group moved this item to the active listing, categorized as nonsubstantive, and exposed revisions to *SSAP No. 37—Mortgage Loans* to clarify that a participant's financial rights may include the right to take legal action against the borrower (or participate in the determination of legal action), but do not require that the participant have the right to solely initiate legal action, foreclosure, or under normal circumstances, require the ability to communicate directly with the borrower.

Interested parties support this proposal.

Ref #2020-20: Disclosure of Rolled Cash Equivalent Investments

The Working Group moved this item to the active listing, categorized as nonsubstantive, and exposed revisions to *SSAP No. 2R—Cash, Cash Equivalents, Drafts and Short-Term Investments* to require the identification/disclosure of cash equivalents and short-term investments, or substantially similar investments, which remain on the same reporting schedule for more than one consecutive reporting period. (This revision expands current disclosure requirements to include cash equivalent investments.) Additionally, the revisions clarify that the disclosure is satisfied through the use of the code on the investment schedules.

Interested parties support the clarification that the disclosure elements as adopted for short term investments shall also apply to relevant cash equivalent investments, and the stipulation that this disclosure is satisfied by use of a designated code in the investment schedules of the statutory financial statements. To avoid inadvertently capturing data which is not relevant to the objectives of this disclosure, we suggest the following qualification be added to the exposed language proposed:

> "Identification of cash equivalents ***(excluding money market mutual funds as detailed in paragraph 7)*** and short-term investments, (or substantially similar investments), which remain on the same reporting schedule for more than one consecutive reporting period."

Ref #2020-21: SSAP No. 43R - Designation Categories for RMBS/CMBS Investments

The Working Group moved this item to the active listing, categorized as nonsubstantive, and exposed revisions to *SSAP No. 43R—Loan-backed and Structured Securities*, to reflect the updated final designation guidance for RMBS/CMBS securities. This update will reflect the guidance recently adopted for the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P manual).

Interested parties support the alignment of final designation guidance for RMBS/CMBS securities in SSAP No. 43R with the instructions recently adopted into Part Four of the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* ("P&P Manual"). To avoid confusion and foster consistent and appropriate application for statutory accounting and reporting purposes in alignment with the instructions in the P&P Manual, we suggest the following editorial clarifications to the proposed updates for SSAP No.43R, paragraph 27.a.iii:

> "Step 3: Determine Final Designation – The final NAIC designation~~**, as determined by the modeled price range,**~~ is determined by comparing the carrying value (divided by remaining par amount) of a security (based on paragraph 27.a.ii.) to the NAIC CUSIP specific modeled breakpoint values assigned to the six (6) NAIC designations for each CUSIP. ***The final*** NAIC designations ***is*** mapped to ***an*** NAIC designation **category according to the instructions** in the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*~~**, along with instructions for tranches that have no expected loss under any of the selected modeling scenarios and instructions for non-modeled securities**~~. The final NAIC designation ~~**and NAIC designation category**~~ shall be applicable for statutory accounting and reporting purposes**, and the NAIC designation category will be used for** investment schedule reporting and establishing ~~**RBC and**~~ AVR charges. The final NAIC designation is not used for establishing the appropriate carrying value method in Step 2 (paragraph 27.a.ii.)."

*The reference to RBC is unnecessary in the statutory accounting and reporting guidance of the AP&P Manual, as this is already appropriately covered with the NAIC's Risk Based Capital Instructions and Forms.

Ref #2020-22: Accounting for Perpetual Bonds

The Working Group moved this item to the active listing, categorized as nonsubstantive, and exposed revisions to *SSAP No. 26R—Bonds*, to clarify that perpetual bonds shall be reported at fair value, not to exceed any current effective call price. Although this is considered a nonsubstantive change, a stated effective date of Jan. 1, 2021, with early application permitted, has been proposed to allow time for reporting entities to make measurement changes as needed.

Interested parties appreciate the opportunity to respond to the SAPWG proposed Ref #2020-22, *Accounting for Perpetual Bonds* ("the proposal"). In the proposal, perpetual bonds are defined as those fixed income securities, representing creditor relationships, with fixed schedules of future payments, however the bonds do not contain maturity dates. The proposal compares perpetual bonds to perpetual preferred stock and concludes that they are substantially the same, with the primary cash flow difference being that perpetual bonds have priority in liquidation versus preferred stock. The proposal also states that due to the lack of a maturity date, insurers do not accrete discounts or amortize premiums. As a result, Ref #2020-22 proposes that perpetual bonds be treated the same as perpetual preferred stock by reporting them at fair value for Statutory reporting. Although not specifically stated in the exposure, it is interested parties' presumption that this implies that periodic changes in fair value would be reported in unrealized capital gains and losses.

Interested parties agree that perpetual bonds do have some characteristics in common with equity securities, which justify their continued reporting as hybrids on Schedule D as established in INT 2008-06's hybrid discussions. However, we believe that the characteristics of these investments are substantially similar to bonds, are utilized by insurers with similar investment objectives as investing in other bonds and are viewed by the capital markets as bonds. As a result, interested parties believe that perpetual bonds should continue to be accounted for as bonds under SSAP No. 26R (as currently written) and reported on Schedule D as hybrids.

In the discussion below, we provide further clarification of relevant attributes and industry practice associated with perpetual bonds, and outline several key reasons why interested parties do not agree that perpetual bonds should be reported the same as perpetual preferred stock (i.e., at fair value with periodic changes in fair value reported in unrealized gains and losses); rather, we believe accounting for all bonds, including perpetual bonds, as prescribed in SSAP 26R, as currently written, is appropriate.

The following are key reasons why interested parties believe perpetual bonds are substantially the same as other bonds, versus perpetual preferred stock:

- **Amortization of premiums and accretion of discounts:** The proposal notes that due to a lack of a maturity date, insurers do not accrete discounts or amortize premiums on perpetual bonds. However, many insurers in the interested parties group do have methodologies to amortize premiums and accrete discounts. Most often, companies amortize premiums to the call date for the bonds (i.e., apply yield to worst) and accrete discounts to a date that is far into the future (i.e., consistent with how Bloomberg treats such bonds when quoting market yields for the bonds). Investors believe this approach to estimating a yield is a reasonable depiction of the true yield expected to be earned on the investments.

- **Call date is a pseudo-maturity date:** The capital markets and investors (including insurers) consider the call date in the bonds to be a pseudo-maturity date. That is, it is expected that the perpetual bonds will be called on the call date. Oftentimes insurers price the bonds to the call date. Many times, the bonds have step-up coupon provisions at the call date, which provides an incentive for the issuer to call the bonds, or there are other reasons why there is a market compulsion for the issuer to call such bonds on the call date. The expectation that the bonds will be called is one of the key characteristics that results in many companies reporting such bonds as fixed income for US GAAP reporting purposes. In the rare cases where perpetual bonds do not have callability, all other characteristics are the same as those bonds with callability (e.g., capital markets consider them bonds, the trade like bonds, the investment objective is the same as bonds, etc.) and thus interested parties believe they should be reported the same as all other bonds.

- **How perpetual bonds trade in the market:** The market's view of the call provisions on perpetual bonds, as outlined above, is a key reason (among others) that perpetual bonds trade in the capital markets like bonds. As a result, these instruments are more sensitive to interest rate movements, are generally priced like bonds (inclusive of accrued interest) and are quantified and measured in terms of par value and not in terms of shares of stock.

- **US GAAP reporting:** Those insurers who invest in perpetual bonds generally report them as fixed income for US GAAP reporting purposes. Some companies evaluate the investment characteristics (per the guidance in Topic 815) to determine if the characteristics such as redemption rights, voting rights, conversion rights, dividend rights, and protective covenants are more debt like or equity like when determining the appropriate reporting. Additionally, companies consider how the investments are viewed in the capital markets. The analysis performed generally concludes that perpetual bonds are more bond like than equity like. When classified as bonds, they are evaluated for impairment like any other bond (e.g., insurers assess the ability for the issuer to pay interest and principal).

- **Investment strategy for perpetual bonds:** Insurers invest in perpetual bonds for their fixed cash flows (interest and expected return of principal when called by the issuer) and not for market appreciation. Like other bonds, the expected fixed cash flows are used for cash flow matching to insurance liabilities. Many perpetual bonds have a fixed coupon and if not called the coupon adjusts to a current floating rate plus a spread (e.g., that is stepped-up significantly from original issuance spreads). Also, when insurers manage their investment portfolios (e.g., investment allocations, assessing risks, etc.), perpetual bonds are classified as bonds and not equities.

- **Monetization of perpetual bonds:** A key reason equity securities are reported at fair value for Statutory reporting purposes is because there is no certainty in the cash flows they generate and return to the investor (return of principal and return on investment), which includes dividend payments. Additionally, the return of an investor's original investment can only be monetized by selling the equity security at fair value. As a result, fair value is an important measurement when considering the expected return to the investor. Regarding perpetual bonds, the opposite situation exists. The cash flows have a much higher level of certainty (interest to be paid for the life of the investment is contractual and does not require the issuer's board declaring a dividend like a preferred stock and the return of par at the call date) like any other bond. As a result, similar to other bonds, we do not believe fair value is a relevant measurement principle for such investments for Statutory reporting purposes.

Interested parties agree that perpetual bonds do have some unique characteristics that are similar to equity securities; however, their characteristics are predominantly those consistent with bonds (e.g., investments are generally priced, traded, and utilized by insurers in the same manner as other bonds). We believe accounting for all bonds, including perpetual bonds, as prescribed in SSAP No. 26R, as currently written, is appropriate. We have not identified any justification to report and account for perpetual bonds differently from other bonds. However, given they may contain some equity-like characteristics, we believe they should continue to be reported as hybrid investments in Schedule D, as established in 2008-06BWG's hybrid discussions. This would provide transparency to regulators as to their existence in insurers' investment portfolios.

Ref #2020-23: Update to Leasehold Improvements

The Working Group moved this item to the active listing, categorized as nonsubstantive, and exposed revisions to *SSAP No. 19—Furniture, Fixtures, Equipment and Leasehold Improvements* and *SSAP No. 73—Health Care Delivery Assets and Leasehold Improvements in Health Care Facilities*, to allow the amortization of leasehold improvements to match the associated lease term, which is guidance that agrees with U.S. GAAP, ASC Topic 842.

Interested parties support this proposal.

Ref #2020-24: Accounting and Reporting of Credit Tenant Loans

The Working Group moved this item to the active listing, categorized as nonsubstantive, and exposed this agenda item with a request for comments on the two general options for the accounting treatment of credit tenant loans (CTL). Notification will also be sent to the Valuation of Securities (E) Task Force of this agenda item in response to their referral. With this notification, NAIC staff will request further confirmation that a SVO-Listing could be developed to capture the CTLs that meet the SVO's structural and legal analysis and possess bond characteristics.

Interested parties' response – please see separate letter

Ref #2020-25EP: Editorial and Maintenance Update

The Working Group moved this item to the active listing, categorized as nonsubstantive, and exposed editorial revisions to *SSAP No. 5R—Liabilities, Contingencies and Impairments of Asset* and *SSAP No. 62R—Property and Casualty Reinsurance*.

Interested parties have no comments on this item.

Ref #2020-26: ***ASU 2015-10, Technical Corrections & Improvements***

The Working Group moved this agenda item to the active listing, categorized as nonsubstantive, and exposed revisions to *Appendix D—Nonapplicable GAAP Pronouncements* to reject *ASU 2015-10, Technical Corrections & Improvements* as not applicable to statutory accounting.

Interested parties have no comments on this item.

Ref #2020-27: ***ASU 2019-09, Financial Services – Insurance; Effective Date***

The Working Group moved this agenda item to the active listing, categorized as nonsubstantive, and exposed revisions to *Appendix D—Nonapplicable GAAP Pronouncements* to reject *ASU 2019-09—Financial Services – Insurance* as not applicable to statutory accounting.

Interested parties have no comments on this item.

Ref #2020-28: ***ASU 2020-01, Investments—Equity Securities (Topic 321), Investments—Equity Method and Joint Ventures (Topic 323), and Derivatives and Hedging (Topic 815), Clarifying the Interactions between Topic 321, Topic 323, and Topic 815***

The Working Group moved this agenda item to the active listing, categorized as nonsubstantive, and exposed revisions to reject *ASU 2020-01, Investments—Equity Securities (Topic 321), Investments—Equity Method and Joint Ventures (Topic 323), and Derivatives and Hedging (Topic 815), Clarifying the Interactions between Topic 321, Topic 323, and Topic 815* for statutory accounting. The revisions note rejection are proposed to *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies*, *SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities* and *SSAP No. 86—Derivatives*.

Interested parties have no comments on this item.

Ref #2020-29: ***ASU 2020-05—Effective Dates for Certain Entities***

The Working Group moved this agenda item to the active listing, categorized as nonsubstantive, and exposed revisions to *Appendix D—Nonapplicable GAAP Pronouncements* to reject *ASU 2020-05, Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842), Effective Dates for Certain Entities* as not applicable to statutory accounting.

Interested parties have no comments on this item.

Ref #2020-30: Premium Refunds and Other Adjustments

The Working Group moved this agenda item to the active listing, categorized as nonsubstantive, and exposed the agenda item with a request for comments/input on the issues described in the proposal. NAIC staff was also directed to draft guidance to address premium refunds and other policy adjustments for both property and casualty and accident and health lines of business.

Comments were requested on the following:

1. NAIC Staff's preliminary recommendation is that the proposed guidance should follow the existing principles of adjustable premium and shall be recognized as adjustments to premium based on experience to date.

2. Examples of existing products that have premium adjustments for reasons other than the existing guidance or how the existing guidance can be expanded.

3. If accounting treatment that is being applied is different from premium adjustments, please provide overview of key attributes.

Interested parties offer the following comments:

1. We agree that the proposed guidance should treat discretionary returns of premium as a reduction of premium, consistent with the conclusion reached in Issue 1 of INT 20-08: COVID-19 Premium Refunds, Limited-Time Exception, Rate Reductions and Policyholder Dividends (paragraphs 8 through 11). There is a difference, however, between contracts that contain loss-sensitive terms and guaranteed cost contracts that become subject to a discretionary return of premium by the insurer. For loss-sensitive contracts, the adjustment to premium is based on loss experience in a prior period and is estimated each period with a true-up recorded in the current period. For guaranteed-cost contracts where the insurer gives policyholders a discretionary refund of premium or credit for future premium periods, the adjustment should be recognized in the period in which the refund or credit is applicable. For example, a premium refund or credit for previous months should be recognized as a true-up in the current period (similar to a loss sensitive contract); however, a premium refund or credit applicable to future periods should be recognized in earned premium in those future periods.

   Specifically, with regard to health insurance, the SSAPs could be made clearer through some examples as illustrated below as an addition to paragraph 4 of SSAP No. 54R. While many examples can be cited, these are just a few to illustrate how examples in the SSAPs can enhance more uniform understanding of the principles involved. Interested parties would be glad to work with SAPWG and NAIC staff in developing a set of examples that is brief, appropriate, and illustrative in achieving that objective.

Suggested revisions to Paragraph 4 of SSAP No. 54-R:

4. Premium income shall be reduced for premiums returned and for allowances to industrial policyholders for the direct payment of premiums. For example:

a. For refunds or reductions in premiums under the terms of the policyholder or group contract refer to:
   1. Contracts Subject to Redetermination – Paragraphs 27-32 below
   2. Retrospectively Rated Contracts - SSAP No. 66

b. For voluntary refunds or reductions in premiums that are not specified by the terms of the policyholder or group contract, the timing of the recognition of the payment (or credit to gross billed premiums) is based on when the corresponding gross premium is or has been earned. To illustrate (not intended to be an exhaustive list):
   1. For premium reductions pertaining to previous or expired periods of coverage, the full amount of the reduction is recognized immediately.
   2. For premium reductions that relate to the current month's coverage, the reduction is recognized in the current month.
   3. For reductions that relate to subsequent months' coverage, the reduction will be recognized in the month to which it pertains so as to match the recognition of the reduction with that of the gross premium and coverage period to which it pertains.

2. Interested parties are not aware of products that have premium adjustments for reason that are not covered by existing guidance in the SSAPs.

   With regard to health insurance, to the extent such situations exist (e.g., regarding some wellness programs), they are adequately covered by the text in SSAP Nos. 54R and 66 pertaining to adjustments to premiums under the terms of the policyholder or group contract, and/or are clearly immaterial.

3. Consistent with the conclusion reached in Issue 4 of INT 20-08, a dividend that is issued on participating policies or issued by non-stock companies such as mutual entities or other corporate entity types in which profits are shared with policyholders should be accounted for as a dividend rather than a return of premium. We are not aware of other situations where such payments or credits are being applied other than as premium adjustments.

Interested parties offer our assistance in developing additional guidance or in providing feedback on draft guidance.

Ref #2020-31: Early application of *SSAP No. 32R—Preferred Stock*

The Working Group voted by e-vote to move this item to the active listing, categorized as nonsubstantive, and exposed edits to *SSAP No. 32R—Preferred Stock* as detailed above. This item has a comment period deadline ending September 18, 2020.

Interested parties have no comments on this item.

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Thank you for considering interested parties' comments. If you have any questions in the interim, please do not hesitate to contact us.

Sincerely,

D. Keith Bell   Rose Albrizio

cc: NAIC staff
Interested parties