Statutory Accounting Principles (E) Working Group
Hearing Agenda #2 - SSAP No. 71
November 12, 2020
10:00 a.m. – 12:00 p.m. CT

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: This meeting may be recorded for subsequent use.

REVIEW of COMMENTS on EXPOSED ITEMS

Ref #	Title	Attachment #	Agreement with Exposed Document?	Comment Letter Page Number
2019-24 SSAP No. 71 (Robin)	**Levelized and Persistency Commissions**	**21– Agenda Item**	**Comments Received**	**MS Ins. Dept - 1 IP – 2 Marty Carus -7**

Summary:
A limited number of 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. As initial key information:

- This issue was raised by a domiciliary state regulator who identified the issue during an examination.
- The Working Group has been discussing this issue since August 2019.
- The practice results with significant differences impacting consistency and comparability in statutory financial statements. It is believed that a vast majority of companies are following the guidance in SSAP No. 71 as originally intended.
- From information received on the basis of U.S. GAAP, it is believed that commission obligation from the writing of an insurance policy would be recognized as a deferred acquisition cost regardless of the third-party arrangement. This treatment is consistent with the intent of SSAP No. 71, with the exception that the commission obligation is immediately expensed under SAP and not recognized as a deferred asset and amortized into expense overtime.

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 and is based on pre-codification guidance. The guidance requires full liability recognition of commission funding agreements. The revisions exposed on Oct. 15:

1. Improve description of funding agreements.
2. Delete the previously proposed revisions regarding other types of commission in order to address concerns that it inadvertently would impact the recognition of traditional persistency commission.
3. Delete the previously proposed revisions referencing application as a correction of an error.
4. Proposes the nonsubstantive revisions apply to contracts in effect on Jan. 1, 2021.

The updated revisions intend to clarify the identification and recognition of funding agreements. Additionally, the revisions clarify that initial sales commission cannot be recharacterized as a "persistency" commission because of elements in a third-party agent contract that may delay when an insurer is required to provide payment.

Prior exposures:
During the Summer 2020 National Meeting (July), the Working Group exposed nonsubstantive revisions to *SSAP No. 71—Policy Acquisition Costs and Commissions* 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. The October exposure addressed the industry concerns regarding traditional persistency commission and also removed the correction of error guidance.

<u>*MS Ins. Dept. Comments*</u>

I am writing as an interested regulator regarding the Statutory Accounting Principles Working Group's ("SAPWG") exposed revisions related to the treatment of levelized commission payments pursuant to SSAP No. 71 (Item #2019-24) and the designation by NAIC staff that these changes be considered a non- substantive change as defined in the NAIC's Policy Statement on Maintenance of Statutory Accounting Principles ("Policy Statement").

I have heard from several interested patties over the past several weeks regarding the exposed revisions to SSAP No. 71 and have some concerns regarding whether these changes have gone through the proper process and received the necessary scrutiny. In addition, I am also concerned about the potential impact these changes could have on insurers that historically accounted for commissions in a manner that conflicts with these new proposed revisions. It is my understanding that levelized commission programs have been around for decades and have gone through multiple examinations by regulators during that time period with little or no material issues noted. Although the current exposed revisions to SSAP No. 71 have been designated a non-substantive change, it appears these new revisions could have unintended consequences and potentially have a material impact on how the company accounts for these particular transactions.

Given the material nature of these transactions and the fact that these programs have been around for decades, it is my opinion that these proposed revisions appear to be a modification to the overall application of an existing SSAP and therefore should be considered a substantive change and follow the NAIC process as defined in the Policy Statement.

I appreciate the opportunity to comment on this issue and encourage the SAPWG to take the necessary steps to study this issue further and provide a reasonable path forward for all of those who are affected by these proposed revisions.

<u>*Interested Parties' Comments:*</u>

IPs would like to propose the following edits to the most recent exposure discussed on October 15, 2020:

Most recent exposure, paragraph #4:

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.

Most recent exposure, paragraph #4, with recommended edits (highlighted):

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 over time. (Note: levelized repayments made by the reporting entity ~~extend the repayment period~~ but might not be a straight-line repayment.) In instances where the levelized commission is not tied to, or contingent upon, traditional elements such as policy persistency or premium payments, 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~~ when the contract between the reporting entity and the third party has no substance but to defer commission payments by the reporting entity. The continuance of the stream of payments specified in the levelized commission contract in these situations 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.

Most recent exposure, paragraph #5:

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.~~

Most recent exposure, paragraph #5, with recommended edits (highlighted):

5. The use of an arrangement such as ~~a levelized commission arrangement~~ that described in paragraph 4 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 shall be accounted for consistent with other funding agreements in accordance with SSAP 52 – *Deposit-Type Contracts* which 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 the third party. ~~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.~~ The reporting entity is required to recognize the full repayment amount of earned commission costs by the direct policy writing agents even if those costs are paid indirectly by a third party through the use of levelized commission, or similar arrangement, which is in substance a funding arrangement. Recognition of those commission costs and recording a liability is required in such arrangements that are not linked to or contingent upon traditional elements. Such treatment shall occur consistently among insurers.

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

IPs found the expansion of paragraph #5 in the most recent exposure to be quite lengthy and redundant in certain aspects. The IP revisions above remove some of the redundancies and clearly state the guidance to be followed to account for arrangements that are in substance funding agreements. IPs retained the concept of the link between the accrual of commissions and traditional elements such as policy persistency.

In addition, we continue to believe that what have been deemed non-substantive clarifications to the original intent of SSAP 71 proposed by the SAPWG in 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. 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 71, thus requiring further evaluation. The interpretation of SSAP No.71 that persistency is the obligating event for accrual of the levelized/persistency commissions has been subject to both independent audits and state insurance department examinations without this interpretation being raised as an issue nor requiring adjustments to the companies' financial statements.

Accrual of Liability – SSAP 5R

There is an inherent difference between levelized commissions utilized as a financing mechanism as compared to those such as contingent commissions tied to policy persistency, whereby the insurance company is not obligated to make a commission payment until the policy anniversary which is when the persistency term of the commission contract is met. Prior to each policy anniversary in such arrangements, commissions are not due, payable or earned. Until the policy reaches each anniversary date, the insurance company is not obligated and has no present duty or responsibility for a commission payment.

We would like to emphasize that the **proposed** wording in paragraph #5 conflicts with the wording contained in paragraph #3. Per paragraph #5, "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". The writing of an insurance contract is not the event that obligates an insurer with respect to all commission arrangements with a third party such as contingent commissions. Contingent commissions tied to traditional elements, such as persistency, should be accounted for in the same manner without imposing a different definition of the obligating event. (As a reminder, similar wording was added to paragraph #2 initially and removed in the subsequent exposures).

Under a levelized commission program a third party has the obligation for the full initial sales commission. The insurer's obligation under a levelized commission program that incorporates persistency should be accrued to the extent of legally contracted amounts owed. We do not believe the original intent of the SSAP required accruing for amounts that are not yet due and that may never be due. We strongly feel that the recognition of an obligation based on persistency is in accordance with the principles of SSAP 5R.

In addition, comments (related to paragraph #3) contained in the October 15, 2020 meeting materials are also inconsistent with the proposed paragraph #5 wording: "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 recommend remaining as principle based as possible regarding types of commissions. 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."

The latest version of the proposed accounting treatment in 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 under any legal contract versus incremental recognition of commission costs over time as they become legal obligations and the policy persists. The current proposed language does not address the many varying product/distribution compensation arrangements in the industry and IPs continue to believe this will cause unintended consequences.

Persistency and Risk transfer:

Management of capital and surplus is a significant process for all insurance companies. "Surplus relief" has been a fundamental, approved management approach within the industry for a long time. It allows companies to manage capital levels without having to access the capital markets. It has mainly been done via reinsurance. The critical test for reinsurance to be effective is evidence of risk transfer. Lapse risk (persistency) is one of the risks used to determine if a reinsurance contract passes risk transfer requirements and is eligible for reinsurance accounting which relieves the insurer of its reserve liability. In Appendix A-791 lapse risk is considered a significant risk in all products except for immediate annuities and guaranteed interest contracts. If lapse risk is significant to a product and that risk is not included in a reinsurance contract, the reinsurance contract will fail the risk transfer requirements and utilize deposit accounting. The ceding company will not be relieved of the reserve liability. The existing SSAP No. 71 guidance is consistent in the application of persistency being part of the transfer of the risk(liability) to another party. If the lapse risk(persistency) is transferred to another party, the liability that the insurance company may have is also transferred to that party and the insurance company has no liability. Removing persistency as a factor in the accrual of commissions is a dangerous precedent.

The differentiation between commissions based on real insurance risks versus payments based solely upon the passage of time in SSAP 71 goes directly to the risk transfer issue of one type of level commissions versus another. The proposed additional language eliminates this differentiation.

The fundamental objective of statutory accounting is to measure solvency, as expressed in the Preamble to the Accounting Practices and Procedures Manual. Statutory Accounting Principles require expensing amounts that are no longer available to pay policyholder claims in the future or that will have no value in liquidation. However, probable future levelized commission payments are payments that have not yet been made and will not be made if the policy lapses. Accordingly, the cash or other assets held by the insurance company prior to the persistency date necessitating commission payment should be considered available to pay policyholder claims.

Other Considerations:

Levelized commission programs began over 30 years ago, before the 1998 publication of Issue paper No. 71. An example of a levelized commission arrangement from prior years is one utilized by American Equity Investment Life Insurance Company through 2010. The American Equity Investment Service Company ("Service Company") paid certain commissions on policies issued during 1997 to 1999 and 2002 to 2004. In return, Service Company was paid a quarterly levelized commission based on account values that was contingent upon the policy being inforce. There is no evidence that the accounting for this arrangement was ever questioned as not being in accordance with SSAP No. 71, or prior to 2001, as not in accordance with then existing Statutory Accounting Principles. The arrangement was identified as allowing American Equity to levelize its upfront commission expenses for statutory accounting purposes and was cited as one of several alternatives available to American Equity to strengthen its statutory surplus.

IP Letter Conclusion:

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

We strongly recommend that NAIC staff consider IP's proposed edits which clarify the funding agreement focus and related accounting, or 2019-24 should be re-exposed and classified as substantive.

<u>*Marty Carus Consulting Comments:*</u>

The following responds to the Exposure Draft of "SSAP 71R--Policy Acquisition Costs and Commissions," exposed for comment at the Statutory Accounting Principles Working Group (SAPWG) meeting held October 15, 2020.

1. This change to accounting principles, as apart from the "error correction" language previously included in the prior exposure, has not been assessed as to whether there are costs that would inure to the *detriment* of consumers as to their purchase of products they would be otherwise disposed to acquire. No cost/benefit study has been conducted to indicate that the quantification of any benefits of the proposal would outweigh any costs, from the perspectives of consumers, stockholders, other statement users or even regulators. Further, there has been no market-impact assessment from the perspectives of both product suppliers and /or product consumers.
2. The basic concept of the exposure draft does not consider the discrete contents of contract provisions which legally determine when obligations are incurred and fulfillment of payment obligations become due. If producer A has a contract with Party B, the obligations of B to A are not contractual obligations of insurer C notwithstanding that under separate contract, insurer C has certain contractual obligations to Party B. In the case where there is this sort arrangement, Party B has assumed the persistency risk of insurer C and the contractually denoted compensation reflected in the compensation ultimately due from C to B reflects that assumption of risk, not unlike a reinsurance agreement.
3. The last sentence of paragraph 5 Reads: "As such, this recognition is required regardless if the insurer owes a selling agent directly agent directly or if a third-party has been contracted to provide payment to the selling agent." The third-party, especially where such party is unaffiliated to the insurer, has undertaken a risk position and may have terms in its contracts with direct sellers that are possibly even unknown to the insurer!
4. The concept underlying the Exposure Draft does not match the principles underlying how similar items are accounted for under SAP. Within SSAP 71 itself, contingent commissions generally related to property/casualty business are not required to post a liability for *possible* contingent commission expense until the contingency threshold has actually been recognized, the threshold generally being the incurral of a stated amount of losses incurred as a percentage of premiums. In the instant case, the contingency is not losses incurred but rather persistency which in the life-annuity industry is a key risk factor that is a part of the premium rate construction/quantification process. This is amplified by the fact that persistency risk is generally a factor in reinsurance agreements and the negotiated ceded premium therefor.
5. Moreover, there are other types of situations that produce outcomes even more likely to come to pass and inure obligations on an insurer; but which currently do not require liability establishment by the insurer. These include long-term lease obligations and long-term employment contracts, where the obligations of the insurer are fixed and basically immutable (except through further negotiation between the lessor and the lessee or through sub-lease) and extend for periods beyond any particular "as of" statement date. In fact such situations do not involve any "contingency." If an insurer has leased space, the rent obligation exists as of the entering of the lease regardless of whether the insurer uses the space or not. The same paradigm applies to long-term employment contracts (as can be gleaned in the press as football coaches and players with multi-year contracts are terminated). In fact, some of those "future" payments have come to pass as of the date statements are filed (e.g., March 1st).
6. Paragraph 5 of the Exposure Draft refers to payment "by a third party to the direct selling agents," but does not consider the possibility that the direct seller is a producer other than agent of the insurer, i.e., possibly a broker.
7. Even accepting the Exposure as is, a question that would pertain was whether the amount alleged to be owed and for which a liability is to be reported, being fixed and determinable as per the contract terms, is to be discounted for the time value of money. Ancillary to that is what discount rate would pertain to the discounting process.
8. Moreover, an historical analysis of each company engaging in the manner contemplated by the Exposure Draft would have a history of the level of ultimate persistency. Therefore, the issue arises as

to whether that should be factored into the amount of any calculation forthcoming if the current Exposure Draft position holds. After all, reserves for insurance liabilities (e.g., life using mortality tables and property/casualty using past loss and loss expense historical experience) employ past experience in their liability formulations.

I note that at the October 15, 2020 SAPWG meeting, I took the opportunity (in detail) to denote the historical perspective as regards the reasons for and the development of Statutory Accounting Principles. Indeed it is hard to compress a decade of that effort (and the reasons therefor) into what turned out to be a few minutes. I did that out of respect to a former generation of regulators who spent their time engaging in the process of formulating Statutory Accounting Principles, not as an academic matter but in order that the regulatory community would have a sound basis, acceptable and respected not only to the American Institute of Certified Public Accountants (AICPA) but to the public, all other relevant institutions and statement users, as well as, of course, regulators "ourselves." It should be noted that the time and effort was in addition to their day jobs, just as your current generation of regulators is doing now. My colleagues and I took that activity seriously and focused on every component of every SSAP we developed. In short, we said what we meant and meant what we said relative to all SSAPs and in particular for these comments, SSAP 71, with due respect to the principles to our foregoing regulators. This does not mean that "our" final work product was sacrosanct from efforts to modernize or change the original SAP; but rather to indicate that when changes are offered and/or implemented they are not cast in such a manner as to cast doubt on the original efforts. The prior comments about "errors" were dismaying and the current comment as to the deletion of that characterization "*for practical reasons*" does not really assuage my dismay.

<u>*Recommended Action:*</u>
As a reminder, this issue was raised by a state regulator. NAIC staff believe that the October exposure addressed the concerns of industry regarding distinguishing traditional persistency commission from a funding agreement. The current comments from "IPs" now appear to be seeking to explicitly allow companies to avoid full liability recognition of funding agreement liabilities if there is a persistency element inserted into a funding agreement.

Given the year-end timing and the material impact to what is believed to be a very limited number of companies, NAIC staff recommends that the Working Group expose the previously exposed nonsubstantive revisions to SSAP No. 71 with minor edits (shown below) to clarify that that the revisions would apply to contracts in effect as of the effective date specified by the Working Group. The intent to apply to all contracts in effect on Jan. 1, 2021 was noted in the prior exposure discussion, however, NAIC staff recommends being clear that it applies to contracts in effect as either the date of adoption of the revisions or a new effective date specified by the Working Group in the exposure. **The Working Group should provide direction regarding the proposed effective date.**

Issue Paper - If desired by the Working Group, NAIC staff could be directed to draft an issue paper documenting the discussion of the revisions. The Working Group should provide direction regarding the classification of the change. (With the exposures and past discussion, date, the Working Group could classify this as either substantive or nonsubstantive.)

NAIC staff does not recommend adopting the revisions suggested by the most recent commenters for reasons elaborated on below. NAIC staff has also prepared an illustration on the following pages to show the difference in positions between the exposure draft and the current comments from interested parties. This illustration reflects both the reduction in commission expense recognition and the delay in commission expense timing suggested by proposed interested parties' revisions.

<u>**NAIC Staff Notes on Comments Received**</u>

1. <u>**Category of Change**</u> **-** MS DOI comment that the changes appear to be substantive. This comment is also made by both the interested parties and Mr. Carus. NAIC staff notes that the revisions have already had the due process required for either a substantive or a nonsubstantive change since it has been under discussion for more than one year and has had multiple exposures and public discussions. NAIC staff continues to believe that the proposed revisions are a nonsubstantive clarification of existing longstanding provisions of SSAP No. 71 which have been in place since prior to 1998 and are being disregarded by only a small number of entities. Under the NAIC Policy Statement on Maintenance of Statutory Accounting Principles, it is not the impact of a change on an individual entity that determines whether a change is substantive or nonsubstantive. It notes that:

    > Nonsubstantive revisions to SAP will be developed to address, but will not be limited to: 1) clarification of the intent or application of existing SSAPs; 2) new disclosures and modification of existing disclosures; 3) revisions that do not change the intent of existing guidance; and 4) revisions to Appendix A—Excerpts of NAIC Model Laws to reflect amendments to NAIC adopted model laws and regulations.

    The Working Group undertook this agenda item at the request of a state, because a limited number of companies were perceived to be misapplying the existing long standing levelized commission guidance.

    The Working Group could direct NAIC staff to draft an issue paper if desired. The NAIC Policy Statement on Maintenance of Statutory Accounting Principles allows for drafting of an issue paper

subsequent to the adoption of revisions. An issue paper can be directed for either substantive or nonsubstantive revisions.

2. Mr. Carus generally opposes all of the revisions.

    a. He suggests that a cost benefit study be conducted. This is not perceived as needed as the issue is a clarification of existing guidance. The total commission paid will not change under this guidance, but rather only the timing of commission expense recognition will change. It is a long-standing statutory accounting principle of expensing acquisition costs when incurred. These funding agreements are being used to delay expense recognition.

    b. Mr. Carus suggests that the liabilities be assessed by the individual contract and not the funding substance of the agreement. This is not consistent with the guidance in SSAP No. 71 that requires recognition of the funding agreement <u>even if repayment is not guaranteed</u>.

    c. He recommends consideration of discounting and assessing expected lapse rates in determining the funding liability. This is not consistent with expensing acquisition costs as incurred or with the paragraph 5 guidance in SSAP No. 71 that 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."

Key discussion points on the current revisions proposed by interested parties are as follows:

3. **<u>Persistency Commission</u>** -Whereas prior IP comments were trying to help the Working Group distinguish between traditional persistency commission and funding agreements, the current comments are trying to use persistency features in a funding agreement to defer and decrease the funding agreement liability.

4. **<u>Funding Agreement Defined -</u>** IP comments recommend that commission funding agreements should only be accrued when repayment is guaranteed. This position has been previously rejected by the Working Group as it is in direct conflict with the existing guidance in SSAP No. 71, paragraph 4 which requires accrual of the full amount of a levelized commission agreement **even when repayment is not guaranteed**.

5. **<u>Funding Agreement Substance</u>** - The purpose of the levelized commission guidance is to identify that the substance of the levelized commission is a funding arrangement. It identifies that a third party in an arm's length transaction would not pay acquisition costs on behalf of an insurer without expectation of repayment and expectation of profit. It requires recognition of the full amount of the funding agreement liability even if repayment is not guaranteed. The funding agreement is an attempt to de-link the relationship to the underlying policy from the normal day one accrual of sales commission. The funding agreement advance made by the third party is made with an expectation of repayment. Thus, the liability for amounts already advanced by the funding agent is not extinguished as a liability (under SSAP No. 5R or SSAP No. 103) until it has either been repaid or the policy is cancelled.

    IP commenters have advocated that the fact that the super-agent has fronted commission, does not require recognition because of the insertion of a persistency contingency provision into the funding agreement which might allow non repayment of the past advance if the policy is subsequently cancelled.

6. **<u>Understated Liability/ Expense</u> -** IP recommended revisions seek to recognize a reduced liability for the funding amount. They recommend ignoring the funding agreement nature of the advances and only recognizing the next payment because the policy might be cancelled in the future. This is the equivalent of assuming a 100% lapse rate on the policies. The IP position is similar to setting up the liability for a single payment on a loan instead of the entire principal balance.

7. **<u>Delayed Timing of Liability/Expense Recognition</u>** - IP comments seek to delay the timing of recognition of commission expense incurred under the funding agreement. Instead of recognition when the sales commission for the underlying policy is incurred the IPs recommend requiring recognition only for the next payment when paid to the funding agent. This is inconsistent with the existing guidance in SSAP No. 71 which requires full accrual of the funding agreement liability. The IP comments appear to be a change from their prior position which supported pro rata recognition.

   <u>Assessment of SSAP No. 5R:</u>
   There are two elements of a liability under SSAP No. 5R:

   - **Current obligation to pay for a past transaction** - the insurer has a contract to repay the funding agent (current obligation). The service that is being paid for is the selling agent's sale of the insurance contract (past transaction). The guidance in SSAP No. 71 provides that related interest payments for the financing charges do not meet the definition of a liability until the passage of time for the interest has occurred. The insertion of a persistency element to the super-agent funding agreement does not extinguish the entire pending liability. Such a liability would only be extinguished by payment or other legal release such as policy cancellation. The advance liability to the third party is for a past transaction- that is, the funding agent has paid commission to the direct agents for the sale of the policy.
   - **Payment probable of occurring** - Here is where the contingency comes into play under SSAP 5R. Payment of the obligation has to be probable of occurring. The only difference between the "persistency linked" funding arrangement and one where payment is guaranteed, is obviously the potential that principal will not be repaid due to lapse. However, the funding agents are not taking this risk without being compensated. The funding agreements are using a conservative estimate of expected lapses and factoring in a profit for the funding agent, hence the existing wording in SSAP No. 71 regarding interest explicit or implied. Therefore, a third-party funding agent would not be willing to provide financing if they did not think it was probable that they would have their full investment, plus a return on investment repaid. As such, the probable element of SSAP No. 5R is also met. The payment is probable and can be estimated and therefore meets the accrual requirements of SSAP No. 5R.

8. **<u>Deposit type contract -</u>** IP recommended revisions seek to add a new reference to *SSAP No. 52—Deposit Type Contracts* for the recognition of funding agreement liabilities.

   a. This appears to be an attempt to allow the funding agreement liability to be calculated using actuarial assumptions in the calculation of the liability. This would be inconsistent with SSAP No. 71 which does not allow discounting of such a liability.

   b. This recommendation could also be an attempt to move the category of commission expense recognition to be an obligation of a deposit type contract. That is, instead of recognizing commission expense, it seems to be advocating treating the commission expense of say a life policy as a separate deposit type contract. It would also be inconsistent with the annual statement instructions and create a mismatch in the underwriting expense measurement of the original policy. Moving the contract to a different category would also have implications on various aspects of surrender charge calculations.

9. **<u>Persistency and Risk Transfer</u>** - IP comments have noted that "SSAP No. 71 is consistent in the application of persistency being part of the transfer of the risk (liability) to another party. If the lapse risk (persistency) is transferred to another party, the liability that the insurance company may have is also transferred to that party and the insurance company has no liability."

> Statutory accounting in Appendix A-791 on Life and Health Reinsurance identifies that lapse risk can be transferred via reinsurance. NAIC staff disagrees that lapse related liabilities can be extinguished with a commission agreement with a noninsurance entity, which seems to be the position of interested parties.
>
> Because of the persistency feature in the funding agreement, interested parties' commenters are advocating to not recognize ANY commission expense in these arrangements until it is due to the third-party agent. This is the equivalent of a 100% lapse assumption. This assertion is not consistent with any other assertions reflected in the recognition of these insurance policies in their financial statements.

IPs are acknowledging they are using the funding arrangements for surplus relief. NAIC staff disagrees with the comment by interested parties that under a levelized commission agreement another party is responsible for an insurer's acquisition costs. This is not appropriate as statutory accounting requires acquisition costs are expensed as incurred, not shifted to a non-insurance entity. IPs are asserting that even though a third party prepaid their acquisition costs that they don't have to recognize an accrual for the levelized commission funding agreement because in some situations such as future policy cancellation, they might not have to pay. They are asserting that including a persistency element in the funding agreement decreases the liability amount and the timing or recognition, to only be the next payment when it is fully earned. They are asserting the right to treat a funding agreement the same as traditional persistency commission even though they are different in substance.

The overall statutory accounting concepts of conservatism and consistency require that financial statements reflect assets available for policyholder claims with comparable financial information. Allowing delayed expense recognition of initial policy commission expenses will contradict both statutory accounting concepts, as assets will be included that are not actually available for policyholder claims (as they are needed for non-recognized commission expenses) and will result with financial statements that are not comparable to other insurance entities.

NAIC staff note that the guidance in SSAP No. 71 requires full accrual of the funding agreement liability even if repayment is not guaranteed. We do not believe that the insertion of a contingency into a funding agreement in any way should delay or decrease the recognized liability for an advance that has already been made on behalf of an insurer.

Example of differences in liability recognition between exposure and IP comments

- **Single Premium Immediate Annuity**: On Jan 1, 2020, agent sells a single premium immediate annuity (SPIA) insurance policy and is owed $2,100 in initial sales commission.
- **Traditional Persistency** - Over the next 3 years, if the policy continues to be in force, on Jan. 1, the agent is awarded a traditional persistency commission of $50, per year. (This is a reward to the agent for the policy not being churned / terminated.) All parties agree that on Jan. 1, 2021 (and subsequent years) as the policy continues in force, the entity would recognize the $50 traditional persistency commission as incurred in each subsequent year. **The rest of the example does not focus on traditional persistency commission, as it is not in dispute.**
- **Direct Agent Arrangement** – On Jan 1, 2020, recognize the $2,100 as direct agent earned commission expense.
- **Super-Agent Funding Arrangement** – The insurer has an arrangement for the super-agent to pay the commission to the sub-agent who sold the policy. The super-agent pays the initial $2,100 commission to the sub-agent on Jan. 1, 2020. The insurer has an arrangement with the super-agent to repay this amount over 3 years with 10% annual interest. The three annual installments are due at the end of each policy period. If the policy cancels, the remaining payments to the super-agent under the contract is not required to be paid by the direct writer.

  - **SSAP No. 71 treatment and exposed clarification**

    The insurer should recognize the full $2,100 as commission expense on Jan. 1, 2020 and accrue interest pro rata annually. (Pursuant to SSAP No. 71, recognition of commission expense should not be impacted by the insertion of third parties into the commission payment structure. SSAP No. 71 identifies such arrangements as funding arrangements and requires the recognition of a liability for the full amount expected but not guaranteed to be repaid. If the policy cancels in year 3, the remaining amount payable to the super-agent would be eliminated.

  - **Funding arrangement commenter position**

    The insurer has a funding arrangement with the super-agent. The super-agent pays the entire $2,100 commission to the sub-agent who sold the policy Jan. 1, 2020.

    The IP commenters have advocated not accruing any of the remaining commission until full earned on the last day of each annual policy period. **Year one commission proposed to be recognized by IPs is $700 plus $210 interest on 12-31-20**

    Commenters have advocated not recognizing the remaining $1,400 of commission which has been paid by the third party, **because the policy might cancel**.

    Therefore, the year two commission of $700 plus $140 interest would be recognized as commission expense on Dec. 31, 2021, etc. Provided the policy did not cancel in year three, the payment would be $700 plus $70 interest. Total payments = $2,100 plus interest of 420.

Nov. shaded revision to Oct. 2020 Exposure of Tracked Revisions to Existing SSAP No. 71

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. (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, until ~~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.

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 TBD date regarding levelized commission are to clarify the original intent of this statement and apply to existing contracts ~~are~~ in effect on the effective date of the revisions either on adoption or a date to be specified~~January 1, 2021~~.

The comment letters are included in Attachment 22 (9 pages). g:\frs\data\stat acctg\3. national meetings\a. national meeting materials\2020\11-12-20 (fall)\ssap no. 71\0 - 11-2020 - public sapwg hearing agenda 71 11-9.docx

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.

<u>July 2019 Proposed Revisions to SSAP No. 71:</u>

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. <u>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.</u>

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. <u>Commission contracts that include persistency (or other such components) shall not use these clauses to defer recognition of commission expense</u>. <u>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.</u>

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.

Fall 2019 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.

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.

July 30, 2020 Exposed 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.

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.

On October 15, 2020, the Statutory Accounting Principles (E) Working Group held a hearing to receive comments, resulting in updated exposed revisions to *SSAP No. 71—Policy Acquisition Costs and Commissions*, as illustrated below. The updated exposed revisions clarify existing levelized commissions guidance, which requires full recognition of funding agreement liabilities incurred for commission expenses obligated when an insurance policy is written. (This guidance clarifies that writing the insurance policy is the obligating event for initial sales commission.) The exposed revisions have the following key changes from the prior exposure:

1. Improved description of the funding agreements in paragraphs 4 and 5.
2. Deletes the previously proposed revisions in paragraph 3 regarding other types of commission to address the comments received regarding unintended impacts on traditional renewal commission.
3. Modifies the revisions in paragraph 7 to remove the language on correction of an error.
4. Proposes the nonsubstantive revisions apply to contracts in effect on Jan. 1, 2021.

For ease of review the following pages illustrate the October 15, 2020 exposed revisions in two formats:

1. **Exposure reflecting tracked revisions to Existing SSAP No. 71**
2. **October 2020 (new) Shaded Revisions to prior July exposure**

Oct. 2020 Exposure of Tracked Revisions to Existing SSAP No. 71

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. (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.

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 are to clarify the original intent of this statement and are effective January 1, 2021.

October 2020 (new) Shaded Revisions to prior July exposure

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 1, 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.~~

G:\FRS\DATA\Stat Acctg\3. National Meetings\A. National Meeting Materials\2020\11-12-20 (Fall)\SSAP No. 71\21 - 19-24 - Commission ED 10-15-20.docx

Attachment 22

Statutory Accounting Principles (E) Working Group
November 12 Interim Meeting
Comment Letters Received

TABLE OF CONTENTS

MIKE CHANEY
Commissioner of Insurance
State Fire Marshal

MARK HAIRE
Deputy Commissioner of Insurance

RICKY DAVIS
State Chief Deputy Fire Marshal

MISSISSIPPI INSURANCE DEPARTMENT

501 N. WEST STREET, SUITE 1001
WOOLFOLK BUILDING
JACKSON, MISSISSIPPI 39201
www.mid.ms.gov

MAILING ADDRESS
Post Office Box 79
Jackson, Mississippi 39205-0079
TELEPHONE: (601) 359-3569
FAX: (601) 359-2474

October 29, 2020

Mr. Dale Bruggeman, Chair
Statutory Accounting Principles Working Group
National Association of Insurance Commissioners

RE: SSAP No. 71 – Policy Acquisition Costs and Commissions

Mr. Bruggeman,

I am writing as an interested regulator regarding the Statutory Accounting Principles Working Group's ("SAPWG") exposed revisions related to the treatment of levelized commission payments pursuant to SSAP No. 71 (Item #2019-24) and the designation by NAIC staff that these changes be considered a non-substantive change as defined in the NAIC's *Policy Statement on Maintenance of Statutory Accounting Principles* ("Policy Statement").

I have heard from several interested parties over the past several weeks regarding the exposed revisions to SSAP No. 71 and have some concerns regarding whether these changes have gone through the proper process and received the necessary scrutiny. In addition, I am also concerned about the potential impact these changes could have on insurers that historically accounted for commissions in a manner that conflicts with these new proposed revisions. It is my understanding that levelized commission programs have been around for decades and have gone through multiple examinations by regulators during that time period with little or no material issues noted. Although the current exposed revisions to SSAP No. 71 have been designated a non-substantive change, it appears these new revisions could have unintended consequences and potentially have a material impact on how the company accounts for these particular transactions.

Given the material nature of these transactions and the fact that these programs have been around for decades, it is my opinion that these proposed revisions appear to be a modification to the overall application of an existing SSAP and therefore should be considered a substantive change and follow the NAIC process as defined in the Policy Statement.

I appreciate the opportunity to comment on this issue and encourage the SAPWG to take the necessary steps to study this issue further and provide a reasonable path forward for all of those who are affected by these proposed revisions.

Sincerely,

MIKE CHANEY
COMMISSIONER OF INSURANCE

October 30, 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: Ref #2019-24 Levelized and Persistency Commission (SSAP No. 71, Policy Acquisition Costs and Commissions)

Dear Mr. Bruggeman,

Interested parties (IPs) would like to thank the Statutory Accounting Principles Working Group (SAPWG) for the opportunity to continue to comment on the revisions to exposure Reference #2019-24 – Levelized and Persistency Commission (SSAP No. 71, Policy Acquisition Costs and Commissions) (the "Exposure").

IPs would like to propose the following edits to the most recent exposure discussed on October 15, 2020:

Most recent exposure, paragraph #4:

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.

Most recent exposure, paragraph #4, with recommended edits (highlighted):

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 over time. (Note: levelized repayments made by the reporting entity ~~extend the repayment period~~ but might not be a straight-line repayment.) In instances where the levelized commission is not tied to, or contingent upon, traditional elements such as policy persistency or premium payments, 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~~ when the contract between the reporting entity and the third party has no substance but to defer commission payments by the reporting entity. The continuance of the stream of payments specified in the levelized

commission contract in these situations 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.

Most recent exposure, paragraph #5:

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.~~

Most recent exposure, paragraph #5, with recommended edits (highlighted):

5. The use of an arrangement such as ~~a levelized commission arrangement~~ that described in paragraph 4 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 shall be accounted for consistent with other funding agreements in accordance with SSAP 52 – *Deposit-Type Contracts* which 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 the third party. ~~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.~~ The reporting entity is required to recognize the full repayment amount of earned commission costs by the direct policy writing agents even if those costs are paid indirectly by a third party through the use of levelized commission, or similar arrangement, which is in substance a funding arrangement. Recognition of those commission costs and recording a liability is required in such arrangements that are not linked to or contingent upon traditional elements. Such treatment shall occur consistently among insurers.

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

IPs found the expansion of paragraph #5 in the most recent exposure to be quite lengthy and redundant in certain aspects. The IP revisions above remove some of the redundancies and clearly state the guidance to be followed to account for arrangements that are in substance funding agreements. IPs retained the concept of the link between the accrual of commissions and traditional elements such as policy persistency.

In addition, we continue to believe that what have been deemed non-substantive clarifications to the original intent of SSAP 71 proposed by the SAPWG in 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. 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 71, thus requiring further evaluation. The interpretation of SSAP No.71 that persistency is the obligating event for accrual of the levelized/persistency commissions has been subject to both independent audits and state insurance department examinations without this interpretation being raised as an issue nor requiring adjustments to the companies' financial statements.

<u>Accrual of Liability – SSAP 5R</u>

There is an inherent difference between levelized commissions utilized as a financing mechanism as compared to those such as contingent commissions tied to policy persistency, whereby the insurance company is not obligated to make a commission payment until the policy anniversary which is when the persistency term of the commission contract is met. Prior to each policy anniversary in such arrangements, commissions are not due, payable or earned. Until the policy reaches each anniversary date, the insurance company is not obligated and has no present duty or responsibility for a commission payment.

We would like to emphasize that the **proposed** wording in paragraph #5 conflicts with the wording contained in paragraph #3. Per paragraph #5, "The amount owed for full initial sales commission shall be recognized immediately **<u>as the writing of an insurance contract is the event that obligates</u>** the insurer, and such action shall occur consistently among insurers". The writing of an insurance contract is not the event that obligates an insurer with respect to all commission arrangements with a third party such as contingent commissions. Contingent commissions tied to traditional elements, such as persistency, should be accounted for in the same manner without imposing a different definition of the obligating event. (As a reminder, similar wording was added to paragraph #2 initially and removed in the subsequent exposures).

Under a levelized commission program a third party has the obligation for the full initial sales commission. The insurer's obligation under a levelized commission program that incorporates persistency should be accrued to the extent of legally contracted amounts owed. We do not believe the original intent of the SSAP required accruing for amounts that are not yet due and that may never be due. We strongly feel that the recognition of an obligation based on persistency is in accordance with the principles of SSAP 5R.

In addition, comments (related to paragraph #3) contained in the October 15, 2020 meeting materials are also inconsistent with the proposed paragraph #5 wording: "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 recommend remaining as principle based as possible regarding types of commissions. 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."

The latest version of the proposed accounting treatment in 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 under any legal contract versus incremental recognition of commission costs over time as they become legal obligations and the policy persists . The current proposed language does not address the many varying product/distribution compensation arrangements in the industry and IPs continue to believe this will cause unintended consequences.

Persistency and Risk transfer:

Management of capital and surplus is a significant process for all insurance companies. "Surplus relief" has been a fundamental, approved management approach within the industry for a long time. It allows companies to manage capital levels without having to access the capital markets. It has mainly been done via reinsurance. The critical test for reinsurance to be effective is evidence of risk transfer. Lapse risk (persistency) is one of the risks used to determine if a reinsurance contract passes risk transfer requirements and is eligible for reinsurance accounting which relieves the insurer of its reserve liability. In Appendix A-791 lapse risk is considered a significant risk in all products except for immediate annuities and guaranteed interest contracts. If lapse risk is significant to a product and that risk is not included in a reinsurance contract, the reinsurance contract will fail the risk transfer requirements and utilize deposit accounting. The ceding company will not be relieved of the reserve liability. The existing SSAP No. 71 guidance is consistent in the application of persistency being part of the transfer of the risk(liability) to another party. If the lapse risk(persistency) is transferred to another party, the liability that the insurance company may have is also transferred to that party and the insurance company has no liability. Removing persistency as a factor in the accrual of commissions is a dangerous precedent.

The differentiation between commissions based on real insurance risks versus payments based solely upon the passage of time in SSAP 71 goes directly to the risk transfer issue of one type of level commissions versus another. The proposed additional language eliminates this differentiation.

The fundamental objective of statutory accounting is to measure solvency, as expressed in the Preamble to the Accounting Practices and Procedures Manual. Statutory Accounting Principles require expensing amounts that are no longer available to pay policyholder claims in the future or that will have no value in liquidation. However, probable future levelized commission payments are payments that have not yet been made and will not be made if the policy lapses. Accordingly, the cash or other assets held by the insurance company prior to the persistency date necessitating commission payment should be considered available to pay policyholder claims.

<u>Other Considerations:</u>

Levelized commission programs began over 30 years ago, before the 1998 publication of Issue paper No. 71. An example of a levelized commission arrangement from prior years is one utilized by American Equity Investment Life Insurance Company through 2010. The American Equity Investment Service Company ("Service Company") paid certain commissions on policies issued during 1997 to 1999 and 2002 to 2004. In return, Service Company was paid a quarterly levelized commission based on account values that was contingent upon the policy being inforce. There is no evidence that the accounting for this arrangement was ever questioned as not being in accordance with SSAP No. 71, or prior to 2001, as not in accordance with then existing Statutory Accounting Principles. The arrangement was identified as allowing American Equity to levelize its upfront commission expenses for statutory accounting purposes and was cited as one of several alternatives available to American Equity to strengthen its statutory surplus.

<u>Conclusion</u>:

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

We strongly recommend that NAIC staff consider IP's proposed edits which clarify the funding agreement focus and related accounting, or 2019-24 should be re-exposed and classified as substantive.

Martin Carus Consulting LLC
250 Gorge Road, Suite 14D
Cliffside Park, New Jersey 07010-1300
mfcarus@gmail com/mcarus@nj.rr.com
201-978-4044

October 15, 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 following responds to the Exposure Draft of "SSAP 71R--Policy Acquisition Costs and Commissions," exposed for comment at the Statutory Accounting Principles Working Group (SAPWG) meeting held October 15, 2020.

1. This change to accounting principles, as apart from the "error correction" language previously included in the prior exposure, has not been assessed as to whether there are costs that would inure to the *detriment* of consumers as to their purchase of products they would be otherwise disposed to acquire. No cost/benefit study has been conducted to indicate that the quantification of any benefits of the proposal would outweigh any costs, from the perspectives of consumers, stockholders, other statement users or even regulators. Further, there has been no market-impact assessment from the perspectives of both product suppliers and /or product consumers.
2. The basic concept of the exposure draft does not consider the discrete contents of contract provisions which legally determine when obligations are incurred and fulfillment of payment obligations become due. If producer A has a contract with Party B, the obligations of B to A are not contractual obligations of insurer C notwithstanding that under separate contract, insurer C has certain contractual obligations to Party B. In the case where there is this sort arrangement, Party B has assumed the persistency risk of insurer C and the contractually denoted compensation reflected in the compensation ultimately due from C to B reflects that assumption of risk, not unlike a reinsurance agreement.
3. The last sentence of paragraph 5 Reads: "As such, this recognition is required regardless if the insurer owes a selling agent directly agent directly or if a third-party has been contracted to provide payment to the selling agent." The third-party, especially where such party is unaffiliated to the insurer, has undertaken a risk position and may have terms in its contracts with direct sellers that are possibly even unknown to the insurer!
4. The concept underlying the Exposure Draft does not match the principles underlying how similar items are accounted for under SAP. Within SSAP 71 itself, contingent commissions generally related to property/casualty business are not required to post a

liability for *possible* contingent commission expense until the contingency threshold has actually been recognized, the threshold generally being the incurral of a stated amount of losses incurred as a percentage of premiums. In the instant case, the contingency is not losses incurred but rather persistency which in the life-annuity industry is a key risk factor that is a part of the premium rate construction/quantification process. This is amplified by the fact that persistency risk is generally a factor in reinsurance agreements and the negotiated ceded premium therefor.

5. Moreover, there are other types of situations that produce outcomes even more likely to come to pass and inure obligations on an insurer; but which currently do not require liability establishment by the insurer. These include long-term lease obligations and long-term employment contracts, where the obligations of the insurer are fixed and basically immutable (except through further negotiation between the lessor and the lessee or through sub-lease) and extend for periods beyond any particular "as of" statement date. In fact such situations do not involve any "contingency." If an insurer has leased space, the rent obligation exists as of the entering of the lease regardless of whether the insurer uses the space or not. The same paradigm applies to long-term employment contracts (as can be gleaned in the press as football coaches and players with multi-year contracts are terminated). In fact, some of those "future" payments have come to pass as of the date statements are filed (e.g., March 1st).
6. Paragraph 5 of the Exposure Draft refers to payment "by a third party to the direct selling agents," but does not consider the possibility that the direct seller is a producer other than agent of the insurer, i.e., possibly a broker.
7. Even accepting the Exposure as is, a question that would pertain was whether the amount alleged to be owed and for which a liability is to be reported, being fixed and determinable as per the contract terms, is to be discounted for the time value of money. Ancillary to that is what discount rate would pertain to the discounting process.
8. Moreover, an historical analysis of each company engaging in the manner contemplated by the Exposure Draft would have a history of the level of ultimate persistency. Therefore, the issue arises as to whether that should be factored into the amount of any calculation forthcoming, if the current Exposure Draft position holds. After all, reserves for insurance liabilities (e.g., life using mortality tables and property/casualty using past loss and loss expense historical experience) employ past experience in their liability formulations.

I note that at the October 15, 2020 SAPWG meeting, I took the opportunity (in detail) to denote the historical perspective as regards the reasons for and the development of Statutory Accounting Principles. Indeed it is hard to compress a decade of that effort (and the reasons therefor) into what turned out to be a few minutes. I did that out of respect to a former generation of regulators who spent their time engaging in the process of formulating Statutory Accounting Principles, not as an academic matter but in order that the regulatory community would have a sound basis, acceptable and respected not only to the American Institute of Certified Public Accountants (AICPA) but to the public, all other relevant institutions and statement users, as well as, of course, regulators "ourselves." It should be noted that the time and effort was in addition to their day jobs, just as your current generation of regulators is doing now. My colleagues and I took that activity seriously and focused on every component of every SSAP we developed. In short, we said what we meant and meant what we said relative to all SSAPs and in particular for these comments, SSAP 71, with due respect to the principles to our foregoing regulators. This does not mean that "our" final work product was sacrosanct from efforts to modernize or change the original SAP; but rather to indicate that when changes are offered and/or implemented they are not cast in such a manner as to cast doubt on the original efforts. The prior comments about "errors" were dismaying and the current comment as to the deletion of that characterization "*for practical reasons*" does not really assuage my dismay.

Very truly yours,

Martin F. Carus, President