

Statutory Issue Paper No. 165

Levelized Commission

STATUS

Finalized December 11, 2021

Original SSAP and Current Authoritative Guidance: SSAP No. 71

Type of Issue:

Common Area

SUMMARY OF ISSUE

1. This issue paper documents for historical purposes the discussion of nonsubstantive revisions to *SSAP No. 71—Policy Acquisition Costs and Commissions*. The intent of these nonsubstantive revisions is to provide clarifying guidance to existing accounting requirements regarding levelized commission arrangements. The statutory accounting guidance in SSAP No. 71 has been in place since 1998 and is based on pre-codification guidance.

SUMMARY CONCLUSION

2. The nonsubstantive revisions to SSAP No. 71 adopted by the Statutory Accounting Principles (E) Working Group on March 15, 2021, the Accounting Practices and Procedures (E) Task Force on March 23, 2021, and the Financial Condition (E) Committee on April 13, 2021 (illustrated in Exhibit A), reflect the following:

- a. Provides additional descriptive guidance to assist with identifying levelized commission arrangements.
- b. Emphasizes the requirements noted in the original SSAP No. 71 guidance that levelized commission arrangements require full recognition of the liability amount. In addition, interest and or fees incurred to date are accrued.
- c. Specifies an effective December 31, 2021, for contracts in effect as of that date.

Policy Acquisition Costs Overview

3. Acquisition costs are those costs that are incurred in the acquisition of new and renewal insurance contracts and include 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). Pursuant to SSAP No. 71, as originally effective January 1, 2001, for the initial SAP Codification, specifically states that acquisition costs and commissions are expensed as incurred. This provision is a fundamental difference from U.S. generally accepted accounting principles (U.S. GAAP) and reflects a statutory concept that was employed prior to codification, as detailed in *Issue Paper No. 71—Policy Acquisition Costs and Commissions*.

- a. Under U.S. GAAP, paid or accrued acquisition costs, which include commission costs, are capitalized and reported as a deferred asset and expensed over time to match the recognition of revenue. Note that under U.S. GAAP and SAP, the liabilities associated with acquisition costs are the same. However, U.S. GAAP allows capitalization of certain acquisition costs where SAP requires immediate expense recognition. From information received on the basis of U.S. GAAP, commission obligations from the writing of an insurance policy would be recognized as a deferred acquisition cost regardless of a third-party arrangement.

- b. The departure from U.S. GAAP is consistent with original and ongoing SAP concepts that focus on the solvency of reporting entities for the protection of policyholders and not the matching of revenue to expenses. As detailed in the Preamble, the ultimate objective of solvency regulation is to ensure that policyholder, contract holder and other legal obligations are met when they come due and that companies maintain capital and surplus at all times and in such forms as required by statute to provide a margin of safety.
- c. As detailed in the Statutory Accounting Recognition Concept, accounting treatments that defer expense recognition do not generally represent acceptable SAP treatment. Even if consideration had occurred to mirror U.S. GAAP and allow the capitalization of expenses as “deferred assets,” such assets would not be considered admitted assets for statutory accounting. This is because such items do not reflect assets with economic value available for policyholder claims. Nonadmitted assets are required to be charged to surplus in the period in which they arise. As such, in either scenario under SAP, the financial statements of the reporting entity would reflect a reduction of available surplus (either through the recognition of expense or through a direct surplus charge for nonadmitted assets) for acquisition costs and commissions.

Levelized Commission - Background

4. Agenda item 2019-24 on levelized and persistency commission was drafted and presented to the Statutory Accounting Principles (E) Working Group at the request of a state department of insurance after the practice was identified on a financial examination. The issues received by the Working Group related to the use of levelized commission arrangements and the amount to be recorded as a liability in accordance with SSAP No. 71 and SSAP No. 5R—*Liabilities, Contingencies and Impairments of Assets*.

5. Both SSAP No. 71 and SSAP No. 5R have relevant guidance on this topic:

a. SSAP No. 71 describes levelized commission arrangements as follows:

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.

b. SSAP No. 5R defines liabilities as follows:

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).

¹ FASB *Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements*, states: Probable is used with its usual general meaning, rather than in a specific accounting or technical sense (such as that in *FASB Statement 5, Accounting for Contingencies*, paragraph 3), and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved.

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.

Levelized Commission Funding Agreement

6. The levelized commission arrangements identified for agenda item 2019-24 had the following key elements:

- a. A third party (referred to as a “funding-agent”) paid selling agents commission amounts for business directly written on behalf of the reporting entity. These payments typically occurred in the first year of policy issuance and were consistent with normal initial sales commissions considered policy acquisition costs.
- b. The reporting entity repaid the funding-agent through a levelized commission arrangement that spread out the commission repayment over multiple years (e.g., 3-6 years). The yearly commission repayments to the funding agent also included additional fees and explicit or implicit interest charged to the reporting entity. Consistent with the guidance in SSAP No. 71, paragraph 4, this levelized commission arrangement is repaying the funding-agent amounts “which are less than the normal first year commissions but exceed the normal renewal commissions.” As noted, SSAP No. 71 characterizes such agreements as in substance, a funding agreement (i.e. loan).
- c. The example agreement between the reporting entity and the funding agent specified 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. This reduction in commission payment for policy cancellation is not materially different than direct agreements with agents that have commission “claw back” features. However, regardless of claw back features, commission is fully accrued and expensed upfront. In the event there is a policy cancellation / lapse, then the liability accrued and recognized expense is adjusted for the amount of the commission that will not be paid.

7. The regulator noted that the reporting entity was not accruing all of the commission liability to the third-party funding agent. The insurance reporting entity employing the disputed practice asserted that the payments to the funding agent were theoretically avoidable until the policy had passed the anniversary date. The reporting entity did not accrue the full amount of initial sales commission that had already been paid on its behalf by the funding agent, which should have been recognized at the time the policy was sold. Although the entity should have recognized the full initial sales commission per SSAP No. 71, the reporting entity also did not accrue the next total expected payment to the third-party. The reporting entity only accrued the next payment when they viewed it as “earned” by the third-party agent. This “earned” date was typically the next policy anniversary when the payment to the funding agent became unavoidable. With this approach, the reporting entity was essentially incorporating a 100% lapse assumption in their process to recognize commission expense, as they would only recognize the commission expense when the policy

continued passed a specific lapse date. This assumption is not permitted in statutory accounting, and therefore not reflected in other aspects of their financial statements such as policy reserves.

8. The reporting entities employing the disputed practice asserted that even though commission has been paid by the funding-agent to the sub agent, that no commission should be accrued by the reporting entity until after the end of each policy year when the policy has persisted past its anniversary. The reporting entity was asserting that inserting a persistency clause into a funding agreement allowed them to avoid the liability accrual and expense recognition for the initial acquisition costs for the issued policy at the time the policy was issued.

9. The assertion from the reporting entity is not consistent with SSAP No. 71, paragraph 5:

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.

10. The regulator viewed the disputed practice as a misapplication of the levelized commission guidance in SSAP No. 71 and that the reporting entity was underreporting its sales commission expense incurred and the related commission expense liability.

DISCUSSION

11. The accounting issue is whether levelized commission funding arrangements require the establishment of a liability for the full amount of the unpaid principal and accrued interest which is payable to a third party. The agenda item and the proposed revisions assert that guidance in SSAP No. 71, which has existed since prior to codification, requires accrual of the full amount that is repayable to the funding agent under the levelized commission agreement. It is important to highlight that the guidance in SSAP No. 71, nor the proposed clarifying edits, do not seek to prohibit funding agreements. The long-standing guidance simply requires full liability recognition to ensure continued reporting across reporting entities of commission obligations.

12. During the discussion of the agenda item, it was identified that this disputed practice of not accruing the full liability for the commission expense was only employed by a small number of reporting entities that employ similar operational practices. It was identified that these limited number of insurers entered into third-party arrangements with the intent to defer the recognition of commission costs for surplus relief. This goes against long-standing statutory accounting guidance and results in those insurers presenting a better financial position than other reporting entities that applied the guidance in SSAP No. 71 when using third-parties to pay commission as well as reporting entities that pay commission directly to agents. The application of this approach by the small number of reporting entities employing the practice resulted in significant differences impacting consistency and comparability in statutory financial statements. From information obtained, it is believed that a vast majority of companies are following the guidance in SSAP No. 71 as originally intended.

13. Research identified that some capital-funding companies were facilitating the practice, with marketing efforts to promote the surplus relief provided by using their structure as a third-party payer. These capital-funding companies were also active commenters in response to the proposed edits to clarify the guidance in SSAP No. 71. Throughout the Working Group discussion, it was identified that if the guidance is not clarified, then all reporting entities would need to contract with third-party agents to pay commissions to prevent competitive disadvantages in reporting financial results in the statutory financial statements. For the small number of companies that have engaged in this practice, these entities have benefited from lower expense recognition. It also results with a decrease in liabilities, resulting with a calculation that fewer assets are needed to meet obligations and improving overall RBC calculations. These results were identified as concerning as the financial statements do not accurately represent the obligations of the reporting entity

from issued in-force policies and could hinder the proper assessment of whether there are appropriate assets available to satisfy policyholder claims and other contractual requirements of the reporting entity.

Development of Statutory Accounting Guidance

14. SSAP No. 71 was adopted in 1998 as part of base codification, which went into effect in 2001.

15. *Issue Paper No. 71—Policy Acquisition Costs and Commissions*, paragraph 10, identifies the pre-codification statutory accounting guidance that is the basis for the existing SSAP No. 71 guidance. The pre-codification guidance also notes the same concerns (reiterated in the agenda item 2019-24) if reporting entities use levelized commission arrangements which operate as funding agreements to inappropriately enhance surplus. *Issue Paper No. 71—Policy Acquisition Costs and Commissions*:

10. Chapter 17, Other Liabilities, of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies contains the following guidance on levelized commissions:

Levelized Commission

The accounting treatment for certain transactions, characterized as levelized commissions, which results in enhancement of surplus, has been determined to be inappropriate for statutory reporting.

These transactions are, in fact, funding agreements between an insurer and a third party. Agents receive normal (non-level) commissions with payments made by the third party. It is intended, but not necessarily guaranteed, that the amounts paid to the agents 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 insurer. 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 premium payment or the maintenance of the agents license with the insurer is not maintained with respect to the payment stream.

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 advanced amount requires the establishment of a liability in the full amount of the unpaid principal and accrued interest.

16. The intent of SSAP No. 71 for levelized commissions is that repayment of an advance (by having a third party pay on the insurer's behalf), requires the establishment of a liability for the full amount of unpaid principal and accrued interest.

Contingent Commission versus Funding Agreement

17. SSAP No. 71, paragraphs 3-5, which are excerpted in the relevant statutory accounting section of this issue paper, describes both contingent commission and levelized commission agreements.

18. Contingent commission: SSAP No. 71, paragraph 3, provides the following key points:

- a. Contingent Commission liabilities are to be determined in accordance with the terms of each individual commission agreement.
- b. Commission liabilities determined on the basis of a formula that relates to loss experience shall be established for the earned portion.
- c. 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.

19. Levelized commission: SSAP No. 71, paragraphs 4 and 5, discuss levelized commission with the following key points:

- a. Such transactions are noted as in substance to be a funding agreement or a loan between a reporting entity and a third party.
- b. Selling agents receive their normal commission from a third party and repayment of the commission amounts to the third party by the reporting entity are intended, but repayment (with interest explicit or implied) to the third party is not necessarily guaranteed.
- c. Commission repayment to the third party by the reporting entity is over time. The levelized commission payments are lower than normal first year (sales) commission, but higher than normal renewal commission.
- d. The levelized commission arrangements are described as an attempt to bypass the recognition of expenses, which are normally charged to expense in the first year of the insurance contract.
- e. This guidance also notes that the use of a levelized commission arrangement is an attempt to break the normal link between underlying policies and the expense recognition, by changing the timing of the payment stream.
- f. SSAP No. 71, paragraph 5, provides:

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.

20. The key differences between traditional contingent commission paid directly to the selling agent and a levelized commission funding agreement that uses a third-party funding agent were a major component of the discussion prior to adopting the clarifying edits. The example brought to the Working Group was identified, by the regulator as a levelized commission funding agreement. Key levelized commission features of this example were: 1) the direct selling agents were paid their sales commission for policies written on behalf of the insurance reporting entity for year one commission by the third party; 2) the third-party funding agent was being repaid over time with some contingency elements in the third party levelized commission contract; and 3) the third party had typically advanced the funds to the selling agents in the same year that the policies were written (however some direct selling agents could choose different payment patterns).

21. Rather than accruing the total expected payments to the third party who had made commission payments to the direct selling agents, the reporting entity was only accruing commission expense based on when the next annual payment was due to the third-party. This levelized commission arrangement attempts to de-link the timing of recognition for the initial sales commission by inserting a third party.

22. As recognition of commission expenses is driven by policy events (such as the issuing or renewing of an insurance policy), the commission expenses had already been incurred, therefore, the reporting entities employing the disputed practice were viewed as underreporting their incurred commission expense and commission liabilities. This was not viewed as consistent with the principle of expensing acquisition costs when incurred or with the treatment of levelized commission funding agreements in SSAP No. 71.

23. In addition, it was identified that waiting to accrue the subsequent expected payments because the underlying policies might lapse in the future reflects a 100% lapse assumption. Using a 100% lapse assumption was noted as being inconsistent with the other financial statement assumptions regarding the underlying policies used for reserving, incurred but not reported claims, etc.

Contingent Commission versus Loan with Contingency Element

24. Comments received often characterized the third-party funding agreements as a persistency commission as support for why the full commission expense should not be required. The use of the term “persistency” in these instances is not in line with the traditional use of this term as it pertains to insurance contracts. Fundamentally, a persistency commission is commission that is earned over time as a policy is renewed or remains in force. A persistency commission occurs subsequent to an initial sales commission, where the triggering event is either the continuation or renewal of a policy. With these terms, an additional commission (beyond what was earned from the initial sales commission) is owed once the policy ‘persists’ overtime. Persistency commissions are generally much smaller payments than initial sales commission.

25. The third-party funding agreements reference to persistency commission in their contracts is not referring to additional commission owed with the continuation or renewal of a policy. Rather, they have taken the position that deferring the initial sales commission overtime and requiring portions of that initial sales commission to be paid to the third-party as the contract remains in force is akin to a persistency commission. This is not an appropriate comparison. As detailed, commission liabilities and the recognition of commission expenses shall occur in accordance with policy events. As such, with the issuance of an initial policy, the initial sales commission shall be recognized, with a liability accrual until paid, and with the recognition of the commission expense. If a policy remains in force over time, the terms of the contract may require additional commission to be paid to the selling agent. These additional commission amounts are considered “persistency” commissions and are only recognized when the policy event occurs that triggers the commission to be owed.

26. The following examples are included to assist with illustrating these concepts:

- a. Single Premium Immediate Annuity (SPIA): On January 1, 2020, agent sells a SPIA insurance policy and is owed \$1,000 in initial sales commission. Over the next 10 years, if the policy continues to be in force, on January 1, the selling agent is awarded a persistency commission of \$10, per year. This is a reward to the agent for the policy not being churned/terminated.
- b. Direct Agent Arrangement: On January 1, 2020, the reporting entity recognizes the \$1,000 as commission expense. On January 1, 2021 (and subsequent years) as the policy continues in force, reporting entity recognizes the \$10 persistency commission as incurred.
- c. Funding Agreement Arrangement: Rather than the reporting entity paying the \$1,000 initial sales commission directly to the agent upfront, the funding agent pays the initial \$1,000 commission to the selling agent. The insurer and the funding agent have an expectation that the reporting entity will repay the funding agent this amount over time. Under SSAP No. 71, an insurer is not permitted to insert a third-party to delay commission expense recognition. As such, under this arrangement the reporting entity insurer shall also recognize the full \$1,000 as commission expense on January 1, 2020. Additionally, the insurer should recognize the \$10 persistency commission on January 1, 2021 (and each year subsequent) if the policy continues to be in force. (This example does not reflect the recognition of the fees/interest of the funding agreement arrangement, which would also be required to be recognized.)

27. To be overly clear, the key concepts within these illustrations are as follows:

- a. The initial obligating event is the selling of the insurance contract. Commission expense for initial sales commission shall be recognized consistently by each insurer, regardless of third-party arrangements where a funding agent pays this on behalf of the insurer.
- b. The second obligation event is the persistency threshold in which additional commission is owed to the selling agent (policy did not lapse). This is also required to be recognized consistently by insurer regardless of any third-party arrangement.
- c. The small number of companies that have delayed recognition of initial commission expense due to the insertion of a funding agent have noted that their agreement allows them to avoid payment in the future even of policy cancellation (lapse). The proper accounting for commission in the event of policy lapse is to decrease the payable to the funding agent when the lapse occurs, not prior to the lapse.
- d. In addition to not altering the triggering event (initial issuance of policy), this dynamic does not reflect a traditional “persistency” commission. This funding agreement and use of a finance agent is simply a financing mechanism that the insurer has paid additional fees and interest to obtain. The proper accounting is to recognize the obligation for the full commission expense at the time of policy issuance, and then derecognize the obligation if, and only if, the insurer is no longer obligated to the funding agent. It is also noted that a third party would not pay large sums of money on an insurer’s behalf in an arm’s length transaction without an expectation of repayment.

Actions of the Statutory Accounting Principles (E) Working Group

28. On August 3, 2019, the Working Group moved this agenda item to the active listing, categorized as nonsubstantive, and exposed revisions to *SSAP No. 71—Policy Acquisition Costs and Commissions* to clarify levelized commissions guidance and provide additional direction regarding commissions that are based on policy persistency. The Working Group exposed initial revisions to paragraphs 2, 3, 4 and 5, which were intended to clarify both levelized and persistency commission because it was identified that some entities were trying to characterize their funding agreements as persistency commission. Key points in the exposed guidance were that:

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

29. The exposed revisions were 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).

- a. Liabilities require recognition as they are incurred.
- b. Accounting treatments which tend to defer expense recognition do not generally represent acceptable SAP treatment.

30. On December 7, 2019, the Working Group exposed nonsubstantive revisions to SSAP No. 71 to provide clarifications to the long-standing levelized commissions guidance and provide additional guidance regarding commission that is based on policy persistency. The revisions proposed to clarify that a levelized commission arrangement (whether linked to traditional or nontraditional elements) requires the establishment of a liability for unpaid principal and accrued interest payable, regardless of the timing of payments made to a third party. Additionally, the exposed guidance required accrual of persistency commission over the associated policy period.

31. The December 7, 2019, revisions were to address some of the comments received from interested parties and two capital funding companies. It was affirmed that the levelized commission repayment amount is owed to the funding agent who made the advance on the insurer's behalf unless the policy has lapsed. It was noted that delaying payment to a third-party does not delay expense recognition. After this discussion, the guidance was exposed with the following revisions from the prior exposure:

- a. Paragraph 2 - Removed previously exposed revisions regarding persistency commission. These provisions were initially included because the levelized commission example included contingency features regarding repayment. Commenters expressed concern that the exposed revisions could have an inadvertent impact on traditional renewal commissions, which was unrelated to a levelized commission arrangement.
- b. 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. This language was also added to address the industry comments regarding inadvertent impacts to traditional renewal commission.
- c. Paragraph 4 - Added two clarifying phrases to assist with identifying levelized commission funding agreements.
- d. Paragraph 5 - Added clarifying phrases regarding funding agreements.
- e. Footnote 1 - Redrafted to remove double negative wording.

32. The December 7, 2019, exposed nonsubstantive revisions were again intended to be consistent with the original intent of SSAP No. 71 as well as the Statutory Statement of Concepts focusing on Recognition (noted in the Preamble, paragraphs 37 and 38) stating that liabilities require recognition as they are incurred and accounting treatments which tend to defer expense recognition do not generally represent acceptable SAP treatment.

33. Notice of the December 7, 2019, exposure was also sent to the Life Actuarial (A) Task Force. The Working Group forwarded comments received at the 2019 Fall National Meeting inquiring whether there is specific *Valuation Manual* language in *VM-20, Requirements for Principle-Based Reserves for Life Products*, and *VM 21, Requirements for Principle-Based Reserves for Variable Annuities*, that needs to be addressed in the coordination process as part of this agenda item. It was noted that the Principles-Based Reserving (PBR) methodology takes commission into account when projecting the present value of future cash flows. However, the projected future cash flows would not be accrued in duplicative if there is an existing liability.

34. On March 18, 2020, the Working Group, deferred discussion of this item for a subsequent call or meeting. This deferral occurred as the 2020 Spring National Meeting was cancelled for COVID-19, and the interim call held by the Working Group was limited in the topics to address.

35. During the July 30, 2020, meeting, the Working Group reviewed comments from interested parties and on behalf of two capital funding companies.

- a. The proposed language from interested parties and one of the capital funding entities, as detailed in the following subparagraphs, was rejected by the Working Group as not viable and inconsistent with existing principles.
 - i. Interested parties' proposed language recommended deleting most of the exposed revisions and adding guidance that would redefine a funding arrangement to only include those items where repayment is guaranteed. This proposal was noted as being in conflict with the long-standing guidance in SSAP No. 71, paragraph 4, which notes that "It is intended, but not necessarily guaranteed, that the amounts

paid to the agents by the third party would ultimately be repaid...” It was also noted that the existing language in SSAP No. 71 seeks to look at the substance of the levelized commission arrangement noting that a third party would not prepay an entity’s commission expenses without an expectation of repayment.

- ii. One of the capital funding companies sent comments through a legal firm. Their comments proposed only requiring levelized commission liability recognition if the third party, which prepays the commission, is under the control or has common control with the insurance reporting entity. The perception of that comment was that if an unrelated party were the third-party funding agent that paid the upfront sales commission expense, no liability recognition would be required by the insurance reporting entity. This recommendation was also rejected as the substance of the transaction is a loan and the accrual of a liability for a loan is the same under SSAP No. 5R for related and unrelated parties.
- b. The Working Group also noted a concern with the capital funding company’s comments regarding assumption of lapse risk by noninsurance entities such as brokers and other third parties. The capital funding company’s comment letter (via the legal firm) asserted that the third-party broker, by virtue of their agreement, has assumed “lapse risk, mortality risk and the commission expense obligation.” The Working Group noted that some of the identified items which were noted as being transferred to the broker are insurance risks that can only be transferable to an insurance entity through a reinsurance agreement.
- c. The comments from the other capital funding company focused on unintended consequences and potential impacts to various entities. It asserted that the clarifying edits to the existing language are a substantive change. The Working Group noted that the proposed revisions are trying to emphasize existing language that has been in effect prior to codification that is being ignored by some reporting entities in an attempt to defer expense recognition. The Working Group affirmed that expensing acquisition costs when incurred is a long-standing principle in statutory accounting.
- d. While commenters agreed that the commission obligations are ultimately liabilities/expenses, they noted that the issue is when to record the liability/expense. The discussion noted that the accrual of sales commission liabilities and the corresponding recognition of expenses are incurred when the insurance contract is written, not when the payment is due. It also noted that an insurer is responsible for the policy acquisition costs of its directly written policies.

36. After the discussion on July 30, 2020, the Working Group exposed additional nonsubstantive revisions to SSAP No. 71 to clarify the original levelized commission guidance and provide additional direction regarding commissions that are based on policy persistency. The exposed edits would require reporting entities that have not complied with the original intent of SSAP No. 71 to reflect the change as a correction of an error (as a mistake in the application of an accounting principle) pursuant to *SSAP No. 3—Accounting Changes and Corrections of Errors* in the December 31, 2020, financial statements. In accordance with SSAP No. 3, correction of accounting errors in previously issued financial statements, for which an amended financial statement was not filed, are to be reported as an adjustment to unassigned funds (surplus) in the period in which the error was detected. This guidance also requires disclosure in accordance with SSAP No. 3. Part of the reason the exposure included correction of error guidance, as opposed to change in accounting principle, is that the Working Group identified that the practice was employed by a small number of reporting entities purposely for surplus relief and it was viewed as inconsistent with the long-standing guidance in SSAP No. 71. Further, it was identified that some funding companies were actively promoting the use of these third-party arrangements as a way to increase surplus by avoiding the recognition of commission expense when incurred.

37. On October 15, 2020, the Working Group held a hearing to receive comments from interested parties and from the American Institute of Certified Public Accountants' NAIC Task Force (AICPA Task Force).

38. Both interested parties and the AICPA disagreed with the correction of an error treatment and stated a preference to have the classification as a change in accounting principle. It was noted that referring as a correction in error could result with issues in previously filed financial statements, prior exams, and previously issued audit opinions. The Working Group agreed to remove the previously exposed correction of error guidance in paragraph 7 and to revert to the change in accounting principle guidance. When making this decision, it was noted that the resulting financial statements would ultimately have a similar result. Under the change in accounting principle guidance, a reporting entity reflects the cumulative effect of the change as an adjustment to unassigned funds (surplus) in the period of change of the accounting principle. This guidance provides that the cumulative effect is the difference between the amount of capital and surplus at the beginning of the year and the amount of capital and surplus that would have been reported at that date as if the accounting principle had been applied retroactively to all prior periods. For a correction of error, domiciliary states may require entities to file corrected financial statements for all prior periods that reflected the error. If this direction does not occur, the change is required as an adjustment to unassigned funds in the period the error is detected. As such, by permitting this correction to be reported as a change in accounting principle, the impacted reported entities will not be subject to different treatment by domiciliary states with the resubmission of previously filed financial statements to correct the error. Rather, all impacted entities will have a consistent approach to update their financial statements accordingly.

39. The Working Group discussed the other comments and proposed revisions from interested parties regarding contingency commission. The Working Group did remove more of the contingent commission guidance that was previously exposed in paragraph 3 to address concerns regarding potential impacts on traditional commission and renewals. This was viewed as addressing the remaining concerns about unintended impacts from the majority of industry that is not using funding agreements.

40. The Working Group also agreed to move the proposed effective date to January 1, 2021, to allow the small number of entities that are employing the practice the opportunity to consult with their domiciliary regulators.

41. With this discussion the Working Group again highlighted that the revisions are a nonsubstantive clarification of existing longstanding provisions of SSAP No. 71 which have been in place before 1998 and are only not being applied by a small number of reporting entities. As some commenters noted the materiality impact to the small number of entities that engaged in this practice, it was noted that 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, but rather if the change alters original intent.

Excerpt from Policy Statement on Maintenance of Statutory Accounting Principles:

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.

42. After the discussion on October 15, 2020, the Working Group exposed updated revisions to SSAP No. 71 to 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:

- a. Improved description of the funding agreements in paragraphs 4 and 5.
- b. 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.
- c. Modifies the revisions in paragraph 7 to remove the language on correction of an error.
- d. Proposes the nonsubstantive revisions apply to contracts in effect on January 1, 2021.

43. On November 12, 2020, the Working Group held a hearing to receive comments on the October exposure. Comments were received from interested parties, the Mississippi Department of Insurance and a former New York state regulator. Key points from the review of comments were as follows:

- a. Given the year-end timing and the material impact to what is believed to be a very limited number of companies, the Working Group discussed having another exposure, with minor edits, to clarify that the revisions would apply to contracts in effect as of the effective date to later be specified by the Working Group. While the Working Group did not want to have the guidance in effect on January 1, 2021, a few members stated a preference to having the guidance effective upon adoption sometime in 2021.
- b. The Working Group discussed the comments from the Mississippi Department of Insurance, interested parties and a former New York regulator that the changes appear to be substantive.
 - i. It was identified that the revisions have already had the due process required for either a substantive or a nonsubstantive change since it has had multiple exposures and public discussions.
 - ii. The Working Group affirmed 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. It was noted that 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, but rather if the change alters original intent.
 - iii. It was also noted that 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 drafted for either substantive or nonsubstantive revisions.
- c. The former New York regulator generally opposed all of the revisions. He noted that the total commission paid will not change under this guidance, but rather only the timing of commission expense recognition will change. In response to these comments, Working Group members noted that the total commission expense is actually higher using these third-party arrangements because the funding agents charge interest and/or fees.

44. The Working Group also discussed and rejected the following revisions proposed by interested parties:

- a. The proposed interested parties' revisions would have allowed both a reduction in commission expense recognition and the delay in commission expense timing. The parties employing the disputed practice are trying to use persistency features in a funding agreement to defer and decrease the funding agreement liability. Interested parties' comments advocated that the funding-agent fronting commission does not require recognition because of the insertion of a persistency contingency provision into the funding agreement. They noted that this persistency contingency provision might allow the reporting entity to avoid repayment of the past advance if the policy is subsequently cancelled. These proposed revisions were not incorporated as they are not in line with the original intent of the guidance and because it is not permissible to assume 100% lapse risk in recognition commission expense. It is only if a policy has been cancelled can a reporting entity derecognize the accrued liability/ commission expenses.
- b. Interested parties' proposed revisions 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. It was noted that 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. The guidance 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—*Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*) until it has either been repaid or the policy is cancelled.
- c. The interested parties recommended revisions to recognize a reduced and delayed liability for the funding amount. They recommended ignoring the funding agreement nature of the advances and only recognizing the next payment because the policy might be cancelled in the future. It was again noted that this is the equivalent of assuming a 100% lapse rate on the policies. This position is similar to setting up the liability for a single payment on a loan instead of the entire principal balance. This proposed revision was rejected as inconsistent with the existing guidance in SSAP No. 71 which requires full accrual of the funding agreement liability.
- d. Interested parties' recommended revisions to add a new reference to *SSAP No. 52—Deposit Type Contracts* for the recognition of funding agreement liabilities. This was possibly 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.
- e. Interested parties commented 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." However, it was noted that guidance in Appendix A-791 on Life and Health Reinsurance identifies that lapse risk, which is an insurance risk, can only be transferred via reinsurance. The

Working Group disagreed that insurance risk liabilities can be extinguished with a commission agreement with a noninsurance entity, which seems to be the position of interested parties.

- f. It was also noted that because of the persistency feature in the funding agreement, interested parties' commenters were advocating to not recognize any commission expense in these arrangements until it is due to the third-party agent. Similar to other positions, 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.
- g. The Working Group did not support the comment by interested parties that under a levelized commission agreement another party is responsible for an insurer's acquisition costs. It was noted that statutory accounting requires acquisition costs to be expensed as incurred, not shifted to a non-insurance entity. Interested parties were asserting that even though a third party prepaid their acquisition costs that they do not have to recognize an accrual for the levelized commission funding agreement. This position was rejected by the Working Group. The Working Group affirmed that a funding agreement is not the same as traditional persistency commission. The Working Group affirmed the original SSAP No. 71 guidance that the substance of a levelized commission agreement is a loan.

45. The Working Group discussed the overall statutory accounting concepts of conservatism and consistency which require that statutory financial statements reflect assets available for policyholder claims with comparable financial information. It was noted that allowing delayed expense recognition of initial policy commission expenses will contradict both statutory accounting concepts, as assets will be included that are not 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. Working Group members also expressed concerns with the competitive advantages that were occurring with companies that were employing these practices and stated a preference to have the guidance in effect in 2021.

46. After the discussion on November 12, 2020, the Working Group took the following actions:

- a. The proposed effective date of January 1, 2021 was changed to be effective upon adoption, and revised text was added to explicitly state that the proposed revisions will apply to contracts in effect as of the date of adoption.
- b. Determined that the revisions to SSAP No. 71 had met the due process for either a substantive or a nonsubstantive revision but concluded to keep the revision classified as nonsubstantive as the edits are in line with the original intent of SSAP No. 71. The Working Group reiterated that it is not the impact of a change on an individual entity that determines whether a change is substantive or nonsubstantive, but whether the revision is in line with the original intent of the SSAP. The Working Group noted that the proposed revisions to SSAP No. 71 are clarifications to the existing guidance consistent with original intent. Commissioner Donelon (LA) noted an objection to the classification as nonsubstantive.
- c. Directed NAIC Staff to draft an Issue Paper to document the discussion on this topic for historical purposes.

47. On March 15, 2021, the Working Group discussed written comments received from six parties including the 1) Montana Commissioner (now U.S. Representative) Matthew M. Rosendale, Sr., 2) a former North Carolina Commissioner 3) National Council of Insurance Legislators (NCOIL), 4) Interested parties, 5) one capital management company, and 6) a national conglomerate insurer. The key points from comments were summarized and draft responses were provided in the hearing materials for the meeting.

- a. Comments that there is no reason to change as current programs have been around for decades, been subject to external audits and insurance examinations and have not

previously been noted of concern. (Montana commissioner, former North Carolina commissioner, capital company and the national conglomerate insurer).

- i. Materials response - It was noted that identifying levelized commission transactions is difficult, without an in-depth review. When this was identified on a 2017 state examination, the reporting entity refused to recognize the full liability, which is why this issue was brought to the Working Group. The guidance to recognize the full liability amount for a levelized commission transaction has been a statutory accounting requirement since before 1998. This guidance is in place to recognize that the substance of an arrangement that has a third party pay an insurer's sales commission costs, is a loan. This is because a third party would not pay out large amounts of costs on another's behalf without an expectation of repayment.
- b. Comments that the change is substantive based on impact and needs more study and review for unintended consequences. (Montana, former North Carolina commissioner, NCOIL, interested parties, the capital company and the national conglomerate insurer)
 - i. Materials response - As noted in earlier meetings, 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. To the extent this is a clarification of existing guidance, the revisions are consistent with the nonsubstantive classification.
 - ii. Materials response - Agenda item 2019-24 has been under discussion since August 2019, and the March 2021 meeting will be the sixth public discussion of this item. This item has been discussed: 1) August 2019; 2) December 2019; 3) July 2020; 4) October 2020; 5) November 2020 and 6) March 2021. It was noted that the underreporting of commission liabilities appears to be a practice employed by only a very small number of reporting entities.
- c. Comments that there can be a negative RBC impact. The former North Carolina Commissioner, NCOIL, and the capital company all noted concern with the potential negative impact to risk-based capital which will result with the revisions requiring companies employing the disputed practice to recognize the full funding agreement.
 - i. Materials response - Reporting previously unrecognized liabilities can have negative RBC impacts; this is why the adoption of the agenda item was delayed from year-end 2020. The delay was to allow the small number of reporting entities which are employing the disputed practice to have an opportunity to have discussions with their regulators. However, it is highlighted that the unrecognized liability also resulted with improved financial statements (and better RBC) than what should have been recognized based on actual operations.
- d. Possible consumer rate increases on guaranteed renewable long-term care were noted by the former NC commissioner and the capital company.
 - i. Materials response - The disputed practice is underreporting incurred commission expense and the obligation to repay it to a funding agent. This financing activity is being used to delay/under report incurred commissions. However, the total commission cost is typically slightly higher as the funding agents charge a fee and or interest (implicit or explicit) for their services. As such, the full financial statement impact is not as clear cut as implied in this comment.

- e. Effective date comments were varied. NCOIL was against a 2020 effective date, however that comment appeared to be related to the prior October exposure. NCOIL also requested a delay for the issue paper and recommended a five-year phase-in. The interested parties and the national insurance conglomerate advocated for an effective date no sooner than December 31, 2021, to allow time to work with regulators, auditors etc.
 - i. Materials response - Effective Date - The Working Group discussed proposed language which allows a December 31, 2021, effective date.
 - ii. Materials response - Phase-in - This is viewed as a practice employed by a small minority of reporting entities, but the potential impact is material. Some Working Group members and some members of industry have noted the unfair competitive advantage that entities which employ this practice are receiving, because it underrepresents the incurred liabilities. Prior Working Group discussions have indicated that a phase-in would need to be a permitted practice granted by the domiciliary regulator.
- f. Interested parties' comments asserted that lapse risk under the contracts had been transferred to a noninsurance entity, with the following comments "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 No. 71 goes directly to the risk transfer issue of one type of level commissions versus another. The proposed additional language eliminates this differentiation."
 - i. Materials response - Statutory accounting guidance in Appendix A-791 on Life and Health Reinsurance identifies that lapse risk can be transferred via reinsurance. Transferring lapse related liabilities with a commission agreement with a noninsurance entity, was not viewed as a viable option under statutory accounting. The long-standing guidance in SSAP No. 71 requires full accrual of the funding agreement liability even if repayment is not guaranteed.
 - ii. Materials response - 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 assumption would be inconsistent with any other assertions reflected in the recognition of these insurance policies in their financial statements. 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.
- g. Interested parties resubmitted some of the previously rejected proposed paragraph 4 revisions which seek to codify the industry position that funding agreements, which incorporate contingencies linked to traditional elements, should not be treated as a funding agreement (i.e. excluded from liability recognition).

- i. Materials response - The proposed revisions were not incorporated as proposed language seeks to codify the treatment which has previously been rejected as inconsistent with the guidance in SSAP No. 71.
- h. Interested parties resubmitted some of the previously rejected proposed paragraph 5 revisions to replace most of the exposed paragraph with language that is less detailed and which seeks to codify the industry position that funding agreements which incorporate contingencies linked to traditional elements should not be treated as a funding agreement (i.e. excluded from liability recognition).
 - i. Materials response - The proposed revisions were not incorporated as proposed language seeks to codify the treatment which has previously been rejected as inconsistent with the guidance in SSAP No. 71.
- i. Interested parties commented that the exposed language which describes funding agreements, is too broad. Notes a concern that interim pay downs are not mentioned.
 - i. Materials response - Additional guidance regarding interim payments to paragraph 5 were not added because liabilities are always reduced when paid. This is detailed in SSAP No. 5R and SSAP No. 103R.

48. Interested parties commented that, “The current revisions require the accrual of a liability in situations that are inconsistent with the guidance SSAP No. 5R. 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.”

- a. Materials response - The comment by interested parties indicates 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. The position of interested parties is that even though a third party prepaid an insurer’s acquisition costs that the insurer does not have to recognize an accrual for the levelized commission funding agreement because in some situations such as future policy cancellation, the insurer might not have to pay. This is rejected as inconsistent with SSAP No. 71 guidance and inconsistent with SSAP No. 5R.
- b. Materials response - SSAP No. 5R incorporates an obligation to recognize contingent amounts that are probable and can be reasonably estimated. The difference is that a levelized commission arrangement is repaying a loan where in most cases the advance of the loan amount has already been made. The loan has contingency elements that may allow the loan repayment to be reduced in the future. Until the policy is cancelled there is a presumption that the amounts will be repaid. This is different from making a future commission payment on commission that has not yet been earned which occurs under traditional persistency commission. The elements of a liability under SSAP No. 5R:
 - i. 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 funding-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.

- ii. Payment probable of occurring - 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.

49. On March 15, 2021, the Working Group discussion included the following key points:

- a. Mr. Bruggeman (OH) and Ms. Marcotte (NAIC) introduced agenda item 2019-24: Levelized and Persistency Commissions. The Working Group has been discussing this topic since August 2019 with this being the sixth public discussion. This agenda item was drafted in response to a specific state insurance regulator request to address an accounting practice identified during a financial examination. It was noted that a few insurers are utilizing a disputed practice by using third parties to pay policy acquisition costs, and they are not recognizing the full liability to repay those third parties. Not recognizing the full liability to repay the parties who are paying acquisition costs on an insurer's behalf is inconsistent with the guidance in *SSAP No. 71—Policy Acquisition Costs and Commissions*. SSAP No. 71, which has been in place prior to 1998, provides statutory accounting guidance and identifies such agreements as funding agreements, which require full liability recognition. Mr. Bruggeman stated that NAIC staff have provided a summary of comments received, which includes a response to each position. Accordingly, NAIC staff are not recommending additional modifications.
- b. Commissioner Mulready (OK) inquired as to whether actions taken by the Working Group regarding this project would go through the complete NAIC committee process, including reporting to the Accounting Practices and Procedures (E) Task Force and the Financial Condition (E) Committee and review by the Executive (EX) Committee and Plenary. Mr. Bruggeman stated that due to the controversial nature of this topic, this agenda item will be specifically considered through all levels of the committee process.
- c. Commissioner Mulready further inquired regarding the expense recognition and payment of cashflows for using a third party to pay policy acquisition costs compared to insurers who directly pay commission expense. Mr. Bruggeman stated that traditional life insurance policies typically have a larger commission in the first year the policy is written. Through the use of a third party, some insurers have used a levelized repayment plan, so the first-year commission is repaid over several years. Additionally, the immediate expense recognition for this first-year commission, as required under SSAP No. 71, is not being properly recognized by some insurers in the year of acquisition. As a third party has remitted funds on behalf of an insurer, the insurer needs to properly recognize the loan as a liability.
- d. Commissioner Mulready inquired about lapse risk, which is a common element built into these financing agreements. Mr. Bruggeman commented that lapse risk cannot be transferred to a noninsurance entity; and SSAP No. 71 still requires the liability to be

recognized, even if repayment to the third party is not guaranteed. Mr. Bruggeman further stated that by not recognizing the full commission financing liability, an insurance company is asserting a 100% lapse rate, which is not an appropriate assumption and not consistent with the reserving methodology used for these products.

- e. Ms. Nettleton (Guggenheim) stated that levelized commissions are not a new concept. She noted that a 2010 U.S. Securities and Exchange Commission (SEC) complaint against another carrier notes that levelized commissions were common practice. She stated that the concept of persistency remains a concern, as Guggenheim believes expense recognition will occur earlier than has traditionally been required. She stated that Guggenheim feels it is a dangerous practice to remove persistency in the treatment of levelized commission. Mr. Bruggeman stated that the concepts regarding traditional persistency commission are not a part of the proposed edits, as this agenda item is to clarify that initial acquisition costs should not be deferred through the use of a funding agreement.
- f. Mr. Stolte (VA) stated that in 1991, Virginia had an insolvency in which the company participated in a structure where it utilized a levelized commission financing arrangement and did not properly recognize a liability for the amounts paid by the third party. However, as the insurer was liquidated, the third-party financier sought reimbursement for commission amounts previously forwarded on behalf of the insurer. Mr. Stolte stated that the insurer had not recorded the full amount of the liability, and this overstated surplus. He stated that if these amounts due are not recorded, they are in essence off book, unrecorded liabilities. He stated that the concept of recognizing commission expenses when incurred has been a long-standing concept of statutory accounting, which was noted even prior to codification. He noted that acquisition costs are expensed as incurred upfront.
- g. Commissioner Donelon responded that the insurer referenced by Mr. Stolte did a levelized commission practice; however, he perceived the accounting practice was fully transparent, and the \$16 million amount of the off-balance sheet liability only represented a fraction of the \$120 million insolvency. He stated that earlier exposures of this item, involved other large life insurers; however their earlier concerns appear to have been accommodated. He inquired regarding the nature of this accommodation. Mr. Bruggeman stated that this comment pertains to clarification involving true persistency commissions—i.e., subsequent year commissions—were not intended to be captured in the scope of levelized commissions revisions in SSAP No. 71. He said the initial revisions were perceived by the broader insurance industry as affecting traditional persistency commission and the Working Group subsequently clarified that that was not the intent of the revisions. Ms. Gann (NAIC) stated that SSAP No. 71 is a common area SSAP, so it is applicable to all insurer and product types. She stated that the intent of the SSAP No. 71 revisions is to capture initial acquisition costs and commissions from the issuance of a policy, not traditional persistency commissions that arise subsequent to initial commissions which are common in many insurance products.
- h. Thomas B. Considine (National Council of Insurance Legislators—NCOIL) stated that NCOIL believes that the changes proposed are substantive in nature and the timing of an adoption is less than prudent, especially in light of the current economic environment. He noted that the revisions will have adverse capital consequences on some companies. Companies utilizing levelized commission structures have done so for decades, and in conjunction with this requiring a significant financial impact, NCOIL would recommend a four or five-year phase-in of expense recognition. Mr. Stolte stated that in response to a multi-year phase-in request, insurers affected could request a permitted practice from their state of domicile. In doing so, a multi-year phase-in could be granted; however, the financial and capital impact could be appropriately disclosed. Mr. Considine stated that

permitted practices are not viewed as favorably as uniform treatment, and this would not be a preferred solution.

- i. Lynn Kelley (Delaware Life), on behalf of interested parties, stated that they do not agree with the proposed edits, and they believe the edits are substantive in nature. She stated that interested parties believe that their accounting practices have been in compliance with SSAP No. 71 and have been subject to numerous insurance exams and independent financial audits. If adopted by the Working Group, an effective date no earlier than December 31, 2021, is requested. She stated her support also for a multi-year phase-in.
- j. Mr. Bridgeland (Center for Insurance Research—CIR), NAIC consumer representative, stated that the most important function of statutory accounting is to ensure solvency and a level playing field among similar insurers. He stated that an insurer's financial statements should reflect capital available to pay policyholder claims and not permit off-balance sheet liabilities. Despite this requiring material adjustments to a few insurers, he stated that adoption was recommended to ensure that financial statements appropriately reflect an insurer's financial position. He stated that if deferring the recognition of commissions is what is maintaining a company in the appropriate risk-based capital (RBC) range, then the company may warrant additional scrutiny for other areas as well.
- k. Mr. Bruggeman stated that as the edits proposed do not change the original intent of SSAP No. 71, he views the edits as nonsubstantive in nature. He stated that the concept of requiring immediate expense recognition of initial acquisition costs meets the spirit of statutory accounting concepts, as well as the concept of conservatism as referenced in the preamble. Commissioner Donelon stated that he believes this issue to be substantive in nature, even if it is not in the technical accounting sense. He indicated that the reporting entity that contacted him indicated that it will not have a materially adverse impact on them. However, he has been told that there are reporting entities that will have a significant financial impact on some small companies, and it will jeopardize members of the ACLI and the National Alliance of Life Companies (NALC). He stated recommendation for grandfathering of existing practices or a multi-year phase-in of any recognition requirements. He stated his agreement with Mr. Considine that a permitted practice is not preferred. Mr. Smith stated that when referencing the definitions of substantive versus nonsubstantive in the *Accounting Practices and Procedures Manual* (AP&P Manual), the exposed edits are nonsubstantive in nature.
- l. Commissioner Mulready stated that this practice has been in place for decades, and to classify this as nonsubstantive signifies to him that all prior insurance exams and independent audits are incorrect. Ms. Andersen (IL) stated that the proposed edits are only clarifying in nature, as they do not change the intent of SSAP No. 71. She stated that this practice has only been employed by a small number of insurance entities, and it results in liabilities that are not recorded in the financial statements. Mr. Stolte stated that commission financial arrangements are difficult to discover; in the prior insolvency example referenced, it was not until the company was in receivership that the issue was discovered. He noted that such arrangements create illusory surplus and violate the concepts of statutory accounting and audits do not review every single contract.
- m. Mr. Bruggeman stated that nonsubstantive agenda items are generally effective immediately; however, due to the nature of this topic, it will need to be approved by the Accounting Practices and Procedures (E) Task Force, the Financial Condition (E) Committee, and the Executive (EX) Committee and Plenary. With the Executive (EX) Committee and Plenary not meeting until the Summer National Meeting, the earliest this adoption could take effect is likely the third quarter of 2021. Mr. Smith (VA) stated that

due to the length that this agenda item has been discussed, they would support an immediate effective date. Ms. Belfi (CT), Mr. Fry (IL), Mr. Clark (IA) and Mr. Kim Hudson (CA) recommended a December 31, 2021, effective date. due to the likelihood of a significant financial impact combined with the requirement for adoption by the Executive (EX) Committee and Plenary. In an inquiry from Mr. Bruggeman, no Working Group member was opposed to a December 31, 2021, effective date, which is the effective date suggested by Delaware Life per the comments from Ms. Kelley.

- n. As this agenda item directs that any adjustments be accounted for as a change in accounting principle under *SSAP No. 3—Accounting Changes and Corrections of Errors*, the effective date will not have a material impact, as any required cumulative adjustments calculated as of January 1, 2021, will impact unassigned funds (surplus). Mr. Bruggeman stated that upon adoption, insurers will be required to record a liability for outstanding amounts due to a third-party funding agent as a cumulative effect adjustment to surplus as of January 1. He noted that activities throughout the year after January 1 are recorded through income.

50. On March 15, 2021, the Working Group took the following actions with Louisiana voting in opposition.

- a. Directed NAIC staff to update this Issue paper for March 2021 and subsequent actions to allow for future exposure. It was noted that the non-authoritative issue paper does not need to be adopted prior to implementation of the SSAP No. 71 revisions.
- b. Supported an annual statement blanks proposal to provide a new general interrogatory to identify the use of a third party for the payment of commission expenses, which will be concurrently exposed with the Blanks (E) Working Group.
- c. Adopted the exposed revisions to SSAP No. 71 with a December 31, 2021, effective date. The Working Group affirmed the nonsubstantive classification of these revisions as consistent with the original intent of SSAP No. 71.

51. On March 23, 2021, the Accounting Practice and Procedures (E) Task Force adopted the report of the Working Group. The Task Force conducted a separate vote on the SSAP No. 71 revisions. The motion passed with 41 in favor and the states of Louisiana and Oklahoma opposed.

52. Key aspects of the March 23, 2021, Task Force discussion are provided below.

- a. Mr. Bruggeman provided an overview of agenda item 2019-24 regarding levelized commission, which affects *SSAP No. 71—Policy Acquisition Costs and Commissions*. He stated that the Working Group has been discussing this item since August 2019, when it was brought to the Working Group by a domiciliary state. Mr. Bruggeman stated that after six public discussions, the nonsubstantive revisions that clarify the guidance in SSAP No. 71 regarding levelized commissions were adopted on March 15, 2021, with a December 31, 2021, effective date. Thirteen Working Group members voted in favor of adoption, and one member was opposed.
- b. Mr. Bruggeman stated that both U.S. GAAP and SAP would calculate acquisition costs in a similar manner. However, one of the major financial reporting differences between SAP and GAAP is that GAAP capitalizes acquisition costs and expenses them over time to match revenue and expenses while SAP expenses policy acquisitions costs as incurred. Mr. Bruggeman stated that at the heart of this issue is that a small number of reporting entities are using third parties to pay their sales commission costs and not recognizing the full liability of what is in essence a loan to repay the third parties as required under SSAP No. 71. He said that the Working Group has had extensive discussion on this topic and has

noted that the revisions clarify the long-standing principles in SSAP No. 71, which have existed since even prior to codification. He stated that the revisions were classified as nonsubstantive because the revisions emphasize the original principles regarding funding agreements and the impact to a minor number of companies do not determine the classification of the revisions.

- c. Mr. Bruggeman noted that state insurance regulators and consumer representatives also voiced concerns about the illusory surplus and unlevel playing field such arrangements create. He stated that because of the unfair competitive advantages that are perceived, the Working Group was not in favor of grandfathering the practices. He noted that the Working Group did discuss that companies could have discussions with their domiciliary states regarding obtaining a permitted practice for phasing in the financial impact. because the impact to the affected companies may vary.
- d. Louisiana staff stated that Commissioner James J. Donelon could not attend the meeting, but he wanted his comments that this is a substantive change noted and also that he is in favor of a phase-in period. Oklahoma staff also noted that Oklahoma also supports the comments from Louisiana.
- e. Ms. Kelley (Delaware Life) stated that their position is also that the revisions are substantive and that they appreciate the time that the Working Group has spent discussing this issue even if not all of the edits they submitted were incorporated. She also stated support for an effective date at least as late as December 31, 2021.
- f. Elly Nettleton (Guggenheim Life and Annuity) highlighted two points from their prior comment letters: 1) levelized commissions are not a new concept and date back several decades. She noted that a 2010 U.S. Securities and Exchange Commission (SEC) complaint against another carrier identified levelized commissions as a common practice in the industry. She said Guggenheim is not aware that the accounting treatment was determined not to be in accordance with statutory accounting principles; and 2) traditional commissions such as those tied to policy persistency are carved out of the proposals. Ms. Nettleton said Guggenheim believes it is a dangerous precedent to remove persistency as a factor in the accrual of commissions as it is a key insurance element. Mr. Bruggeman noted that similar comments as Ms. Nettleton's were made at the Working Group. He stated that the Working Group did hear the comments but did not agree with them.
- g. Thomas Considine (National Council of Insurance Legislators—NCOIL) stated that NCOIL members feel strongly that the revisions are substantive but are willing to put that aside and do not feel the need to debate that classification again at this time. He stated that this is a practice that has been going on for decades. He stated that to implement this change during a period of great economic turmoil seems not only short-sighted, but also it is dangerous to require entities to make such a change in a period of a year. He stated that NCOIL recommends a significant phase-in period with a proposed effective date of December 31, 2025. He stated that a permitted practice does not reflect positively on the state granting the practice or the reporting entity receiving the practice. He stated that accreditation reviews note the permitted practices granted by a jurisdiction. He stated that the most fair and equitable solution and a way to avoid the debate of change classification is to add a four- or five-year phase-in.
- h. Mr. Bruggeman stated that funding agreements to levelized commission costs are not prohibited. He said the issue is that the full liability for the funding agreement must be recognized for the inherent loan. In other words, it is a financing arrangement; it does not delay the timing of recognition of the acquisition costs. He stated that a permitted practice

may not have a positive perception. However, permitted practice disclosure requirements allow state insurance regulators to understand the surplus impact of the arrangement. He stated that a permitted practice provides transparency and noted that if there were any decisions to extend the effective date beyond December 31, 2021, there would need to be a disclosure of the impact. Ms. Walker (TX) agreed, noting that consistency, meaning the ability to compare reporting entities' financial positions, is a fundamental concept that statutory accounting is based on. She noted its importance for solvency regulation.

- i. Mr. Considine noted that to address Mr. Bruggeman's point about state insurance regulators' information needs, he is confident that if there were a four- or five-year phase-in, legislators would be supportive of a reasonably tailored data call. Mr. Rehagen (MO) asked if Mr. Considine envisioned a confidential data call or one that would be publicly produced. Mr. Considine indicated he assumed if it were for the state insurance regulators, then such a data call would be confidential. However, he said NCOIL would be open to discussion. Mr. Bruggeman stated his intent was for a disclosure to be part of the public statutory accounting filing.
- j. Mr. Stolte stated that the Task Force is discussing noncompliant statutory accounting by a handful of companies. He stated that in 1991, Virginia had an insurance receivership of a large life insurance company that had a deferred commission funding arrangement. He said that the insurer had not booked the liability, but when the company was put into receivership, the funding entity/financier filed with the receivership a request for payment of \$16 million. He said that the reporting entity prior to the receivership was reporting \$120 million in surplus, but true surplus ended up being approximately \$4 million. He said he disagreed with the statement that what the handful of companies are doing is an acceptable SAP practice. He said it is noncompliance with statutory accounting in SSAP No. 71, and also with the statutory accounting guidance that existed even prior to codification. He said from a level playing field perspective, he does not want to be forced to approve such agreements for his companies to be able to compete with reporting entities employing this practice. He stated that not recording the full liability for the funding agreements creates illusory surplus. He stated that if a reporting entity needs more time to implement the revisions, a permitted practice is what should be employed. He noted that he received notification of more than 100 permitted practices in an average year. He stated that the permitted practices are designed to provide transparent disclosure for all state insurance regulators.
- k. Mr. Considine stated that what Mr. Stolte is terming "noncompliance" has been accepted in the regulatory community for 20 years. He said if reporting entities have been doing so for 20 years, it seems unreasonable to require a change in one year. Mr. Stole said that in Virginia, they have not accepted such practices. He noted that there may be some that they were unaware of, but they do not view it as an acceptable practice. He stated that this has been noted as problematic in a formal examination report, and he respectfully disagrees with Mr. Considine's statement that it was an acceptable practice. Ms. Walker also noted that she has been a Texas state insurance regulator for 20 years and is not aware of any entities that are using funding agreements to defer the recognition of acquisition costs. She noted that she would also take exception to doing so if it were identified in an examination or other regulatory review.
- l. Mr. Bridgeland (Center for Insurance Research—CIR) stated support for the proposal as adopted by the Working Group. He stated that one of the top priorities for state insurance regulators was ensuring that the insurers are solvent. He stated that part of that is also ensuring that there is a level playing field. He stated that in this case, there are a handful of

companies using a technique that, by their own admission, is enhancing surplus. He noted that as a consumer advocate, he does not want to see insurers have illusory surplus.

53. On April 13, 2021, the Financial Condition (E) Committee, adopted the revisions with 11 in favor and the three states of Mississippi, New Mexico, and South Carolina dissenting. The following key comments were part of the discussion:

- a. Commissioner White stated that the last item on the agenda is an issue that has received a considerable amount of discussion within the Statutory Accounting Principles (E) Working Group over the last couple years. He stated that unlike the premium refund issue from 2020, where the Committee overturned the adoption of a position and suggested that the issue be redrafted, he does not believe that should occur for this particular issue. He stated that the reason for this was that it was his understanding that the vast majority of the life insurance industry is very much opposed to the practice that has apparently been used by what we think is a handful of companies. The reason being is they believe it gives those handful of companies an unfair competitive advantage over the rest of the industry that has been abiding by Statement of Statutory Accounting Principles (SSAP) No. 71—*Policy Acquisition Costs and Commissions* ever since its inception, as well as even dating back before at least the 1990s. He suggested that if the Committee does not adopt this item, his understanding is that it would force the Working Group to change the entire SSAP No. 71 to allow all commissions and related acquisition costs to be deferred and amortized over time. The reason this would be required is that is essentially what the handful of companies are doing today, while the rest of the industry expenses these costs at the inception of the contract in accordance with statutory accounting principles (SAP). Commissioner White summarized that this would require the Working Group to go back and basically adopt U.S. Generally Accepted Accounting Principles (GAAP) for this particular issue, even though this is one of the biggest differences between SAP and U.S. GAAP. He noted that even if the Committee adopts the issue, it still needs to be adopted by the Executive (EX) Committee and Plenary. He also noted that he already recommended that the Executive (EX) Committee and Plenary consider taking it up either at the Summer National Meeting or during an interim call of the Executive (EX) Committee and Plenary.
- b. Ms. Walker noted that included in the materials is a document that provides an overview of the levelized commission agenda item 2019-24 from the Working Group, which modifies SSAP No. 71 through a clarification. She discussed how the Working Group began discussion on the issue in August 2019, and on March 15, 2021, the Working Group adopted nonsubstantive revisions illustrated at the end of the attachment, with an effective date of December 31, 2021. The Working Group vote was 13 states in favor and one state opposed. On March 23, 2021, the Accounting Practices and Procedures (E) Task Force adopted the Working Group’s revisions without modification. The vote was 41 members in favor and two opposed (Louisiana and Oklahoma).
- c. Ms. Walker discussed that although U.S. GAAP and SAP calculate acquisition costs in a similar manner, one major financial reporting difference between the two is that U.S. GAAP capitalizes acquisition costs and expenses them over time to match revenues and expenses while SAP expenses policy acquisitions costs as incurred. This accounting treatment is in line with the SAP Statement of Concepts, particularly the recognition concept. This concept specifically identifies that accounting treatments that defer expense recognition are not generally acceptable under SAP.
- d. Ms. Walker noted that this agenda item was initiated because some reporting entities are using third parties to pay their sales commission costs without recognizing the full liability to repay the third parties, as required under SSAP No. 71. These entities have taken the position that their agreements are not funding agreements, as they pass on lapse risk to the

third party. Ms. Walker discussed how the Working Group has noted that the revisions clarify the long-standing principles in SSAP No. 71, which have existed since even prior to codification. The nonsubstantive revisions emphasize the original principles that require full liability recognition for the commission paid on an insurer's behalf and any interest and fees incurred to date. Ms. Walker described how the Working Group noted that it is not permissible to pass insurance lapse risk to a non-insurance entity. Furthermore, as the commission is owed with the issuance of an insurance contract, the proper recognition shall continue to require recognition at the time the insurance contract is issued. Ms. Walker indicated that the Working Group confirmed that it is not permissible to utilize a third-party payer of sales commission as a means to defer recognition of commission expenses.

- e. Ms. Walker described how if the agenda item is adopted, a small number of companies will have a material financial impact. She emphasized that because of the unfair competitive advantages that are perceived, and as the guidance is in line with the original intent of SSAP No. 71, the Working Group did not adopt grandfathering or transition provisions. She discussed how the Working Group has recommended that affected companies speak to their domiciliary states regarding potential permitted practices, as needed, for phasing in the financial impact. This approach was favored because the impact to the affected companies may vary, and it provides disclosure in Note 1 to ensure the comparability of all insurers with SAP. Ms. Walker noted that it is her understanding that most companies are not employing this practice and will not be affected by the agenda item's adoption.

- f. Superintendent Toal (NM) suggested that the Committee should consider modifying the effective date from the current proposed year-end 2021 to year-end 2022. Ms. Walker stated that the Working Group had already delayed the effective date from its usual practice of effective upon adoption for nonsubstantive items such as this, but the Working Group wanted to allow time for domestic states to work with any of their companies affected. She also described how a further delay was considered, but since the vast majority of the industry is complying, such a suggestion was rejected by the Working Group. Superintendent Toal questioned whether having less than six months allows enough time for companies to make the changes necessary. Commissioner Donelon repeated a comment that he indicated he has made in the past, which was that even though this was not a substantive change, the real-world impact to some companies was to the tune of hundreds of millions of dollars; therefore, grandfathering of the old contracts, perhaps on a phased-in approach, should be allowed. He described that he had been directed to some communication from the U.S. Securities and Exchange Commission (SEC) where this practice was identified as far back as 30 years ago. He described how such companies therefore may have been using this practice in good faith, or at least one they believed was appropriate, and they are being asked to record hundreds of millions of changes in surplus from this practice. He stated that for this reason, he and other commissioners have interceded in this process. Mr. Slape (TX) stated that the reference to SEC action may not be accurate, as he believes the facts indicate that the company was in worse financial condition after entering into these transactions. In essence, these companies are borrowing money, paying interest on that borrowed money, then competing against other companies that are following the current accounting requirements. Mr. Slape noted that this is not a new issue; this is the first thing that a state insurance regulator learns about regarding the differences between SAP and U.S. GAAP.

- g. Commissioner White indicated that everything he has been told is that this may have been taking place within a handful of companies, but that does not mean the state insurance regulators of those companies were aware of its existence in those companies. He described how this is not readable or identified in the financial statements since it is an unrecorded liability. He described how expensing these costs as incurred has been a bedrock principle

within statutory accounting for years, even before SSAP No. 71 was adopted in 2001. He noted that he understands the argument for phasing in the impact, given that it could be material for some companies; however, the other side of that is the argument about the level playing field. He emphasized what Ms. Walker said earlier about affected companies working with their domestic regulator about a permitted practice, which is disclosed in Note 1 of the financial statements. Commissioner Donelon stated that he believes from his experience as a commissioner for so many years that the term “permitted practice” certainly comes with a negative connotation. He stated that for the companies he has heard from, the affected companies are unwilling to pursue a permitted practice. However, he stated his appreciation for the time that the Committee and its subsidiary task forces and working groups have given to this issue.

- h. Mr. Galbraith (AR) asked if it is possible to determine definitively if there were just a handful of companies and also whether the practice will definitively cease with all companies going forward on the same level playing field if the proposed changes are adopted. Commissioner White stated that he has heard no evidence to the contrary that it was anything more than a handful of companies since he believes state insurance regulators would have heard from those companies that are affected, and he noted that he is aware of companies in only three states where this is an issue. He described how this is a difficult practice to identify since it is not recorded in the financial statements. He also stated that with the significant discussion, the industry appears to be very aware of the issue, and the vast majority of the industry is supportive of the clarification to have a level playing field.
- i. Commissioner Mulready stated his support for the comments made by Commissioner Donelon, noting that his concerns have never been about the issue but rather the implementation. He stated his understanding that grandfathering may be difficult, but a delayed effective date, as suggested by Superintendent Toal, should be considered. Commissioner White responded that he believes that point was debated at the Working Group and the Accounting Practices and Procedures (E) Task Force. Commissioner Mulready noted that as a result of these discussions, Oklahoma had sent communication to all of its domestics to determine if other insurers are affected, and he suggested that he is sure other states are likely doing the same thing. Commissioner White stated his support for that practice, noting that it allows the domestic regulator to determine what is best for any affected companies. Wayne Goodwin, former North Carolina Insurance Commissioner, stated that he had previously submitted comments on this issue, noting slippery slope concerns with what could happen if it is implemented as quickly as is suggested since those concerns affect consumers. He stated his support for comments from Commissioner Donelon, Commissioner Mulready and Mr. Galbraith, and he noted concern about the potential impact on smaller carriers.
- j. Superintendent Toal stated that he wants to be clear in the idea of moving to a level playing field, and he is not objecting to the policy, rather his objection was with the limited time to implement, particularly given that state insurance regulators do not know the number of companies affected. Commissioner White responded that his deputy refers to the issue that arises from this practice as illusory surplus, and if in fact there are millions in unrecorded liabilities, that indicates information should be available to solvency regulators and indicates a level of concern. Ms. Walker stated that she believes this is a consumer protection issue, and her highest responsibility is ensuring that carriers can pay policyholder claims as they come due. She stated that when she hears some of the concerns that are being stated, as the domiciliary regulator, she needs the companies to come speak to her so that the two can work out a practice that takes care of consumers while considering the concerns of the company. She stated that the Accounting Practices and Procedures Task Force is trying to adopt some disclosures to gather information on companies, but that

depends upon accurate completion by the company, something that may not occur given this particular accounting practice of expensing commissions as they are incurred, which is a fundamental bedrock of statutory accounting that differs from other standards. She noted that there was discussion of trying to obtain more data on the companies using this practice, but the companies did not come forward to their state insurance regulator even though that was requested. So, while a complete scope is not known, the Working Group and the Task Force did not receive information from state insurance regulators that are on the Task Force or follow it. Ms. Walker also noted that the current proposed effective date of year-end 2021 is already a delay. Mr. Slape suggested that if this is going to have hundreds of millions of impacts on a handful of companies, that is illusory surplus, and that raises questions about the solvency of such insurers using this practice. Therefore, it could have an impact on this small number of companies.

- k. Ms. Kelley (Delaware Life Insurance Company), on behalf of interested parties, stated that this is an issue that has been discussed for some time, and she appreciates the ongoing discussions of the Committee and NAIC staff that have worked with Delaware Life. She strongly advocated for additional time to work through this implementation because Delaware Life still believes there are unanswered questions with regard to the calculations. She stated that Delaware Life has advocated all along for an extended effective date. She stated that Delaware Life maintains that this is a substantive change and believes that it has applied SSAP No. 71 in good faith, with all prior financial statements subject to examination and audit. Mr. Corbett (Guggenheim Life and Annuity Company) stated that the accounting for levelized commissions has been presented as a solvency issue, whereby companies have unrecorded liabilities for future commission payments. If this is the case, the liability is deemed necessary for policyholder protection, so how would the Committee be comfortable with any persistency commissions being recorded over time when all insurers have policy experience to be used as a basis for estimating the liability for these future expected commission payments. Therefore, the obligating event, which is defined by one of three essential characteristics in *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets*, has not occurred until the policy anniversary date. Mr. Corbett noted that paragraph 2 of SSAP No. 71, which contains no proposed modifications to the definition of a liability, determine when that liability has been incurred. The proposed changes to levelized commissions with a link to persistency are contradictory to paragraph 2. Commissions that are paid and earned according to persistency, which is a long-standing insurance element, should be treated in a consistent manner to ensure comparability among reporting entities. Guggenheim believes the proposed changes to SSAP No. 71 sets a dangerous precedence for the need to accrue for other liabilities for other predictable future expenses. Ms. Walker noted that the expense is incurred for the first year when the policy is written. So, even if the funding agreement allows the company to pay the sales agent in the future, that does not allow the company to defer expenses the first year of the policy. She stated that by deferring, and not recording the liability, and making the statement that it is not due until after the period is contrary and has a different assumption. The assumption that one does not have to book the liability until the policy is still in effect ignores the fact that the policy is currently in effect. As long as the policy is in effect, that amount will be owed. Therefore, you are not to adjust the liability down until the policy lapses or is cancelled. Using a funding agreement simply changes the timing of when the payment is due and does not affect if there should be an expense. Mr. Slape said these are not persistency commissions because in those situations the agent is paid a commission in future years for when that policy stays in force. These are referred to as renewal commissions, and they are reported on the future anniversary date, but the first-year commission must be expensed immediately up front regardless of the existence of a funding agreement since that is a loan. Mr. Slape stated that he takes issue with the statement that these funding agreements provide for a persistency commission.

1. Roger Sevigny (Sevigny Consulting), as a former state insurance regulator, stated that what he keeps hearing is a lack of information, and he asked that the work be slowed down. Commissioner Donelon stated that with respect to the companies referred to, they are owned by wealthy owners and some of the largest insurers in the world. Commissioner White stated that the debate has been vigorous, and he reminded everyone that even if the Committee votes to adopt the proposal, it will still need to be considered by the Executive (EX) Committee and Plenary. at the Summer National Meeting or during an interim meeting before that date.

54. The revisions were adopted by the Executive (EX) Committee and Plenary on August 17, 2021, with 10 jurisdictions voting as opposed. The discussion primarily centered around whether to allow a one-year deferral of the effective date to December 31, 2022. The December 31, 2021, effective date was maintained.

RELEVANT STATUTORY ACCOUNTING

55. Existing guidance in *SSAP No. 71—Policy Acquisition Costs and Commissions*.

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.

Effective Date

56. As issue papers are not represented in the Statutory Hierarchy (see Section V of the Preamble), the subsequent consideration and adoption of this issue paper will not have any impact of the December 31, 2021, effective date of the nonsubstantive revisions adopted to SSAP No. 71 by the Working Group on March 15, 2021.

EXHIBIT A – NONSUBSTANTIVE REVISIONS TO SSAP No. 71—POLICY ACQUISITION COSTS AND COMMISSIONS**Statement of Statutory Accounting Principles No. 71****Policy Acquisition Costs and Commissions**

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for policy acquisition costs and commissions.

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 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. 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

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 of if the insurer owes a selling agent directly or if a third-party has been contracted to provide payment to the selling agent.

Relevant Literature

6. This statement rejects *ASU 2018-12, Targeted Improvements to the Accounting for Long-Duration Contracts*, *ASU 2010-26, Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts*, *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises*, *FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, and *Statement of Position 05-1, Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection with Modifications or Exchanges of Insurance Contracts*.

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 on March 15, 2021, regarding levelized commission are to clarify the original intent of this statement and apply to existing contracts in effect as of December 31, 2021, and new contracts thereafter.

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 71—Policy Acquisition Costs and Commissions*
- *Issue Paper No. 165—Levelized Commission*