



Comment Template

Draft Statement of Intent (SOI) for ISAP [7] – “Current estimates” and other matters in relation to the IAIS capital standards

1. Do you agree an ISAP is needed on “current estimates” and other matters in relation to the IAIS capital standards?

Yes

No

2. Are any of the proposed topics inappropriate for inclusion in ISAP [7]?

Yes

No

If yes, please explain why the particular topic should not be included.



3. What other topics should be included in this ISAP?

Please cover why you wish guidance in this area and if appropriate provide an example to illustrate the issue. Please note that the ISAP is not intended to address unique, country-specific issues. Member associations and local actuarial standard setting organizations could address such issues by providing additional guidance to their members as the ISAP is adopted, or adding such additional guidance within the local adaptation of the ISAP.

Non-insurance contracts: it is our (perhaps incorrect) understanding that capital standards in development by the IAIS are to apply to *insurers*, while international financial reporting standards are being based on contract types; for example, IFRS 4 Phase 2 will apply to *insurance contracts*, while other IFRSs apply to non-insurance contracts issued by insurers. To the extent that “current estimate” measurement of other contract types (any contracts issued by insurers that are not strictly insurance contracts, e.g., contracts classified as investment contracts or service contracts, or some forms of reinsurance agreements) is not covered under the ISAP, we suggest that the IAA clarify the scope of the ISAP and identify any potential gaps accordingly.

Contract boundary: the concept of “contract boundary”, referring to the projection horizon of contract cash flows that are to be included in the measurement of the current estimate of the liability, often causes much debate and confusion among actuaries, especially in relation to contracts with non-guaranteed elements and/or renewal provisions. There may be value in clarifying the guidance here (ultimately for the purpose of determining capital requirements) to ensure comparable implementation of a current estimate, which may or may not align with the requirements and guidance to be provided in connection with IFRS 4 Phase 2.

Other accounting concepts: there are other financial reporting concepts (e.g., recognition/de-recognition of liabilities), whose definitions for capital purposes may or may not align with the corresponding definitions for financial reporting purposes. We suggest this ISAP address these concepts.

The following topics are named in the draft SOI, but we would like to make some points of clarification:

Discounting: our understanding is that the IAIS will prescribe discount curves to be used in the calculation of the basic capital requirements (BCR), and perhaps also ultimately for the insurance capital standard (ICS). These discount curves have a direct impact on the valuation of insurance liabilities, and hence on the value of capital resources available to meet capital requirements. We reiterate here a concern we expressed in our submission to the IAIS in respect of the BCR: that the discount rates used for years 30+ will, for insurance entities of several jurisdictions, have a very material effect both on the available capital resources and on the capital requirements (i.e., both the numerator and the denominator, and in opposite directions, exacerbating the impact on the capital ratio).



Comments on draft Statement of Intent to Issue ISAP [7]

We would strongly advise that the discount rates only be linked to the current market data for durations where the market is deep and liquid and in sufficient volume to be credible. Discount rates used for the period beyond the last liquid point of the observable spot curve should be graded (over a reasonably short period of time) to an ultimate discount rate at a duration that is prescribed. The ultimate discount rate should be developed giving more weight to long-term estimates than to short-term fluctuations, and could, for example, reflect the best estimate investment returns expected for a typical asset portfolio backing long-term insurance liabilities. The IAA would confirm that the ultimate discount rate should represent a long-term best estimate view of net investment returns on a typical asset portfolio and that the ongoing appropriateness of this ultimate discount rate would be reviewed periodically. This would refine the IAIS proposal that seems to place too much emphasis on the current market yields in the first 30 years, and then keeps the curves flat after 30 years.

As an example, assume that the current 20-year spot rate is the last liquid point observable with a rate of 3.5%, and that the long-term estimate is a spot rate of 5%. We would then suggest that the discount rates for the period beyond the last liquid duration of the observable term structure be prescribed to grade from the longest observable rate (3.5% at year 20) to a rate of 5% by year 30 or 40, for example, and then be level for all subsequent years. This seems to us consistent with the principle of calculating an unbiased current estimate of the liability, and simultaneously mitigates the undue volatility in the capital ratios. The Canadian Institute of Actuaries would be happy to support the development of methodology for determining long-term discount rate assumptions consistent with this approach.

Profit sharing: we suggest this includes all forms of pass-through and discretionary features (e.g., participating dividends, experience refunds, adjustable premiums or benefits, and credited rate formulas). An important area of guidance on this topic is how to ensure consistency in the modelling of these features, in particular the projection of investment income, with each other and with the discounting for time value of money of the modelled cash flows to the reporting date.

Financial options and guarantees: we believe this is meant to include items such as death and living benefit guarantees on variable products, and minimum credited interest rate guarantees. In all cases, we would encourage discussing the use of so-called real-world and risk-neutral valuation frameworks (as both are in use), and addressing the effect that risk management practices, including all forms of hedging (e.g., of equity, and of interest rate and currency risks), would or would not have on the measurement of “current estimates” of the liability.

Insurance elements: mortality, morbidity, and longevity are mentioned. We suggest including guidance on the modelling of improvement (or deterioration) rates in mortality and morbidity, both in the short term and the longer term.



4. Please use this space for any additional comments not covered above.

We support the development of a standard to ensure consistent modelling for the purposes of calculating current estimates for use in determining capital requirements in accordance with the IAIS’s BCR and/or the global ICS. The term “current estimates” would ideally have the same meaning in all IAIS applications, and also be as consistent as possible with “current estimates” used for other purposes. To the extent the definitions proposed in this ISAP are different than other definitions in use by insurers for other purposes (e.g., IFRS and local reporting requirements), we do not believe it would be appropriate at this time for this ISAP to lead to a revised definition of “current estimates” if a similar concept already exists for purposes beyond the BCR/ICS. For example, the latest exposure draft of the IFRS 4 Phase II is based on a few basic building blocks, one of which is the requirement for an unbiased view of a current estimate. Given the short time-line for development of the BCR/ICS, the amount of work for the IAIS and the companies affected should be kept to a minimum where this is appropriate. In that context, we suggest the current scope of the ISAP be limited to the development of standards for the calculation of current estimates for IAIS capital requirements.

We also support the stated desire to avoid artificial instability in the relative values of assets and liabilities, especially when they are well matched. We note that instability is most likely to arise in connection with long-duration liabilities, if the discount rate is not defined so as to avoid artificial instability. Refer to our comments on discounting in section 3 above.

5. Please provide the name of the person completing the consultation response, association and email address for further clarifications (if needed).

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Type of response	<input type="checkbox"/> Personal <input checked="" type="checkbox"/> Organization

IMPORTANT:

Please check if the relevant check boxes are ticked appropriately and save the file renamed with the organization’s or individual’s name (e.g., SOI_CommentTemplate_[NAME].Doc).

E-mail the file as an attachment to SOI.ISAP7.comments@actuaries.org, with “ISAP[7]” in the e-mail header. Please respond by Friday, 5 September 2014.