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AMERICAN ACADEMY *of* ACTUARIES

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March 5, 2013

Financial Accounting Standards Board (FASB)  
401 Merritt 7  
Norwalk, CT 06856  
Via email: [jmweiner@fasb.org](mailto:jmweiner@fasb.org), [cgirwin@fasb.org](mailto:cgirwin@fasb.org), [lalexander@fasb.org](mailto:lalexander@fasb.org)

Dear FASB Staff Members:

On Nov. 29, 2012, several members of the American Academy of Actuaries'<sup>1</sup> International Accounting Standards Task Force met with you in Norwalk to review issues related to the insurance contracts project. We found the meeting very helpful, and wish to follow up on two topics that were discussed.

The first topic is the transition to the new standard. We agreed to provide an outline of the types of "objective evidence" that could be used to establish an initial margin in the liability for insurance contracts issued before the date of transition.

The second topic is the discount rate for insurance contracts in which cash flows depend on invested assets but to which mirroring does not apply. We had an extensive discussion on this topic during our meeting, and wanted to explain our views in more detail.

We do not suggest changing board decisions on either of these topics. Rather, we are sharing our interpretations of those decisions, and asking for reactions. Our hope is that any implementation guidance that is written will be consistent with our interpretations, or refrain from disallowing them.

If you have any questions, please submit them to Tina Getachew, senior policy analyst, Risk Management and Financial Reporting Council, by phone (202-223-8196) or email ([getachew@actuary.org](mailto:getachew@actuary.org)).

Sincerely,

Stephen J. Strommen, FSA, CERA, MAAA  
Chairperson, International Accounting Standards Task Force  
American Academy of Actuaries

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<sup>1</sup> The American Academy of Actuaries is 17,000-member professional association whose mission is to serve the public and the U.S. actuarial profession. The Academy assists public policy-makers on all levels by providing leadership, objective expertise and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice and professionalism standards for actuaries in the United States.



## Transition: Objective Evidence Supporting Initial Margins

During our Nov. 29, 2012 meeting in Norwalk members of the American Academy of Actuaries<sup>1</sup> International Accounting Standards Task Force discussed the transition from current GAAP standards to the new standard for insurance, with a focus on the establishment of margins in the valuation of liabilities for insurance contracts already in force.<sup>2</sup> We expect margins will be established in cases in which there is objective evidence to support determination of what the margin would have been when existing contracts were first issued. We agreed that there could be different opinions on whether certain kinds of evidence meet the standard of objectivity. The members of the task force present agreed to assemble a sample list of objective evidence for use in determining margins on transition to the new standard.

The following is an initial list of categories of evidence that could be used to support establishment of margins. The list starts with the most objective evidence and ends with evidence that could be viewed as indicative but not fully objective. In assembling the list, we considered criteria relevant to the Conceptual Framework, including relevance, cost to produce, and usefulness to investors. We would welcome any input you have on the following types of evidence:

1. **Historical documentation of conditions at time of issue.** The most objective evidence comes in three forms:
  - a. Economic conditions when contracts were issued. There are objective sources for U.S. economic conditions, including interest rates, for more than a century. In many cases, such records can be used as evidence to support the original locked-in discount rate for purposes of measuring Other Comprehensive Income (OCI).
  - b. Original pricing documentation. Pricing documentation typically provides details on the assumed claims experience, expense levels, and expected investment income and profitability at the time contracts were originally issued. Reinsurance agreements entered into contemporaneously with the initial sales of the direct policies also can provide a market assessment of the value of the business. These details can be used to reconstruct the original margin and its pattern of amortization over time.
  - c. Original GAAP valuation assumptions. Like pricing documentation, GAAP valuation assumptions include details on assumed claims experience and related

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<sup>2</sup> This applies to transition in valuation of pre-claim and post-claim liabilities for insurance contracts that are measured under the building block approach.

items at the time contracts were originally issued. The original margin and its pattern of amortization can be reconstructed from such information.

- 2. Evidence concerning discretionary margins on non-guaranteed elements.** Contracts with discretionary participation features can be addressed by documenting the basis on which non-guaranteed payments or credits were anticipated to be made or have been made. Often such payments are determined by holding back a margin and returning the remainder to the policyholder. If the originally-expected holdback was documented, that documentation can be used as the basis for the originally-expected margin. If the originally-expected holdback was not documented but the actual holdback can be determined, then that can be used as the basis of a reasonable margin.
- 3. Historical records of results.** Historical results from the time period near contract issuance can be used to infer what was expected at that time. That information can be used to reconstruct pricing documentation.
  - a. Historical claims and expense records. When the original pricing documentation is not available, it may be reconstructed by assuming that experience in the early years of the contract reflected the experience assumed in pricing. In the absence of evidence that early experience was in some way unexpected or unusual, experience records can provide objective evidence of what was normal, or expected, at that time. An actuary can use that experience, in connection with economic conditions and documented premium rates, to carry out a pricing exercise in which the premium is already set to back into the margin that must have been included.
  - b. Historical profitability of the business. In cases in which business has been consistently profitable, the historical record of profits can be used to estimate the amount of margin that has been released so far. If one has a basis for amortizing margins, then one can infer the proportion of the original margin would have been released so far and the proportion that is expected to be released in the future. Those two estimates together can be used to estimate the original margin.

Information in Category 3 (historical records of results) may include data from time periods after the contracts were originally issued. One might argue that such information could not have been known when the contracts were issued because it had not yet occurred. Nevertheless, such information is relevant to making a good-faith estimate of the originally-anticipated margin and can be objectively applied.

As noted at the November meeting, insurers can enter into transactions that result in realizing any margins that exist on business previously issued. As such, a good-faith estimate of the original margin, based on evidence like that enumerated above, will provide more useful information than disallowing initial recognition of a margin altogether. Insurers should not be required to enter into transactions in order to report margins that existed when contracts were issued and which remain in existence upon transition to the new standard.

We have one final suggestion. For contracts that are not onerous, we suggest that a minimum residual margin should be allowed equal to the present value of indirect expenses not included in the first building block (i.e., allocated overhead expenses). This minimal margin is needed to eliminate expected reporting of future losses on contracts that are not onerous.



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## **Discount Rate Discussion**

During our Nov. 29, 2012 meeting in Norwalk members of the American Academy of Actuaries<sup>1</sup> International Accounting Standards Task Force discussed FASB's decisions on the discount rate for valuation of contracts to which mirroring does not apply but in which cash flows are affected by expected asset returns. The board tentatively decided that the discount rate "shall reflect the extent to which the estimated cash flows are affected by the returns from those assets". In addition, the board decided that with any change in expectations of the crediting rate used to measure the insurance contracts liability, an insurer shall reset the locked-in discount rate that is used to present interest expense.

During this meeting, we agreed that these decisions are reasonable, but we also expressed significant concerns about implementation guidance that has been discussed by the board. In particular:

1. The first decision is that the discount rate<sup>2</sup> shall reflect the extent to which the estimated cash flows are affected by the returns from those assets. While we agree with this decision as stated, based on the discussion at our November meeting, we understand that the board has interpreted this to mean that the cash flows from a contract need to be split into pieces (e.g., guaranteed benefits versus non-guaranteed payments) with different discount rates applied to each. The decision as stated, however, does not require this.

We prefer an interpretation where the cash flows from the contract are viewed as a whole, and a single discount rate is used for the aggregate cash flows. The single discount rate should reflect the extent to which the estimated aggregate cash flows are affected by the return from the assets. We prefer this interpretation because of the degree to which all cash flows under such contracts are interdependent.

2. The second decision is that any change in expectations of the crediting rate shall cause a reset of the locked-in discount rate used to present interest expense. We agree with the idea of changing the discount rate for interest expense under these conditions. However, based on our November discussion, we understand that the board has interpreted this to mean that the cash flows need to be split into pieces (e.g., guaranteed benefits versus non-guaranteed payments) with the discount rate for guaranteed benefits being locked at issue for measuring interest expense, with only the discount rate for non-guaranteed payments being unlocked. If our understanding is correct, this implies that the board intended a partial lock-in of the discount rate(s) for measurement of interest expense. We would like

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<sup>2</sup> Throughout this note, the term "discount rate" is used as shorthand for both a yield curve at a point in time and a set of discount rates for multiple years. We are not suggesting that a single interest rate will be applied to all cash flows in all years.

to recommend a more practical alternative approach to achieving this partial lock-in. The approach outlined below, based on changes in book yields, is consistent with the decision to unlock or reset the discount rate used to present interest expense.

We believe our interpretations are fully consistent with the decisions as stated. We do not ask for any change in the decisions, but only for recognition that these more robust interpretations would not be disallowed through strict implementation guidance. The remainder of this document explains in more detail the basis for our suggested approaches to the discount rate and Other Comprehensive Income (OCI) issues.

### **Use of a Single Discount Rate**

The decision that the discount rate “shall reflect the extent to which estimated cash flows are affected by returns from the assets” has been interpreted by the board to mean that the cash flows under a universal life (UL) contract must be split between those that are guaranteed under the contract and those that are non-guaranteed. Under that interpretation, the guaranteed cash flows would be discounted at a rate that does not depend on the assets, and only non-guaranteed cash flows would be discounted at a rate that depends on the assets.

We believe that interpretation may be based on a misunderstanding of the nature of the guarantees under UL contracts. The guarantees under the contract are constantly changing, and every incremental non-guaranteed credit results in an increase in guarantees going forward. Therefore, the non-guaranteed credits affect the guaranteed cash flows in the following ways:

**Guaranteed premiums.** Under a UL contract, premiums are paid into an account that is credited with interest and used to pay for guaranteed benefits. When only the minimum guaranteed interest rate is credited, one can determine the exact premium required to keep the contract in force. However, when additional non-guaranteed interest is credited, the amount of premium required to keep the contract in force declines because the account is being replenished by interest in place of required premiums. This means that the minimum guaranteed premium is constantly changing due to interest credits that depend on the assets.

**Guaranteed benefits.** Under a UL contract, benefits are guaranteed only as long as the account value from which the monthly cost of providing those benefits remains positive. If only the minimum guaranteed interest rate is credited, one can determine the length of time before the contract will terminate. However, when additional non-guaranteed interest is credited, the time before the contract will terminate is extended thereby increasing the guaranteed benefits. This means that the guaranteed benefits under the contract are constantly changing due to interest credits that depend on the assets.

Because of the dynamic relationship between the guaranteed and non-guaranteed elements of a UL contract, it is appropriate to view the aggregate cash flows under the contract as a package. The discount rate should depend on the extent to which the aggregate estimated cash flows are affected by returns from assets. In addition, the dynamic relationship between guaranteed and non-guaranteed cash flows introduces significant difficulties in defining the split between

guaranteed and non-guaranteed amounts. It also introduces practical difficulties in implementing systems to calculate and project the split, however it might be defined.

There are two analogies to asset valuation that might be helpful in understanding our interpretation that all cash flows should be valued as a package using a single discount rate. The analogies are to valuation of floating rate instruments and to mortgage securitization.

**Floating rate bonds.** Consider a bond with periodic coupon payments and a lump sum maturity payment. The coupons are paid at a floating rate based on current market rates at the time of each coupon payment. The market value of such an instrument is determined by discounting all future cash flows, both coupons and the maturity payment, at the current market rate (e.g., the floating coupon rate). However, if one were to apply the board's interpretation of UL valuation, the maturity payment would be considered fixed and guaranteed while the coupons would be non-guaranteed. This would require valuation of the coupons at one discount rate and the maturity payment at another discount rate. It is not clear what the two rates should be in order to arrive at a value consistent with the current market value, so a single discount rate is normally used.<sup>3</sup> The situation with UL contracts is analogous to this because the account value is similar to a floating rate liability. It is appropriate to value UL contracts using a single current discount rate just as it is appropriate to value floating rate assets using a single current discount rate.

**Mortgage securitization.** Consider a block of fixed-rate mortgages with default risk. Investment bankers often securitize a block of such mortgages by splitting it into two or more tranches with different levels of credit risk. Suppose there are just two tranches—an AAA-rated tranche with virtually no default risk and a “junk” tranche that holds virtually all of the credit risk. One can think of this process as separating the mortgage repayments into those that are guaranteed and those that are non-guaranteed. The market will value the cash flows from the AAA-rated tranche at a discount rate lower than that of the underlying mortgages, and the market will value the “junk” tranche at a discount rate much higher than that of the underlying mortgages. This is similar to what the board is expecting to be done with the cash flows from a UL contract by splitting them between guaranteed and non-guaranteed amounts. However, consider the consequences of doing this:

1. The discount rate for the “junk” tranche is higher than the rate on the underlying mortgages. In the UL situation this means that the discount rate for the analogous non-guaranteed cash flows may be higher than the return on the assets underlying the contract as a whole. In other words, this would be higher than the return on the assets on which returns any non-guaranteed benefits depend. It is not clear what the basis

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<sup>3</sup> The agenda paper for the November board meetings made an apt analogy. When valuing floating rate debt instruments the discount rate is updated when necessary, at least whenever the credited rate changes. The updated discount rate is applied to all the projected cash flows on the floating rate debt instrument – both principal and interest, even though the principle remains fixed. The updated discount rate is not applied solely to the interest payments. And this is necessary to achieve a coherent value of the instrument, because the floating crediting rate applies not just to the interest payments, but to the principal itself.

for that discount rate should be. In the case of the mortgages, the discount rate for the “junk,” or non-guaranteed tranche, is set by the market. But, there is no market for the non-guaranteed benefits under UL contracts, so any estimate of the discount rate for non-guaranteed benefits alone would be speculative at best.

2. Investment bankers undertake this securitization to change the market value of the whole package—the sum of the market values for the AAA-rated tranche and the “junk” tranche is greater than the market value of the underlying mortgages. This is because the two parts are sold to different buyers with different risk preferences. In the UL case, the contract is not split between two buyers, so we do not wish to change its value. It is much simpler to value the contract as a whole.

## **Determination of OCI**

For contracts not subject to mirroring that are affected by asset returns, the board decided that an insurer shall reset the locked-in discount rate used to present interest expense upon any change in expectations of the crediting rate used to measure the insurance contracts liability. We note that expectations regarding future crediting rates are likely to change on each valuation date due to the change in market interest rates. If a single discount rate is used for valuation of all cash flows, this could mean that the discount rate for presentation of interest expense would not be locked-in at all.

However, we understand that the board has interpreted the unlocking in a context in which cash flows are split into pieces such as guaranteed benefits versus non-guaranteed payments. The discount rate for guaranteed benefits would be locked at issue for measuring interest expense, and only the discount rate for non-guaranteed payments would be unlocked. If our understanding is correct, this implies that the board intended a partial lock-in of the discount rate(s) for measurement of interest expense. Due to the difficulties involved in splitting cash flows between guaranteed and non-guaranteed payments (as discussed above), we suggest that a different approach to achieving this partial lock-in would be more practical.

At time of contract issue, the discount rate for presentation of interest expense could be equal to the discount rate for balance sheet valuation. This prevents the creation of OCI on issuance of a new contract. After issue, the discount rate for presentation of interest expense should change (i.e., be unlocked) each period by the amount of change in “book yield”<sup>4</sup> on the invested assets backing the contract. The “book yield” reflects the basis of valuation of the invested assets for determination of net income. Changes in book yield should be reflected in parallel for both investment income and interest expense. Since changes in book yield tend to be smaller and more gradual than changes in market interest rates, this approach accomplishes the desired partial lock-in of the discount rate used for presentation of interest expense. Changes in book yields generally are consistent with changes in credited rates, which are the proposed “trigger” for updating the discount rate for presentation of interest expense.

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<sup>4</sup> Book yield is a weighted average of the yield to maturity for assets held at amortized cost and current market yields for assets held at fair value.

Basing changes in discount rates on changes in “book yields” is consistent with currently proposed “principles-based” rules for regulatory valuation of these contracts in the U.S. Also, a similar valuation approach was used in Canada for several years for both public reporting and regulatory purposes. Application of this approach for reporting interest expense on the statement of profit and loss is therefore not a new idea. It has a place in the new general-purpose accounting standard as well, and is a robust interpretation of the board’s stated decisions and intent.