AMERICAN ACADEMY *of* ACTUARIES

Objective. Independent. Effective.™

September 2, 2014

International Accounting Standards Board
30 Canon Street
London, EC4M 6XH
United Kingdom

Re: Comments on treatment of participating contracts

On behalf of the American Academy of Actuaries'[1] Financial Reporting Committee, I appreciate the International Accounting Standards Board's (IASB) decision to reconsider the treatment of participating contracts in its insurance contracts project. The following comments reflect several of our observations regarding participating contracts.

As discussed in our comment letter[2] in response to the October 2013 *Insurance Contracts* exposure draft (ED), the measurement approach used for certain types of participating insurance contracts should differ from that used for non-participating contracts. The category of contracts eligible for a measurement exception should include typical universal life and U.S. participating whole life contracts. Also, some of the details of the proposed measurement approach would be difficult to implement or would produce results that do not represent the economics of some contracts.

In general, either of the two measurement approaches for participating contracts discussed at the June and July IASB meetings could be effectively implemented and produce results consistent with the underlying economics of the contract. However, some aspects of each of these approaches may need to be clarified or modified to ensure accounting results that are meaningful. These suggested modifications/clarifications are summarized below and discussed in more detail in the paragraphs that follow:

Book yield approach:

- The criteria for using book yield discounting should be aligned with the criteria for treating the insurer's share of asset return as an "implicit fee."
- The additional criterion for treating insurer's share of asset return as an "implicit fee" is not necessary or appropriate.

[1] The American Academy of Actuaries is an 18,000-member professional association whose mission is to serve the public and the U.S. actuarial profession. The Academy assists public policymakers 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.

[2] http://actuary.org/files/Academy_%20Response_to_IASB.pdf

- The criteria for qualifying for the book yield discount rate should be clarified to avoid a possible interpretation that would exclude typical U.S. participating whole life and universal life contracts.

Effective yield approach:

- There should be a vector of discount rates used to determine profit and loss to vary with expected credited rates rather than a single effective yield rate.
- A possible interpretation of one criterion might improperly exclude typical U.S. participating whole life and universal life contracts from qualifying for a book yield approach.

Other modifications:

- Hedged risks should be measured in a manner consistent with the underlying hedging instruments.
- Possible asymmetry in contractual service margin (CSM) unlocking between cash flow delays and accelerations.

Book yield approach

Our understanding of the approach, as discussed in June, is that interest expense would be based on the "book yield" of the assets backing the participating contracts for which other comprehensive income (OCI) is elected. Also, the CSM would be unlocked for certain changes in expected asset returns, in addition to the items for which the CSM is unlocked for non-participating contracts.

This is a reasonable measurement approach because the combination of OCI and unlocking the CSM can serve the IASB's purpose to "segregate the effects of changes in the discount rate that are expected to unwind over time from other gains and losses, so that users of financial statements could better assess the underwriting and investing performance of an entity that issues insurance contracts."[3] Locking in the interest rate used to determine interest expense would not be appropriate for participating contracts because, unlike non-participating contracts, the actual rate credited to participating insurance contracts is not locked in. Since participating insurance contracts have asset dependent returns, it would be consistent to use the book yield approach that accretes interest to both the assets and liabilities at the same rate.

We are nevertheless concerned that the IASB has proposed an additional criterion for treating the insurer's share of asset returns as an "implicit fee," which seems to be a prerequisite for the IASB to permit changes in the insurer's share to be eligible for CSM unlocking. As we understand the book yield approach proposed by certain sectors of the insurance industry, using the asset book yield to determine interest expense would effectively "segregate the effects of changes in the discount rate" to the extent those changes in the discount rate apply to insurance

[3] Insurance Contracts Basis for Conclusions Exposure Draft (ED/2013/7), page 40, paragraph BC 119: http://www.ifrs.org/Current-Projects/IASB-Projects/Insurance-Contracts/Exposure-Draft-June-2013/Documents/ED-Insurance-Contracts-Basis-for-Conclusions-June-2013.pdf

cash flows that are backed by assets currently held by the insurer.[4] But CSM unlocking also is needed to segregate the effects of changes in the discount rate applied to cash flows that extend beyond the maturity of the assets currently held by the insurer. Since there are no asset cash flows currently backing those insurance cash flows, there is no corresponding book yield applicable to those cash flows so the book yield itself does not provide a mechanism for segregating the effects of the discount rate. As a result, an alternative mechanism is needed.

In addition, not only is CSM unlocking necessary to segregate the effect of changes in discount rates, but without it the profit and loss results can be misleading. For example, assume a participating insurance contract with a Macaulay duration that is matched exactly to the assets. If the asset book yields are used to determine OCI for cash flows up to the maturity of the assets, since there is no mechanism to segregate the effect of discount rates from the cash flows beyond the maturity of the assets, changes in discount rates beyond the asset maturity will impact profit and loss. The results would be inconsistent with the exactly Macaulay duration matched assets and liabilities.

In addition, the extra criterion for treating the insurer's share of asset returns as an implicit fee is not appropriate. The extra criterion would prevent the insurer's share from being treated as an implicit fee unless "there is a minimum amount that the entity must retain." If there is no "minimum amount," the provision would not be considered an implicit fee because there could be periods where the insurer effectively chooses not to collect a fee. Any contract for services with an explicit fee can specify that the fee is zero or can be waived under certain circumstances. This would not prevent explicit fees that do get charged from being treated as revenue under IFRS 15. Also, even if a contract specifies an explicit fee that is greater than zero, such a fee can always be waived at the insurer's (other provider's) discretion. So the fact that an implicit fee could be zero should not preclude it from being treated as a fee.

We also are concerned with the criterion that the policyholder receives a substantial share of the total return on the underlying assets for using both book yield and for treating the insurer's share of returns as a fee. Conceptually, while this criterion makes sense, we are concerned that the Appendix suggests that participating whole life and universal life contracts as typically sold in the U.S. may not meet this criterion. This could be because the assets backing these contracts also might be backing non-participating contracts, so the participating contracts may not receive a substantial portion of the return on the total portfolio of assets. We believe this criterion should be modified so that it would be met if the policyholder receives a substantial share of the pro-rata return on the underlying. That way, if the participating book represents 10 percent of the total liabilities backed by the underlying assets and the participating policyholder receives close to 10 percent of the returns on the assets backing liabilities, the participating contracts would still meet the criterion. The participating policyholders still would receive a substantial portion of the return on the assets attributable to their contracts, making this modification to the criterion appropriate.

[4] This seems to be more consistent with option (b) in paragraph 49 of agenda paper 2D from July 2014. We further note that option (a) could be read as double counting effects of discount rate in both OCI (from the book yield) and in CSM unlocking.

Effective yield

At its July meeting, the IASB considered an effective yield approach to calculating OCI for participating contracts. In its comment letter on the ED, the Financial Reporting Committee agreed with such an approach and we continue to support it.

In our comment letter, we also pointed out that when using an effective yield approach for participating insurance contracts, it generally would not be appropriate to use a single effective yield to discount cash flows at all future durations when determining interest expense and profit and loss. In contrast, it is generally necessary to use a vector of discount rates consistent with the pattern of projected future credited rates. Under the approach we suggested in our comment letter, "a constant spread (which could be positive or negative) would be calculated off of the path of projected credited rates, such that the value of the liability used for net income purposes after the change in both credited rates and interest accretion rates equaled the value of that liability before the changes in rates."[5]

An approach of this sort is necessary to avoid future profit patterns that are inconsistent with the economics of how the contract is managed. When market interest rates change, the credited rate on the participating contract may be projected to change slowly over time, often in relation to the projected pattern of book yields. In this case, if a single effective yield is used, this rate typically will be lower (higher) than the credited rate in the early years, and higher (lower) than the credited rate in later years, when interest rates decline (increase). Assuming the insurer sets its credited rate to maintain a spread to asset book yields, as is typical, a single effective yield will cause additional profits (losses) to be shown in the early years, and losses (profits) to be shown in later years, following a market interest rate decline (increase). These profits and losses would not reflect the underlying economics of the contract, if the credited rate is set to achieve a relatively constant interest spread over time.

We also are concerned with the proposed criteria for using the effective yield approach for participating contracts. As noted above, with a slight modification the criteria proposed for the book yield approach could be appropriate for participating contracts. With a similar modification so that the criterion applies to a pro-rata portion of the underlying assets, that criterion would be appropriate for the effective yield approach as well. We are concerned that the alternative criterion proposed for the effective yield approach (i.e., that a substantial proportion of the cash flows vary with investment returns) could lead to arbitrary interpretations, with some interpretations inappropriately excluding U.S.-type participating whole life and universal life contracts for which the effective yield approach would be appropriate.

Other participating contract concerns

Besides the choice of basic model, we have a few additional concerns about the proposed accounting for participating contracts.

[5] http://actuary.org/files/Academy_%20Response_to_IASB.pdf

Hedging

As we noted in our comment letter, certain risks within participating contracts may be hedged. Even though OCI and CSM unlocking may be appropriate for the majority of cash flows within such contracts, these adjustments may create an accounting mismatch to the extent risks are hedged with derivatives that are reported at fair value through net income. Such hedging instruments would not report the effect of changes in discount rates in OCI and would not have a mechanism analogous to CSM unlocking to offset the effect of changes in cash flows. Although the IASB tentatively agreed to make OCI optional at the February Board meeting, that decision does not entirely address this issue, since the use of OCI may be appropriate for the cash flows related to the unhedged risks in the contract and that decision did not address CSM unlocking.

Similar to a proposal we made in a comment letter to FASB dated June 30, 2014,[6] we believe this accounting mismatch can be alleviated by permitting hedged risks within insurance contracts to be measured using a current discount rate, without applying OCI to the cash flows related to the hedged risk, even if OCI is applicable to the unhedged cash flows within the contract, and excluding CSM unlocking. Thus, changes in the hedged risk would be measured on a fully current basis, consistent with the hedging instruments used. Since derivative use by insurance companies is heavily regulated in most jurisdictions, it is unlikely this provision would be misused. A possible criterion that could be used to permit this approach might be that the hedging instruments meet the derivative use regulations for insurers.

Asymmetric CSM unlocking

A characteristic of many participating contracts is that experience variances in one period can offset those in a future period. For example, if mortality is worse (better) than expected in the current period, future dividends can be reduced (increased) to offset the current period effect. This makes it particularly important that the current period impact and projected future impact related to the same event or experience are treated consistently. Therefore, the clarification in the decision the IASB tentatively made for CSM unlocking in March (i.e., that CSM unlocking is determined by the net impact of the current and future effects of a particular event) is important for achieving representatively faithful accounting for participating contracts.

Nonetheless, we are concerned that asymmetric CSM unlocking is an unintended consequence of that clarification. Under that clarification, experience that delays cash flow payments is offset by CSM unlocking, but experience that accelerates cash flow payments is reported in net income. If in the current period mortality is worse than expected, with future dividends reduced accordingly, the net effect would be reported in profit and loss, which would occur even if the net present value of the impact is a gain. If in the next period mortality is better than expected, with dividends increased accordingly, however, the net effect would be offset by CSM unlocking and released into profit and loss over time, even if the net effect is a loss. This asymmetry does not reflect the economics of the contracts, where offsetting deviations from multiple sources are expected to occur from period to period. It also can result in current losses being recognized in current profits and losses on experience variances that are economically beneficial to the insurer, and profits being accelerated on experience variances that are adverse to the insurer. The treatment of both accelerations and decelerations of cash payments should be consistent.

[6] http://actuary.org/files/AAA_letter_on_targeted_improvements_063014.pdf

We appreciate the opportunity to provide these comments regarding treatment of participating contracts. If you have any questions or would like to discuss any of these comments in more detail, please contact Lauren Sarper, the Academy's senior policy analyst for risk management and financial reporting, at 202.223.8196 or sarper@actuary.org.

Sincerely,

Leonard Reback, MAAA, FSA
Chairperson, Financial Reporting Committee
Risk Management and Financial Reporting Council
American Academy of Actuaries