



**ASSOCIATION ACTUARIELLE INTERNATIONALE
INTERNATIONAL ACTUARIAL ASSOCIATION**

January 14, 2015

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

Dear Sir,

Re: IAA comments on the IASB 2014 Discussion Paper *Reporting the Financial Effects of Rate Regulation*

In response to the request for comments on the Discussion Paper *Reporting the Financial Effects of Rate Regulation* (the DP), I am pleased to transmit on behalf of the International Actuarial Association (IAA) our comments and recommendations.

These comments have been prepared by the Insurance Accounting Committee of the IAA. If, upon reading these comments, you identify any points that you wish to discuss or obtain further insight, please do not hesitate to contact William Hines, the chairperson of the committee, care of the IAA secretariat. We hope that our comments provide assistance to the IASB Board and staff on this project. The IAA will be pleased to develop the ideas presented in this comment letter further with you.

Yours sincerely,

Fred Rowley
President

Attachment: [IAA comments](#)

Comments by the International Actuarial Association on the IASB 2014 Discussion Paper Reporting the Financial Effects of Rate Regulation

International Actuarial Association and its Due Process

The International Actuarial Association (the “IAA”) represents the international actuarial profession. Our sixty-seven Full Member actuarial associations, listed in [Appendix A](#) to this statement, represent more than 95% of all actuaries practicing around the world. The IAA promotes high standards of actuarial professionalism across the globe and serves as the voice of the actuarial profession when dealing with other international bodies on matters falling within or likely to have an impact on the areas of expertise of actuaries.

We are pleased to be given the opportunity to provide input to the IASB on this important Discussion Paper. These comments have been prepared by its Insurance Accounting Committee, the members of which are listed in [Appendix B](#) to these comments. It has also been subject to the due process required for it to constitute a formal view of the IAA and will be posted to the IAA’s official web site

Introduction

The International Actuarial Association is a global voice for actuarial bodies worldwide. While the practice of actuaries, with their focus on risk management, is not limited to analysis of insurance and related businesses, it is for insurance and retirement programs that actuarial opinions are most traditionally accepted and expected. For this reason our response to the Discussion Paper “Reporting the Financial Effects of Rate Regulation” (the DP) is largely limited to insurance-related aspects of rate regulation. We have also restricted our response to those questions with most relevance to the businesses for which our profession provides services.

In the view of the International Actuarial Association, the scope of the DP is not sufficiently broad. From an insurance perspective at least, it needs to address a wider range of regulation than would be covered by the defined rate regulation as described in the DP.

Regulation of insurance fundamentally affects the manner and the context in which the business of insurance operates. One of the key elements of this regulation is the regulation of the rates (and corresponding benefit features) of many insurance contracts. It can result in both direct and indirect changes in insurance contracts.

Direct changes are the result of immediate changes to premiums charged the insurance contract holder affected by the rate regulation and the rate regulator’s decisions. Indirect changes occur when the rate regulation in effect at the contract inception is allowed to have a consequential effect on the product offering.

Thus, if it can be considered that global convergence is an aim for ease of understanding of financial accounts then rate regulation of any type may have a negative influence.¹

The interpretation of financial statements of entities affected by rate regulation can be mitigated by enhanced information in both accounting measurements and disclosures, but any such information

¹ An example may be provided by workers’ compensation business: in certain parts of the world, rate regulation has triggered legislative change to benefits. This has changed the profile of risk, meaning that like-named products cannot be accurately compared across different jurisdictions without extensive disclosure of information. Note that although a higher percentage of situations rates are constrained (that is, lower than otherwise the insurer would charge in the absence of rate regulation), in some cases rates might also be higher or include subsidies for other insurance contracts offered by the insurer.

needs to be of sufficient detail to explain differences in apparently similar product offerings. This additional information is very difficult to provide, while at the same time providing financial statements in a form that can be understood easily by users.

Question 1: (a) *What information about the entity's rate-regulated activities and the rate-regulatory environment do you think preparers of financial statements need to include in their financial statements or accompanying documents such as management commentary? Please specify what information should be provided in:*

(i) *the statement of financial position;*

(ii) *the statement(s) of profit or loss and other comprehensive income;*

(iii) *the statement of cash flows;*

(iv) *the note disclosures; or*

(v) *the management commentary.*

(b) *How do you think that information would be used by investors and lenders in making investment and lending decisions?*

IAA Response

Given our general comment on the need for information differentiating insurance product offerings by risk, the entity's financial statements and accompanying disclosures should also describe the effect on risk by rate regulation. These would be expected to largely relate to premiums, expenses, contractual service margins and risk adjustments (the latter two anticipating the adoption of the IASB's Insurance Contract offering.

Rate regulation raises accounting issues if the effect of the application of rate regulation economically links two items that cannot otherwise be recognized simultaneously in IFRS (due to recognition boundaries of IFRS). These issues may, for example, involve current liabilities linked directly related to assets that cannot yet be recognized under IFRS or expenses similarly related to revenue that again cannot be recognized. The regulated linkage between otherwise separate items is the reason these issues arise. Normally, such relations or linkages can only result from law or regulation, since the items are usually independent otherwise.

In the case of current expenses that, as a consequence of rate regulation, can be recovered by (i.e., allocated to revenue associated with) contracts to be issued in future, then revenues from those contracts cannot be recognised today. Only accounting mismatches in such cases are within the scope of the DP.

In the case of losses under one contract that can be recovered as a consequence of rate regulation by surplus generated from another contract, similar issues arise if the loss has to be recognised immediately, while the surplus from the other contract is to be deferred as services are provided. Such cases also result in accounting mismatches.

Practical examples include: power plants where the construction cost can be charged to future customers; unisex life insurance, where the excess cost of one sex can be charged to the other sex; and catastrophe insurance where customers with little exposure have to pay the average premium for all risks, the same as those with high risk exposure, thus entailing non-cost related cross-subsidies.

In other cases, the presentation requirements, if the link resulting from rate regulation among items is not reflected, could cause at best, misleading financial results. Examples of this situation include those areas of rate regulation that requires an entity to accept onerous business in one segment or P&L subdivision by allocating an equivalent amount excess surplus in another segment or P&L

division, in which case, the ability of the entity to make economic decisions is not properly reflected without additional accompanying disclosure.

The effect of such rate regulation would need to be quantified and presented in both the balance sheet and profit and loss statement, including any commentary and other explanation, as required. This would be essential to communicate the effect of rate regulation on the business to investors and other users of the accounts.

Question 2: *Are you familiar with using financial statements that recognise regulatory deferral account balances as regulatory assets or regulatory liabilities, for example, in accordance with US generally accepted accounting principles (GAAP) or other local GAAP or in accordance with IFRS 14? If so, what problems, if any, does the recognition of such balances cause users of financial statements when evaluating investment or lending decisions in rate-regulated entities that recognise such balances compared to:*

- (a) non-rate-regulated entities; and*
- (b) rate-regulated entities that do not recognise such balances*

Before deregulation in 1994, car insurers in Germany were required to hold “equalization liabilities” under German GAAP of a certain prescribed amount. The movements of the liability had to be considered in the regulated rates for (one year) car insurance contracts. For example, in year 1 a higher premium had to be charged to contract A to provide for the needed increase in the equalization liability; in year 2 the new contract B was charged a lower premium due to a prescribed decrease of the equalization liability. Under current IFRS 4 this amount would not have been permitted to be recognized as a liability in IFRS, since it is not a liability under an existing contract. However, under the rate regulation the insurer was obliged to off-set any reduction of the liability by a corresponding decrease of premiums for new business. Only if the insurer had not “renewed” the car insurance relationship with the insured entirely would the insurer have been permitted to release the liability to profit. However, typically that intention had been known sometimes in advance and the liability was derecognized earlier to the advantage of policyholders. Similar techniques still exist today in regulated health insurance in Germany, but since those contracts are life-long, the equalization liability is often expected to be applied for the benefit of the same policyholders who contributed to it.

The recognition of such liabilities enhanced the understanding of the financial statements since it clarified which amounts will never inure to the benefit of the insurer since they are an integral part of the state-controlled pricing of the insurer. This is different from equalization liabilities for non-rate-regulated business, which are recognized as liabilities under German GAAP, which are treated as equity under IFRS perspective.

A U.S. example is automobile insurance which is priced for a one year period that reflects the cost of similar policies no matter what their policy duration. Since normally the expected cost for a given risk category is greater for the first contract year measured from inception of the policyholder relationship, the contract for its first year is often less profitable than for its subsequent years, other things being equal. This profit and loss result is inconsistent with the economics of the contracts between the insurer and the insured. The opposite situation occurs with some long-duration U.S. health insurance contracts that, due to initial selection, may be expected to have better than average experience during the first contract year.

Question 3: *Do you agree that, to progress this project, the IASB should focus on a defined type of rate regulation (see Section 4) in order to provide a common starting point for a more focused discussion about whether rate regulation creates a combination of rights and obligations for which specific accounting guidance or requirements might need to be developed (see paragraphs 3.6–3.7)? If not, how do you suggest that the IASB should address the diversity in the types of rate regulation summarised in Section 3?*

IAA Response

While we agree that the type of rate regulation defined in Section 4 is worthy of study and possible inclusion in a standard, we believe that more generally described forms of rate regulation, not mentioned in Section 3, are also worthy of consideration as we outlined in our response to Question 1.

In insurance, most contracts not covered by rate-regulation as defined in Section 4 could be categorised as Community Rated Pricing (CRP) and exist where there is a constraint requiring a common price for a product or service, despite differences in the expected cost of delivering that product or service. Entities providing that product or service are not constrained as to the level of that price. A variation of this is where entities are allowed a limited range of deviation around the CRP; but this range is narrower than the range of associated costs. Obviously, CRP can only survive in the context of regulation or some other support mechanism. Otherwise, entities subject to CRP would only provide the product or service where it is profitable, leaving the unprofitable market segments unserved.

This can be seen in flood coverage offered in Germany: before deregulation in 1994, some state owned local insurers offered flood coverage; every house-owner in the area had to be insured by the insurer (who was obliged to accept all who applied) and had to pay the same premium, regardless of whether the house was directly at the bank of a river or on top of a mountain. Since the insurer knows the address of the house, the premium charged for the house on top of the mountain for the flood coverage represents nearly 100% profit, while the premium charged for the house at the bank of the river is ten times less than the corresponding expected cost. Under German GAAP, all contracts in the aggregate were accounted for as being profitable since the rate-regulation ensured that the insurer would get a profit per capita (reflecting the amount of the equalization liability).

Actuaries commonly encounter CRP in the context of particular classes of insurance considered as an essential service, where (usually both of) the following constraints apply:

- a) Individuals are required, or have a strong incentive, to take out insurance against specified perils.
- b) Insurers must provide the individuals insurance against those perils.

Classes of insurance commonly affected include:

- Workers compensation;
- Motor vehicle (third party);
- Hospital and medical;
- Home building and contents (in high-risk regions);
- Life, health and automobile insurance (where unisex rating is mandated).

CRP is often applied to other “essential services”, particularly at the retail level. CRP may also be adopted voluntarily, typically for marketing or administrative cost reasons. Retailers with stores in multiple locations, for example, may prefer to ignore differences in distribution costs. Similarly, insurers often choose not to use one or more potential rating variables, usually for practical reasons, e.g., it is too expensive to assess them compared with the respective effect.

Accounting for CRP usually only raises issues where there is a timing difference between payment and delivery of related services. If there is a timing difference, then it will be possible to identify:

- Profitable contracts, for which profit would normally be deferred until earned; and
- Loss-making contracts, where the loss would normally be recognised immediately.

If these profits are deferred and losses are recognised in accordance with normal accounting practice, the result would be unfaithful representation of the overall economics involved and the insurer's financial position.

However we recognize that extending the scope of the Rate-Regulation Project to CRP will likely add a great deal of detail (and time) to this project. If it is decided that the focus should stay solely on defined rate regulation, then consideration should be given to outlining the pre-conditions for which the recognition boundaries of IFRS are overruled by the economics of the rate regulation.

An appropriate principle that might be considered is that the entity has to be virtually certain that it can apply the compensating effect of the rate regulation to the affected separate items. The treatment of rate regulation should include criteria for use to ensure that it is highly likely that the aggregate expectations will be achieved. Guidance may be needed regarding the definition of "virtually" in these circumstances. Often regulated entities do not have a monopoly position, as there is the possibility that many customers choose another provider, with the consequence that the entity will be unable to make use of the compensating effect of rate regulation, although that might be unlikely.

For example, in case of insurance issued with unisex rates (if required by law or regulation), rates for the gender with the higher expected cost might choose to surrender their contracts so that the assumed subsidizing effect for both sexes cannot be achieved, although that is highly unlikely, because there is no alternative for the surrendering policyholders in the market (all offers would be unisex rated due to state rate-regulation requirements). To consider the items in an isolated manner (e.g., each contract separately) would ignore the important overall economic effect of the rate regulation on the insurer and consequently would not provide decision-useful information by not presenting the economic substance of the business in a faithful manner. Consequently, a judgment is needed to determine the significance of the effect of the rate regulation and its associated uncertainties.

Question 4: Paragraph 2.11 notes that the IASB has not received requests for it to develop special accounting requirements for the form of limited or 'market' rate regulation that is used to supplement the inefficient competitive forces in the market (see paragraphs 3.30–3.33).

(a) Do you agree that this type of rate regulation does not create a significantly different economic environment and, therefore, does not require any specific accounting requirements to be developed? If not, why not?

(b) If you agree that this type of rate regulation does not require any specific accounting requirements, do you think that the IASB should, alternatively, consider developing specific disclosure requirements? If so, what would you propose and why?

IAA Response

Our response to Q3 makes it clear that we feel specific accounting requirements should be developed for some aspects of this type of rate regulation.

Questions 5 and 6: see our response to Question 1 providing a more conceptual response to the issue of rate-regulation from an accounting perspective. We do believe that accounting guidance is needed.

Question 7: Section 5 outlines a number of possible approaches that the IASB could consider developing further, depending on the feedback received from this Discussion Paper. It highlights some advantages and disadvantages of each approach.

(a) Which approach, if any, do you think would best portray the financial effects of defined rate regulation in IFRS financial statements and is most likely to provide the information that investors

and lenders consider is most relevant to help them make their investing and lending decisions? Please give reasons for your answer.

(b) Is there any other approach that the IASB should consider? If so, please specify and explain how such an approach could provide investors and lenders with relevant information about the financial effects of rate regulation.

(c) Are there any additional advantages or disadvantages that the IASB should consider before it decides whether to develop any of these approaches further? If so, please describe them.

If commenting on the asset/liability approach, please specify, if it is relevant, whether your comments reflect the existing definition of an asset and a liability in the Conceptual Framework or the proposed definitions suggested in the Conceptual Framework Discussion Paper, published in July 2013.

IAA Response

The primary issue involved arises from whether an asset created by rate-regulation can be recognized in a manner consistent with the IASB *Conceptual Framework*. We only respond with respect to liabilities which it might be easier to recognize. However, the issue is similar for assets: Does the expectation of future business provide sufficient reason to recognize an asset or a liability in such cases? Is the expectation of (deferred) future profits from other current contracts (that might be surrendered prematurely) sufficient to avoid the immediate recognition of a loss from onerous contracts, where rate regulation permits off-setting? Consistent with the definition of assets and liabilities in the IASB *Conceptual Framework*, we believe it to be essential that there is a (legal or contractual) right or obligation to off-set losses and profits among contracts. However, although the ability to receive the benefit of that right (or obligation) might be somewhat uncertain, it is certainly a right (or obligation) of the entity.

With respect to contract boundaries in the IASB's Insurance Contracts Project, it is sufficient for there to exist an incentive for applicable policyholders to continue their insurance – not necessarily as an enforceable right of the insurer. If there is no incentive for the customer to move coverage to another provider (due to rate-regulation in the entire market) or, because of the types of service involved, not to demand the service, or, even more in case of a liability, an incentive to come to the entity, that the right (or obligation) should be recognized and the uncertainty being measured on an expected basis (with an appropriate adjustment for risk and uncertainty).

In theory the entity could decide to cease conducting business. However, in the case of insurance, the insurance pool has a significant value and re-entering the business represents an overwhelming cost, even after a temporary pause of only a year (including the extreme insurance risk from a small initial pool and the total disruption to the entity's distribution system). Terminating the business just to release the liability into profit is never a realistic alternative. Hence, consideration of non-violation of "going concern" should be considered in determining whether an asset or liability under rate-regulation can be recognized. That is recognized by the IASB *Conceptual Framework* phrase "has no practical ability to avoid the transfer".

A further reference might be to participating insurance contracts, where the IASB has tentatively decided that a liability can be the result of the obligation under one contract to distribute excess premiums to other, and potentially future unspecified policyholders. Nevertheless, except in the case that the entity exits its insurance business entirely, the amount would never inure to the benefit of the insurer. We agree that in such a situation a liability needs to be recognised.

Question 8

The IAA has no comments in response to this question at this time.

Question 9: *If, after considering the feedback from this Discussion Paper and the Conceptual Framework project, the IASB decides to prohibit the recognition of regulatory deferral account balances in IFRS financial statements, do you think that the IASB should consider developing specific disclosure-only requirements? If not, why not? If so, please specify what type of information you think would be relevant to investors and lenders in making their investing or lending decisions and why.*

IAA Response

The IAA would be in favour of specific disclosure requirements in such a circumstance. Any requirements would need to be very carefully thought through to preserve the transparent nature of accounting information for investors and lenders.

Questions 10 and 11: The IAA has no comments in response to these questions at this time.

Question 12:

The IAA believes that it would be relevant to require the existence of a rate regulator with appropriate authority for a standard to apply.

Appendix A

Full Member Organizations - 67

Caribbean Actuarial Association
 Consejo Profesional de Ciencias Económicas de la Ciudad Autónoma de Buenos Aires (Argentina)
 Actuaries Institute Australia (Australia)
 Aktuarvereinigung Österreichs (AVÖ) (Austria)
 Institut des Actuairens en Belgique (Belgique)
 Aktuarsko Drustvo U Bosni I Hercegovini (Bosnia and Herzegovina)
 Instituto Brasileiro de Atuária (IBA) (Brazil)
 Bulgarian Actuarial Society (Bulgaria)
 Canadian Institute of Actuaries/Institut Canadien des Actuairens (Canada)
 China Association of Actuaries (China)
 Actuarial Institute of Chinese Taipei (Chinese Taipei)
 Asociación Colombiana de Actuarios (Colombia)
 Institut des Actuairens de Côte d'Ivoire (Côte D'Ivoire)
 Hrvatsko Aktuarsko Drustvo (Croatia)
 Cyprus Association of Actuaries (Cyprus)
 Česká Spolecnost Aktuárù (Czech Republic)
 Den Danske Aktuarforening (Denmark)
 Egyptian Society of Actuaries (Egypt)
 Eesti Aktuaaride Liit (Estonia)
 Suomen Aktuaariyhdistys (Finland)
 Institut des Actuairens (France)
 Deutsche Aktuarvereinigung e. V. (DAV) (Germany)
 Hellenic Actuarial Society (Greece)
 Actuarial Society of Hong Kong (Hong Kong)
 Magyar Aktuárius Társaság (Hungary)
 Félag Islenskra Tryggingastærðfræðinga (Iceland)
 Institute of Actuaries of India (India)
 Persatuan Aktuaris Indonesia (Indonesia)
 Society of Actuaries in Ireland (Ireland)
 Israel Association of Actuaries (Israel)
 Istituto Italiano degli Attuari (Italy)
 Institute of Actuaries of Japan (Japan)
 Japanese Society of Certified Pension Actuaries (Japan)
 The Actuarial Society of Kenya (Kenya)
 Latvijas Aktuaru Asociacija (Latvia)
 Lebanese Association of Actuaries (Lebanon)
 Lietuvos Aktuaru Draugija (Lithuania)
 Persatuan Aktuari Malaysia (Malaysia)
 Colegio Nacional de Actuarios A. C. (Mexico)
 Association Marocaine des Actuairens (Morocco)
 Het Koninklijk Actuarieel Genootschap (Netherlands)
 New Zealand Society of Actuaries (New Zealand)
 Den Norske Aktuarforening (Norway)
 Pakistan Society of Actuaries (Pakistan)
 Actuarial Society of the Philippines (Philippines)
 Polskie Stowarzyszenie Aktuariszy (Poland)
 Instituto dos Actuários Portugueses (Portugal)
 Asociația Romana de Actuaris (Romania)
 Russian Guild of Actuaries (Russia)

Udruzenje Aktuara Srbije (Serbia)
Singapore Actuarial Society (Singapore)
Slovenska Spolocnost Aktuarov (Slovakia)
Slovensko Aktuarsko Drustvo (Slovenia)
Actuarial Society of South Africa (South Africa)
Institute of Actuaries of Korea (South Korea)
Col.legi d'Actuaris de Catalunya (Spain)
Instituto de Actuarios Españoles (Spain)
Svenska Aktuarieföreningen (Sweden)
Association Suisse des Actuaires (Switzerland)
Society of Actuaries of Thailand (Thailand)
Association of Consulting Actuaries (United Kingdom)
Institute and Faculty of Actuaries (United Kingdom)
American Academy of Actuaries (United States)
American Society of Pension Professionals & Actuaries (United States)
Casualty Actuarial Society (United States)
Conference of Consulting Actuaries (United States)
Society of Actuaries (United States)

Appendix B

Members of the IAA Insurance Accounting Committee

Chairperson:

William C. Hines

Co-Vice-Chairpersons:

Micheline Dionne

Stefan Engeländer

David John Finnis

Members:

Gunn Albertsen	Den Norske Aktuarforening
Victor Hugo Cesar Bagnati	Instituto Brasileiro de Atuária (IBA)
Daniel N. Barron	Israel Association of Actuaries
Guy Castagnoli	Association Suisse des Actuares
Antonella Chiricosta	Istituto Italiano degli Attuari
Simon R Curtis	Canadian Institute of Actuaries
Alexander Dollhopf	Svenska Aktuarieföreningen
Ann Duchêne	Institut des Actuares en Belgique
David John Finnis	Actuaries Institute Australia
Rokas Gylys	Lietuvos Aktuaru Draugija
Jozef Hancar	Slovenska Spolocnost Aktuarov
Maximilian Happacher	Deutsche Aktuarvereinigung e. V. (DAV)
Armand Maurice Ibo	Institut des Actuares de Côte d'Ivoire
Satyan Jambunathan	Institute of Actuaries of India
Dragica Jankovic	Udruzenje aktuara Srbije
Burton D Jay	Conference of Consulting Actuaries
Gareth L Kennedy	Casualty Actuarial Society
Jinwon Kim	Institute of Actuaries of Korea
Christoph Krischanitz	Aktuarvereinigung Österreichs (AVÖ)
Yin Lawn	Actuarial Institute of Chinese Taipei
Mustapha Lebbar	Association Marocaine des Actuares
Kristine Lomanovska	Latvijas Aktuaru Asociacija
Ana Maria Martins Pereira	Instituto dos Actuários Portugueses
James B Milholland	Society of Actuaries
Brian Joseph Morrissey	Society of Actuaries in Ireland
Yoshio Nakamura	Institute of Actuaries of Japan
Manuel Peraita Huerta	Instituto de Actuarios Españoles
Andreja Radic	Hrvatsko Aktuarsko Drustvo
Ravi Clifton Rambarran	Caribbean Actuarial Association
Thomas Ringsted	Den Danske Aktuarforening
Zdenek Roubal	Ceská Spolocnost Aktuárù
Jaanus Sibul	Eesti Aktuaaride Liit
Henry W Siegel	American Academy of Actuaries

Maxime Simoen	Institut des actuaires
Mateja Slapar	Slovensko Aktuarsko Drustvo
John Laurence Smith	New Zealand Society of Actuaries
Pentti Soininen	Suomen Aktuaariyhdistys
Arseny Leonidovich Timakov	Russian Guild of Actuaries
E.P. Visser	Het Koninklijk Actuarieel Genootschap
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Yuanhan Zhang	China Association of Actuaries
Jesús Alfonso Zúñiga San Martín	Colegio Nacional de Actuarios A. C.