



**ASSOCIATION ACTUARIELLE INTERNATIONALE  
INTERNATIONAL ACTUARIAL ASSOCIATION**

May 3, 2005

Mr. Rob Esson  
Chair, Insurance Contracts Subcommittee  
International Association of Insurance Supervisors  
c/o Bank for International Settlements  
CH-4002 Basel  
Switzerland

Dear Mr. Esson,

**Re: IAIS Comments Regarding Issues Arising as a Result of the IASB's Insurance  
Contracts Project – Phase II**

In response to the request for comments on the above-mentioned document, 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 would wish to pursue, please do not hesitate to contact the chairperson of the Insurance Accounting Committee, Sam Gutterman, or any of the other members of the committee. The IAA will be pleased to develop these ideas further with you.

Yours sincerely,

Yves Guérard  
Secretary General

Attachment: IAA Comments

cc: Peter Cooke, IAIS Secretariat

**A Commentary on the  
IAIS COMMENTS REGARDING ISSUES ARISING AS A RESULT OF THE  
IASB'S INSURANCE CONTRACTS PROJECT – PHASE II  
Released by the International Association of Insurance Supervisors: 15 April 2005**

**International Actuarial Association**

The International Actuarial Association (the “IAA”) represents the international actuarial profession. Our fifty Full Member actuarial associations represent more than 95% of all actuaries practicing around the world. The Full Member associations of the IAA are listed in an Appendix to this statement. 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. The IAA appreciates the opportunity to provide comments on this IAIS document.

**Due Process**

These comments have been prepared by the Insurance Accounting Committee, the members of which are listed by name and association in the Appendix to this submission. 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.

**IAA Comments**

The International Actuarial Association (IAA) applauds the IAIS for taking a proactive approach to examining the fundamental issues that are associated with the development of international regulatory financial reporting for insurance contracts based on the IASB’s International Financial Reporting Standards (IFRSs). The IAA notes that many of its observations may also be applicable to contracts issued by insurers that do not qualify as insurance contracts under the IASB definition. However, the IAA feels that to comment in detail on such contracts now is outside the scope of this response.

The IAA agrees completely, or with small reservations noted below, with the following concepts expressed in the IAIS draft paper that would facilitate the two sets of accounts being developed in a consistent manner. The paragraphs in the IAIS paper where these concepts are discussed are noted in parentheses:

1. Liability measurement should be prospective in nature reflecting both the time value of money and appropriate risk margins (7). Note that historical information may still be used in a prospective system such as accumulated accounts in unit linked insurance contracts.
2. Reconciliation and clear explanation of any differences between general purpose and prudential accounting should be provided (8).
3. Both insurer and policyholder behaviour should be reflected in both the liability recognition and the liability measurement criteria used in both sets of financial reports (11) and an allowance for probability of expected cash flows should preferably be *directly* incorporated into the concept of measurement of both assets and liabilities (12). If the direct method cannot be accepted by the IASB a similar result should be sought

*indirectly* through the introduction of a portfolio of similar contracts as the unit of account (13).

4. Imposition of the cash value floor in general-purpose accounting is inconsistent with the recognition of behaviour referred to in the previous point (14).
5. Liability measurement should, when possible, be based on current “best estimates” (meaning probability-weighted expected values) that reflect the specific features and characteristics of the contract (22). The IAA notes, while such best estimates (with some exceptions such as after the emergence of a new illness such as AIDS) may be relatively reliable in common life insurance and general (or P & C) personal lines insurance, that there may be considerably less reliability concerning best estimates for low incidence high severity commercial lines of general insurance.
6. Liability measurement should include some risk margins (22). The risk margins should incorporate time decay reflecting increasing certainty as the contract, or claim, matures in a manner consistent with the “release from risk” principle. In this regard the IAA suggests that risk margins that are applied to all major exposures underwritten are more likely to be robust than risk margins that are applied to exposures in which there are a limited number of expected contingent events. The IAA also notes both that the level of the risk margins demanded between a willing buyer and a willing seller will reflect knowledge about the probability distribution function of the insured contingencies and that this knowledge, concerning commercial lines of insurance in particular, will frequently be less reliable, demanding higher margins.
7. The concept of having consistent and reliable risk margins based on an additional level of confidence above the best estimate level is desirable (23) and will provide valuable guidance even for risks of considerable uncertainty. In this regard, the IAA notes, for certain risks involving “fat tailed”, “long tailed” or “catastrophic” distributions, that concepts such as using contingent tail expectation (CTE) or “moments” of the probability distribution function might be more prudent (and more market consistent) than the use of traditional statistical “confidence levels”.

The IAA has plans to conduct research regarding possible approaches to take with respect to appropriate risk margins consistent with its members’ observations about willing buyer and willing seller behaviour. The IAA observes that, to the extent that the risk margins felt appropriate by regulators are greater than the levels expected to be demanded by a willing buyer and willing seller, consideration might be given to requiring these additional risk margins in the form of risk based capital in order to ease the reconciliation and explanation burden.

Similarly, when additional regulatory prudence is demanded to reflect parameter and model risk, the IAA feels that consideration should be given to requiring prudence above that observed in the market, in the form of risk based capital as well as disclosure of the nature of risks undertaken by the insurer that make it so difficult to estimate reliable best estimates and confidence measures.

8. Regardless of whether “own credit rating” is adopted for general purpose financial statements, it should not be adopted for prudential financial reporting purposes (35).

9. Assets and liabilities should be measured in a consistent manner within a particular insurance segment (22) and (38) for both general-purpose and regulatory financial reporting purposes. The IAA notes that it has been recommending such consistent measurement since its first submissions on the insurance project back in the late 1990s, as well as having published jointly with the American Council of Life Insurance (ACLI) a research paper on this subject in 2003.

The IAA also notes that the concept of measuring assets and liabilities on a consistent basis is not the same concept as reflecting the actual assets held by an insurer to measure liabilities. Such liabilities would be more properly measured by reflecting assets which most closely replicate the expected cash flow characteristics of the liabilities. (Note that, when the assets held directly influence the benefits paid, the assets held are part of the replicating portfolio.)

10. The accounting for assets should reflect the accounting for the liability segment which they are (notionally or actually) supporting on a consistent basis. The IAA would like to emphasize the importance of the concept of “managing together” which already exists in some bank accounting (39) and is essential for the asset / liability management of any mismatch risk (40). However, the IAA notes that asset segmentation to back specific liability segments is far more common for life insurers than for general (P&C) insurers, in part because future renewal premiums on long term life insurance contracts make active asset / liability management more practical.
11. A profit should only be recognized at issue when appropriate risk margins have been provided in the measurement of liabilities (46).
12. Since underwriting cycles can affect product pricing, care must be taken that any constraint against the recognition of profit at issue does not result in a lack of recognition of losses at issue (48).
13. Liability measurement should reflect the time value of money (49) by reflecting the shape of the yield curve rather than by using an average discount rate across duration, as long as deep liquid debt securities appropriate to the nature of the liabilities are sufficiently available.

The IAA believes that more consideration by the IAIS needs to be given to several elements of the April 15 draft paper, some of which could lead to internal inconsistencies:

1. Paragraphs 9 and 11 call for recognition of policyholder behaviour, while paragraph 14 leads to the observation that such recognition may lead to a general purpose liability measurement that is less than the cash value floor. Paragraph 22 calls for valuations to be based on assumptions that reflect best estimates taking into account the specific features and characteristics of the contracts (plus risk margins as discussed in paragraph 23). Paragraph 52 notes that future premiums include a charge to cover initial acquisition costs. Yet, paragraph 15 concludes that “for regulatory purposes, it would be inappropriate to measure the insurance liability for a contract as less than its current surrender value”. While the IAA believes it understands the regulatory rationale underlying paragraph 15, the IAA also believes that the imposition of such a contract-by-contract liability floor is inconsistent with the intent of the statements in paragraphs 9, 11, 14, 22, 23 and 52.

- To achieve the objectives in paragraph 15, the IAA suggests an alternative method which the IAIS might consider that does not require the imposition of a policy-by-policy cash value floor in regulatory financial statement liabilities for insurance contracts. First liabilities would be measured in a segment without reference to contract-by-contract cash value minima. Then, an additional risk based capital item would be required that reflects the difference between the contract liabilities and the contract-by-contract cash value floors.
  - The advantage of such an approach is that it is more transparent and straightforward for regulators to track actual emergence of profits against what would be suggested from the current best estimate experience and release of margins without “polluting” the analysis with the impact of amounts desired for prudential reasons. The IAA believes that one of the best tools available to a supervisor is a realistic emergence of earnings.
  - The IAA does not dispute the desirability that an insurer should have on hand adequate resources with which to meet its current and future obligations within some reasonable confidence level. While the IAA understands that the IAIS might wish initially to require 100% of the difference between the liabilities calculated without reference to the cash value floor and total cash value floors in a segment, the IAA also suggests that, in time, the IAIS may come to the conclusion that an amount less than 100% (whether held in a prudential liability, in equity or in a combination of liabilities and equity) should prove to offer adequate protection depending on the nature of the totality of the risk based capital that the IAIS recommends.
2. With respect to the use of risk free discount rates in the measurement of liabilities (49), the IAA notes the following:
- There are many countries in which there is not a deep liquid long term government debt market. In those countries, the IAA doubts that the use of the forward rate for the longest term liquid government security is appropriate. One such example is Brazil where current government interest rates are 19.5% and where long term debt instruments are not available due to future economic uncertainty.
  - There are other markets in which the government has ceased to issue long term liquid securities. In such cases, the IAA doubts that the use of the curve for the remaining “on the run” government securities is appropriate.
  - In some jurisdictions, cash flows from assets such as mortgages, long term public utility debt may be more consistent with the nature of a given set of liabilities. In still others, it may be equities (especially with indexed linked insurance contracts).
  - In many cases adherence to paragraph 38, may make it inappropriate to invest in risk free government securities. This may be because, although default risk would be lessened by using such securities, term mismatch risk may be increased by use of such securities. Should this be the case, it would seem to make little sense to require the measurement of contract liabilities with reference to a risk free yield curve that is unrelated to the assets that best match the liability characteristics.

The following are some alternative approaches that the IAIS might consider:

- When both a deep liquid risk free market and a deep liquid rated corporate debt market exist side by side, allow the use of risk free duration-specific discount rates for the durations when they are available or the use of comparable and credible default and expense adjusted rates from high quality corporate debt. When best estimate default rates are used, either credible default risk margins might be included or additional risk based capital may be desirable to meet prudential requirements.
- The same concept could be applied to cover commercial debt where it is the most appropriate asset class given the nature of the liabilities.
- When there are only corporate bond or mortgage securities available with respect to mid term or long term liabilities, allow the use of default and expense adjusted rates from these securities together with any prudential risk based capital requirements.
- When only real estate or equity investments are available to match future long term cash flow needs, consider the use of prescribed discount rates together with risk based capital requirements. In countries with well established deep liquid equity markets, the prescribed rates could reflect actual long term experience with a high degree of statistical confidence such as that derived from contingent tail expectation (CTE) - or the closely related TailVar - analysis.
- Swaps and other derivatives often exist in liquid markets when an underlying physical security does not exist in liquid form. Generally any accompanying counter-party risk can be considered to be low; but this would need to be assessed on a counter-party by counter-party basis taking into account whatever netting of derivatives is allowed. The IAA recognizes that, in many jurisdictions, actuaries and insurers are not familiar with techniques of using derivatives to hedge asset / liability mismatch risks. While the IAA believes that its national member associations will often be in a better position than the IAA to provide educational material on such issues, the IAA is prepared to consider developing generic educational material should the IAIS accept the concept that derivatives can be properly used in establishing discount rates.

The IAA is prepared to work with the IAIS to develop these concepts if the IAIS desires.

Finally, the IAA believes that it is essential that a single international prudential financial reporting model be developed that meets the characteristics outlined above. The IAA is willing to provide whatever assistance it can to both the IAIS and the IASB to derive a regulatory model based on, but not identical to, future IFRSs developed by the IASB. The IAA has long advocated that the merits from such a combination of general purpose international financial reporting based on IFRS, together with international regulatory reporting itself based on a soundly constructed IFRS core would be of immense benefit both to insurers and to the financial markets as a whole.

Notwithstanding the intellectual and market merits of a common financial reporting platform for both general purpose and regulatory purposes, this ideal may be unable to be met. Despite best

efforts, the IASB and IAIS may be unable to agree on a common platform that meets these objectives. It is the IAA's view that the credibility of the insurance industry may depend on both investor and policyholder confidence that the industry is soundly regulated. Therefore, if the IASB and IAIS fail to develop a common platform, the IAA believes that the importance of the need for a robust international regulatory financial reporting system increases even more.

Regardless of whether or not a common financial reporting platform is developed, the IAA reiterates the need for comprehensive reconciliation and explanation of any differences between general purpose and statutory financial reporting.

**Members of the IAA's Insurance Accounting Committee**

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**Full Member Associations of the IAA**

Consejo Profesional de Ciencias Económicas de la Ciudad Autónoma de Buenos Aires  
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Institute of Actuaries of Australia (Australia)

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Canadian Institute of Actuaries/Institut Canadien des Actuaire (Canada)

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Israel Association of Actuaries (Israel)

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New Zealand Society of Actuaries (New Zealand)

Den Norske Aktuarforening (Norway)

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Singapore Actuarial Society (Singapore)

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Actuarial Society of South Africa (South Africa)

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American Academy of Actuaries (United States)  
American Society of Pension Professionals & Actuaries (United States)  
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