

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

Zurich, 22 October 2013

ED/2013/7 Insurance Contracts: Re-Exposure Draft

Dear Madam / Sir

The Swiss Association of Actuaries is the professional association of actuaries practicing in Switzerland, representing more than 1'000 members.

We appreciate the option to comment on the Re-Exposure Draft ED/2013/7 ("ED2") issued by the International Accounting Standards Board ("IASB") in June 2013. In our comment, we focus on the practitioner's perspective:

Many actuaries are engaged in the valuation of liabilities from insurance contracts. They use a wide range of valuation techniques in order to meet the requirements of regulatory, legal, internal, or other reporting frameworks – regularly several of them in parallel. Members of our profession have substantial experience with respect to reconciliation of results under different reporting frameworks, and also between approaches taken by different entities under the same framework.

Based on this experience, we would like to take the opportunity to express our concerns regarding the practicability of the proposed model. In this context, practicability goes beyond the mere computational challenge from a complex measurement model, but refers to general comprehensibility by anyone addressed by or affected by insurers' financial information.

If our concerns would be widely shared by preparers and users of financial statements, key goals of the IASB's insurance project – such as an increase in comparability between and transparency of financial reporting for insurance contracts – would be at risk.

Please find our detailed arguments in the Appendix to this letter.

Yours sincerely



Dr. Hanspeter Tobler
President



Holger Walz
Managing Director

Appendix: Response to the Invitation to Comment

Section A – General comment regarding the consequences of the use of stochastic valuation techniques (applies specifically to Question 1 [“Adjusting the CSM”], Question 4 [“Use of OCI”] and Question 6 [“The likely effects of a Standard for insurance contracts”])

The Swiss life insurance industry started implementing modern stochastic valuation models 5 to 10 years ago as a key prerequisite to calculate and report MCEV and Swiss Solvency Test (SST) results. Prominent embedded Options and Guarantees (e.g. minimum guaranteed level of interest accrual or guaranteed surrender values, both in combination with participation features) cannot be priced analytically. Thus valuations are based on projections of future cash-flows in a dynamic and stochastic model, where thousands of economic scenarios (instead of a single best-estimate scenario) are run, and then discounted and averaged. The discount rate in these models is not a free parameter but must be determined in such a way that the assets held by the company and other reference assets are priced correctly (i.e. "market-consistently").

It is our impression that the ED2 has been developed with a deterministic measurement approach in mind (similar to Traditional Embedded Value). However, as soon as stochastic modelling is required (for instance for the determination of the Time Value of Financial Options and Guarantees), many key details are left open for interpretation and pose enormous implementation challenges. We are convinced that the following methodological issues are not specific to Switzerland, but will affect insurers in many other countries, too:

- Market-consistent models require the same projected returns and **discount rates** to be applied to all liabilities backed by the same assets. Otherwise, the convergence of the model cannot be guaranteed. Currently, the guidance for key aspects of the measurement model is not clear. But also on a general note, it is not clear how to apply requirements such as the Mirroring approach (which requires separate valuation approaches for cash-flows from one contract), or the OCI solution (which requires different products backed by the same assets but underwritten at different times to be discounted with different reference rates).
- The OCI amount is calculated as the difference between the same set of fulfilment cash flows using two sets of discount rates. This approach requires insurers to maintain (at least) two sets of balance sheet records: one for the actual balance sheet determined with current rates, and another (only used for the calculation of profit and loss) calculated with a series of historical discount rates going back in time to the rates applied for the initial recognition of the oldest insurance contracts liability in-force at the reporting date. Apart from the discounting issue mentioned above, this requires insurers to **store and use a huge amount of data** which will lead to operational challenges.
- Due to the nature of the business and the company-wide nature of these stochastic models (for example with respect to common underlying assets, cross-subsidies, management rules for managing and distributing profit etc.), a **granular view** with reporting on a Portfolio level, based on product and re-pricing-cohort, is an enormously challenging task. It necessarily involves approximations on how profit is allocated at the product level. Such approximations will inevitably distort the results obtained on such a fine granular level. The distortion itself will significantly reduce the usability of the granular results or even make a meaningful interpretation impossible. Similarly, the **decomposition of cash flows** in order to exclude the deposit components, and split cash flows into directly linked, not expected to vary directly and fixed payments will also present material operational challenges for insurers, as current models do not support these requirements.
- The current stochastic models are mainly based on annual calculations, but will now likely need to be run on a **monthly** (or at least quarterly) basis. Moreover, new-business cash-flows for the first year will likely need to be modelled in more detail than the simple “new business strain” top-down adjustment currently used in MCEV, in order to allow for a reconciliation of movement in the insurance contracts liabilities over the year.

- The techniques used to **reduce runtime** include grouping of data and other approximations like scaling. If these techniques are challenged by the auditors, there will also be a major additional effort necessary and/or it will require significant investments into buying additional computational power.

All of the aforementioned points will lead to high (re-)implementation costs, increased runtimes and the need for significant additional resources for production, interpretation and communication of the results and the audit trail. For practitioners it is clear that adding all these additional strains on the insurance industry is not justified by the desired increase in transparency and comparability. Even more so when considering that results will be tainted by modelling effects and are therefore of only limited usability.

Other common topics when working with these actuarial valuation models are sample error, as well as model errors and model changes. The current practice around the allocation of these items is sometimes arbitrary which does not increase the comparability and clarity of the results. We therefore ask the board to include **guidance** on how these items should be treated. Similarly, separating causal effects in an analysis of change can be burdensome and comes not only with a high calculation cost but also with the risk of having a large residual of unexplained effects. More guidance on how to allocate these is also needed.

*Section B – Questions 1-2 and 4-6***Question 1 - Adjusting the contractual service margin**

Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial position and performance if differences between the current and previous estimates of the present value of future cash flows if:

- a) differences between the current and previous estimates of the present value of future cash flows related to future coverage and other future services are added to, or deducted from, the contractual service margin, subject to the condition that the contractual service margin should not be negative; and
- b) differences between the current and previous estimates of the present value of future cash flows that do not relate to future coverage and other future services are recognised immediately in profit or loss?

Why or why not? If not, what would you recommend and why?

We generally believe that adjusting the contractual service margin ("CSM") provides for more relevant information and appreciate that the IASB responded to concerns from the industry. Adjusting the CSM provides for a stronger link between the CSM – an accounting induced item – and the basic concepts underlying the proposed measurement model for insurance contracts.

In addition to our general consent with the concept of adjusting the CSM, we would like to highlight to the IASB some practical aspects that in our view require improvements to the model:

First, we see significant practical limitations of such approach for cash flows subject to stochastic valuation. Please be referred to our detailed analysis in Section A of this Appendix.

Second, and more generally, we believe that the unit of account for such adjusting (and thus the measurement of the CSM as a whole) is similar to a "Cohort" as introduced in the 2010 Exposure Draft on Insurance Contracts (ED/2010/8, "ED1"). This view is supported by paragraph BCA113 (ED2 Basis for Conclusion).

Our key concern regarding the unit of account is of practical nature: Calculations on a Cohort level (of granularity) impose data requirements being many times higher than for a purely Portfolio driven view. We do not believe that the additional cost is justified.

Finally, we have concerns regarding the suitability of the scope of the adjustments to the CSM.

According to paragraph 30 only updates of cash flow estimates for future coverage can be recognised by way of adjusting the CSM. In our understanding coverage in this context refers to the insured event only. However, for many products, such as workers' compensation and income protection, benefits are provided by way of regular payments (i.e. a pension type benefit). The number of payments for these pension type benefits typically depends on the survival of the beneficiary (and other factors) and in our view thereby carries key characteristics of coverage itself. This view, we believe, is supported by the fact that pension benefits as such qualify for insurance accounting and the coverage period for such products would be the payment term.

Thus, we believe that changes to the cash flow estimates for those kinds of benefits in pay-out should adjust the CSM as well.

Question 2—Contracts that require the entity to hold underlying items and specify a link to returns on those underlying items

If a contract requires an entity to hold underlying items and specifies a link between the payments to the policyholder and the returns on those underlying items, do you agree that financial statements would provide relevant information that faithfully represents the entity's financial position and performance if the entity:

- a) measures the fulfilment cash flows that are expected to vary directly with returns on underlying items by reference to the carrying amount of the underlying items?
- b) measures the fulfilment cash flows that are not expected to vary directly with returns on underlying items, for example, fixed payments specified by the contract, options embedded in the insurance contract that are not separated and guarantees of minimum payments that are embedded in the contract and that are not separated, in accordance with the other requirements of the [draft] Standard (i.e. using the expected value of the full range of possible outcomes to measure insurance contracts and taking into account risk and the time value of money)?
- c) recognises changes in the fulfilment cash flows as follows:
 - i. changes in the fulfilment cash flows that are expected to vary directly with returns on the underlying items would be recognised in profit or loss or other comprehensive income on the same basis as the recognition of changes in the value of those underlying items;
 - ii. changes in the fulfilment cash flows that are expected to vary indirectly with the returns on the underlying items would be recognised in profit or loss; and
 - iii. changes in the fulfilment cash flows that are not expected to vary with the returns on the underlying items, including those that are expected to vary with other factors (for example, with mortality rates) and those that are fixed (for example, fixed death benefits), would be recognised in profit or loss and in other comprehensive income in accordance with the general requirements of the [draft] Standard?

Why or why not? If not, what would you recommend and why?

In many jurisdictions, such as Switzerland, products with participation features provide for a substantial share of the insurance market. Understanding those features is key to understanding the economics of the overall products.

We appreciate the efforts undertaken by the IASB to eliminate accounting mismatches resulting from certain forms of policyholder participation. The vast majority of Swiss life insurance business is subject to some form of participation and the elimination of purely accounting driven mismatches is a necessary condition for any measurement model to gain acceptance with both preparers and users of financial information.

We also fully acknowledge the complexity of the task, especially for a globally applicable measurement framework.

However, we do not believe that the IASB's current concept of "Mirroring" for *Contracts that require the entity to hold underlying items and specify a link to returns on those underlying items* is a practical solution. This is for the following two main reasons:

First, in our view some key concepts and definitions underlying the Mirroring approach are not sufficiently clear. In particular, the specific interaction between "underlying items", a "link between payments", and "direct varying" (paragraph 33) does not become sufficiently clear.

Secondly – and most importantly – the available guidance for the required split of cash flows is insufficient for practical use. Actual products involve substantially more complex features than the example used in the ED2 (paragraph B86). It is not clear to us how the IASB intends the principles underlying the split to be applied to real features found in relevant products. Such features comprise contracts with recurring premiums, annual guarantees of minimum interest accruals / minimum cash

surrender values, and participation by the policyholder in excess returns in the more complex way that many participating policies (which would be expected to qualify for Mirroring) provide. Notwithstanding our concerns regarding the Mirroring Approach, we encourage the IASB to continue its efforts to develop an accounting model for participation features that fully reflects all relevant contractual elements of the underlying contracts.

Question 4—Interest expense in profit or loss

Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial performance if an entity is required to segregate the effects of the underwriting performance from the effects of the changes in the discount rates by:

- a) recognising, in profit or loss, the interest expense determined using the discount rates that applied at the date that the contract was initially recognised. For cash flows that are expected to vary directly with returns on underlying items, the entity shall update those discount rates when the entity expects any changes in those returns to affect the amount of those cash flows; and
- b) recognising, in other comprehensive income, the difference between:
 - i. the carrying amount of the insurance contract measured using the discount rates that applied at the reporting date; and
 - ii. the carrying amount of the insurance contract measured using the discount rates that applied at the date that the contract was initially recognised. For cash flows that are expected to vary directly with returns on underlying items, the entity shall update those discount rates when the entity expects any changes in those returns to affect the amount of those cash flows?

Why or why not? If not, what would you recommend and why?

We refer again to our general comment regarding stochastic models in Section A of this Appendix. The OCI solution as it is presented in ED2 does not include inflation movements, which are however closely linked to the interest rate environment. They should thus be accounted for, as we understand that the aim of the OCI solution is to split the main economic effects from the impact of actuarial assumptions.

On a more general note, we would like to highlight that the proposed recognition in Other Comprehensive Income ("OCI") for certain updates of interest rates used to discount contractual cash flows ("OCI-Solution") is sensible only if OCI-recognition of changes in the market values of the corresponding assets is possible, too.

In particular, many life insurers grant long-term interest rate guarantees in their products. Hedging those risks often involves derivatives that have interest rates as an underlying (e.g. swaptions). According to the proposals in ED2, changes in interest rates would change insurance liabilities and that effect would be recognised in OCI. Such treatment would cause purely accounting mismatches if changes in the fair value of derivatives used to hedge actual interest rate risk in insurance contracts had to be recognised in Net Income. We therefore believe that at least for certain derivatives (e.g. those used to hedge interest rate risks from insurance contracts under mandatory OCI-Solution) a FVOCI-Option should be granted.

Notwithstanding the above, we believe the IASB should make the OCI-Solution optional. The relevance for the use of OCI may be substantially different depending on facts and circumstances. It may even add artificial complexity to financial reporting and thus insurers should not be required to use it.

Question 5—Effective date and transition

Do you agree that the proposed approach to transition appropriately balances comparability with verifiability?

Why or why not? If not, what do you suggest and why?

We generally agree that the proposed approach to transition appropriately balances comparability with verifiability.

Notwithstanding, some of the specific concerns stated above would carry over to the measurement for policies in-force as of the beginning of the earliest period presented.

And, as discussed in more detail below in our response to question 6, we believe that insurers should be granted at least 5 years to implement the final standard for insurance contracts.

Question 6—The likely effects of a Standard for insurance contracts

Considering the proposed Standard as a whole, do you think that the costs of complying with the proposed requirements are justified by the benefits that the information will provide? How are those costs and benefits affected by the proposals in Questions 1–5?

How do the costs and benefits compare with any alternative approach that you propose and with the proposals in the 2010 Exposure Draft?

Please describe the likely effect of the proposed Standard as a whole on:

- a) the transparency in the financial statements of the effects of insurance contracts and the comparability between financial statements of different entities that issue insurance contracts; and
- b) The compliance costs for preparers and the costs for users of financial statements to understand the information produced, both on initial application and on an ongoing basis.

We appreciate the efforts undertaken by the IASB to respond to feedback on its proposals in ED1. There is a variety of perspectives on insurance business and what would be a suitable view on liabilities incurred and profits earned from such business.

The IASB made several key adjustments to its ED1 model for measurement and presentation for insurance contracts. Arguably, any single key change could be implemented and used in practice by insurance companies – even though we hold up to our concerns regarding the “Mirroring” approach and the practical concerns resulting from the use of stochastic models.

However, in our view the combination of all changes creates an increase in complexity that goes beyond the mere “sum of complexity” from the individual changes. Given the range of internal and external stakeholders we have strong concerns that the resulting model is useful in practice.

More specifically, we want to stress that the insurance model does not only affect actuaries and accountants within an insurance operation, plus some analysts. In most cases it is likely to affect the majority of employees of a company by way of variable payments based on company earnings. It will affect sales agents by way of amended profitability measures for the business they write. It will affect asset managers by way of different interaction between assets and (insurance) liabilities. It will affect Controlling functions. It will affect IT functions in many ways. – It will affect many companies around the world operating in the same specialised business at the same time.

We thus strongly recommend the IASB allow for a transition period of five years.

Also, we ask the IASB to drop certain requirements that add complexity but, in our view, do not add any value to users or preparers on financial statements.

In particular, we re-iterate our objection against the required disclosure of the Risk Adjustment by way of a “Value-at-Risk” confidence level (paragraph 84). In our view, transformations of results from many models actually used by insurers (such as the cost of capital model, to name but one) would be arbitrary.

As a closing comment, we ask the IASB again to bear in mind the complexity of its measurement and presentation model for insurance contracts when further deliberating the project: During the comment period, we were not in a position to implement a full representation of the ED2 model for even simplified versions of standard products in the Swiss market. We doubt that any model of such complexity is suitable for increasing comparability between and transparency of financial reporting for insurance contracts.

In this context we note that generally the examples used to discuss the measurement and presentation model are overly simplified.