



ACTUARIAL SOCIETY
of
H O N G K O N G
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16 September 2015

International Accounting Standards Board
Mr. Hans Hoogervorst, Chairman
30 Cannon Street
London EC4M 6XH
England

RE: Comments on the Certain Aspects of the IASB's Insurance Contracts Project

Dear Mr. Hoogervorst,

The Actuarial Society of Hong Kong ("ASHK") is a professional membership organization for actuaries in the industries of insurance, consultancy, finance, educational institutions and government in Hong Kong. The ASHK is governed by an elected Council with a President, an Immediate Past President, a Vice President and ten Council Members. Currently the ASHK has over 1,000 members.

Among the objectives of the ASHK are the following:

- To discuss and comment on the actuarial aspects of public, social and economic and financial questions which from time to time may be the subject of public interest;
- To consider the actuarial aspects of legislation existing and proposed and to take such action as is considered desirable.

Financial reporting in Hong Kong is governed by Hong Kong Financial Reporting Standards, which follow IFRS. Moreover, many multinational insurance companies with operations and / or regional headquarters in Hong Kong report financial results using IFRS. The coming changes in financial reporting as a result of the IASB's insurance contracts project will fundamentally change the financial reporting for Hong Kong's insurance companies. Therefore we would like to present the ASHK's views on certain tentative decisions that the Board has taken during its deliberations on its insurance contracts project.

We preface our remarks by stating that the ASHK supports the IASB's objective of developing a high quality insurance accounting standard. We believe that the general direction of a standard based on current estimates, including a provision for risk, together with a profit release mechanism that reports profits in a rational manner is sound and in fact long overdue. Nevertheless we are concerned that certain tentative decisions could result in a standard that is less useful to investors and other stakeholders than it might be. It is in this spirit that we offer the following comments. We recognize that the IASB has not solicited these comments, but hope the Board will consider them nonetheless.

Our comments relate to the following areas:

- Indirect participating contracts
- Determination of the discount rate
- Unit of account
- Unlocking the contractual service margin

We would be happy to discuss our views in person with you and to answer any questions or respond to any comments that you may have.

Yours faithfully,

Queenie Hui
President
Actuarial Society of Hong Kong

Comments on Certain Aspects of the IASB's Insurance Contracts Project by the Actuarial Society of Hong Kong

Indirect Participating Contracts

Many participating contracts in Asia, including Hong Kong, and also US style Universal Life contracts do not have a link to a clearly identified pool of underlying items. Under the current IASB proposals this means they would not be eligible for the variable fee approach, which potentially implies an accounting mismatch and increased volatility in reported results. We propose an "accounting designation" as a method to allow firms to account for these indirect participating contracts using the variable fee method.

At its June 2015 meeting, the IASB agreed to adopt a variable fee approach for participating contracts, as long as they meet certain criteria. These criteria are:

- The contractual terms specify that the policyholder participates in a share of a clearly identified pool of underlying items;
- The entity expects to pay the policyholder a substantial share of the returns from the underlying items; and
- A substantial proportion of the cash flows that the entity expects to pay to the policyholder are expected to vary with the cash flows from the underlying items.

The variable fee approach treats the entity's share of returns on underlying investments as a variable fee for service. This is beneficial for giving a more faithful representation of the economics of participating contracts in the IFRS financial statements because it means changes in the future cost of options and guarantees, along with changes in the insurer's share of returns on underlying assets, are adjusted through the contractual service margin (CSM) and released to the P&L over the remaining life of the portfolio of contracts, rather than immediately. Such an approach eliminates the significant volatility that would arise from using the general 'building block' approach for participating contracts and that would distort the underlying reality of the risk sharing agreement that the insurer and the policyholder have agreed to have by entering into the participating contract.

The IASB appears to be moving towards the view that a contractual link is necessary between "a clearly identified pool of underlying items" and the insurance contract liabilities. Many participating contracts in Asia, including Hong Kong, and also US style Universal Life contracts do not have this link. They pay an 'asset-like' return, which is similar to the returns on a particular pool of assets but is not formally linked to those assets.

Without a "clearly identified pool of underlying items," a contract cannot be classified as a direct participating contract under the IASB's proposed definition. In this case, the contract may have to be accounted for using the basic 'building block' approach, which would only allow movements in future cash flows to be adjusted against the CSM. The shareholders' portion of movements in underlying items would be recorded immediately in profit or loss, causing an accounting mismatch and increased volatility from year to year that would not faithfully represent the economic matching of assets and liabilities that the insurer has achieved irrespective of the presence of a contractual link between assets and participating contracts' cash flows.

One proposal that the ASHK believes the Board should consider is that it would be possible to create a link between insurance liabilities and a specific pool of underlying items by using an accounting designation similar to Approach 3 as presented in Agenda Paper 2D on hedging activities related to participating business and discussed during an educational session at the June 2015 IASB meeting. Using this approach, the entity makes an accounting designation of assets to associate a specific pool of assets with the insurance liabilities. This could be documented in a similar way as a hedging relationship, so the

designation documentation forms the link between insurance liabilities and the “clearly identified pool of underlying items”.

The “accounting designation” approach has the advantage of allowing the effect of movements in both the insurance liability and underlying assets to be recorded in the CSM using the variable fee approach that the IASB approved in June 2015 for direct participating contracts. This approach essentially provides the documentation that identifies the “pool of underlying items” backing the insurance contract. Using an accounting designation means the link between assets and liabilities can be made without having to create a contractual link in the policy terms between the insurance liabilities and underlying items, which is not practical for business that is already in force and would be inconsistent with market practice. It would also be expensive and time-consuming.

Determination of the Discount Rate

Significant non-economic volatility can be introduced into the IFRS income statement and balance sheet if the discount rate is allowed to move as a result of changes in unobservable interest rates. ASHK urges the IASB to allow a flexible approach to discounting such that companies are permitted to stabilize the discount rate when there is no market data to support a change.

In Hong Kong and various other jurisdictions in Asia, it is common for life insurance liabilities to be significantly longer in duration than the assets backing them. This arises both from historical and continuing sales of long-duration liabilities and from the limited availability of long-duration assets.

In many markets, the portfolio of liabilities consists of a high proportion of traditional whole of life, endowment or health contracts which have material contractual obligations stretching many years into the future. Such contracts are for much of the population one of the only long-term savings or protection vehicles available in the market; other vehicles such as corporate pensions, a state pension, or life annuities do not exist or are very limited. In this way, the long-dated contracts form part of the socio-economic landscape and even government policy of the jurisdictions themselves. There is a socio-economic expectation that they would continue to be offered for sale in the future.

On the asset side, in many cases governments have not issued long-dated bonds. For example, in Hong Kong deep and liquid risk free bonds are available only up to 10 years in duration. In general, there is little indication that governments might issue longer-dated bonds in the future.

The resulting duration mismatch between assets and liabilities in many Asian jurisdictions is therefore significantly greater than in European or North American jurisdictions. It is both inherent in the often large portfolios that have already been issued and in the new business that is expected to be sold in the future.

Such duration mismatches give rise to an exposure to unhedgeable interest rate risk. The choice of liability discount rate (including any liquidity premium) for unobservable durations of the yield curve therefore has a fundamental impact on the volatility of earnings and shareholder equity. The sensitivity of this choice is in general much greater in Asia than elsewhere. In prescribing its methodology for the determination of the liability discount rate, we therefore request that the IASB considers this sensitivity to asset-liability mismatches in Asia and the potential socio-economic impacts that could occur if the resulting accounting volatility were to lead to insurers withdrawing long-dated policies from a market that is currently dependent on them.

Unit of Account

The unit of account for the contractual service margin (CSM) is a material input that will determine the reported profitability of insurance contracts. ASHK believes that to provide investors and other stakeholders with relevant information the unit of account should align with the business model adopted by insurers and the way they manage risk. We are therefore concerned about the tentative decision to measure the CSM at the individual contract level. This is not only operationally difficult to implement, more fundamentally it actually misrepresents the economics of the insurance business, whose most basic principle is the pooling of risk.

Pooling of risk is the fundamental premise on which insurance is based. The insurance contract transfers the burden of a risk borne by the individual to the entire insured population. While the contractual rights and obligations relating to a portfolio of insurance contracts arise from the individual contracts comprising

the portfolio, in a very real economic sense, the converse is true as well. The insurer is able to underwrite and issue the individual contracts only by virtue of the existence of other contracts in the portfolio with which the risk is shared. The individual contracts do not and cannot exist in isolation from the portfolio as a whole. It is not a rational action for an insurer to assume the insurance risk resulting from the issuance of an individual contract unless that risk can be pooled with similar risks of other contracts. The individual contracts would not exist but for the existence of the larger portfolio of contracts. This is fundamental to the insurance business.

The Board appears to believe that the fulfilment cash flows can be measured at the portfolio level while the CSM should be measured at a more granular level, in theory at the individual contract level if sufficient information were available. But the CSM is defined at issue as the negative of the fulfilment cash flows and therefore is necessarily measured at the same level as the fulfilment cash flows themselves. This seems to be an inherent contradiction in the Board's position.

When insurance contracts are priced certain distinct risk characteristics are pooled together and averaged. Depending on the particular characteristic, there may or may not be information to quantify the impact of this averaging. For example, mortality rates differ by age, race, gender and economic status, yet in most jurisdictions only differences by gender and age are recognized in the pricing of life insurance. In some jurisdictions it may be illegal to recognize differences by gender. To our knowledge differences by race are not recognized.

Consider a concrete example. Insurers A and B operate in a jurisdiction where rate differentiation by gender is illegal. They charge the same premium rates and the composition of the insured population is the same for both companies. Suppose further that insurer A is able to quantify the differences in mortality between males and females but insurer B is not. Under the Board's proposed approach Insurer A would need to calculate the CSM and therefore the fulfilment cash flows separately for the two groups. This would render the group of policies issued to males considerably less profitable on average than the group of policies issued to females and in certain circumstances, could cause them to be reported as onerous, while the profits on the policies issued to females would be deferred through the CSM mechanism. On the other hand, Insurer B that issues the same policies but that is not able to quantify the mortality differences between the two groups would report an average profitability. We believe strongly that the reporting by Insurer B is the proper reporting for Insurer A as well as Insurer B. This is consistent with the pricing and management of the business and the fundamental principle of pooling of risk on which insurance is based. We believe that to do otherwise will lead investors to the completely erroneous conclusion that Insurer B is more profitable than insurer A. One can change the example by substituting race, smoking status, family history of heart disease or many other factors in place of gender.

The Board's approach has potentially undesirable implications at transition, if applied as though this had been the approach since issue. Large numbers of contracts could be reported as onerous, while others would have inflated CSM's. The information would be very difficult to explain to external stakeholders.

Unlocking the contractual service margin

The IASB has reached a tentative conclusion that the discount rate for the contractual service margin (CSM) should be locked in at issue. This contrasts with the fulfilment cash flows, which are measured at a current rate. The accounting model therefore becomes mixed – the CSM liability measured using an amortised cost model and the policy liability using a current value approach. Over time the difference between the discount rate embedded in the CSM and the discount rate used for the policy liability can become substantial, potentially leading to results that are difficult to explain.

This feature is more important in Asia than in mature markets due to two factors. Firstly interest rates in much of Asia are more volatile. Secondly in Asia the CSM is large in proportion to the policy liability. This is because margins are generally higher, a larger proportion of protection business is sold, and volumes of new business are greater.

We suggest that the Board consider a model in which the CSM is adjusted at each reporting date by discounting the future amortization amounts at the same (current) rate as the fulfilment cash flows. The accounting model would thus be fully prospective, with the CSM and the fulfilment cash flows measured consistently. Any change in the CSM due to a change in the discount rate would be classified as part of investment results, similar to gains or losses resulting from a change in the fulfilment cash flows.

For portfolios of contracts where the "OCI solution" has been adopted, there would in effect be two CSM's. The above described approach would be used for the balance sheet, while the locked-in approach would be used for the income statement.