

# The Financial Reporter

ISSUE 97 SEPTEMBER 2014

## Trading Places

LIFE AND PENSION ACTUARIES FIND COMMON GROUND TO EXPRESS FUNDING CONCEPTS

By Tom Herget and Evan Inglis

- 1 Trading Places  
Life and pension actuaries find common ground to express funding concepts  
*By Tom Herget and Evan Inglis*

- 2 Chairperson's Corner  
Time Flies!  
*By Bill Sayre*

- 9 The Challenge and Opportunity of Sustainability Reporting—Part 1  
*By Frank Grossman*

- 13 Update on Regulatory Developments  
*By Francis de Regnacourt*

- 15 PBA Corner  
*By Karen Rudolph*

- 18 Communication  
*By Henry Siegel*

- 22 The AAA's Actuarial Opinion and Memorandum (AOM) Discussion Group  
*By Francis de Regnacourt*

**F**rom Tom: Living in the state of Illinois, funding levels of public pension plans are always in the headlines—and it's never good news. At an actuarial club speech a few years ago, the speaker lamented that if life actuaries used pension rules to establish insurance company reserves they would be in jail. Still living in my hometown, I'm friends with many of my schoolmates who became firefighters, policemen and teachers. I'm a well-qualified life actuary, but found myself unable to find the prose to express to these pension fund members the gravity of their situation.

So, I searched for a colleague who had the same passion for this issue and who could translate the life terms into pension ones. My first two attempts fell flat. Then, at a dinner party, I was seated next to Evan Inglis and was amazed to discover that, after happy hour, communications went so well. To that, I should credit techniques championed by Raj Koothrappali.<sup>1</sup>

**From Evan:** Tom, public pension plans are in the news in Illinois, but everywhere else too! I've been following the issue and working and thinking about it for many years. While some systems are in reasonable shape, there are many city and state plans around the country that are heading for disaster. I know it's a complicated issue when even other actuaries like Tom don't fully understand it. Of course, I've always wondered about the actuarial numbers behind life insurance products, so when he described his idea to translate pension information into life insurance terms and vice versa, I said, "Sign me up!"

CONTINUED ON PAGE 4

**2013-2014 Section Leadership**

Bill Sayre, Chairperson  
Tara Hansen, Vice Chairperson  
John Esch, Secretary  
Jim McWilliams, Treasurer  
Larry Bruning, Board Partner  
Henry Egesi, Council Member  
John Esch, Council Member  
Michael McDonald, Council Member  
Craig Ryan, Council Member  
Michael Schmuker, Council Member  
David Weinsier, Council Member  
Kerry Krantz, Web Site Coordinator

**Content Managers**

Lisa Markus, Newsletter Editor  
e: lmarkus@callutheran.edu

Michael Fruchter, Associate Editor  
e: mfruchter@kpmg.com

**SOA Staff**

Sam Phillips, Staff Editor  
e: sphillips@soa.org

James Miles, Staff Partner  
e: jmiles@soa.org

Christy Cook, Lead Section Specialist  
e: ccook@soa.org

Published by the Financial Reporting Section  
Council of the Society of Actuaries

This newsletter is free to section members.  
Current issues are available on the SOA website ([www.soa.org](http://www.soa.org)). To join the section, SOA members and non-members can locate a membership form on the Financial Reporting Section Web page at [www.soa.org/fr](http://www.soa.org/fr).

This publication is provided for informational and educational purposes only. The Society of Actuaries makes no endorsement, representation or guarantee with regard to any content, and disclaims any liability in connection with the use or misuse of any information provided herein. This publication should not be construed as professional or financial advice. Statements of fact and opinions expressed herein are those of the individual authors and are not necessarily those of the Society of Actuaries.

© 2014 Society of Actuaries.  
All rights reserved.

## Chairperson's Corner

### TIME FLIES!

By Bill Sayre

**H**ow quickly a year goes by! While my term as section chair is by no means over, I got my first reminder that the end is rapidly approaching as the registration for the Annual Meeting is now open. It seems like just yesterday that Matt Clark and I were discussing transition plans as his term ended. The older I get, the more precious I value time and realize the importance of using it effectively as it does run away from us very aggressively.

On the subject of the Annual Meeting and the use of time, the Financial Reporting Section Council (FRSC) has played an active role in contributing sessions for the meeting, along with all the contributions of the other sections (the same is true for the Valuation Actuary Symposium, but that will already have occurred as you read this). As I registered for the meeting, I found it difficult to select just one session in each time slot. I am excited for the upcoming meeting and encourage you to register for it, if you have not already done so.

Time moves a little more slowly when it comes to the subject of our GAAP textbook (which is now likely two books—an International Financial Reporting Standards (IFRS) and a US GAAP textbook). Things are moving forward very effectively under the leadership of Tom Herget. He held a kickoff meeting for the IFRS textbook immediately following the Valuation Actuary Symposium. While this has not yet occurred as I write this, I have seen the meeting agenda and he has developed quite an auspicious agenda. I am optimistic as they move forward! The US GAAP textbook will proceed a little later as the Financial Accounting Standards Board (FASB) moves further along with its agenda. Frankly, it is just an exhausting amount of work and I am thankful to have a driven individual like Tom forging ahead for us. Initial prognostication is for a two-year timetable to completion; more to come on this subject.

This is my last column as section chair, and in October I turn everything over to Tara Hansen's capable stewardship. I have been honored to serve the section in this capacity and will continue to do so in other roles even though my term on the FRSC is ending. Thank you! ■



Bill Sayre, FSA, MAAA, is principal and consulting actuary at Milliman. He can be reached at [bill.sayre@milliman.com](mailto:bill.sayre@milliman.com).



## ENTERPRISE RISK MANAGEMENT SYMPOSIUM

**New time of year: Sept. 29 – Oct. 1, 2014.  
Swissotel Chicago, Chicago, IL**

The ERM Symposium is designed to strengthen the standards of ERM practice, grow and develop the current and next generations of ERM practitioners, and facilitate incorporation of best practices from other industries.

The purpose of this symposium is to provide thought leadership to professionals and practitioners working in ERM. Sessions will include discussions on risk topics and challenges across a broad spectrum of industries, as well as support in the development of professionalism and best practices among ERM practitioners without regard to industry, sector or geography.

Learn more at [SOA.org/calendar](http://SOA.org/calendar).



Canadian Institute of  
Actuaries Institut  
canadien  
des actuaires



SOCIETY OF ACTUARIES



*Tom Herget, FSA, MAAA,  
is a retired life actuary.  
He can be reached at  
herg411@gmail.com.*



*Evan Inglis, FSA, MAAA,  
is a pension actuary  
and principal with the  
Terry Group. He can be  
reached at evan.inglis@  
terrygroup.com.*

## OBJECTIVE OF THE PAPER

Here's what we want to do:

- Help life actuaries to understand pension funding mechanics and to help pension actuaries to understand life valuation fundamentals,
- Enable life company actuaries to better grasp the issues surrounding public (state and local government) pension funding,
- Give pension actuaries a look at the funding requirements for life companies, and
- Form a foundation for future comparative and analytic work.

## THE METHOD

Translating pension terminology into the life insurance vernacular is as fun and rewarding as translating British English into American. After some less than successful endeavors to grasp the similarities and differences with words, it appeared the only way out was with numbers. A case study. A very simple case study.

U.S. life companies prepare between three and five sets of financial statements. These accounting methods are statutory, GAAP, tax and perhaps economic value or a foreign parent's shareholder accounting. For this study, we selected U.S. statutory (regulatory) accounting (as opposed to U.S. GAAP) to display life company treatment since required capital calculations are tied to statutory accounting. Also, the resulting liabilities would not be materially different between statutory and GAAP.

Pension valuations are typically of two varieties—accounting and funding. In the world of government pensions, the Government Accounting Standards Board (GASB) recently changed pension accounting rules, but conceptually they are still quite similar to the way plans are funded. In this article we will illustrate the pension approach using typical funding techniques to determine contributions made up of a normal cost plus an amount to amortize deficits or surplus.

## PENSION BENEFITS

Our illustration will focus on a single employee, Kim, who enters the workforce at age 60 then retires at age 65 with a lifetime benefit.

Kim receives annual salary increases, and the employer allows the inclusion of a final payment for unpaid sick and vacation days in the final year of salary. This pushes up the benefit amount and will allow us to illustrate the effect of amortization of deficits in the pension calculations. Kim's annual retirement benefit is based on years of service and pay, like this:

$$\text{Ben65} = \text{FAP} \times \text{YOS} \times 2\%$$

- Ben65 is the benefit payable at the normal retirement age of 65.
- FAP is final average pay; in this case we use one year of pay only and the last year will include extra pay for unpaid sick and vacation days.
- YOS is years of service.

**Table 1**

Age	Salary	Spiked Salary Last Day of Year	Unspiked Cumulative Retirement Benefit	Spiked Cumulative Retirement Benefit
60	50,000	50,000	1,000	1,000
61	51,875	51,875	2,075	2,075
62	53,820	53,820	3,229	3,229
63	55,839	55,839	4,467	4,467
64	57,933	67,933	5,793	6,793

## KEY ASSUMPTIONS

The pricing (not accounting) interest environment is 4.5% level—a 4.5% return on assets (equal to the yield after defaults on a high-quality fixed income instrument) is assumed for the entire pricing period. Since life companies don't put equities into their general accounts, this reflects a high-grade corporate bond type of investing. In the pension world, the typical asset allocation is about 50% to equities, 25% to fixed income and 25% to real estate, private equity and other alternative investments. However, in our example, we assume a 4.5% return on the assets to facilitate comparison with the insurance company world.

We assume that mortality is also the same in the different environments, although government pension plans would generally use less conservative mortality rates than insurance companies. This study uses the RP2014 healthy table. Mortality improvements of 2% are projected annually for 10 years.

This is an extremely efficient enterprise, so there are no acquisition costs and no maintenance costs on the insurance side. The tax rate in this jurisdiction is 0%.

So far, we have created an environment where insurance and pensions are on even ground.

Now, let's take a look at the differences!

## THE INSURANCE COMPANY GROSS PREMIUM

An annuity factor at age 65 using the interest and mortality assumptions described above is 13.08. Multiplying this by the annual benefit (with spiked pay) of \$6,793 generates a single premium of \$88,851, which generates a present value of benefits equal to \$68,174 at age 60.

Most life insurance products are developed anticipating the policyholder will pay a level dollar premium. The level premium over five years for these benefits is \$15,098. This premium is then loaded by 12% to cover risk, the cost of capital and to provide a provision

for profits. (Please don't ask how the 12% was developed—our proprietary methods cannot be divulged). This generates a gross annual premium of \$16,910. We expect Kim to pay five of these.

Please note that the insurance company insisted on recognizing the retirement benefit based on the expected "spiked" salary average.<sup>2</sup> While the pension plan provisions may or may not guarantee this, it has been the practice at Kim's employer for over a decade. Had not the life company understood this at contract inception, it still would have been required to establish similar reserves using the expected level of benefit payments based on best estimate assumptions used for cash flow testing in statutory accounting and for loss recognition testing dictated by U.S. GAAP accounting. For U.S. life companies, a liability using best estimate assumptions prevails over the often locked-in assumptions used as of policy issue date.

## CASH FLOWS

The first 10 years' expected cash flow pattern, for the insurer, excluding interest, is:

**Table 2**

Age	Cash Flows
60	16,910
61	16,779
62	16,640
63	16,492
64	16,336
65	(6,496)
66	(6,424)
67	(6,347)
68	(6,265)
69	(6,177)

The cash outflows starting age 65 would be the same for the public pension plan but the cash inflows will be different, as we will get to in a moment.

CONTINUED ON PAGE 6

## INSURER FINANCIAL STATEMENT

Assets accumulate from cash flows. Benefit payments draw down the assets. For the insurer, there is an additional source of cash drain: dividends paid to shareholders. Before a shareholder dividend can be paid, the insurer needs to be sure it is retaining an amount of capital adequate to satisfy regulators and to receive a satisfactory evaluation from rating agencies.

In our example, required capital is established as 5% of reserves—in other words, additional funds are set aside to ensure the insurance company's viability, even in adverse circumstances. A key component of this cushion will be to provide for interest rate risk.

A major insurer concern is an unexpected demand by policyholders to cash in their policies in a rising interest rate environment—aka disintermediation. Policyholders take their cash value and run—to seek out higher-yielding policies. This would force an insurer to sell assets at a loss while the policyholder's cash value experiences no loss. As the accumulation period winds down, and the policyholder transfers to income-paying status, the option to cash in the policy disappears and this interest rate risk diminishes. Consequently, at the retirement age of 65, the required capital drops to 3% since this disintermediation risk is no longer a possibility.

Statutory reserves are calculated using assumptions that are conservative for the environment at the time

the policy is issued. Interest has been lowered to 3.5%, and mortality has assumed an additional 3% annual improvement forever.

Table 3 shows excerpts from the insurance company financial statements.

Note the distributable earnings (shareholder dividend) column. The negative numbers in the first years indicate that shareholders (often a holding company) will need to provide additional funds—in other words, overall dividends from the company will be reduced in order to maintain a resilient balance sheet while this new business develops. The ability to distribute earnings from this policy improves as the required surplus drops to 3% of liabilities.

Life insurers are often owned by holding companies. These holding companies will periodically provide their subsidiaries with fresh capital to either support new business like Kim's policy or to shore up a weakened position.

How funded is this? In year 1, the ratio of assets to liabilities for the company is 105%; in year 10, 103%. Further, the liabilities use conservative valuation assumptions, which provide for adverse deviation and cushion for solvency.

Surplus actually held by companies is dictated by what the market and rating agencies demand. Actual surplus

**Table 3**

Age	Distributable Earnings	Ending Balance Assets	Liabilities	Surplus
60	(1,322)	18,993	18,089	904
61	(1,038)	38,420	36,590	1,830
62	(468)	58,005	55,508	2,498
63	14	77,836	74,842	2,994
64	505	97,905	94,594	3,311
65	1,652	93,871	91,137	2,734
66	1,122	90,260	87,631	2,629
67	1,085	86,604	84,081	2,522
68	1,048	82,905	80,491	2,415
69	1,012	79,169	76,864	2,306

being held will be notably higher than what we illustrate here.

Kim is sleeping well.

### PUT ON THE PENSION HAT

Now that we have seen how a life company would determine then fund for its liabilities, let's see how the public pension world differs.

First, the funding would be based not on a level dollar amount, but on a level percentage of salary because the pension is a component of pay. In the real world, this difference is more significant than in our five-year example.

Second, the funding, in practice, has been based on a benefit that doesn't anticipate any surge of annual salary a moment before retirement. This additional benefit has not been accrued during the active working period but is recognized the moment Kim retires. With a typical pension funding approach, any newly observed liabilities are not immediately funded but instead are incrementally recognized evenly over a 30-year period. The term for this delayed recognition is called amortization, a term life company actuaries use for adjusting asset values.

### BUT WAIT

Before we proceed, let's look at terminology. The concepts are very much the same, but the names and numbers are different.

Life Insurance	Pension Actuarial
Gross premium	Normal cost
Reserve	Actuarial accrued liability (AAL)
Paid premium	Contribution

### THE LIABILITY SIDE UNVEILED

For pension calculations, we will use the entry age normal, level percent of pay method for allocating costs. Table 4 shows the actuarial liability using this method.

**Table 4**

Age	AAL (EOY)
60	12,211
61	25,520
62	39,970
63	55,567
64	88,851
65	85,751
66	82,587
67	79,363
68	76,082
69	72,748

Notice that the liability is pushed up substantially when the actual benefit based on final salary is determined in year 5. Below we describe how this change in liability is paid off gradually over a 30-year period. Here are the amounts that the insurance approach requires to be set aside compared to the pension liability.

**Table 5**

Age	Life Company				Targeted Level of Funding (Assets) Using 30-Year Amortization
	Company Liabilities	Company Capital	Assets (Liabilities plus Capital)	Pension Actuarial Accrued Liability	
60	18,089	904	18,993	12,211	12,211
61	36,590	1,830	38,420	25,520	25,520
62	55,508	2,498	58,005	39,970	39,970
63	74,842	2,994	77,836	55,567	55,567
64	94,594	3,311	97,905	88,851	72,169
65	91,137	2,734	93,871	85,751	68,988
66	87,631	2,629	90,260	82,587	65,743
67	84,081	2,522	86,604	79,363	62,437
68	80,491	2,415	82,905	76,082	59,074
69	76,864	2,306	79,169	72,748	55,657

CONTINUED ON PAGE 8

The insurer provision (column 4) is significantly higher than its pension counterpart (column 6) for several reasons:

- Use of level, not increasing, funding premiums in the accumulation period,
- Immediate and full recognition of the anticipated benefit,
- Use of conservative interest and mortality assumptions, and
- The requirement to hold capital to support uncertainty.

### BUT WAIT, THERE'S MORE

The prior section dealt only with the liability. What about the assets supporting these commitments?

In the insurer world, the policyholder remits the gross premium. The insurer holds it and invests it. It only relinquishes earnings to shareholders after benefits have been paid and when certain risk thresholds have been surpassed.

In the public pension world, contributions are determined as the normal cost plus an amortization amount to pay down the deficit or reduce surplus—the target is for the plan to eventually be 100% funded. The normal cost pays for benefits during the current year. The amortization is designed, theoretically, to pay off the entire deficit over a certain period of time—often 30 years. The amortization payment is usually back-loaded by assuming that it will increase each year with pay and be a constant percentage of the payroll. The amortization is frequently “open,” meaning that a new 30-year amortization is calculated every year and the prior year’s 30-year amortization schedule is wiped out.

Table 6 illustrates how a typical open amortization approach to paying off the unanticipated increase in liability due to spiked salary would work. This information is compared to the insurance company funding. The pension information in column 3 can be compared to the higher level of insurance company funding in column 5.

Note how the amortization of unanticipated increases in the liability for pensions defers funding well into the future, resulting in low levels of assets relative to the AAL.

### IN CONCLUSION

So what have you learned? The pension actuary and life actuary can now gauge standard practices in each other’s world where the objective is essentially the same: to make good on promises to pay benefits in the future. The life company actuary can now better anticipate his conversation in the supermarket when the talk turns to public pension funding.

It seems ironic that the same legislators who pass such strict laws for insurers don’t provide the same level of security for employees of their own jurisdictions. Why can’t legislation be passed or accounting rules changed to recognize obligations to safeguard the retirement of its employees? ■

### ENDNOTES

<sup>1</sup> See any episode of “The Big Bang Theory.”

<sup>2</sup> “Spiking” has been well-publicized and still exists, but is less common today than it was in the past. In this article, we use spiking as a convenient way to illustrate an unanticipated change in cost for the pension plan to illustrate how pension methods deal with deficits.”

**Table 6**

Age	AAL	Assets Based on 30-Year Amortization Increasing with Payroll	Pension Funded Status	Assets Based on Insurance Company Premium	Pension Funded Status
60	12,211	12,211	100%	18,993	156%
61	25,520	25,520	100%	38,420	151%
62	39,970	39,970	100%	58,005	145%
63	55,567	55,567	100%	77,836	140%
64	88,851	72,169	81%	97,905	110%
65	85,751	68,988	80%	93,871	109%
66	82,587	65,743	80%	90,260	109%
67	79,363	62,437	79%	86,604	109%
68	76,082	59,074	78%	82,905	109%
69	72,748	55,657	77%	79,169	109%
70	69,365	52,191	75%	75,401	109%
71	65,940	48,682	74%	71,606	109%
72	62,478	45,137	72%	67,791	109%
73	58,987	41,562	70%	63,963	108%
74	55,476	37,966	68%	60,132	108%
75	51,954	34,359	66%	56,337	108%

# The Challenge and Opportunity of Sustainability Reporting—Part 1

By Frank Grossman

**T**he subject of this extended article is a new and emerging counterpoint to financial reporting, namely sustainability reporting. The first portion of the article, describing the advent and recent evolution of sustainability reporting, as well as its relevance to actuaries, is set out below. Its second and concluding installment is forthcoming, and will deal with the way forward for sustainability reporting, as well as the opportunity it presents for insurance companies.

## 1. THINGS NOT TRADITIONALLY TAKEN INTO ACCOUNT

Financial actuaries worth their salt have a keen appreciation of how well financial accounting standards support the various accounting principles. Proper recognition of income and expenses can be a challenge for life insurance products, due to their intricacy and inherent risk-transforming nature. The myriad complexities of accounting for acquisition costs, flexible as opposed to scheduled premiums, and embedded options—whether hedged or not—will doubtless be familiar to many readers.

One accounting principle is often completely taken for granted. This is the requirement that only events or transactions that can be expressed in monetary terms be reported. And yet, the financial consequences of certain events can be difficult to quantify, at least in the near term. Particular examples include the resolution of a key management disagreement, development of

a new product or sales concept, and the loss of intellectual capital due to staff turnover. It's possible that details about these types of events may be located in footnotes to the financial statements, but by and large they are "externalities," or things not otherwise taken into account.

Taking a broader perspective, there has been growing public awareness of a number of social and environmental issues in recent years, not only at home but around the world. These issues include the apparent threats posed by communicable diseases such as HIV/AIDS, climate change, lax labor standards, obesity, and the degradation of our environment. Greater awareness has led to an unprecedented level of scrutiny of firms, including those in the insurance industry, and the sustainability of their business practices. However, the economic consequences of such issues are generally not included in traditional financials, and the risk is that they too are deemed to be externalities by management teams.

## 2. EMERGING FRAMEWORKS

In response to growing interest, there has been a significant increase in the voluntary disclosure of non-financial information by firms. Initially done on an ad hoc manner beginning in the late 1990s, these disclosures have achieved greater consistency and breadth over the intervening years, due in large part to the emergence of several reporting frameworks.



Frank Grossman, FSA, FCIA, MAAA, is based in Toronto, Canada. He can be reached at [Craigmore54@hotmail.ca](mailto:Craigmore54@hotmail.ca).



CONTINUED ON PAGE 10

The United Nations (UN) Global Compact is the largest voluntary corporate responsibility initiative in the world with over 12,000 corporate participants in more than 145 countries. Launched in 2000, the UN Global Compact encourages firms to align their operations and strategies with 10 universally accepted human rights, labor, environment and anti-corruption principles.

- Human Rights (principles 1-2)—Businesses should support and respect the protection of internationally proclaimed human rights; and make sure that they are not complicit in human rights abuses.
- Labor (principles 3-6)—Businesses should uphold the freedom of association and the effective recognition of the right to collective bargaining; the elimination of all forms of forced and compulsory labor; the effective abolition of child labor; and the elimination of discrimination in respect of employment and occupation.
- Environment (principles 7-9)—Businesses should support a precautionary approach to environmental challenges; undertake initiatives to promote greater environmental responsibility; and encourage the development and diffusion of environmentally friendly technologies.
- Anti-Corruption (principle 10)—Businesses should work against corruption in all its forms, including extortion and bribery.

An international coalition of investors and non-governmental organizations (NGOs), Ceres, in collaboration with the Tellus Institute and with the support of UN Environment Program (UNEP) launched the Global Reporting Initiative (GRI) in 1997. Their shared challenge was to develop a standardized approach from the several competing sustainability reporting visions. Today the GRI is based in Amsterdam, and more than 2,500 firms worldwide use its framework to voluntarily inform their stakeholders about how they are integrating sustainability into their operations.

More recently, at the 2012 UN Conference on Sustainable Development held in Rio de Janeiro (aka Rio+20), a set of four Principles for Sustainable Insurance (PSI) was launched with the support of the UNEP's Finance Initiative and 27 insurance company signatories. The four principles are as follows:

1. We (the insurance companies) will embed in our decision-making environmental, social and governance issues relevant to our insurance business.
2. We will work together with our clients and business partners to raise awareness of environmental, social and governance issues, manage risk and develop scenarios.
3. We will work together with governments, regulators and other key stakeholders to promote widespread action across society on environmental, social and governance issues.
4. We will demonstrate accountability and transparency in regularly disclosing publicly our progress in implementing the principles.

Though there are 42 PSI signatory companies today, only one is domiciled in either the United States or Canada: the Co-operators Group, based in Guelph, Ontario.

### 3. SIMILAR BUT DIFFERENT

In practice, corporate responsibility reporting can often be reactive, responding to public relations crises and adopting a defensive stance. Some firms focus narrowly on issues such as the cost of limiting their greenhouse gas emissions. Too often, the linkage between vague statements and circumscribed data disclosures that comprise some corporate responsibility reports on one hand, and management's strategic goals and the viability of its underlying business model on the other, may be weak or absent.

Sustainability reporting, by comparison, describes sustainability objectives and relates progress toward achieving those goals. It strives to augment traditional financial reporting by delivering an unvarnished and comprehensive self-assessment of the environmental, social and governance (ESG) issues that affect the firm and its stakeholders. Figuratively speaking, sustainability reporting succeeds by getting the firm's externalities on the table for all to see.

The foregoing might prompt one to ask: What is sustainability? The adjective "sustainable" means something that can be maintained over time. Twenty-five years ago, the UN World Commission on Environment

and Development defined “sustainable development” as development that “meets the needs of the present generation without compromising the ability of future generations to meet their own needs.” Hence, a sustainable business strategy, which resides at the core of sustainability reporting, is one that paves the way for success over the long run—a time frame that seems only natural to most actuaries.

#### 4. THINKING CAPS ON

Sustainability reporting may seem like a complex, unstructured problem to many, and its resource requirements should not be underestimated. Identifying or creating reliable data across one’s organization can be an obstacle, particularly for multinationals operating in different jurisdictions or industries. Developing key performance indicators that make sense is an ongoing challenge. And, delivering a single integrated report is becoming the new norm. Even though sustainability reporting frameworks offer much-needed structure and promote comparability, they may lack the flexibility needed to capture the circumstances and issues confronting individual firms.

Insurance company issues typically addressed by sustainability reporting often reside in the catch-all category of operational risk—for example: regulatory concerns about product suitability; technological safeguards associated with data security and privacy concerns; physical risks to plant and staff posed by extreme weather events and inundation; and resource issues like energy costs and the development and retention of human capital. Firms may understandably struggle to gain a thorough appreciation of how sustainability issues affect their entire value creation chain, from suppliers through to clients and their beneficiaries.

Common examples, such as installing solar panels on the head office roof, and taking steps to improve energy efficiency, may appear to be good news all around. However, providing free parking for staff, and indirectly promoting personal vehicle use, may present quite a different sustainability story. And the real-world complexity of sustainability reporting doesn’t end there.

---

**“...sustainable development...meets the needs of the present generation without compromising the ability of future generations to meet their own needs.”**

---

How sustainable is a product development strategy that sails too close to the wind when interpreting relevant statutes and supervisory guidelines in an attempt to win market share? In another real-world example, U.S.-based companies are increasingly transferring back office functions to low-cost countries where labor markets and environmental conditions are more lightly regulated. Just how does one begin to assess the hidden social and environmental costs of outsourcing, including the elimination of jobs closer to home?

#### 5. SHAREHOLDER VERSUS STAKEHOLDER VALUES

At one point, the basic question arises: What should be the purpose or goal of a firm? This question can obviously trigger a wide range of strongly held opinions. One familiar answer is that a firm should exist solely to make money for its shareholders. Support for this view can be traced back through Milton Friedman all the way to Adam Smith and his view that most companies do good simply as a byproduct of their pursuit of profits—that private profit is a public virtue. And, by extension, Friedman held that the firm’s only responsibility to non-shareholders is that which is required by the law.

Alternatively, supporters of a stakeholder theory of the firm, first articulated by Edward Freeman in the early 1980s, believe that the firm must balance the needs of all stakeholders, and this means any group affected by the activities of the firm. Stakeholders include not only shareholders, but the firm’s employees, customers, suppliers and the government, as well as the commu-

CONTINUED ON PAGE 12

**Table 1: GRI Sustainability Disclosure Database—Number of Reports Filed\***

	2008			2013			2008 to 2013 Increase		
	Financial Services	Other	Total	Financial Services	Other	Total	Financial Services	Other	Total
Northern America <sup>†</sup>	20	140	160	59	536	595	195%	283%	272%
Europe	95	432	527	181	1,168	1,349	91%	170%	156%
Other	56	449	505	249	1,639	1,888	345%	265%	274%
Total	171	1,021	1,192	489	3,343	3,832	186%	227%	221%

\*Note that not all reports included in GRI database are compliant with the most recent GRI Guidelines.

<sup>†</sup>Northern America (sic) excludes Latin America and the Caribbean.

nity in which the firm is physically located. Because sustainability reporting transcends financial reporting's focus on net income, it speaks to those who may not be investors, and yet are deeply invested in the ongoing success of the firm. And these external stakeholders are increasingly asking tough questions, pointing out strategic options, monitoring progress and holding management accountable. The challenge of responding effectively to these diverse audiences may seem overwhelming, and yet doing so is essential to long-run sustainable wealth creation.

## 6. GAINING TRACTION

The emergence of a standard framework for sustainability reporting, namely the GRI mentioned previously, has facilitated its adoption by firms, both across industry sectors and around the globe. Over their short history, the GRI Sustainability Reporting Guidelines have evolved, and become more stringent. The most recent fourth release (G4) aims to "help reporters prepare sustainability reports that matter, [and] contain valuable information about the organization's most critical sustainability-related issues."

The Corporate Sustainability Reporting Coalition (CSRC), spearheaded by U.K.-based insurer Aviva, representing financial institutions, professional bodies, NGOs and investors with US\$2 trillion of assets under management, sought greater disclosure of ESG performance via a global Convention on Corporate Sustainability Reporting presented at Rio+20. Despite the horse-trading typically encountered when drafting a UN conference communiqué, there was partial acceptance of the CSRC's policy proposal. In particular, its call for greater integration of sustainability issues within the annual reports of all listed and large private companies is reflected in Point 47 of "The Future We Want" agreement:

*We (the UN member states) acknowledge the importance of corporate sustainability reporting and encourage companies, where appropriate, especially publicly listed and large companies, to consider integrating sustainability information into their reporting cycle. We encourage industry, interested governments and relevant stakeholders with the support of the United Nations system, as appropriate, to develop models for best practice and facilitate action for the integration of sustainability reporting, taking into account experiences from already existing frameworks and paying particular attention to the needs of developing countries, including for capacity-building.*

A second core element of the CSRC proposal advocated for sustainability reporting on a "report or explain" basis, and this was not taken on board at the conference. "Report or explain" means that firms may elect not to report on sustainability issues, but they would have to explain their reasons for opting-out to their stakeholders. Essentially, this was a continuation of the voluntary approach to sustainability reporting, but required a good reason—or at least a plausible excuse—for noncompliance.

## 7. EVER-PRESENT PITFALL

Maybe it's not so surprising, in an age of widespread disbelief, that skepticism about corporate progress on the environmental front has generated a new dictionary definition. The term is "greenwash," which is defined as "misleading information disseminated by an organization so as to present an environmentally responsible public image." Clearly, there is some particular need for firms to avoid the temptation to burnish their green credentials by overstating ESG results, and thereby risk having their sustainability reports dismissed as just another greenwashing effort. On reflection, sustainability reporting seems to necessitate adherence to another age-old accounting principle in order to be wholly credible—the principle of conservatism. ■

# Update On Regulatory Developments

By Francis de Regnaucourt

This is a quarterly update on developments at the National Association of Insurance Commissioners (NAIC), the International Association of Insurance Supervisors (IAIS), as well as other groups who may get involved in group supervision, with emphasis on those that may be important to members of the Financial Reporting Section.

In March 2014, New York Department of Financial Services (NYDFS) announced its intention to update reserving formulas for term business issued after Jan. 1, 2015, greatly simplifying the current XXX process and reducing reserves significantly based on empirical evidence of mortality improvement.

In June 2014, the Senate passed a bill to clarify the “Collins Amendment” and allow the Federal Reserve to apply insurance-specific capital standards to the insurance portion of groups they supervise.

The NAIC does not have an in-person meeting during the second quarter, but the Life Actuarial Task Force (LATF) and its working groups continue to push many initiatives forward. We report below on a few items that may be of interest to members.

On the international side, the IAIS has started work on its basic capital requirements (BCR) formula. The formula structure has been exposed, and the development of the specific risk coefficients is to be completed by the end of 2014. Capital standards are extremely important to the insurance industry, and there have been several comments that the process needs to be made more transparent well before the standards are finalized.

## NEW YORK REVISIONS OF XXX (AND POSSIBLY AXXX) RESERVES

On March 27, 2014, New York’s Superintendent of the Department of Financial Services issued a letter to other insurance commissioners setting out the department’s intention to overhaul XXX (and eventually AXXX) reserves.

For term life policies issued after Jan. 1, 2015, they will propose regulation changes to allow:

- Annual mortality improvement adjustments to the 2001 CSO table of 1 percent for years 2008-2047 and 0.5 percent thereafter, during the initial level term

period only;

- A two-year full preliminary term formula to reflect the higher up-front expenses of issuing term business.

The department said that the XXX methods produced reserves that were high in relation to emerging actuarial experience, and that the new proposed method should reduce reserves by 30 to 35 percent. They plan to address AXXX reserves for universal life with secondary guarantees next.

This is a radical departure from the department’s past position. New York is also taking a different direction from the principle-based reserves approach adopted by the NAIC, but for the time being, the NAIC’s Principles Based Reserving Task Force is continuing its work as before. As of this writing, we know of no discussions taking place to reconcile the two approaches, but we will continue to report on developments.

## FEDERAL REGULATION: CLARIFICATION OF THE “COLLINS AMENDMENT”

On June 3, 2014, the Senate passed S. 2270, “the Insurance Capital Standards Clarification Act of 2014,” to clarify Section 171 to the Dodd-Frank Act (the “Collins Amendment”). This amendment, introduced in 2010 by Senator Susan Collins (R-Maine), was meant to hold insurers deemed “too big to fail” (known as Systemically Important Financial Institutions or SIFIs) to capital standards at least as high as those required for community banks.

“At least as high” does not mean that the expectations are the same for all institutions. The Federal Reserve has “tailored expectations for BHCs<sup>1</sup> of different sizes, scope of operations, activities, and systemic importance in various aspects of capital planning,”<sup>2</sup> showing its willingness to customize its regulatory analysis to the unique circumstances of individual institutions. Its lawyers, however, were concerned that the Collins Amendment could be interpreted to require the same capital rules for SIFIs as for banks, in effect taking away the Fed’s flexibility.



Francis de Regnaucourt, FSA, CERA, FCIA, MAAA, is a director at KPMG. He can be reached at fderegnaucourt@kpmg.com.

CONTINUED ON PAGE 14

In a March 2014 statement, Senator Collins clarified that her intentions were not to “supplant prudential state-based insurance regulation with a bank-centric capital regime for insurance activities,” and sponsored Bill S. 2270, to allow the Fed to apply insurance-based capital standards to the insurance portion of the business, while still keeping banking capital standards for the banking portion of the business.

Most observers expect the companion House bill (H.R. 4510) to get support in the House Financial Services Committee, and to be passed as well. This should allow the Fed to set capital standards better tailored to the insurance operations of SIFIs.

## NAIC DEVELOPMENTS

The American Academy of Actuaries (AAA) Life Experience Subcommittee is continuing work on a proposed 2014 VBT mortality table with a view toward a proposal at the NAIC’s summer meeting in August. The current work focuses on (a) the slope of the mortality curve at older ages, and (b) margins to be included for confidence levels, variations among companies, random fluctuations and unknown fluctuations.

LATF is working on a number of technical changes to VM-20 with the help of the AAA’s Life Reserving Working Group: treatment of due and deferred premiums, and the small company exemption among them.

LATF also has a working group on non-forfeiture values for guaranteed living benefits. The idea is that the policyholder pays a premium for a significant option and should get a refund of the unused part of that option if they surrender the contract.

## IAIS BASIC CAPITAL REQUIREMENTS (BCR)

The IAIS held an observers’ session on BCR on March 14, 2014, ahead of its field testing with insurers who are likely to be designated Internationally Active Insurance Groups (IAIG). The current plan<sup>3</sup> is to set BCR based on exposures to six categories of activity:

- Traditional life insurance (risk-weighted liabilities),
- Traditional non-life insurance (risk-weighted liabilities),

- Assets (risk-weighted assets),
- Asset-liability matching (indicator to reflect mismatch),
- Non-traditional insurance (other indicator or estimate), and
- Non-insurance (measure based on the non-insurance sector, e.g., Basel requirements for banks).

$$\text{BCR} = \alpha \{\beta_1 (\text{Trad Life}) + \beta_2 (\text{Trad Non-Life}) + \beta_3 (\text{Assets}) + \beta_4 (\text{ALM}) + \beta_5 (\text{Non-Trad Ins})\} + \gamma (\text{Non-Ins})$$

The current BCR proposal is to multiply each of the indicators of activity by coefficients calibrated to reflect relative riskiness, and the overall level of confidence. Coefficients are to be developed in the field testing exercise.

Dr. Yoshihiro Kawai, the secretary-general of the IAIS, spoke on this topic at the NAIC’s International Insurance Forum in May 2014. He reported that the IAIS intended to complete the BCR formula and make it public by the end of 2014. Several attendees at the conference expressed concern about their perceived lack of openness around the process for setting the coefficients in the formula. Connecticut Governor Dannel Malloy, in a keynote address the previous day, had also commented that capital rules needed to be developed in a way that was acceptable to the industry and to the United States. This writer agrees. Capital standards are crucial to the industry, and the process of defining them would benefit from open discussion and participation by all parties, including those subject to them. Dr. Kawai was very graceful in his remarks, and we expect he will respond equally gracefully to the concerns voiced at the forum. ■

## ENDNOTES

<sup>1</sup> Bank holding companies.

<sup>2</sup> Source: Capital Planning at Large Bank Holding Companies: Supervisory Expectations and Range of Current Practice, U.S. Federal Reserve, August 2013.

<sup>3</sup> The entire presentation is available at [www.iaisweb.org/view/element\\_href.cfm?src=1/21698.pdf](http://www.iaisweb.org/view/element_href.cfm?src=1/21698.pdf).

# PBA Corner

By Karen Rudolph

*The views expressed in this article are those of the author and do not necessarily reflect the views of Milliman nor are they intended as methods of regulatory or tax compliance.*

## UPDATE ON STATE ADOPTION STATUS OF PRINCIPLE-BASED RESERVES

Fifteen states adopted the complement of principle-based reserve (PBR) legislation in either 2013 or 2014. These states include Arizona, Indiana, Iowa, Louisiana, Maine, Mississippi, Nebraska, New Hampshire, New Mexico, Ohio, Oklahoma, Rhode Island, Tennessee, Virginia and West Virginia. Total premium contributed by these 15 states, based on 2008 annual statement data, is 19 percent. Three state legislatures have advanced the PBR package to the governor and await signatures, including Connecticut, Florida and Hawaii. These states are expected to have the adoption in place for 2014, providing an additional 9 percent of premium for a total count of 18 states and 28 percent of industry premium. This implies a gap of 24 states and 47 percent of premium in achieving an operative date for the Valuation Manual. There are states in which the PBR package is in various earlier stages of introduction. These include Georgia, Illinois, Missouri, Texas and Washington.

## NEW YORK PROPOSED AMENDMENTS TO REGULATIONS 147 AND 179

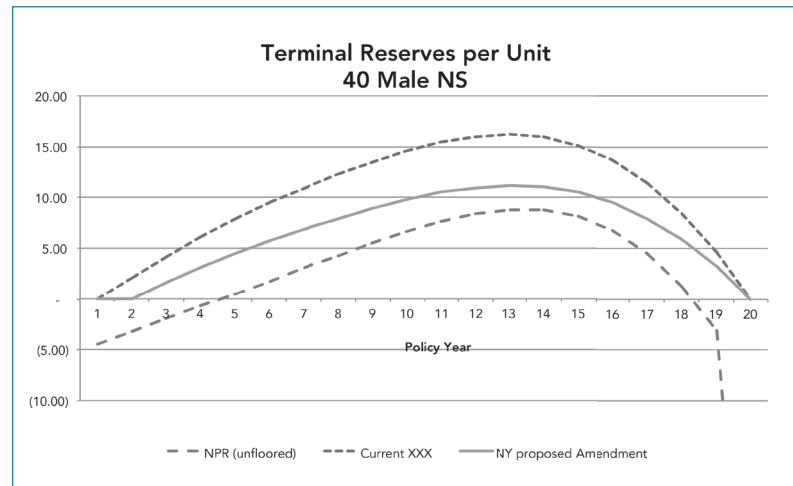
On April 30, 2014, the New York Department of Financial Services (NYDFS) proposed changes to its term reserving requirements by issuing proposed changes to Regulation 147 (Valuation of Life Insurance Reserves) and Regulation 179, which recognizes and permits use of the 2001 CSO Mortality Table and corresponding preferred mortality tables. This proposal follows the March 27, 2014 N.Y. Superintendent's letter to insurance commissioners that "... our term life formula results in reserves that are high relative to actuarial experience and should be modernized." The proposed changes to N.Y. regulations include two critical elements applicable only to varying premium term life insurance policies<sup>1</sup>: (i) allowance of a prescribed

level of mortality improvement in the first segment and (ii) introduction of an alternative segment method which, together with the unitary method,<sup>2</sup> is to be used as the basic reserve for varying premium term life insurance policies issued on or after Jan. 1, 2015. The alternative segment method is equivalent to a two-year preliminary term methodology during the first segment. The recognition of mortality improvement provides the majority of reserve relief from current Triple-X minimum reserves. The chart below uses the single-cell 20-Year Level Term policy from the December 2013 *Financial Reporter* PBR Corner article and overlays this demonstration with the NYDFS proposed amendment reserve for a policy issued in 2015. The NYDFS March 27, 2014 letter included a similar chart and suggested the reserve reduction would be 30 to 35 percent on a prospective basis. Both charts support this claim.

It is not surprising to see the N.Y. proposed reserve comes in higher than the PBR floor reserve (i.e., the net premium reserve (NPR)) given New York's continued opposition to components of PBR in general. The comment period for these proposals ended on June 16, 2014. NYDFS has also indicated it continues with efforts to modernize its reserve standards for universal life with secondary guarantee (ULSG) products. This is a direct result of New York's rejection of the Actuarial



Karen Rudolph, FSA, MAAA, is a consulting actuary at Milliman Inc. She can be reached at Karen.rudolph@milliman.com.



CONTINUED ON PAGE 16

Guideline 38 compromise, advanced by the National Association of Insurance Commissioners (NAIC) last September. This initiative will be more difficult, obviously, given the flexible nature of ULSG policies.

The Life Insurance Council of New York, Inc. (LICONY), which is an industry group for N.Y. companies, issued a response letter to NYDFS on June 13, 2014. In the letter, LICONY applauds NYDFS for acknowledging the conservatism in today's term life insurance reserves, but goes on to point out critical items that may preclude companies from benefiting from the NYDFS proposal.

- The scope of the proposal will benefit life insurers domiciled in New York that write business only in New York. Companies domiciled in New York and writing business in New York and other states will still need to meet the minimum reserve requirements of the other states, and no other state is contemplating changes similar to NYDFS' proposal.
- It is unclear to LICONY whether NYDFS intends to allow the recognition of mortality improvement in the deficiency reserve calculation as well as the basic reserve calculation. The proposed amendments appear to revise only the section of New York's regulations that pertain to basic reserves. If the mortality improvement is disallowed for deficiency reserves, LICONY points out that little reserve relief will occur should the deficiency reserve level remain unchanged.
- Another critical observation pertains to New York's Special Considerations Letter (published Oct. 31, 2013).

In the context of aggregate life insurance reserves, LICONY points out that the onerous requirements of the Special Considerations Letter work to dictate an aggregate reserve floor that may be unaffected by the NYDFS term reserve proposal. Specifically: (i) disallowing mortality improvement beyond the valuation date of the analysis, (ii) the requirement to "pass" all the N.Y. seven interest rate scenarios; (iii) the 125-basis-point net yield pick-up test, (iv) disallowing recognition of tail profits for level premium term insurance in the analysis, and (v) capping the lapse rate for ULSG policies at 1 percent for durations 11 and later without regard to actual company experience.

## AMERICAN COUNCIL OF LIFE INSURERS (ACLI) SMALL COMPANY EXEMPTION AND OTHER PROPOSALS

ACLI and its member companies advanced several proposals to the Life Actuarial Task Force (LATF) of the NAIC. One proposal outlines criteria for exemption from the modeled components (deterministic reserve; stochastic reserve) of VM-20. At the time of this article, LATF was considering ACLI's proposals and requesting demonstrations to facilitate discussion. A summary of the proposals follows. As of this article, regulators have taken no action on these items.

1. Small Company Exemption. The objective of this proposal is to proportion the work imposed by VM-20 to the size and risk of the company. Currently, VM-20 allows exemption by product based on the risk profile of the product through use of the stochastic exclu-



sion test and deterministic exclusion test. ACLI suggests these tests represent a material amount of work for some companies and the proposal would permit companies meeting certain criteria to forgo the work involved in these exclusion tests and continue to apply the minimum reserve standards of VM-A and VM-C. The criteria include:

- a. Company has less than \$300 million of ordinary life premium and, if the company is a member of an NAIC group of life insurers, the group has combined ordinary life premiums of less than \$600 million, and
- b. The company reported total adjusted capital of at least 450 percent of the authorized control level risk-based capital (RBC) in the most recent RBC report, and the appointed actuary has provided an unqualified opinion on the reserves, and
- c. Any ULSG policies issued or assumed by the company after the operative date of the Valuation Manual meet the definition of a non-material secondary guarantee ULSG product.

In the case of a company meeting the criteria, minimum reserves for the non-material ULSG policies would be the VM-20 Section 3 NPR (for basic reserves) and VM-A, VM-C reserves for the alternative minimum (or deficiency) reserves; and such policies would not be deemed to automatically fail the deterministic exclusion test.

It is notable that the state of Oklahoma included a similar exemption in its adopted legislation (SB2045). In the Oklahoma law, the premium thresholds are \$300 million/\$1 billion; the RBC threshold is 450 percent; and the actuarial opinion must be unqualified. There is no non-material ULSG criterion. No other state has included such a provision in its adopted version. The domestic industry in Oklahoma pressed its regulators for this provision and it was supported by the commissioner. Should the ACLI's provision or another company exemption provision be included in the Valuation Manual, it is likely the Oklahoma version will be modified to be consistent with the NAIC version.

2. Non-Material Secondary Guarantee. This proposal is necessary given item "c" in the Small Company Exemption proposal described in item 1 above. ACLI suggests there are universal life products with notional,

---

**"ACLI suggests these tests represent a material amount of work for some companies ..."**

---

or non-material, secondary guarantee provisions. Such provisions allow the contract to remain in force primarily through the surrender charge period by specifying the cumulative premium total or shadow account balance necessary to remain in force for 15 or 20 years, for example. The definition includes a 20-year limit on the secondary guarantee period, grading down by 2/3 year for each issue age higher than 60; and a comparative test on required minimum premiums over the secondary guarantee period.

3. Modifications to the Stochastic Exclusion Ratio Test (SERT). Allows use of gross premium reserves determined from the company's asset adequacy testing models in lieu of the modified deterministic reserve amounts currently required by VM-20 for the SERT. In this case, the company may use the assumptions in the asset adequacy testing model as the anticipated experience assumptions required by SERT. The ACLI suggests that the original concept of SERT was based on the asset adequacy testing models and assumptions in order to facilitate ease in calculation. The proposal also increases the 4.5 percent SERT threshold to 6.0 percent, to accommodate volatility in this statistic in the early years of implementation of PBR as well as to mitigate false negative results. A false negative in the NAIC Impact Study was defined as a "failure" of the SERT, while the calculated stochastic reserve was not the greatest component of the PBR comparison. ■

#### ENDNOTES

<sup>1</sup> Varying premium term life insurance means a policy with an initial premium rate guaranteed for up to 30 years ending at or before age 80, followed by increasing varying premiums thereafter.

<sup>2</sup> Minimum reserve is greater of alternative segment method and unitary method.

# Communication

By Henry Siegel

**"The single biggest problem in communication is the illusion that it has taken place."**  
—George Bernard Shaw



Henry W. Siegel, FSA,  
MAAA, is a semi-retired  
actuary most recently  
with New York Life  
Insurance Company.  
He can be reached at  
[henryactuary@gmail.com](mailto:henryactuary@gmail.com).

One of the great problems with the International Accounting Standards Board's (IASB's) Insurance Contracts project is the difficulty explaining to the IASB and staff concepts that actuaries know very well, including their many nuances. One example of this is the use of the portfolio concept in the 2013 Insurance Contracts Exposure Draft (ED).

The ED defined portfolio as: "A group of insurance contracts that: (a) provide coverage for similar risks and that are priced similarly relative to the risk taken on; and (b) are managed together as a single pool."

This would seem a reasonable basis except for the phrase "priced similarly relative to the risk taken on." This could imply that policies with different issue ages but that are otherwise identical would have to be in different portfolios if their profitability was different, a rather common situation.

As actuaries, we also know that we group policies together differently for different purposes. For assumption setting, we group policies in rather large groups to get sufficiently credible experience. On the other hand, when we actually calculate reserves, we take into account every relevant factor. This will result in very different groupings for these purposes. Furthermore, for management purposes, companies may group many different types of contracts together (e.g., all auto insurance policies or all annuity policies). The groupings thus depend on the purpose for which they are used.

In all our discussions with the IASB and staff, the concept of portfolio was generally considered well understood by both sides. Recent discussions, however, have made it clear that our use of the term and the staff's understanding were not in accord. At its recent meetings, the IASB has clarified the use of portfolio. As we go forward, we must be careful to confirm that our communication is actually well understood.

More generally, one can rarely be overly careful to make sure communication has actually taken place.

This quarter the IASB had important discussions on a variety of subjects, most importantly on participating contracts. It appears that its discussions will not end until the fourth quarter.

## APRIL IASB MEETING

The IASB met on April 25, 2014 to discuss insurance contract revenue. After discussion the IASB tentatively confirmed the revenue proposal in the ED, namely that revenue should exclude amounts that resemble deposits and should be allocated by year based on expected expenses. Many commenters believe this will confuse rather than clarify the income statement of insurers but the IASB opted for consistency with its revenue recognition standard.

The IASB also approved disclosures that would reconcile beginning and ending reserves, as well as premium and revenue.

According to the *IASB Update*,<sup>1</sup> "... the IASB tentatively decided that an entity should be prohibited from presenting premium information in the statement of comprehensive income if that information is not consistent with commonly understood notions of revenue." I don't understand exactly what this means, but at a minimum it would seem to prevent use of premiums in the income statement since premium is not recognized in accord with how services are provided.

In addition to approving a list of non-targeted issues for future discussion, according to the *Update*, the IASB also agreed not to discuss further the following issues:

- 1) Disclosures;
- 2) Premium allocation approach;
- 3) Combination of insurance contracts;
- 4) Contract boundary for specific contracts;
- 5) Unbundling—lapse together criteria;
- 6) Treatment of ceding commissions;
- 7) Discount rate—top-down and bottom-up approaches;
- 8) Tax included in the measurement; and
- 9) Combining the contractual service margin with other comprehensive income.

## MAY IASB MEETING

On May 20, the IASB continued its discussions on the 2013 ED by holding an education session on contracts with participating features. The IASB has been having considerable difficulty dealing with participating contracts, starting with how to define them and then how their measurement and presentation should be different



from non-participating contracts. The IASB continued this discussion at its June meeting and is not expected to deal with making decisions until the September or October meeting.

One complicating element is that the European industry has made a separate proposal on how to handle these contracts that the IASB is attempting to understand. This proposal is specifically targeted to situations where a specific percentage of profits (e.g., 90 percent) is allocated to policyholders. For universal life and traditional participating contracts it's not clear exactly how well that proposal works.

The IASB met on May 21 to discuss the following issues raised in the response to the ED on which the IASB had not specifically asked for comments:

- Recognizing the contractual service margin (CSM) in profit or loss; and
- Fixed-fee service contracts, significant insurance risk, portfolio transfers and business combinations.

With respect to how to recognize the CSM in profit or loss, the IASB tentatively decided to confirm the principle in the ED that an entity should recognize the remaining contractual service margin in profit or loss “over the coverage period in the systematic way that best reflects the remaining transfer of the services that are provided under an insurance contract.” It’s not exactly clear how to implement this principle for every type of contract.

They did clarify that, for contracts with no participating features, the service represented by the CSM is insurance coverage that is provided on the basis of the passage of time and reflects the expected number of contracts in force. One way of interpreting this is to amortize the CSM based on either face amount or number of policies in force.

## OTHER ITEMS

The IASB tentatively decided, according to the Update:

- 1) That entities should be permitted, but not required, to apply the Revenue Recognition Standard to the fixed-fee service contracts that meet the criteria in paragraph 7(e) of the 2013 ED.
- 2) To clarify the guidance in paragraph B19 of the 2013 ED that significant insurance risk only occurs when there is a possibility that an issuer will incur a loss on a present value basis.
- 3) To clarify the requirements for contracts acquired through a portfolio transfer or a business combination in paragraphs 43-45 of the 2013 ED, that such contracts should be accounted for as if they had been issued by the entity at the date of the portfolio transfer or business combination.

## JUNE IASB MEETING

The IASB met on June 17 in an education session to continue its discussions on insurance contracts, in particular on contracts with participating features. The IASB has acknowledged that some adjustments are

CONTINUED ON PAGE 20

needed to the non-par standard for these contracts but wants to limit the scope of the application of any such alternatives. Having more or less given up on its proposed “mirroring” concept, it is still focused on those contracts where the liability relies on the underlying items, such as variable contracts. After discussion, the IASB tentatively directed staff to continue work on the following basis:

1. Should an entity adjust the CSM for changes in its share of the underlying items on the grounds that the insurer’s share represents an implicit management fee? The IASB tentatively agreed that should happen only when:
  - a. The returns to be passed to the policyholder arise from the underlying items the entity holds (regardless of whether the entity is required to hold those items or whether the entity has discretion over the payments to policyholders);
  - b. There is a minimum amount (either fixed or determinable) that the entity must retain<sup>2</sup>; and
  - c. The policyholder will receive a substantial share of the total return on underlying items.
2. The IASB will also discuss if an entity should apply a book yield approach for determining the interest expense presented in profit or loss if:
  - a. The returns passed to the policyholder arise from the underlying items the entity holds (regardless of whether the entity is required to hold those items); and
  - b. The policyholder will receive a substantial share of the total return on underlying items.

The book yield approach would use existing book yields on a portfolio of assets rather than market yields in order to more closely reflect the returns credited to policyholders. For participating policies where the crediting rate is based on a portfolio book yield rather than current market yield, this will produce more reasonable results.

At its June meeting, the IASB also discussed issues raised in the response to the 2013 ED that were unrelated to the five targeted proposals, but that the IASB nonetheless agreed to reconsider. These issues related to:

- The discount rates for long-term contracts when there are few or no observable market data;
- The asymmetrical treatment of gains from reinsurance; and
- The level of aggregation.

## DISCOUNT RATES FOR LONG-TERM CONTRACTS WHEN THERE ARE FEW OR NO OBSERVABLE MARKETS

This issue arose as a result of testing done by a group of insurers who found that selection of rates at the very long end of the yield curve has a significant effect on the liability for long-term contracts. In particular, there is no clear guidance when the duration is beyond the point where there is useful information from the market. After discussion, the IASB tentatively decided to:

- a) Confirm the principle that the discount rates used to adjust the cash flows in an insurance contract for the time value of money should be consistent with observable current market prices for instruments with cash flows whose characteristics are consistent with those of the insurance contract; and
- b) Provide additional application guidance that, in determining those discount rates, an entity should use judgment to:
  - i) Ensure that appropriate adjustments are made to observable inputs to accommodate any differences between observed transactions and the insurance contracts being measured.
  - ii) Develop any unobservable inputs using the best information available in the circumstances, while remaining consistent with the objective of reflecting how market participants assess those inputs. Accordingly any unobservable inputs should not contradict any available and relevant market data.

This agreement would seem to allow sufficient leeway for insurers to use appropriate judgment in setting discount rates for the longest duration contracts, provided auditors don’t place undue emphasis on the “not contradict” clause and allow companies to consider the relevance and reliability of observable inputs. I believe this is what the IASB intends but, again, communication may not be perfect.

## ASYMMETRICAL TREATMENT OF GAINS FOR REINSURANCE CONTRACTS THAT AN ENTITY HOLDS

According to the Update, “the IASB tentatively decided that, after inception, an entity should recognize in profit or loss any changes in estimates of fulfillment cash flows for a reinsurance contract that an entity holds when those changes arise as a result of changes in estimates of fulfillment cash flows for an underlying direct insurance contract that are recognized immediately in profit or loss.” This would appear to make reinsurance accounting more symmetrical with the accounting on underlying contracts.

## LEVEL OF AGGREGATION

This issue is a perfect example of the communication problem writ large. The IASB has had a very difficult time understanding how policies are grouped for a variety of purposes (e.g., loss recognition, assumption setting and liability calculation). There appeared to be considerable surprise when they discovered that portfolio means various groupings in different situations. Accordingly, the IASB tentatively decided to:

- a. Clarify that the objective of the proposed insurance contracts Standard is to provide principles for the measurement of an individual insurance contract, but that in applying the Standard an entity could aggregate insurance contracts provided that it meets that objective.
- b. Amend the definition of a portfolio of insurance contracts to be:  
“insurance contracts that provide coverage for similar risks and are managed together as a single pool”; and
- c. Add guidance to explain that in determining the contractual service margin or loss at initial recognition, an entity should not aggregate onerous contracts with profit-making contracts. An entity should consider the facts and circumstances to determine whether a contract is onerous at initial recognition.

This result is very important in that it more closely aligns the standard with how liabilities are really calculated. The change to the definition of portfolio also

would seem to reduce the number of portfolios that will need to be used for various purposes; the previous definition might have resulted in many hundreds of portfolios.

The issue of combining onerous and non-onerous contracts remains a potentially difficult one depending on how one measures this. If one includes only marginal expenses in the calculation, you might get a very different result than if you include all overhead. Many insurers price in a way that might appear to produce losses on part of a portfolio (e.g., life policies issued to individuals over age 65) that are offset by gains on another part, depending on how overhead is allocated. The same problem can arise on policies issued in different years. Whether those types of losses must be recognized at issue or can be combined may be an important issue for further discussion.

In another example of alleviating the confusion caused by misunderstanding the nature of a portfolio, the IASB tentatively decided to clarify that an entity should select and apply its accounting policies consistently for similar contracts, considering the portfolio in which the contract is included, the assets that the entity holds, and how those assets are accounted for. In other words, accounting can differ for contracts within a portfolio if, for instance, assets supporting one type of contract are held at fair value through other comprehensive income (OCI) while for another the assets are held at fair value through income. This clarifies an earlier tentative decision that accounting had to be consistent for all contracts in a portfolio.

Communication seems, therefore, to be improving between the industry and the IASB. Another example of why

***Insurance accounting is too important to be left to the accountants!*** ■

### ENDNOTES

<sup>1</sup> <http://www.ifrs.org/updates/iasb-updates/Pages/iasb-updates.aspx>.

<sup>2</sup> The “must” probably eliminates almost all U.S. contracts from consideration here.

# The AAA's Actuarial Opinion and Memorandum (AOM) Discussion Group

By Francis de Regnacourt



Francis de Regnacourt,  
FSA, CERA, FCIA,  
MAAA, is a director  
at KPMG. He can  
be reached at  
[fderegnacourt@kpmg.com](mailto:fderegnacourt@kpmg.com).

For a long time, regulatory actuaries have noted the difficulty of getting the information they need from AOMs. They receive voluminous (several hundred pages is common) memoranda from hundreds of companies, each in its own format, with results and data presented differently. The quality of the contents—and of the communication—varies widely. Regulatory actuaries have been asking for a way to simplify the communication of the key elements they need to understand and get comfortable with the analysis behind the actuarial opinions.

In 2012, the Life Practice Council of the American Academy of Actuaries (AAA) formed the AOM Discussion Group, chaired by Tom Campbell, to facilitate the communication between appointed actuaries and regulatory actuaries. The group sponsored sessions at the 2012 and 2013 Valuation Actuary Symposia; and in March 2014, it issued its first report, titled "Improving the Communication of Issues within the Appointed Actuary's Memorandum."

## PURPOSE OF THE DISCUSSION GROUP

The AOM Discussion Group is not:

- Charged with recommending changes to the AOM requirements;
- Concerned with the content of AOMs, just the communication of the content; or
- Asked to form a consensus position or a recommendation.

It is focused on communication issues for presenting the very involved analysis behind an actuarial opinion, as effectively as possible. Uniformity is not a primary goal; the fact is that each appointed actuary reaches his or her conclusion in a way unique to themselves and to the business they are opining on. There is, however, enough commonality that some streamlining is possible. Three subgroups were formed to focus on areas of potential simplification common to all AOMs:

- Consolidation and Standardization of Actuarial Memoranda Subgroup, to discuss ways to minimize multiple submissions, avoid duplication of information, and group together elements that are common to

many sections of a typical AOM (for example, general assumptions common to all blocks of business).

- Executive Summary Subgroup, to provide ideas for a summary of key points that would allow a regulatory actuary to get a high-level understanding of the main lines of reasoning behind the opinion, and decide which areas, if any, warrant further investigation.
- Adding Links to the Actuarial Memorandum for Key Issues Subgroup, to suggest ways to facilitate referencing common areas of interest (for example, stochastic results or AG 43 analysis) using links or bookmarks.

## CONSOLIDATION AND STANDARDIZATION

The Consolidation and Standardization of Actuarial Memoranda Subgroup came up with seven ideas to consolidate all required reports into one report to minimize the number of filings; they continue to work on new ideas. They also produced a prototype format that actuaries can customize and use to structure the presentation of their results, complete with links to quickly jump to items that may interest the reviewer.

## EXECUTIVE SUMMARY

The Executive Summary Subgroup is exploring two options: an enhanced Regulatory Asset Adequacy Issues Summary (RAAIS) or a summary section in the AOM. They also suggest six items to improve communication of results (and acknowledge that there may be several more):

1. High-level description of assets and liabilities
2. Discussion of methods of analysis
3. Clear identification of any additional reserves and how they were determined
4. Summary of key results of testing between current year and past year, and discussion of the reasons for changes
5. Description of sensitivity testing to stress the most significant risks
6. Description of changes from previous years in assumptions, models, risk mitigation strategies, etc., and their effects.



## ADDING LINKS

The Adding Links to the Actuarial Memorandum for Key Issues Subgroup came up with a sample table of contents template that actuaries can customize, complete with links to quickly jump to items that may interest the reviewer. The template promotes standardization, both across companies and across time periods.

## OTHER CONSIDERATIONS: ELECTRONIC SUBMISSION

The discussion group also considered electronic submissions—for example, a single submission to the National Association of Insurance Commissioners (NAIC), where the entire AOM would be distributed to the state of domicile and RAAIS or executive summaries to other states. They identified some systems and confidentiality issues that may require support from the NAIC.

## NEXT STEPS

The discussion group is still getting the word out about their work, through Society of Actuaries meetings, webcasts, articles, etc. They are looking for feedback from actuaries on both sides of the regulatory divide. Some NAIC Life Actuarial Task Force (LATF) members have also agreed to discuss the issue with appointed actuaries of their domestic companies.

In a similar vein, but not in the discussion group's domain, Mark Birdsall (Kansas Department of Insurance) is heading up an effort to test electronic data capture with a sample of 50 to 75 companies, in anticipation of principle-based reserving (PBR). They are looking for volunteer companies to incorporate

the proposed requirements into their 2014 reporting. The recommendations made as a result of this effort will incorporate emerging PBR and risk-based capital (RBC) requirements.

## CONCLUSION

The brief discussion above is no substitute for reading the March 2014 report, and seeing the concrete templates they have developed.

The discussion group has produced many good suggestions to improve communications of AOMs and their underlying analysis. They continue to look for other ways to streamline the process, reducing some of the burden on both appointed actuaries and regulatory actuaries. Also, they are anticipating the explosion in reporting that will come with PBR.

Finally, they are always looking for ideas. Please contact Tom Campbell, or your local member of the AOM Discussion Group, if you have any to contribute. ■

### ENDNOTES

<sup>1</sup> The report is available at [http://www.actuary.org/files/AOMR\\_Communication\\_Group\\_Report\\_3-18-14.pdf](http://www.actuary.org/files/AOMR_Communication_Group_Report_3-18-14.pdf).

# SOA 2014

SOCIETY OF ACTUARIES  
Annual Meeting & Exhibit

Oct. 26-29, 2014  
Rosen Shingle Creek  
Orlando

Invent  
Change  
Adapt  
Learn  
Build  
Innovate  
Perform



Through the profession,  
collaboration, research, education and  
our members...

## TOGETHER WE PROGRESS

[SOAAnnualMeeting.org](http://SOAAnnualMeeting.org)

100+ INSIGHTFUL SESSIONS

25+ PRODUCTIVE  
NETWORKING  
OPPORTUNITIES

1,800+ INNOVATIVE MEMBERS

300+ DEDICATED  
PRESENTERS

## Already an FSA? CERA with Four Exam Hours More

The Society of Actuaries' Fellowship exam structure allows current Fellows of the Society of Actuaries (FSAs) to obtain the Chartered Enterprise Risk Analyst® (CERA) credential with just four additional exam hours.

As the most comprehensive and rigorous risk management credential available, the CERA offers an enhanced enterprise-risk-based curriculum that better prepares professionals with the in-depth knowledge and expertise they need to play more strategic roles across more industries--including risk manager, chief risk officers and CFOs.

To become a CERA, Fellows need only complete the four-hour Enterprise Risk Management exam, along with the ERM module if it was not part of their FSA pathway.

Get on the path to the future of risk management.  
Registration for the fall ERM exam is now open.

See what the future holds at [CERAnalyst.org](http://CERAnalyst.org).

The CERA is offered by the Society of Actuaries (SOA), an educational, research and professional organization dedicated to serving the public and its 24,000 members. | [soa.org/about](http://soa.org/about)

**CERA**  
Chartered Enterprise Risk Analyst  
CREDENTIAL

**SOCIETY OF ACTUARIES**

# SOA Professional Development E-Learning

Grow your knowledge and expertise while  
earning CPD credit.

Webcasts  
E-Courses  
Podcasts  
Session Recordings  
Virtual Sessions  
Webcast Recordings  
Distance Learning

View all of our **Professional Development**  
opportunities by visiting [www.soa.org/  
professional-development](http://www.soa.org/professional-development)





# Knowledge On The Go

Insightful podcasts are now available to listen to anywhere!

The Society of Actuaries is offering topical podcasts for those interested in insight and perspectives from fellow members. The podcasts are free to download and can be listened to from your computer or any portable audio device. Check back often as new podcasts sponsored by various sections are released.

[www.soa.org/podcasts](http://www.soa.org/podcasts)



## Enhance your business skills from the convenience of your desk

The SOA now offers a wide array of online courses to help candidates and members strengthen the everyday skills necessary in the business world. There are more than 30 video and audio courses designed for business professionals at all stages of their careers. Topics include business writing, verbal communications, relationship management, interpersonal skills, leadership insight and business strategies.

Sign up for only \$240, earn CPD credit and select five courses from the library. Courses are easily archived and accessed from your computer for a full year.

***Visit [SOA.org/BizLibrary](http://SOA.org/BizLibrary)***

**SOCIETY OF ACTUARIES**

Financial Reporting  
Section

475 N. Martingale Road, Suite 600  
Schaumburg, Illinois 60173  
p: 847.706.3500 f: 847.706.3599 w: [www.soa.org](http://www.soa.org)

# The **Financial Reporter**

NONPROFIT  
ORGANIZATION  
U.S. POSTAGE  
PAID  
SAINT JOSEPH, MI  
PERMIT NO. 263

