Actuarial Standards Board
Conseil des normes actuarielles

Memorandum

To: All Fellows, Affiliates, Associates, and Correspondents of the Canadian Institute of Actuaries and Other Interested Parties

From: A. David Pelletier, Chair
Actuarial Standards Board

Ty Faulds, Chair
Designated Group

Date: December 21, 2012

Subject: **Notice of Intent to Revise Economic Reinvestment Assumptions within the Practice-Specific Standards on Insurance Contract Valuation: Life and Health (Accident and Sickness) Insurance (Section 2300)**

Comment Deadline: **March 15, 2013**

Document 212112

INTRODUCTION

The Actuarial Standards Board (ASB) proposes to revise the Practice-Specific Standards on Insurance Contract Valuation: Life and Health (Accident and Sickness) Insurance (section 2300) with respect to the economic reinvestment assumptions and investment strategies utilized for long-tail liability cash flows under the Canadian asset liability method (CALM).

BACKGROUND

The CALM methodology (the insurance contract liability is set to recognize the risks of the investment strategy employed to back the liability over its relevant term through cash flow testing and explicit margins for adverse deviations (MfADs)) remains generally accepted as a sound methodology. However, concerns have been raised about the application of CALM in this low-interest-rate environment for liabilities with cash flows beyond the term of readily available liquid fixed income assets (20 to 30 years for the primary jurisdictions under consideration). The range of investment strategies that can be employed can significantly impact insurance contract liabilities while being somewhat hypothetical as they are dependent on reinvestment actions in the distant future.

ISSUES

The more specific concerns with the current practices include:

- Emerging differences between the guidance supporting stochastic and deterministic testing:

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    - The widening difference between the Conditional Tail Expectation (CTE) (0) results in stochastic testing and the base scenario result in deterministic testing; and
    - The breadth of ranges tested under the current prescribed deterministic interest rate scenarios compared to those resulting from the stochastic testing:
        - Does grading to risk-free fixed assets in some of the scenarios result in an unreasonably conservative basis?
        - Does assuming current rates forever in today's low-interest-rate environment result in an unreasonably conservative basis or drive inappropriate volatility?
        - Do the calibration criteria currently under development for stochastic testing recognize current low interest rates sufficiently?
- The impact of reinvestment strategies using non-fixed income assets to support projected insurance contract liability cash flows in the distant future in terms of both:
    - The percentage of insurance contract liability cash flows assumed to be supported by non-fixed income assets; and
    - The risk premiums assumed for non-fixed income assets over fixed income assets returns; and
- The extent of risk premiums which may be assumed for reinvestments beyond this horizon considering the varying current investment strategies which may be employed:
    - Does assuming current risk premiums based on the current investment strategy forever, as defined in a number of the deterministic scenarios, result in an unreasonably large range of results?

PROPOSED CHANGES AND DESIRED OUTCOMES

The following changes to the Standards of Practice are proposed:

1. To incorporate promulgated calibration criteria for stochastic interest rate models used for CALM. Consideration will be given as to whether the calibration criteria developed, and under development, by the Committee on Life Insurance Financial Reporting (CLIFR) sufficiently recognize the possibility that the current low-interest-rate environment may persist for an extended period of time.
2. To revise the deterministic scenarios specified for the calculation of insurance contract liabilities to produce results comparable to those provided by stochastic methodology using the prescribed calibration criteria.
3. To establish maximum assumed net risk premiums (after provisions for default, market movements) over risk-free rates for specific asset classes and scenarios which may include:
    - Replacing the maximum of 0 after 20 years for fixed income assets;
    - Possible revision of the 20-year horizon and any transition to the horizon; and
    - Non-fixed income asset classes.
4. To establish limits on the extent to which investment in non-fixed income assets is assumed, which may include setting maximum percentages regardless of current investment strategy and/or establishing a prescribed reinvestment strategy beyond some future horizon point regardless of a company's current investment strategy.

The desired outcome of these changes is to maintain an appropriate range of practice for the calculation of insurance contract liabilities whether calculated using deterministic or stochastic methodologies, considering the current interest rate environment and appropriate allowance for anticipated investment returns in excess of risk-free interest rates.

PROPOSED TIMELINE AND EARLY IMPLEMENTATION

It is the responsibility of the ASB to make final decisions regarding the revised Standards of Practice. The International Accounting Standards Board has recently announced that revised standards for insurance contracts (IFRS 4 – Phase II) are unlikely to come into effect before January 1, 2018. Given this timing, the ASB considers that it is not appropriate to defer necessary changes to CALM pending implementation of IFRS 4 – Phase II. The ASB hopes to issue an exposure draft by June 2013 and adopt the final standards in 2013, with a proposed effective date of October 15, 2013. The ASB recognizes that this timetable is aggressive.

It is expected that early implementation will be prohibited.

ISSUES AND FEEDBACK

Comments on this notice of intent (NOI) are invited **by March 15, 2013**. Please send your comments, preferably in an electronic format, to Ty Faulds at ty.faulds@londonlife.com with a copy to Chris Fievoli at chris.fievoli@actuaries.ca.

The Designated Group (DG) plans to hold an electronic discussion forum to discuss these proposals during January and/or February of 2013. No other specific forums for submitting comments are planned regarding this NOI other than the receipt of written comments at the above addresses.

Due process has been followed in the preparation of this NOI.

The DG responsible for the development of the revisions to the standards is chaired by Ty Faulds, and includes the following members: Michael Banks, Luc Farmer, Alexis Gerbeau, Edward Gibson, and Jacques Tremblay.

ADP, TF