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: Jim Christie, Chair
Actuarial Standards Board

Ty Faulds, Chair
Designated Group

Date: May 15, 2014

Subject: **Final Standards – Revisions to Economic Reinvestment Assumptions within the Practice-Specific Standards on Insurance Contract Valuation: Life and Health (Accident and Sickness) Insurance (Section 2300 and Subsection 1110)**

Document 214048

INTRODUCTION

The attached final standards and the accompanying Final Communication of Promulgations of the maximum net credit spread, ultimate reinvestment rates, and calibration criteria for stochastic risk-free interest rates were approved by the Actuarial Standards Board (ASB) on May 8, 2014. These changes revise section 2300 and subsection 1110 of the standards with respect to the economic reinvestment assumptions and assumed investment strategies utilized under the Canadian asset liability method (CALM) with a focus on long-tail liability cash flows.

BACKGROUND

The ASB created a designated group (DG) that is responsible for developing these revisions to the Standards of Practice. It included Ty Faulds (Chair), Michael Banks, Luc Farmer, Alexis Gerbeau, Edward Gibson, and Jacques Tremblay.

A notice of intent (NOI) on this topic was issued on December 21, 2012. A webcast discussing the proposed changes was held on March 20, 2013. Two voluntary quantitative impact studies (QIS's) were conducted. The first was issued on May 16, 2013, and the second on July 29, 2013.

Updates on the emerging thoughts of the DG were provided at both the 2013 Annual Meeting and the 2013 Seminar for the Appointed Actuary. An exposure draft (ED) and an Initial Communication of Promulgations of the maximum net credit spread, ultimate reinvestment rates, and calibration criteria for stochastic risk-free interest rates were published on December 13, 2013, with a comment period ending February 14, 2014.

A third QIS was conducted during the ED comment period.

COMMENTS RECEIVED

A total of five written submissions on the ED were received. Two were made by regulators, two by life insurance companies, and one by an individual CIA member.

The comments received, and the responses of the DG to them, are summarized in the section below.

1. Subsection 1110

It was suggested that the definitions be expanded to include such items as:

- Asset type, credit rating, asset depreciation;
- Investment policy, strategy, and practice; and
- Liability cash flow, cash outflow, net cash flow, and substantially linked cash flows.

The DG is of the view that these terms are generally used in their normal context and further precise definition of these terms is not practical. However, the group has invited the Committee on Life Insurance Financial reporting (CLIFR) to provide guidance regarding the interpretation of these terms in their forthcoming guidance where appropriate.

2. Subsection 2320

Due to changes arising from the International Financial Reporting Standards (IFRS), it was suggested that paragraph 2320.12 be expanded to include references to statement value, and assets not carried at fair value. The DG acknowledges that this change should have been made when IFRS was adopted, so it has included a revision that removes the definition of book value altogether, since the description could be found confusing and unnecessary.

In paragraph 2320.15, it was noted that deferred realized capital gains would apply to very few asset classes under IFRS, so the paragraph should be removed or clarified. The DG acknowledges that this comment has merit, but it is not related to the scope of the group's work, so it recommends that the ASB consider it in the next general review of part 2000.

Revised wording was suggested for paragraph 2320.27, to clarify the definition of future renewal date. The DG suggests that the ASB consider this point as well in the next general review of part 2000.

3. Subsection 2330

A concern was raised around the volatility of the base scenario, and that the use of forward rates would result in a scenario that was either too conservative or too aggressive under extreme interest rate environments. It was also questioned as to why the reserve would be capped to the deterministic base scenario (as described in CLIFR's educational note). The DG considers that the base scenario should be retained, to encourage matching of cash flows and discourage deliberate mismatch that would reduce policy liabilities.

It was also suggested that CTE(0) of the liability distribution be used to determine the margin, and that the base scenario be set at a higher CTE level which is equal to the deterministic base scenario at the time the revised standard is implemented. The DG does see CTE(0) as a reasonable alternative to define the margin, but the base scenario was chosen to be a more explicitly defined common scenario, and to ensure that the liability produced in a stochastic application was at least as large as that required under the base scenario.

In paragraphs 2330.01, .04, .05, and .06, it was questioned whether the terms "investment policy", "investment strategy", and "investment practice" needed to be defined. The DG decided to make no change, since these terms are already defined, currently used, or clear from the context.

In paragraph 2330 .01, it was suggested that "subject to default" be replaced with "subject to depreciation". The DG agreed and made that change.

It was suggested that paragraph 2330 .06 use the phrase "consistent with" instead of "in accordance with", to be more consistent with paragraph 2330.05. The DG considers that the ED wording more accurately conveys the intent, so no changes were made.

A concern was raised around the deletion of the sentence in paragraph 2330.06 that made reference to paragraph 2130.02, dealing with the treatment of business issued after the valuation date. The DG believes this is covered by paragraphs 2130.03 and 2103.18, but has also expanded paragraph 2330.05 to emphasize that new business issued after the valuation date should not be taken into consideration with regard to the assumed investment strategy.

In paragraph 2330.07.01, it was suggested that it should be clarified that the promulgated maximum between the asset's credit spread and its asset depreciation assumption has been developed to apply for Canadian assets. The DG agrees and has incorporated wording into paragraph 2330.09.03 to accommodate this.

In paragraph 2330.12, it was suggested that reference to how remaining net positive cash flows are reinvested after repaying any outstanding balance from borrowing be added back. The DG considers that the guidance provided in the ED is sufficient and that the suggested addition is unnecessary.

4. Subsection 2340

In paragraph 2340.02, it was suggested that the asset depreciation assumption not depend on duration since issue. The DG recommends that the ASB address this in the next general review of part 2000.

It was suggested that the definition of "asset depreciation" for fixed income assets in paragraph 2340.03 was inadequate, since there are costs associated with asset downgrades, without the asset actually defaulting. The DG acknowledges that this comment has merit, but it was not included in the scope of the group's work. It recommends that CLIFR develop expanded guidance on this topic and that the ASB consider it in the next general review of part 2000.

In paragraph 2340.10.1, it was suggested that "quality rating" be changed to "credit rating". The DG agreed with this suggestion and has incorporated this change. The definition of non-fixed income assets in paragraph 2340.13 was suggested to be too narrow, as the ED referred only to "common shares and real estate". The DG agreed with this comment, and made changes to paragraphs 2340.13, .13.01, and .13.1 to include references to "a class of non-fixed income assets".

In paragraph 2340.14.01, it was questioned whether the definition of terms such as "liability cash flow", "cash outflow", and "net cash flow" were adequate. Because this is a new section in the standards, concern was raised that different interpretations could lead to a wide range of practice. The DG decided to make no change, as the terms are already widely used in the standards without definition and are used in their normal context.

A concern was raised over the deletion of the word "actuary" from paragraph 2340.11, in that it could imply the actuary does not have to take ownership for the estimates. The DG notes that the word "actuary" is used (or not used) throughout the standards, and its absence does not imply that that actuary is not taking responsibility for his or her work, so no change was made.

One commenter suggested that the limits on non-fixed income assets recognized in paragraph 2340.14.1 are too high and permits too much credit to be taken for future returns that are subject to substantial risk. The DG spent considerable time considering this issue. The DG recognizes that there is no definitive basis on which to fix these limits. The DG considers the approach taken in the ED as appropriately balanced between providing some narrowing of practice and imposing large financial impacts on insurers. Therefore, no change has been made in this regard.

5. Timing

It was suggested that it would be highly desirable to align the implementation of these changes to Q3, when a number of insurers implement their assumption changes for the year. After extensive consultation with the industry and regulators, the effective date has been established as October 15, 2014.

DUE PROCESS

The ASB’s Policy on Due Process for the Adoption of Standards of Practice has been followed in the development of these revisions to the standards.

EFFECTIVE DATE AND EARLY IMPLEMENTATION

These final standards and the accompanying promulgations are effective on October 15, 2014. Early implementation is not permitted.

JC, TF