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Project **Insurance Contracts**

Topic **The use of other comprehensive income (OCI)**

Purpose

1. This paper discusses whether the boards should permit or require insurers to use other comprehensive income (OCI) for remeasurements of insurance liabilities if financial assets held to back those liabilities are not carried at fair value through profit or loss.

2. In this paper, we presume that the future standard for insurance contracts will use a current measurement model based on a building block approach. [Agenda paper 7A (FASB Memorandum 32A) discusses the measurement model for insurance contracts.]

3. This paper does not address the following issues regarding changes in insurance liabilities. They will be discussed later:

   (a) how to deal with accounting mismatches that may arise in some cases for assets backing unit-linked contracts and index-linked contracts. We plan to discuss these contracts in January 2010. The discussion paper *Preliminary Views on Insurance Contracts* defined a unit-linked contract as one for which some or all policyholder benefits are determined by reference to the price of units in an internal or external investment fund (ie a designated pool of assets held by the insurer or a

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third party and operated in a way similar to a mutual fund). These contracts are often called variable contracts in the US.

(b) whether an insurer should be permitted to redesignate financial assets backing the insurance liabilities on transition to the new standard for insurance contracts[1]. We plan to discuss this issue when we discuss transition.

(c) whether the effects of changes in estimates should always be recognised immediately (in profit or loss or OCI) or whether they could give rise, in some cases, to remeasuring the remaining margin. Agenda paper 7B (FASB memo 32B) discusses this issue.

Summary of recommendations

4. In this paper, the staff recommends that the boards:

(a) should not, in this project, change the accounting for assets held to back insurance contracts, subject to future consideration of assets held to back unit-linked (variable) and index-linked insurance contracts.

(b) should not permit or require the use of OCI for insurance liabilities.

Structure of this paper

5. This paper is structured as follows:

(a) The discussion paper on insurance contracts (paragraphs 6 – 8)

(b) Accounting mismatches (paragraphs 9 – 13)

(c) Changing the accounting for an insurer's assets (paragraph 14)

(d) The use of OCI for insurance liabilities (paragraphs 15 – 29)

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[1] IFRS 4 *Insurance Contracts* contains a similar option at transition as it permits an insurer to redesignate financial assets as at fair value through profit or loss when it changes its accounting policies for insurance liabilities, either on initial adoption of IFRS 4 or later.

(e) Short-term market volatility (paragraphs 30 – 33)

(f) Summary and staff recommendation (paragraph 34)

The discussion paper on insurance contracts

6. In the Discussion Paper *Preliminary Views on Insurance Contracts* (DP), the IASB proposed that profit or loss should include all changes in the carrying amount of insurance contracts.

7. Discussing one specific application of this conclusion, the DP concluded that a practice known as “shadow accounting” would no longer be relevant in phase 2 of this project (see further discussion in paragraphs 23 – 29).

8. Most comment letters to the DP agreed that all changes in the insurance liability should flow through profit or loss. However, some respondents argued that some or all changes should be required or permitted to be presented in OCI, for one or both of the following reasons:

   (a) to avoid **accounting mismatches** if assets backing insurance liabilities are not measured at fair value through profit or loss (see paragraphs 9 – 13); or

   (b) to distinguish **short-term market volatility** that might reverse over the long term of the insurance contracts (see paragraphs 30 – 33).

Accounting mismatches

9. Throughout this project, we have consistently heard from users, preparers and others that it is important to avoid accounting mismatches. It is burdensome for insurers to explain volatility caused by accounting mismatches even to sophisticated users. Less sophisticated users may not understand these effects at all.

10. It is important to distinguish accounting mismatches from economic mismatches. The Basis for Conclusions on IFRS 4 *Insurance Contracts* describes these notions as follows:

(a) **Economic mismatch** arises if the values of, or cash flows from, assets and liabilities respond differently to changes in economic conditions. For example, an economic mismatch arises if the duration of insurance liabilities is longer than the duration of fixed interest assets backing those liabilities.

(b) **Accounting mismatch** arises if changes in economic conditions affect assets and liabilities to the same extent, but the carrying amounts of those assets and liabilities do not respond equally to those economic changes.

11. The most prominent reason for accounting mismatches at present is measuring insurance liabilities on a basis that does not reflect current interest rates while measuring interest-bearing financial assets at fair value. If interest rates change, the carrying amount of the assets changes but the carrying amount of the insurance liabilities does not change, with the following consequences:

    (a) For financial assets classified as 'at fair value through profit or loss', there is an accounting mismatch in both the income statement and the balance sheet.

    (b) For 'available-for-sale financial assets', there is no accounting mismatch in the income statement (unless the assets are sold), but there is an accounting mismatch in equity.

    (c) If the insurer sells assets, an accounting mismatch occurs not only for available-for-sale financial assets, but also for assets carried at amortised cost.

12. In the DP, the IASB expressed the preliminary view that an ideal measurement model would report all economic mismatches that exist and would not cause any accounting mismatches.

13. If the boards wish to address accounting mismatch, they may do so by:

    (a) changing the accounting for an insurer's assets (paragraph 14), or

    (b) requiring or permitting insurers to use OCI to report some or all changes in their insurance liabilities (paragraphs 15 – 33).

Changing the accounting for an insurer's assets

14. Addressing the asset side does not seem a viable option (except perhaps for unit-linked and index-linked insurance contracts, to be discussed at a future meeting), because:

    (a) the project on insurance contracts should focus on the liability side of insurance contracts, it is not the objective to change the accounting for the balance sheet of an insurer.

    (b) it would create an exemption from other standards that would normally apply for the accounting for assets. The IASB does not wish to create industry-specific standards because that would reduce transparency for users.

    (c) it may not be possible to identify which of the insurer's assets are held to back insurance liabilities and which are not.

Question 1 – assets held to back insurance contracts
The staff recommends that the boards should not, in this project, change the accounting for assets held to back insurance contracts, subject to future consideration of assets held to back unit-linked (variable) and index-linked insurance contracts. Do the boards agree?

The use of OCI for insurance liabilities

15. Paragraphs 15 – 29 consider whether the boards should consider requiring or permitting insurers to use OCI to report some or all changes in their insurance liabilities if those liabilities are backed by assets measured at amortised cost or at fair value through OCI. In preparing that analysis, the staff has assumed that insurers will no longer be applying the existing standards on financial instruments when they first apply the new standard on insurance contracts. Thus, the analysis reflects the requirements published by the IASB in IFRS 9 *Financial Instruments* and the latest developments in the FASB's work on the project on accounting for financial instruments. The analysis is divided into the following sections:

(a) IFRS 9 – amortised cost for some financial instruments (paragraphs 16 – 18)

(b) IFRS 9 – OCI presentation alternative for some equity instruments (paragraphs 19 – 20)

(c) FASB – fair value through OCI for some debt instruments (paragraphs 21 – 22)

(d) Shadow accounting (paragraphs 23 – 29)

IFRS 9 - amortised cost for some financial instruments

16. IFRS 9 requires an entity to measure a financial asset at amortised cost if both of the following conditions are met (unless the entity applies the fair value option to that asset):

    (a) the asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows.

    (b) the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

17. An accounting mismatch will arise if an insurer measures insurance liabilities on the basis proposed in this project (see agenda paper 7A (FASB Memorandum 32A) and measures the financial assets backing those liabilities at amortised cost. However, if the insurer were to use OCI to present some or all of the changes in the insurance liability, that:

    (a) might eliminate some or all of the accounting mismatch in profit or loss (net income), but

    (b) would not eliminate the accounting mismatch from comprehensive income or equity.

18. For the following reasons, the staff recommends that the IASB should not permit or require the use of OCI to report changes in insurance liabilities backed by financial assets that could, applying IFRS 9, be measured at amortised cost:

(a) users would not benefit from such a complex presentation, particularly because accounting mismatches arising from amortised cost measurement cannot be fully eliminated. The presentation, therefore, would not be transparent, but difficult to understand.

(b) Use of OCI would be likely to require complex and perhaps onerous procedures:

  (i) to determine which part of the insurance liability is deemed to be backed by assets measured at amortised cost.

  (ii) to track "cost" information for that part of the liability, to achieve the desired split between amounts reported in profit or loss and amounts reported in OCI.

  (iii) to determine whether, and when, to recycle amounts from OCI to profit or loss.

(c) An insurer could avoid this accounting mismatch by using the fair value option for its assets.

IFRS 9 – OCI presentation alternative for some equity instruments

19. Applying IFRS 9, an entity may elect to present gains and losses on some equity instruments measured at fair value in OCI. If an entity uses that option:

(a) dividends are to be recognised in profit or loss.

(b) fair value gains and losses are not recycled from OCI to profit or loss on disposal of the instrument.

20. For the following reasons, the staff recommends that the IASB should not permit or require the use of OCI to report changes in insurance liabilities backed by equity instruments for which an insurer elects to use the OCI presentation alternative:

(a) unless all insurance liabilities are backed by equity instruments for which an insurer elects to use the OCI presentation alternative, an insurer would report changes for a part of its insurance liabilities in OCI and changes for the remaining part of its insurance liabilities in

profit or loss. This would result in a complex presentation that would not be informative for users and would not provide sufficient transparency, clarity or understandability.

(b) The use of OCI would be likely to require complex and perhaps onerous procedures:

   (i) to determine which part of the insurance liability is deemed to be backed by equity instruments measured at fair value in OCI.

   (ii) to track “cost” information for that part of the liability, to achieve the desired split between amounts reported in profit or loss and amounts reported in OCI.

(c) in addition to (b), it would be difficult, perhaps even impossible, to design a system that reports changes in the liability:

   (i) in OCI to the extent they relate to gains and losses reported in OCI for the equity investments, but

   (ii) in profit or loss to the extent they relate to dividends on the equity investments.

FASB - fair value through OCI for some debt instruments

21. The FASB has been developing proposals to replace the current requirements in FASB Accounting Standards Codification (ASC) *Investments – Debt and Equity Securities*, which it plans to publish in the first quarter of 2010. The FASB’s tentative decisions would permit entities to select fair value through OCI for debt instruments that are held to collect payments of contractual cash flows. Interest income would be recognised in profit or loss and any amounts recognised in OCI would ultimately be recycled. The FASB has not yet decided in its project on financial instruments whether an entity would be able to use a fair value option, for example to avoid an accounting mismatch.

22. The staff recommends that the FASB should not permit or require the use of OCI to report changes in insurance liabilities backed by debt instruments for

which an insurer uses the fair value through OCI approach:. The use of OCI would be likely to require complex and perhaps onerous procedures::

(a) to determine which part of the insurance liabilities are deemed to be backed by assets measured at fair value through OCI.

(b) to track "cost" information for that part of the liability, to achieve the desired split between amounts reported in profit or loss and amounts reported in OCI.

(c) to determine whether and when to recycle amounts from OCI to profit or loss.

Shadow accounting

23. This section discusses two applications of a practice sometimes known as shadow accounting. The first application arises because in some accounting models, realised gains or losses on an insurer's assets have a direct effect on the measurement of some or all of its non-participating insurance liabilities. The most prominent such model is used in US GAAP in FASB ASC Topic *Financial Services – Insurance* 944-30-35, originally introduced by SFAS 97 *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*. It measures insurance liabilities within its scope on the basis of the (present value of) estimated gross profit, which includes amounts expected to be earned from the investment of policyholder balances less interest credited to policyholder balances.

24. When many of those models were constructed, unrealised gains and most unrealised losses were not recognised in financial statements. Some of those models were extended later to require some financial assets to be measured at fair value, with changes in fair value recognised directly in OCI. When this happened, a practice sometimes known as 'shadow accounting' was developed with the following two features, of which the second is relevant to this paper:

(a) A recognised but unrealised gain or loss on an asset affects the measurement of the insurance liability in the same way that a realised gain or loss does.

(b) If unrealised gains or losses on an asset are recognised in OCI, the resulting change in the carrying amount of the insurance liability is also recognised in OCI.

25. In the model the boards are now developing, gains and losses on assets do not affect the measurement of a non-participating insurance contract. Thus, the first application of shadow accounting is no longer relevant.

26. The second application of shadow accounting is for participating contracts. When policyholders participate wholly or partly in OCI arising on assets, shadow accounting results in the corresponding policyholder participation also being recognised in OCI. The following paragraphs consider whether this application could still be relevant in the model the boards are now developing, in relation to:

(a) IFRS 9's OCI presentation alternative for some equity instruments.

(b) the FASB's proposed fair value through OCI approach for some debt instruments.

27. In relation to IFRS 9's OCI presentation alternative for some equity instruments, there is no recycling of realised gains and losses on disposal, but dividend income is presented in profit or loss. Thus, shadow accounting would result in a complex presentation that would not be easy for users to understand and might require complex tracking to match movements in the assets with movements in the liability.

28. In relation to the FASB's proposed fair value through OCI approach for some debt instruments, shadow accounting could be used to match the effect in OCI. However, shadow accounting would result in a complex presentation that would be difficult for users to understand. In addition, complex tracking would be required to determine when to recycle cumulative OCI related to the liabilities.

29. Given the arguments in paragraphs 27 and 28, staff recommends that the boards should not retain shadow accounting.

Short-term market volatility

30. The other reason why some people see the use of OCI as useful for the accounting for an insurance liability is to distinguish short-term market volatility from the entity's longer-term performance. Changes in the insurance liability that derive from:

    (a) changes in financial inputs or market variables (possible short-term market volatility) would be shown in OCI with, to the extent necessary, subsequent recycling to profit or loss, while

    (b) changes in other variables, such as mortality or frequency and severity of claims (longer-term performance) would flow through profit or loss.

31. Some think this split better reflects the economics of the insurance business (long-term horizon). Others think that OCI should always be used for the measurement of insurance liabilities due to their long-term nature. Some would say that insurers need the option to use an OCI presentation because all insurance liabilities would be measured using a current measure, which puts them in disadvantage to other financial institutions, such as banks, which may use amortised costs for some financial assets and many financial liabilities. In contrast to the accounting by other financial institutions insurers would in their view in effect be required to adopt a measurement model that, without an OCI presentation, would result in reporting short-term volatility in profit or loss which in many case will reverse over time.

32. The boards' standards on pensions and other post-employment benefits permit the use of OCI for those liabilities. Pension liabilities and insurance liabilities, particularly for some long-duration life contracts, have some common characteristics, although they may not be identical in all respects. Some therefore might argue that the boards should consider using the same or very similar accounting for both types of liabilities.

33. The boards expect to review the accounting for employee benefits more broadly in due course. Therefore, existing requirements and possible short term proposals are not necessarily a relevant precedent for the future standard on insurance contracts. Also, some argue that pension liabilities are not part of the employer's core operating activities and that this factor justifies using OCI for remeasurements of those liabilities. Even if that argument is valid for pension – which the staff does not necessarily accept – it is clearly not valid for insurance liabilities, which are an integral part of an insurer's core operating activity.

Summary and staff recommendation

34. The staff could not identify a convincing conceptual or practical reason to propose reporting any effects of remeasuring insurance liabilities outside profit or loss. Any use of OCI would make it more difficult for users to understand the amounts reported. It would also be likely to require complex tracking procedures that would be burdensome to implement, lead to arbitrary results and lack transparency for users.

Question 2 – using OCI for insurance liabilities
The staff recommends that the boards should not permit or require the use OCI for insurance liabilities. Do the boards agree?