Project **Insurance contracts**

Topic **Locking in the discount rate**

What is this paper about?

1. Some propose a locked-in discount rate for all or some contracts as a possible solution to reduce volatility in the financial statements. They believe that this volatility is not consistent with how insurers managed their business. This paper provides the boards with an analysis of that proposal.

2. This paper does not discuss the selection of the discount rate. Agenda paper 3D discusses the selection of discount rate for non-participating contracts. The staff intend to provide a separate analysis for participating contracts at the joint meeting in March. This paper:

   (a) explains the background to the proposal to lock in the discount rate;

   (b) identifies similarities and differences between financial instruments at amortised cost and insurance contracts;

   (c) identifies potential criteria and requirements for a locked-in discount rate; and

   (d) discusses the arguments for and against locking the discount rate.

Staff recommendation

3. The staff recommend that the boards should not lock in the discount rate for any insurance contract. In other words, the discount rate used to measure all insurance contracts should be a current rate that is updated each reporting period.

Background to the proposal

4. The Exposure Draft *Insurance Contracts* and the Discussion Paper *Preliminary Views on Insurance Contracts* propose that future cash flows should be adjusted for the time value of money, using discount rates that are consistent with current market prices. In other words, the discount rate is updated at each reporting date.

5. Some commentators, mainly preparers, have stated that for some or all insurance contracts the insurer focuses on managing the uncertainty of cash flows arising from these contracts, rather than on managing the assets backing these contract liabilities. Some of these commentators suggest that an insurer should measure these contracts in a way that is not sensitive to changes in market interest rates. They base this view on the argument that many insurers focus on matching cash flows of their liabilities with cash flows of their financial assets. This includes matching duration to the extent possible and holding the assets backing the liabilities for a long period of time.

6. Proponents of this view draw an analogy between these contracts and loans issued by banks. They state that the IASB has decided to measure loans by banks at amortised cost and that banks need show the market interest rate sensitivity only in the fair value disclosures. Paragraphs 12-18 below discuss whether some or all insurance contracts should qualify for analogous treatment.

7. Proponents of this view argue that a treatment that was similar to amortised cost under IFRS 9 *Financial Instruments*[1] would align the measurement of the

[1] The FASB has not yet finalised the classification for financial instruments, but has tentatively decided to include amortised cost as a main measurement model. However the criteria for entities to apply amortised cost are still under consideration.

insurance contracts with how they manage their business. They argue that this would also reduce the much-criticised volatility in the financial statements of the insurer and thus keep the focus on the most relevant information.

8. Under IFRS 9, amortised cost is the amount at which a financial asset or liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest rate method. The effective interest is determined at inception and is not changed subsequently (ie it is locked in). At initial recognition, a financial asset or financial liability is measured at its fair value plus or minus transaction costs that are directly attributable to its acquisition or issue.

9. If a contract were measured using a locked in discount rate, the only difference from the proposed measurement in the ED is that the discount rate would be locked in at contract inception (in the building block approach) or at initial recognition of the claims liability (in the modified measurement approach).

10. A locked in discount rate is proposed mainly by some large preparers in some countries in Europe and in the US. They are supported by standard setters in those countries and by international audit firms. However, users that responded to the exposure draft did not agree with a proposal to lock in the discount rate.

11. Some argue that the exposure draft introduces an accounting mismatch between the current measurement for liabilities and the ability to carry financial assets at amortised cost. However, the fair value option in IFRS 9 enables entities to avoid such accounting mismatch. Consequently, the staff do not see the need to create any further mechanism to address this accounting mismatch.

Identifying similarities and differences between insurance contracts and financial instruments measured at amortised cost

12. There are different requirements for financial assets and financial liabilities. We have consequently analysed separately whether there could be an analogy between insurance contracts and financial assets and financial liabilities.

Similarities with financial liabilities

13. In the staff's view, it is difficult to draw an analogy between financial liabilities carried at amortised cost and insurance contracts. The general treatment for financial liabilities (eg debt instruments) is amortised cost after separating most embedded derivatives. The main sources of uncertainties in the cash flows are due to these embedded derivatives. Those embedded derivatives are carried at fair value after being separated. The remaining variability of the cash flows is based on own non-performance and discrete prepayment decisions made and are therefore rather small compared to the variability in insurance contracts. Consequently insurance contracts and financial liabilities are too different in their characteristics to draw an analogy.

Similarities with financial assets

14. Another way of locking at insurance contracts is to compare them with the loan book of banks. Banks usually will classify the loans under IFRS 9 *Financial Instruments* under amortised cost. IFRS 9 assumes that entities can measure financial assets at amortised cost only if there is no large variability of the cash flows under regular circumstances (other than credit events and prepayments). Consequently, if the holder adopts a 'hold to collect' strategy, interest rate fluctuations in a current measurement model will reverse by the time the instrument matures. This means that the amounts of the cash flows are largely predictable. However, this does not imply that there is absolute certainty about the timing or the amounts of cash flows.

15. Some insurance contracts can be viewed as having features similar to those of financial assets eligible for amortised cost. One example is a contract that offers the policyholder a lifetime annuity (a series of monthly payments). The cash outflows under these contracts are predictable, to the extent that the policyholder survives. Some may feel that some other insurance contracts lead to relatively predictable payments (eg some property and casualty insurance contracts).

16. Some would argue that, on an individual contract level, there is virtually no predictability in the cash outflows before the insured event occurs, especially in property and casualty and 'classic' life insurance. Consequently, some argue that for these contracts there is no analogy between these insurance contracts and those financial assets that are eligible for amortised cost.

17. However, others argue that there is comparable uncertainty for the cash flows of financial assets carried at amortised cost. For financial assets, the measurement of credit losses is based on historical experience projected into a future expectation and on clustering of contracts with similar characteristics on a portfolio level. The uncertainty in some insurance contracts is also based on historical experience projected into future expectation by using, for example, mortality and morbidity tables, or frequency and severity data.

18. Some would argue that the level of predictability for insurance contracts is lower than for financial assets carried at amortised cost, even for plain life insurance. This is because the contracts expose the insurer to the risk of, for example, a pandemic or a catastrophe, but the same holds true for entities trying to predict future credit losses. A financial crisis may also lead to unforeseen defaults. Some therefore argue that the predictability of insurance contracts' cash flows is not very different from that of financial assets.

Potential criteria and requirements for a locked-in discount rate

19. This section analyses how a locked-in discount rate model could be implemented in practice if the boards were to decide to lock in the discount rate for some insurance contracts.

20. IFRS 9 *Financial Instruments* requires a two-step approach for establishing whether financial assets are eligible to be carried at amortised cost:

    (a) Is the business model for managing financial assets to hold assets in order to collect contractual cash flows (IFRS 9 4.1 (a) and 4.2 (a))?

(b) Are the characteristics of the instrument such that the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest (IFRS 9 4.1 (b) and 4.2 (b))?

21. If some insurance contracts were to be considered analogous to financial assets eligible for measurement at amortised cost as discussed in paragraphs 12-18 , a similar two-step test could be considered.

22. The first condition could relate to whether the business model for managing insurance contracts is to hold those contracts in order to pay contractual cash flows. All insurers write contracts and hold them to collect the premium and pay compensation to the policyholder for an insured event. This part therefore is true for all insurance contracts and there is no need to analogise to create a specific test that considers whether the insurer has a 'hold-to collect' strategy.

23. However, insurers have different ways of managing their assets that are backing the insurance liabilities. Different insurers have different intentions in their strategy to fulfil their obligations under the insurance contracts. Some will invest in riskier assets and try to maximise their income. Consequently, these entities would not have a 'hold to collect' strategy for their assets. Conversely, other entities do have a 'hold to collect' strategy of matching the cash flows and may therefore be interested in having an option to lock in the discount rate for the liabilities. There could therefore be an intention-driven designation analogous to the fair value option under IAS 39. Because such designation is subject to judgement, and also to minimise abuse and improve comparability, the option to designate should be an irrevocable decision for the designated contract.

24. The second step would depend on whether there were similarities between financial instruments carried at amortised cost and insurance contracts as discussed in paragraphs 12-18. The main characteristics of instruments carried at amortised cost are described in IFRS 9 B 4.7-B 4.26 (see Appendix A for an extract of the standard, especially on the uncertainty that is still inherent in the cash flows). One aspect of the financial instruments eligible for amortised cost is that the interest and principal payments are specified in advance and not varied

other than for defined factors (eg variable interest rates; see Appendix A B4.12). Insurance contracts eligible for this treatment should therefore also have cash flows that do not vary for other factors than insurance risk, eg cash flows linked to market variables.

25. To avoid including insurance contracts with other types of variability to the cash flows, it is important that the contracts eligible for this approach would not be subject to significant investment risk. To ensure that this would not be the case, the criteria should exclude contracts that have cash flows that vary based on market movement (eg interest rates or equity returns). Consequently, one possible criterion is that a locked-in measurement would be permitted only when: **'the amount of the insurance contract's inflows and cash outflows do not vary based on investment risk'.**

26. This criterion could capture contracts that merely provide coverage for insurance risk. This would include property and casualty insurance and also simpler forms of life insurance and health insurance.

Arguments for and against a locked in discount rate approach (including consequences for the overall model)

27. A locked-in discount rate could be considered to be aligned with the way in which some insurance contracts are managed. Locking in the discount rate would provide users with a measure to compare the return inherent in the discount rate at inception of a contract with the actual investment performance measured against the contract. Additionally, a locked-in discount rate would reduce short-term volatility that some perceive to be irrelevant information for users of financial statements.

28. However, the staff disagrees with a locked-in discount rate for the following reasons:

    (a) Many insurance contracts contain options and guarantees, some of which would be separated and measured at fair value under existing US GAAP

for insurance contracts. However, current IFRSs do not separate features such as interest rate guarantees if they are out of the money at inception (IAS 39 AG 33 (b)). The staff view this as a significant flaw of a locked-in interest rate approach and of some existing accounting models for contracts with these features because failing to report the time value and intrinsic value of guarantees would not be a faithful representation. Some proponents of an amortised cost-type approach for some insurance contracts would want to measure some or all options and guarantees separately at fair value and measure only the remaining host contract using a locked-in interest rate. This could be seen as being in line with the current liabilities treatment under IFRS 9. However, an increase in bifurcation and unbundling for insurance contracts would make insurance accounting even more complex and reduce comparability and would not be an improvement to existing standards.

(b) Many advocates of a locked-in approach would require an onerous contract test to be triggered if the insurer foresees that the assets will not provide sufficient returns to fulfil the insurance contract. However, the amortised cost regime for financial liabilities in IFRS 9 does not currently include an onerous contract test and provides no mechanism for linking the discount rate for financial liabilities to the returns on financial assets. Consequently, the introduction of such a test would create an inconsistency with IFRS 9, thus reducing comparability. It would also make it necessary to determine when the test would be triggered, the level of aggregation for the test and whether subsequent changes in interest rates would result in reversals of additional liabilities recognised as a result of the test.

(c) It is unclear how changes to the contract should be treated and whether the discount rate is unlocked because a new contract arises. The existing guidance in US GAAP (AICPA Statement of Position 05-1) is very detailed and quite onerous to apply.

(d) If the boards permit, but do not require, a locked-in discount rate, they will probably have to consider a mechanism to avoid abuse. This would add complexity.

(e) The insurer would need to track the locked-in discount rate based on the year of inception which could be burdensome. This will also dilute comparability even within one entity.

(f) A problem might arise if claims are discounted at a locked-in rate. A change in claims inflation that is at least to some extent correlated with general inflation would only be reflected in the cash flows, not in a corresponding change in interest rates. Because claims inflation is one of the assumptions in the cash flow measurement, the original correlation (which is an offsetting effect) would also be locked in and could therefore lead to unintended results. Nevertheless, in countries with a relatively stable inflation rate this problem should be less significant.

29. Some believe that a more appropriate analogy than financial instruments would be liabilities within the scope of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets.* In that standard, the measurement of a liability reflects the current time value of money.

30. It could also be argued that developing a different measurement model for some types of long-term insurance contracts and not for others would reduce comparability with the accounting for other types of insurance contracts and reduce understandability.

31. In addition, this would introduce unwarranted extra complexity into the model. Furthermore, locking in the discount rate does not represent a current value measurement.

32. Current insurance models for long term life type contracts accounted for under US GAAP are built on the notion of locking in all assumptions from inception. There are split views on whether locking in the discount rate and updating the remaining

assumptions would represent a sufficient improvement over current accounting to offset the costs of implementing change.

Staff recommendation:

33. The staff agree with some of the arguments in paragraphs 12-18 and see similarities between some insurance contracts and financial assets or liabilities measured at amortised cost. However, it is not possible to draw a full analogy:

    (a) The analogy drawn should theoretically be with financial liabilities, which have virtually no variability in their cash flows rather than with financial assets. However, trying to establish an analogy with financial liabilities is not successful because these instruments and insurance contracts are not comparable because of the reduced variability in the cash flows of financial liabilities.

    (b) Most proponents of the locked-in discount rate proposed an 'onerous contract test'. This would introduce a new requirement that is not present for financial instruments and would present the difficulties described in more detail under paragraph 28(b). In contrast, the measurement model of financial assets at amortised cost does not require the holder to earn sufficient interest to continue this strategy.

34. Furthermore, the item most similar to an insurance contract liability is a liability within the scope of IAS 37, which would be discounted at a current value.

35. Given the lack of analogy and the practical problems with the locked-in model, the staff do not believe that the boards should require or permit locking in the discount rate for any insurance contracts. Locking in the interest rate would make insurance accounting more complex and less understandable. Therefore staff recommend measuring insurance contracts using a current discount rate (that is, with an update each reporting period).

Question for the boards
Do the boards agree the discount rate used to measure all insurance contracts should be a current rate that is updated each reporting period?

Appendix: Extract from IFRS 9 *Financial Instruments*

Chapter 4 Classification

4.1 Unless paragraph 4.5 applies, an entity shall classify financial assets as subsequently measured at either *amortised cost* or *fair value* on the basis of both:

(a) **the entity's business model for managing the financial assets; and**

(b) **the contractual cash flow characteristics of the financial asset.**

4.2 A financial asset shall be measured at amortised cost if both of the following conditions are met:

(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.**

Contractual cash flows that are solely payments of principal and interest on the principal amount outstanding

B4.7 Paragraph 4.1 requires an entity (unless paragraph 4.5 applies) to classify a financial asset as subsequently measured at amortised cost or fair value on the basis of the contractual cash flow characteristics of the financial asset that is in a group of financial assets managed for the collection of the contractual cash flows.

B4.8 An entity shall assess whether contractual cash flows are solely payments of principal and interest on the principal amount outstanding for the currency in which the financial asset is denominated (see also paragraph B5.13).

(...)

B4.12 A contractual term that changes the timing or amount of payments of principal or interest does not result in contractual cash flows that are solely principal and interest on the principal amount outstanding unless it:

(a) is a variable interest rate that is consideration for the time value of money and the credit risk (which may be determined at initial recognition only, and so may be fixed) associated with the principal amount outstanding; and

(b) if the contractual term is a prepayment option, meets the conditions in paragraph B4.10; or

(c) if the contractual term is an extension option, meets the conditions in paragraph B4.11.

(...)

B4.15 In some cases a financial asset may have contractual cash flows that are described as principal and interest but those cash flows do not represent the payment of principal and interest on the principal amount outstanding as described in paragraphs 4.2(b) and 4.3 of this IFRS.

B4.16 This may be the case if the financial asset represents an investment in particular assets or cash flows and hence the contractual cash flows are not solely payments of principal and interest on the principal amount outstanding. For example, the contractual cash flows may include payment for factors other than consideration for the time value of money and for the credit risk associated with the principal amount outstanding during a particular period of time. As a result, the instrument would not satisfy the condition in paragraph 4.2(b). This could be the case when a creditor's claim is limited to specified assets of the debtor or the cash flows from specified assets (for example, a 'non-recourse' financial asset).

(...)