IFRS

IASB meeting
12 May 2011

Agenda paper **6A**

Staff Paper

Project	**Insurance contracts**
Topic	**Assets backing insurance contract liabilities**

What is this paper about?

1. This paper addresses concerns about income statement volatility that could arise when financial assets held to back insurance contract liabilities are measured at fair value through profit or loss.

2. It considers whether the IASB should change the requirements of IFRS 9 *Financial Instruments* so that gains and losses on such assets are presented as a component of other comprehensive income (OCI) instead of as a component of profit or loss.

3. The Board could change the requirements by either:

   (a) changing the general requirements of IFRS 9; or

   (b) excluding gains and losses on assets backing insurance contracts from the presentation requirements of IFRS 9 and specifying different presentation requirements for those gains and losses within the insurance contracts standard.

Staff recommendation

4. The staff recommends that the IASB should not change the requirements for assets held to back insurance contract liabilities.

This paper has been prepared by the technical staff of the IFRS Foundation for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

Background - IFRS 9 requirements

5. Financial assets - including those held by insurers to back insurance contract liabilities - are within the scope of IFRS 9. IFRS 9 requires entities to measure financial assets 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; and

   (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.

6. However, IFRS 9 also permits entities the option to measure any financial asset at fair value through profit or loss if so doing would avoid an accounting mismatch. Some insurers might use that fair value option for the assets backing their insurance contract liabilities to avoid an accounting mismatch in the statements of performance. The mismatch – which is discussed further in Agenda paper 6B on *Reducing accounting mismatches in profit or loss through presentation* – would arise because the insurer would be recognising changes in the current values of its insurance contract liabilities each period but, if it has assets backing those contracts that are measured at amortised cost, would not be not recognising compensating changes in the fair values of the assets backing those contracts.[1]

[1] If the assets backing the insurance contracts are equities measured at fair value through other comprehensive income, there would also be an accounting mismatch in profit or loss because changes in the carrying amount of the insurance contract liability would be presented in profit and loss whereas most changes in the carrying amount of the assets would be presented in OCI. There would also be an economic mismatch because the insurance contracts and the equities would not respond in the same way to changes in economic conditions. In general we believe that the economic mismatch would have a far greater effect than the accounting mismatch. Equities held at fair value through OCI are particularly relevant to participating contracts, which we discuss in Agenda paper 5. We do not discuss the mismatch for these instruments further in this paper.

7. The requirements of IFRS 9 for assets measured at fair value differ from the previous requirements of IAS 39 *Financial Instruments: Recognition and Measurement*:

   (a) IAS 39 allowed all financial assets that were designated as available-for-sale to be held at fair value, with gains and losses recognised as components of OCI.

   (b) In contrast, IFRS 9 requires that all financial assets are measured either at amortised cost or at fair value through profit or loss, except for equity investments that are not held for trading for which an entity can elect irrevocably to present changes in fair value in other comprehensive income but is prohibited from recycling such gains or losses to profit or loss.

8. As a result some assets previously required to be measured at fair value may now be measured at amortised cost (such as liquid vanilla bonds held to collect contractual cash flows). However, for assets measured at fair value, more of the volatility in asset values will be presented as a component of profit or loss applying IFRS 9 than was previously the case applying IAS 39.

9. Furthermore, although the gains or losses on an insurer's backing assets presented in profit or loss might be offset by compensating losses or gains in the carrying amounts of the corresponding insurance liabilities, the gains and losses are unlikely to offset each other exactly. For instance, when an asset is measured at fair value through profit or loss in accordance with IFRS 9, changes in the asset's credit risk will be recognised and presented in profit or loss each reporting period. However, no offsetting changes in the credit risk (ie non-performance risk) of the insurance contract liability will be recognised because credit risk is not a component of the proposed measurement of the insurance liability[2]. This, coupled with duration mismatches, will result in reported volatility.

---

[2] Even if credit risk was included as a component of measurement of the insurance liability, it would have limited correlation to the credit risk of the assets.

Feedback received

Concerns about impact of IFRS 9 requirements

10. Some respondents raised concerns about the implications of the IFRS 9 presentation requirements for assets held to back insurance contract liabilities.

11. A general concern was that the proposed requirements for insurance contracts considered only the contracts themselves and not the assets held to back them. Respondents argued that a fundamental aspect of insurers' business models is the matching of assets and liabilities. Hence, the measurement basis should accurately reflect the interaction of assets and liabilities, as it forms part of insurers' business model. In their view, the final standard should provide a clear communication tool to investors of an insurer's business performance with the interaction of assets and liabilities fully considered and presented.

12. Some respondents argued that the volatility associated with short term fluctuations in credit risk, or that of risk-free rates and illiquidity premiums, may disguise the underlying economic performance of taking on, pooling and being released from insurance and other risks through an effective asset-liability management. In other words, they fear that key performance indicators would be overshadowed by short term market volatility.

13. Respondents also noted that IFRS 9 allows banks to reflect their business models in their accounting. For instance, banks are able to account for most or all of their lending and deposit-taking activities in a consistent manner, measuring both financial assets and financial liabilities at amortised cost. In this way, they are able to avoid accounting volatility in their financial statements, present stable earnings patterns irrespective of market noise and are not required to report duration mismatches.

14. These respondents noted that banks and insurers are competing for the same capital. They argued that insurers will be at a disadvantage if they cannot avoid volatility in their financial statements.

Solutions proposed by respondents

15. Respondents suggested that, to overcome this perceived problem, changes in financial assumptions for *both* insurance contract liabilities and the backing financial assets should be excluded from profit or loss and presented as components of OCI. In respect of the assets this would have an effect similar to the effect of reintroducing a category similar to available-for-sale in IAS 39. Such an approach would allow insurers to present their performance in fulfilling the insurance contracts as a component of profit or loss while at the same time enabling them to measure their assets and liabilities at current value in the statement of financial position.

16. Respondents suggested two different means of achieving this outcome. They suggested that the Board could either:

    (a) reintroduce into IFRS 9 an accounting model similar to the available-for-sale category in IAS 39; or

    (b) exclude gains and losses on assets backing insurance contracts from the presentation requirements of IFRS 9 and specify different requirements for those gains and losses within the insurance contracts standard. The insurance contracts standard could require insurers to present short term market movements related to both insurance contract liabilities and the assets backing those liabilities as components of OCI.

Staff analysis

Suggestion to amend IFRS 9

17. The Board has received requests, particularly from some European organisations, to reopen aspects of IFRS 9. In particular, some parties would like the IASB to consider reintroducing bifurcation of financial assets and reintroducing some notion of 'available-for-sale' for financial assets. On the other hand, many organisations, including some European organisations, have asked the Board *not* to reopen the classification and measurement parts of IFRS 9.

18. The Board has consistently indicated that it has no plans to reopen IFRS 9 at present. This is because to do so would reintroduce some of the complexity in the accounting for financial instruments that the Board sought to eliminate in amending IFRS 9, in particular in the number of classification categories, but also in the associated complexity of the impairment requirements. Furthermore, many jurisdictions have already made IFRS 9 available for use by their registrants, including Japan (for those applying IFRS from 2010), Hong Kong, Brazil, South Africa, Australia and New Zealand. In addition even in Europe we are aware that some large preparers have invested significant resources preparing to apply IFRS 9 as written.

19. The FASB are currently redeliberating their classification and measurement proposals for financial instruments. That discussion is not yet complete. The Board has agreed that when the FASB has completed its redeliberations on classification and measurement of financial instruments it will seek views from constituents on the FASB model. The staff believes it would be premature to consider changes to IFRS 9 before then.

20. This process would extend well beyond the timescale in which the Board intends to complete the insurance contracts project. (It is worth noting that the project has now been running for more than 10 years and the interim standard, IFRS 4, which

allows diverse accounting practices to remain in place, has been in existence for more than 7 years). Consequently, if the IASB wished to make any changes to the requirements for assets that back insurance contracts, it would need to do so by introducing new requirements specifically for those assets.

Suggestion to include the assets within the scope of the insurance contracts IFRS

21. The Board could introduce specific requirements within the insurance contracts standard for the assets backing the contracts.

22. However, one of the assumptions confirmed by the boards during their joint meeting on 1 and 2 February 2011 is that the proposed accounting standard for insurance contracts will deal with the accounting for insurance contracts from the perspective of the insurer, and not for the assets backing the contracts or for the *entities* that issue those contracts. The accounting for assets backing insurance contract liabilities does not fall within the scope of this project and there are several reasons why the Board might not wish to expand the scope of the project to also address the assets backing the insurance contracts.

23. The first reason is that any special requirements for financial assets held by insurers would make the financial statements of insurers less comparable with those of entities in other industries. One of the basic objectives of accounting standards is to ensure that identical assets and liabilities are accounted for in the same way. The accounting treatment should not depend on the nature of the entity holding the asset or liability.

24. The second reason against introducing special requirements for assets held by insurers is that it could be difficult to define robustly and meaningfully the assets and entities to which the special requirements would apply:

    (a) applying the requirements to all financial assets issued by insurers could lead to opportunities for arbitrage. An entity could take advantage of the special requirements simply by issuing a single insurance contract.

(b) if the special requirements were instead limited to those assets that are held to back insurance contracts, insurers would need to identify from within their financial assets those assets that are held to back insurance contracts. Guidance would be needed to ensure that insurers adopted consistent methods for identifying the liabilities. The process of identifying backing assets could be vulnerable to manipulation. And the financial statements - which would present gains and losses on backing assets differently from gains and losses on other financial assets - would be less readily understandable.

25. If the Board were to consider special approaches for assets backing insurance contracts, it would also need to consider whether to make them mandatory or optional. In other words, it would need to consider whether to *require* insurers to disaggregate changes in the measures of insurance contract liabilities and the related backing assets, identifying the changes that they see as relating to underlying performance separately from the effects of changes in market variables. In some cases, those changes might be inter-related and insurers would find it difficult or impossible to disaggregate them. However, making the disaggregation optional could lead to differences in practice, which would impair comparability further.

Other staff observations

26. IAS 1 *Presentation of Financial Statements* allows entities considerable flexibility in the way in which they disaggregate the components of profit or loss. If insurers wish to separate the gains and losses that they see as relating to their underlying performance from the effects of changes in market variables, they are free to do so. Although presenting information in this way would not eliminate volatility from the net amount reported as profit or loss, it would enable financial statement users to understand the source of the volatility and the effect of changes in market variables on profit or loss. Further discussion of the ways in which insurers could disaggregate performance information is contained in the appendix.

Staff conclusions and recommendations

27. For the reasons outlined in paragraphs 18-20, the staff have concluded that reopening IFRS 9 is not an option within the timescale of the insurance contracts project. Consequently, if the Board wished to make any changes to the requirements for assets that back insurance contracts, it would need to do so by introducing new requirements specifically for those assets within the insurance contracts standard.

28. For the reasons given in the staff analysis in paragraphs 21-25, the staff conclude that the disadvantages of creating new requirements specifically for assets that back insurance contracts would outweigh the advantages. In particular, the accounting requirements would depend on the entity holding the assets, rather than on solely on the characteristics of the assets themselves, reducing comparability and introducing opportunities for arbitrage. If insurers wish to separate the gains and losses that they see as relating to their underlying performance from the effects of changes in market variables, they are free to do so by presenting the amounts as separate components of profit or loss. Although presenting information in this way would not eliminate volatility from the net amount reported as profit or loss, it would enable financial statement users to understand the source of the volatility and the effect of changes in market variables on profit or loss.

29. For these reasons, the staff recommends that the Board does not introduce new requirements specifically for financial assets that back insurance contracts.

Question: Assets held to back insurance contracts
Does the Board agree that it should not introduce new requirements specifically for assets held to back insurance contract liabilities?

Appendix: Identifying underlying performance from insurance contracts

A1. Many respondents to the ED thought that changes in the insurance contract liability should be disaggregated to separate information in the change in the insurance contract liability that insurers see as relating to underlying performance from the change that relates to external factors they see as outside their control. This appendix discusses:

(a) how to identify underlying performance from insurance contracts.

(b) how underlying performance from insurance contracts could be presented, even when all changes in the insurance liability are presented in profit and loss.

Objectives for financial statement presentation

A2. We believe that the presentation requirements of the insurance contracts standard should aim to meet the Board's more general objectives for financial statement presentation. Those objectives were most recently articulated in the joint IASB/FASB discussion paper *Preliminary Views on Financial Statement Presentation* (the 'FSP DP') and in the subsequent staff draft of a proposed standard on financial statement presentation (posted to the boards' websites on 1 July 2010). The staff draft discussed the purpose of financial statement presentation as follows:

> **Purpose of financial statement presentation**
>
> 43 How an entity presents information in its financial statements is critical to effectively communicating that information to those outside the entity. Effective financial statement presentation provides disaggregated information organised in a manner that communicates clearly a cohesive financial picture of an entity.

A3. Two aspects of this paragraph are important:

(c) *The need for disaggregated information.* The staff draft noted that disaggregated information should explain the components of the entity's financial position and financial performance. The FSP DP elaborated on the need for disaggregated information to say that information should be disaggregated so that it is useful in predicting an entity's future cash flows.

(d) *The need for a cohesive financial picture of the entity.* A cohesive financial picture means that the relationship between items across financial statements is clear and that an entity's financial statements complement each other as much as possible.

A4. In this appendix, we consider how those needs could be met by:

(e) Further disaggregation of changes in the insurance contract liability to separate changes that insurers see as relating to underlying performance from the changes that relates to external factors they see as outside their control.

(f) Better information about the relationship between insurance contract liabilities and the assets held to back those contracts.

Operating profit

A5. We observe that many preparers provide non-GAAP measures, in particular of 'operating profit', in an attempt to explain their underlying performance to investors[3]. Operating profit[4] is often described in ways intended to convey that it

[3] We note that although some have stated that a measure of success for the insurance contracts project is the elimination of non-GAAP measures, we do not believe this to be feasible. Insurers will always want to interpret their results in the way that they believe best portrays their business. Furthermore, regulators will always demand more detailed information than is needed for general purpose financial statements and users will inevitably find some of that detailed information useful.

[4] Operating profit generally considers all of an entity's operations, and entities often define it in a way that excludes various items such as the effects of restructurings or amortisation of intangible assets acquired in business combinations. (We also note that operating profit generally excludes investing activities, but observe that investing is a core business activity of many insurers.) Therefore a definition of 'operating profit' is well beyond the scope of this project, which deals only with the accounting for insurance contracts.

represents the profit earned from an entity's normal, core business activities and therefore provides information about the underlying performance of the entity.

A6. Therefore, in attempting to determine how an insurer should identify underlying performance, we took as our starting point the operating profit reported in the financial statements and press announcements of some insurers. We believed an assessment of the items that those insurers excluded from operating profit would provide insight into the type of information that insurers and users would consider to represent underlying performance.

A7. We found that operating profit measures usually exclude non-recurring items and contain adjustments to exclude some investment returns and some financial assumption changes. Such adjustments included market-based fluctuations which many believe to obscure trends in the entity's performance[5]. We did not consider any non-insurance related adjustments, because the classification of such items is beyond the scope of this project.

A8. The adjustments made are consistent with our view, based on the reading of the comment letters and other outreach, that insurers wish to exclude from their operating results the volatility that arises through short-term changes in financial market variables. Those variables relate predominantly to changes in the discount rate and changes in the fair value of financial assets held to back the insurance liabilities. We also note that it may be difficult to distinguish changes in financial from changes in non-financial market variables, particularly in contracts for which those changes are inter-related, such as contracts with guaranteed minimum death benefits (eg contracts that pay on death the higher of a fixed sum and the value of an underlying pool of investments). Some insurers reduce this problem by excluding from underlying performance only the effect of changes in discount rate, and not other financial market variables.

---

[5] We also believe that insurers generally attempted to report separately some changes in the fair value of assets to eliminate the accounting mismatches that arise when insurance contracts are measured on a cost basis and the assets backing them are measured on a current basis. This would no longer be relevant under the proposals in the ED, to the extent that the insurer classifies those assets at fair value through profit or loss.

A9. We noted that income and expense arising from non-financial assumptions (and changes in them), such as assumptions about mortality and morbidity, are generally included within operating profit. We think that this reflects that such changes are regarded as part of an insurer's operations, are affected by management decisions and, to an extent, manageable, for instance through pricing.

A10. We also believe that the reason for the focus on operating profit is because users see this information as providing a basis for predicting future performance. Many believe that users of financial statements would want to distinguish information that helps to assess the future timing and amount of cash flows from information that helps assess the variability of those cash flows. We note that this view is consistent with the IASB's forthcoming amendments to IAS 19 *Employee Benefits*. In those amendments, the IASB concluded that it is useful to present separately components of changes in a liability when those components have different predictive implications.

A11. We draw from this analysis two points:

(g) Insurers have a desire to adjust profit or loss to report some kind of "underlying" result which provides information about the amount and timing of future cash flows.

(h) Those underlying results typically exclude the effects of changes in financial market variables, in particular discount rates. While such effects provide information about the uncertainty and risk of future cash flows, they provide less information about the amount and timing of those cash flows.

A12. Accordingly, we believe that reporting the effect of changes in financial market variables on both assets and liabilities would provide information that distinguishes changes with different predictive value.

A13. One way to do this is illustrated in the following example:

	'000m
Underwriting margin	14
Gains and losses at initial recognition	3
Experience adjustments	12
	29
Investment income, excluding changes from financial market variables in assets backing insurance contracts	12
Changes in estimates of insurance contract liabilities, excluding changes in discount rate	25
Interest on insurance liability	(23)
Net interest and investment	14
Profit before tax and changes in financial market variables	**43**
Assets backing insurance contracts	17
Changes in insurance liability from discount rate	(15)
Short-term fluctuations in financial market variables	2
Profit before tax	**45**

A14. This example illustrates how insurers might identify separately changes in financial market variables below an operating line (which need not be defined in this project). We believe that similar presentation could be useful in the following circumstances:

(i) To highlight underlying performance when the assets backing insurance contracts are measured at fair value through profit or loss

(j) To reduce the effects of the accounting mismatch when the assets backing insurance contracts are measured at amortised cost, but the insurer does not choose to use the option (proposed in agenda paper 6B) to use OCI.

A15. We have identified no obstacles to providing this presentation, but do not believe it should be required.