



Developing an ‘OCI solution’

Presentation by the
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in conjunction with the Comité Européen des
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A reminder of our ED response letter

- In our response letter to the Insurance Contracts ED we highlighted the long term nature of insurance business and the significance of the interaction between assets and liabilities for the industry.
- We noted that such factors mean that specific consideration of the basis of reporting business performance for insurers is required. Short term market movements that are not representative of long term performance should not be presented as key performance indicators.
- We indicated that solutions available to address concerns in this area included an “OCI solution” as well as one involving a locked in discount rate to match assets held at amortised cost. In addition it was noted that insurers should always be able to default to a current value option applicable for both assets and liabilities.
- We have subsequently been developing our thinking around the “OCI solution” and the following slides consider that topic.

An 'OCI' solution – why is it needed?

- Our concern is that, whilst we conceptually support the current fulfilment value measurement model in the ED, the nature of the model, and the related basis of valuation of backing assets, can create inappropriate volatility within reported profit or loss that is not reflective of business performance.
- Recent market conditions provide a topical example of extreme market volatility which is not reflective of sustainable performance. Appendix A illustrates recent levels of such volatility in a number of areas.
- Consequently an 'OCI solution' is needed to allow insurers to reflect short term volatility in asset and liability values outside of net income such that an insurer's Income Statement represents its long term business performance.
- Recent amendments to the proposals (such as discount rates, remeasurement of the residual margin and the “mirroring solution” for measuring participating contracts) are generally welcomed and will address the concerns of some of our members. However, these solutions alone will not provide fully effective reporting of long term business performance.

OCI offers an effective, transparent basis of financial reporting and some of the recent IAS 19 changes offer a good precedent

- We acknowledge the importance of transparency as a key objective of financial reporting. Furthermore, as indicated above, it is fundamental that reported profit is an effective reflection of sustainable profitability.
- We believe that the ability to use OCI would address these objectives by allowing appropriate current balance sheet values to be placed on assets and liabilities whilst reporting sustainable profits in the income statement and identifying short term movements in OCI.
- The most recent application of OCI reporting under IFRS is in relation to IAS 19 *Employee Benefits*. In a paper published in August, Patricia McConnell sets out the rationale for disaggregating changes in plan assets and liabilities as follows: “we believe that it is more useful to present separately items that have different predictive implications.” We believe that aspects of the thinking on IAS 19 should be considered in developing accounting for insurance contracts.

CFO Forum principle

- The CFO Forum supports an ‘OCI solution’ that allows both sides of the balance sheet to be measured on a “current” basis, hence providing a transparent balance sheet approach, and an income statement reflective of underlying long term performance.
- In order to achieve this objective, we believe that the principle for reporting in the income statement should be along the following lines:
Long term sustainable movements in asset and liability values should be recognised in the income statement whereas short term movements in asset and liability values should be able to be reported in OCI
- Over the last few months we have considered the application of this principle to insurance businesses. However, no single basis of application is adequate to reflect the above principle for the wide range of products sold by insurers. We have thus concluded that it is necessary to develop a limited range of applications which will work for specific categories of insurance products.

Examples of why application of the principle may vary by product

- Work we have done to date confirms the importance of first developing a principle for OCI due to the variety of products offered by insurers given the different nature of insurance contracts written in different jurisdictions.
- Consider two examples – An insurer writing “continental style” participating contracts and insurer writing UK style with profits contracts:

Feature	“Continental” style participating contract	UK style with-profits contract *
Accumulated surplus	Unrealised gains on asset portfolio not credited to policyholders or shareholders.	Realised and unrealised gains that have not been credited to policyholders or shareholders.
Participations	Bonus distributions reflect asset realisations to meet contractual requirements to policyholders over duration of contract on a smoothed return basis.	Bonus declarations reflect allocations of total returns to meet contractual requirements to policyholders over duration of contract on a smoothed return basis.
Volatility	Shareholder share of unrealised gains is not matched by liability changes.	Shareholder share of unrealised and realised gains in excess of bonuses declared is not matched by liability changes.

- The mechanics of an OCI solution must provide a solution for contracts with the same fundamental economic attributes.

** Such products are also written more widely in Asia.*

Examples of why application of the principle may vary by product

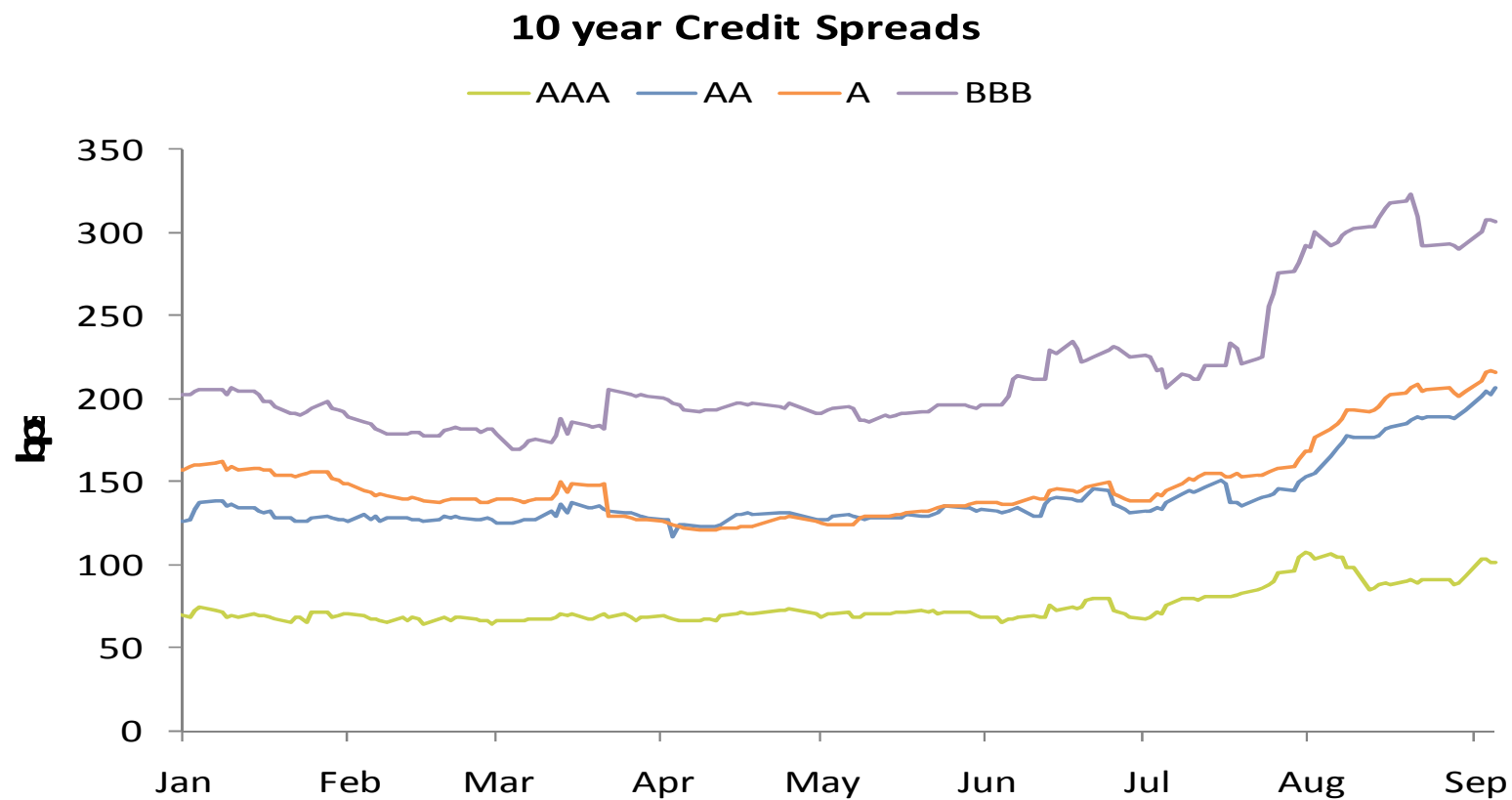
- For the “continental style” participating contracts where the participation is based on realisation of assets, in this case an ‘OCI solution’ could be based on an AFS model with unrealised gains/losses on assets backing insurance liabilities and interest rate movements impacting the value of liabilities taken to OCI. In this example, investment gains and losses would be recycled to profit or loss on asset realisation and liability changes would be similarly recycled when policyholders are credited with their participations.
- For the UK style with-profits contracts, to reflect the sustainable element as the net result in the income statement the mechanics of the ‘OCI solution’ would require a transfer to or from OCI in the income statement of the difference between the shareholder's share of investment returns for the year and the sustainable movement attaching to the shareholder's share of the cost of the declared bonuses.
- Addressing specific issues around mechanics such as designation of assets, types of assets covered and recycling between OCI and the Income Statement is premature.

Next steps

- Attention should now be focused on building the mechanics of an OCI model for differing groups of insurance products and in our view the following attributes should be considered:
 - To satisfy the needs of users it will be necessary for the potential OCI applications to be as specific as possible to increase comparability between insurers.
 - However, at the same time the definition of those applications should not be too narrow as a smaller range of applications is appropriate to reflect particular differences of product features.
- We would anticipate that this work could form a foundation for further IASB work on a wider principle around the use of OCI. Such an approach thus ensures that insurers are not waiting for a wider project to be carried out before a pressing need is addressed for their industry.
- The CFO Forum are keen to work closely with the IASB to develop thinking in this area.

Appendix A1

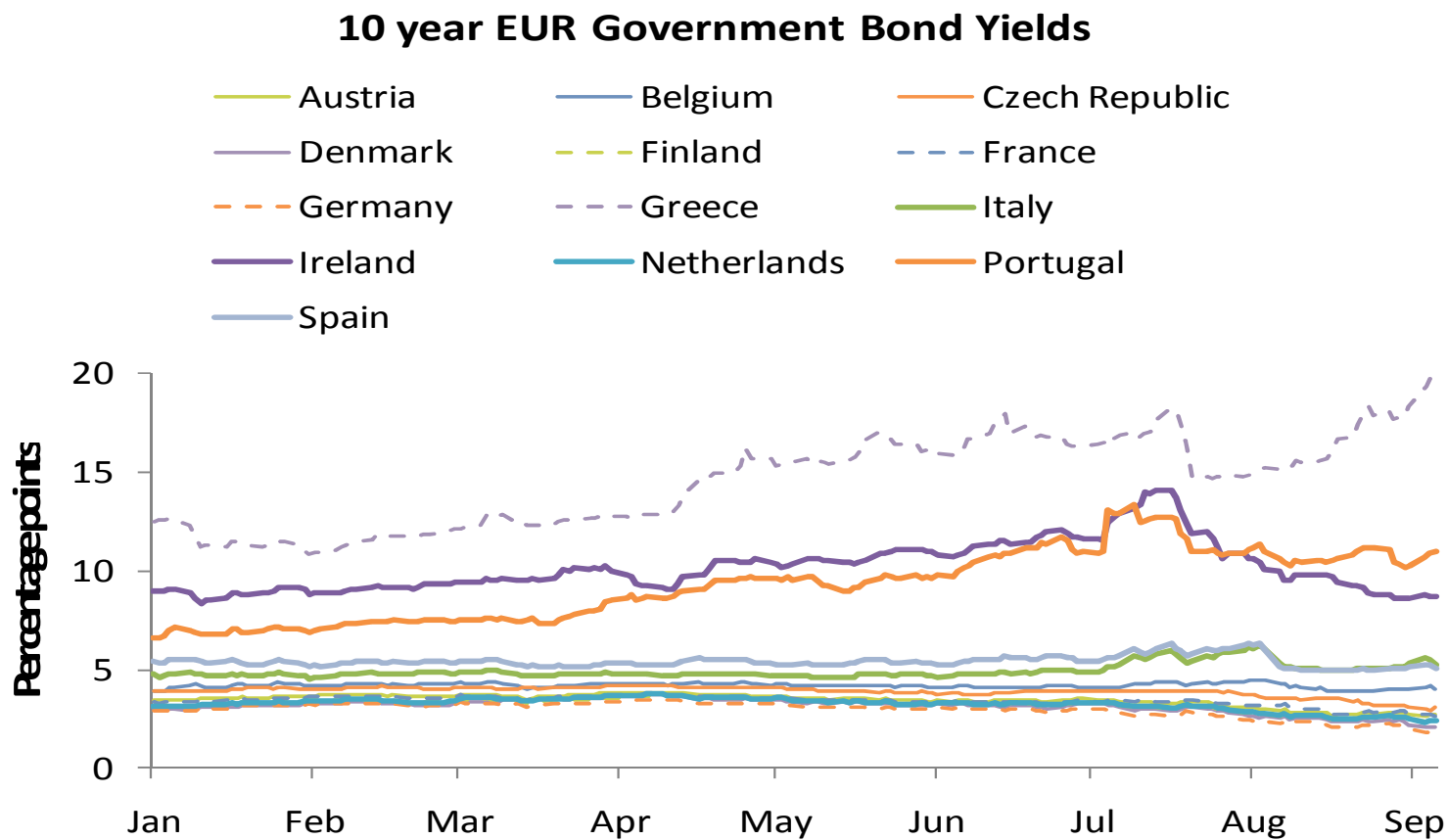
10 year Eurozone credit spreads over swaps by credit rating



Source: ThomsonReuters

Appendix A2

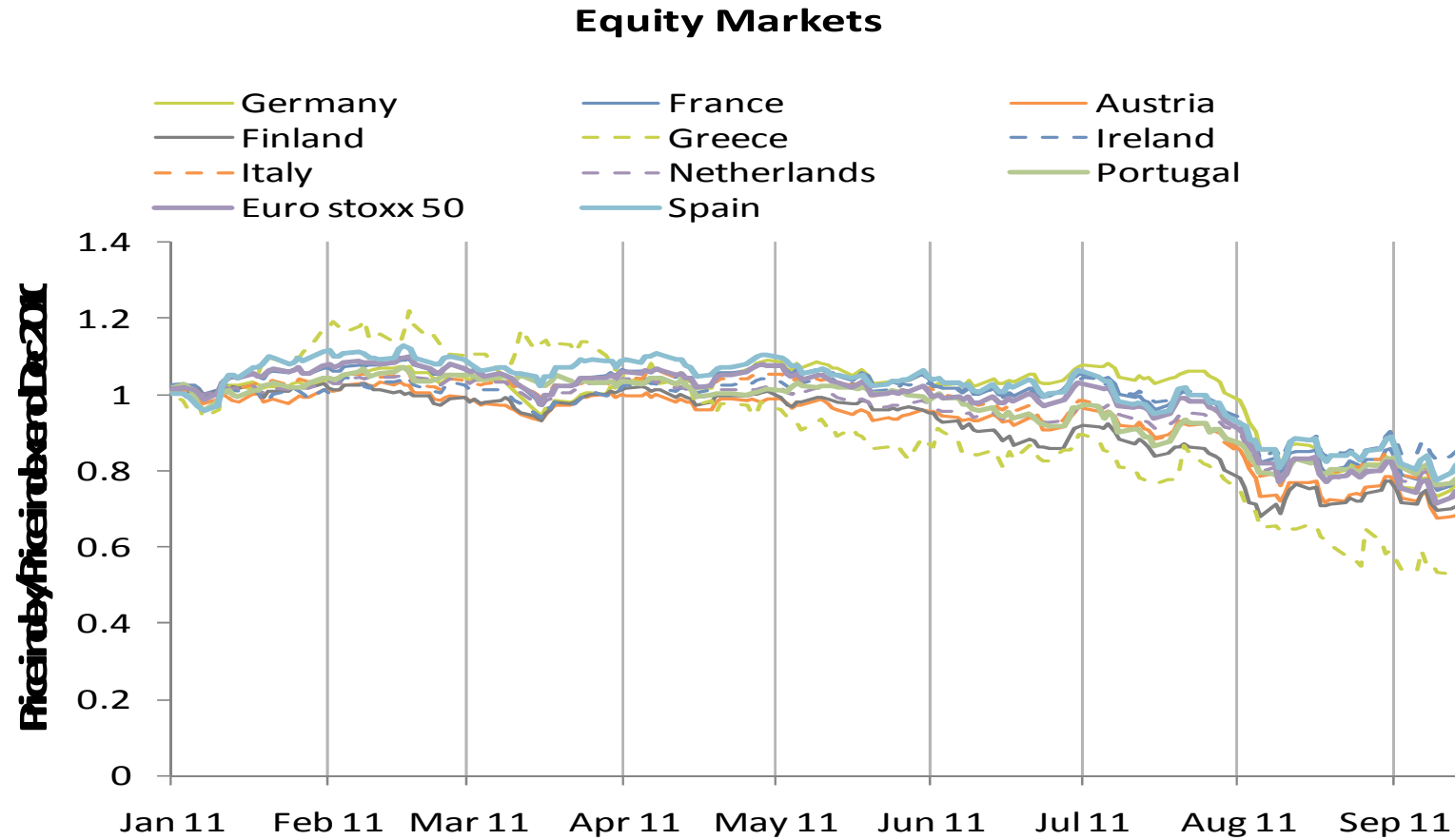
10 year European government bond yields



Source: Bloomberg

Appendix A3

Equity index movements



Source: Thomson Reuters