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STAFF PAPER

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FASB | IASB Meeting

Project	**Insurance Contracts**		
Paper topic	Background on the Use of Other Comprehensive Income		
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This paper is identical to AP2A/82A that was discussed at the joint education session in April 2012. The questions in this paper are superseded by the questions in AP2G/82G *Summary of questions and staff recommendations for using OCI for insurance contracts*.

What are these papers about?

1. This paper provides a summary of feedback on the use of OCI from constituents (both in the comment letter process and additional outreach), as well as alternative approaches.

2. This paper provides background information on the following papers for the April 2012 joint board education session:

(a) Agenda paper 2B/82B[1], which discusses reporting changes in the insurance contract liability arising from changes in specified assumptions in other comprehensive income (OCI). If so:

(i) whether to require or permit the use of OCI

(ii) the unit of account

(iii) frequency of election/determination.

(b) Agenda paper 2C/82C, which discusses the mechanics of recording changes in the insurance liability arising from changes in the discount rate in OCI.

(c) Agenda paper 2D/82D, which discusses whether cumulative losses arising from the remeasurement of the insurance liability recognised in OCI should be accelerated to profit and loss under specified circumstances (a loss recognition test).

(d) Agenda paper 2E/82E provides a comprehensive example of how OCI can be used to present changes in the insurance liability arising from changes in interest rates.

3. These papers will be discussed at a non-decision making joint education session. We plan to ask the boards to make decisions on these issues at the joint meeting in May.

4. The agenda papers for this education session do not discuss what items should be presented in the face of the income statement. We intend to address this in a future meeting.

5. The FASB staff held an education session regarding the use of OCI with their board on April 15, 2011. The IASB staff held education sessions regarding the use of OCI with their board on May 12, 2011 and March 20, 2012.

[1] Agenda paper references are to the papers posted for the April 2012 education session.

Background

Feedback received on the IASB ED/FASB DP

6. The IASB exposure draft *Insurance Contracts* and the FASB Discussion Paper *Preliminary Views on Insurance Contracts* proposed a current measurement model for insurance liabilities with all changes in the liability recognised in profit or loss.

7. In response to the ED and the DP the critical issue raised in almost all jurisdictions and from most respondent types is the volatility in profit or loss and equity that would arise under the proposed model. Almost all insurers think that it would not be a faithful representation of their performance. In particular, some insurers have stated that the gains and losses arising from short term fluctuations in interest rates are not relevant when analysing an insurer's performance as, in general, insurance liabilities are long term in nature. For example:

   (a) Some believe that when insurance liabilities and the assets backing them are both measured on a current basis, swings in credit spreads[2] on the assets may not be relevant to users. It is not useful to report large magnitude of those swings (as seen during the financial crisis) when the insurers' business model collects the principal and interest from debt instruments.

   (b) Some regard short term changes in financial inputs or market variables as irrelevant to an insurer's long term performance. In contrast, they regard other variables, such as mortality or frequency and severity of claims as indicative of longer-term performance, and believe that information about changes in those variables is more relevant to

[2] The boards' have tentatively decided that, in a top-down approach for determining the discount rate, fluctuations in the overall asset spread, other than those arising from expected credit losses and the market risk premium for bearing credit risk, would be attributed to the illiquidity component of the asset yield and hence would also be mirrored in the changes in the liability discount rate. In the staff's view, this decision removes a portion of the volatility from the changes in bond yields, compared to 'bottom-up' approach that most interpreted the ED/DP to require.

assessing an insurer's longer term performance. Those with this view suggest that short-term market movements should be clearly distinguished so that they do not obscure longer term performance. Reported performance should reflect that insurers manage their investments so as to achieve a stable investment return from their assets backing insurance contract liabilities.

(c) Some believe that changes arising from interest rate changes are not a relevant performance indicator and should not be presented in profit or loss. For example, if an insurer had fully matched assets and liabilities—the insurer has effectively hedged its interest rate risk. However, others note that changes in interest rates are relevant when there are mismatches between assets and liabilities.

8. Some state that this volatility results from not measuring and reporting assets and liabilities in the same way. The measurement approach in the ED/DP applies only to insurance contracts and not to the assets that insurers hold to back those contracts. The assets would be accounted for as follows:

(a) some financial assets must be measured at fair value through profit or loss. Where assets are measured at fair value through profit or loss no accounting mismatch arises between the assets and the insurance liability (other than the mismatch that arises from excluding the effects of credit from the measurement of the insurance liability, as discussed in paragraph 10).

(b) some financial assets may be measured at amortised cost. This results in an accounting mismatch under the proposals in the ED/DP in both profit or loss and equity.

(c) [FASB only] Some debt instruments may be measured at fair value through OCI. Measuring changes in the liability through earnings results in an accounting mismatch under the proposals in the ED/DP. Under existing IFRS 9, no debt instruments are measured at fair value through OCI. However, the IASB and the FASB are seeking to reduce

differences in their respective classification and measurement models for financial instruments. This will include consideration on whether the IASB should introduce a third category of financial asset that would be measured at fair value through OCI.

(d) [IASB only] some equity instruments may be measured at fair value through other comprehensive income, with no recycling of the cumulative gains and losses on ultimate disposal. This results in an accounting mismatch under the proposals in the ED in profit or loss.

9. Insurers can reduce the accounting mismatch by choosing to measure their financial assets at fair value through profit or loss. However, many insurers are concerned that current measurement of insurance liabilities (specifically for interest rates) would create such a large accounting mismatch that it would, in effect, prevent them from measuring financial assets at amortised cost, even though the boards have decided that amortised cost is an appropriate measurement in some circumstances. The same argument applies to debt instruments at fair value through OCI under the FASB's financial instruments model. Many suggest that this places them at a disadvantage compared to banks, which compete with insurers in attracting investor capital

10. When assets backing insurance contracts are measured at fair value (either through profit or loss or through OCI), the measurement of such assets reflects the risk of non-performance by the borrower. In contrast, the proposed measurement approach for insurance liabilities excludes the risk of non-performance by the insurer. Thus, fluctuations in credit spreads on the financial assets would not be matched with corresponding changes in the measurement of the insurance liability. When changes in fair value are presented in profit or loss, this mismatch causes volatility in profit or loss. This effect was exacerbated during the financial crisis.

11. Another cause of volatility occurs when the measurement of insurance liabilities and the measurement of assets that an insurer holds to back those liabilities

respond in different ways to changes in interest rate. As discussed in paragraph 7(b), this can occur:

(a) when an insurer has not matched the duration of the insurance liabilities with the duration of the assets that it holds (eg because assets are not available with sufficiently long durations); or

(b) when the insurance contract includes minimum interest rate guarantees.

12. Some, but not all, respondents believe that the measurement model should not report the effect of duration mismatches or mismatches caused by minimum interest rate guarantees in profit and loss. They argue that this would place them at a disadvantage when compared to other financial institutions. Under the boards' financial instruments models banks do not need to report duration mismatches nor the time values of similar embedded minimum interest guarantees because many of their financial assets and liabilities are measured at amortised cost.

13. Others agree that reporting duration mismatches would provide useful information but are concerned that the short-term market volatility in the movements of the interest rates in profit or loss would overshadow the key performance indicators. They recommend that the boards address their concern by presenting in OCI some of the changes that result from discounting the liability using current interest rates.

14. Some believe that changes in the measurement of the insurance liability arising from changes in the current discount rate should be recognized in net income as those changes occur. Those respondents stated the following:

(a) Regardless of whether changes in the discount rate are short- or long-term, those changes are economic and may be useful in analysing an insurer's performance.

(b) While recognition of changes in the discount rate in net income may result in earnings volatility, an asset-liability mismatch resulting from the accounting measurement (and the classification of the changes in

that measurement) would not occur if an insurer's assets are measured at fair value with changes recognized in net income.

(c) In general, OCI, either should not be used or should only be used minimally.

The boards' responses to volatility concerns

15. The following table summarises the respondents' proposals to address their concerns about volatility and the boards' tentative decisions in those areas:

Respondents' feedback	Boards' tentative decisions (or future areas of considerations)
Some propose that using an adjusted asset-based rate to discount the insurance contract liability would reduce volatility.	The boards confirmed that the discount rate used to discount the insurance contract liability should be a rate that reflects only the characteristics of the liability. As a clarification, the boards confirmed that both a top-down and a bottom-up approach can achieve the objective of the discount rate and that the insurer can decide which approach is best in its circumstances The top-down approach significantly reduces accounting mismatch arising from the effect of credit spread changes by reflecting the effect of credit spread changes in both the asset and liability measurement.
Some propose that the discount rate should be locked-in at the inception of the contract.	The boards confirmed that the discount rate used to measure all insurance contracts should be a current rate that is updated each reporting period (ie not to lock in the discount rate for any insurance contract).
Some propose that the residual/single margin should be used as a means of absorbing volatility. That is changes in the measurement of the insurance liability should first be recognised as an adjustment to the margin rather than recognised in profit or loss (i.e. the margin should be unlocked).	The FASB has tentatively decided that the single margin should not be unlocked. The IASB has tentatively decided that the residual margin should be unlocked for some changes in cash flows. The IASB will consider in the future which cash flows should be offset against the residual margin, and whether the effect of changes in the discount rate should lead to unlocking of the residual margin.
Some propose widespread use of unbundling for components that could be measured at amortised cost and are backed	The IASB tentatively decided that insurers should exclude from the aggregate premium presented in the statement of

Respondents' feedback	Boards' tentative decisions (or future areas of considerations)
by financial assets also measured at amortised cost. However, most of those that propose this approach imply that they would prefer to explore other ways of addressing the volatility issue first.	comprehensive income a specified investment component. The FASB will consider what amounts should be excluded from the aggregate premium at a future meeting. Both boards will consider in the future whether a specified investment component should be recognised separately and measured applying the financial instrument standard, rather than the insurance contracts standard.
Some propose that the effects of volatility could be presented in a more useful way by presenting some components of the change in the insurance liability in other comprehensive income.	Agenda papers 2B/81B and 2C/81C for this meeting consider whether and how OCI could be used to present volatility in a more useful way.

16. Furthermore, the boards introduced a 'mirroring approach' for participating contracts, which eliminates any volatility arising from accounting mismatches between assets and liabilities that are contractually linked. This approach also means that, when permitted by existing accounting treatments, insurers could use cost-based measurements for the items underlying the policyholder participation, without creating an accounting mismatch.

17. However, volatility will arise in participating contracts as a result of the boards' tentative decision to confirm that options and guarantees embedded in insurance contracts should be measured using a current, market-consistent, and expected value approach. For embedded options and guarantees that are closely related to the host insurance contract, this will be achieved by including them within the overall measurement of the insurance contract liability. For embedded options and guarantees that are not closely related to the host insurance contract, this will be achieved by separate measurement at fair value through profit or loss.

Feedback from stakeholders on the boards' tentative decisions

18. Most stakeholders welcome the boards' tentative decisions that address concerns on volatility, for example on the top down discount and the 'mirroring' approach for participating contracts. However, staff continues to hear concerns about the volatility presented in profit or loss.

19. Some participating contracts have performance-linked participation features that return to policyholders both realised and unrealised asset returns (for example, UK style with profits contracts). The assets backing these contracts are normally measured at fair value through profit or loss. These contracts are not 100% performance linked, the insurer is exposed to some of the volatility arising from the fair value changes in the assets backing those contracts. Some are concerned that recognising some of the changes in the insurance liability in OCI would not address the volatility arising on the insurers' exposure to the fair value changes of the assets backing those contracts.

Users' feedback

20. Some users of financial statements are concerned about the effects of recognising in profit or loss or net income changes in a current value measurement, and the earnings volatility that this will cause. They do not want to see volatility in the income statement when it is due to factors outside management's control (ie market volatility, or as some call it "extraneous volatility"). In particular, there are concerns that there would be huge swings in earnings in interim periods (eg quarterly reporting). In many discussions, users said that earnings volatility made it difficult for them to know "what normal is". Some suggested a corridor approach or an "other-than-temporary" approach to the recognition of changes in current values. Most felt that some of their concerns about volatility could be addressed by recognising some changes in the liability measurement in OCI instead of in profit or loss.

21. However, some told us that they can accept volatility that reflects economic reality. Even some of those who prefer to remove from earnings the effects of

market volatility have different views on where (and whether) those effects should be shown in the financial statements. Several analysts suggested that defining "operating income" would ensure that there would be more consistency in what is included above and below operating income.

22. Some users said that they are less concerned about volatility and more concerned with their ability to model, project and judge performance. They think stable earnings should not be an end in itself, as long as the source of any volatility can be understood and clearly related to economic phenomena. In particular, they note that investors and analysts need to be able to isolate what is on-going and operational in nature ("real volatility") and what is short-term or one-off ("extraneous volatility"), whether that is in operating income, net income or OCI—they think it just needs to be clear and it needs to be consistent across insurers. However, the staff observes that there is no consensus amongst investors and analysts about what is on-going or real, and what is one-off or extraneous.

Other alternatives for reporting volatility

23. Agenda papers 2B/82B-2C/82C, explores whether concerns about volatility could be addressed by presenting gains and losses arising from changes in the interest rate used to discount the insurance liability in OCI. The following section discusses other possible approaches to reporting volatility in the statement of comprehensive income that we do not intend to explore at this stage:

    (a) Requiring some components of the changes in the insurance liability to be presented as operating income, and other changes (for example the effect of changes in the discount rate) to be presented below the operating income line. This is discussed in paragraphs 24-29.

    (b) Using some form of hedge accounting. This is discussed in paragraph 30.

    (c) Using an approach similar to that used for reporting pensions obligations. This is discussed in paragraphs 31-37.

Operating profit or loss

24. Operating earnings is a non-GAAP metric used by some to communicate underlying performance to investors[3]. There is diversity in practice in what is included or excluded from operating profit and typical adjustments to reconcile the net income balance to operating earnings include adjustments not directly related to the insurance liabilities or those assets backing those liabilities (See Appendix A for examples of those adjustments).

25. The general principle behind reporting operating earnings is often described as being to convey results that are core to operations and to exclude non-core, ancillary, unusual or volatile items. Operating profit is used to assist users in predicting future performance by distinguishing information to assess the future timing and amount of cash flows from information about the variability of those cash flows.

26. Some constituents have suggested that volatility concerns could be addressed by requiring some components of the changes in the insurance liability to be presented as operating income and other changes (for example the effect of changes in the discount rate) to be presented below the operating income line.

27. Staff notes that, in general, insurers wish to exclude from their operating results the volatility that arises from 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. Appendix A provides an example of how this split could be presented. Such an approach could be useful in the following circumstances:

    (a) to highlight underlying performance when the assets backing insurance contracts are measured at fair value through profit or loss; and

[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.

(b) to reduce the effects of the accounting mismatch in profit or loss when the assets backing insurance contracts are measured at amortised cost or fair value through OCI.

28. However, the staff believes it is beyond the reasonable scope of this project to consider whether to develop a comprehensive definition of operating earnings. That would require the boards to consider whether to include or exclude many items not related to insurance contracts. In addition,

(a) operating profit is not defined elsewhere in US GAAP or IFRS. This approach would create industry specific presentation for the statement of comprehensive income.

(b) introducing operating profit as a component of the statement of comprehensive income but only excluding changes in financial variables could be confusing for users who associate operating profit as excluding additional items.

(c) some find it hard to argue that asset and liability management is not part of the core operations of an insurer.

29. Consequently, the staff does not recommend this approach.

Hedge accounting

30. Some have suggested that the use of, hedging or macro-hedging, could reduce or eliminate the volatility concerns raised by stakeholders. The staff believes that hedge accounting (or macro-hedge accounting) may reduce some reported volatility. However:

(a) Hedge accounting (as opposed to macro-hedge accounting) cannot be applied to portfolios of contracts. Typically insurers do not enter into a financial instrument to hedge the risks arising on a single insurance contract. In addition, because of the long duration of some insurance contracts, it is difficult to obtain a financial instrument to cover the risks when the duration of the insurance liability is significantly longer than

the duration of most financial instruments. If a financial instrument could be obtained with a third party, its cost would be prohibitive.

(b) Macro-hedging can be applied to open portfolios. However, a discussion paper or an exposure draft on the IASB's proposals for macro-hedging is not expected to be issued until the third quarter of 2012. Consequently, the staff believes that we should consider other ways of addressing volatility concerns and not wait for the decisions to be made in the macro-hedging project. Also, as stated in (a), it is typically difficult to hedge the entire duration of long-term insurance contracts.

Using an approach similar to the accounting model for pension liabilities

31. Under US GAAP and IFRS, the amounts recognised in profit or loss relating to pension liabilities are based on the current assumptions at the start of the reporting period. Consequently, the interest expense reported in profit or loss is based on the interest rate at the start of the reporting period. The effects of changes in the interest rate during the reporting period on the measurement of the pension liability are recognised in OCI (under IFRS and US GAAP[4]). No accounting mismatch arises for funded plans because the change in both the value of the plan assets and pension liabilities are recorded in the same part of the financial statements.

32. A similar approach to that used for funded plans could be used in the insurance contracts project. Under such an approach:

(a) Interest expense reported in profit or loss on the insurance liability, would be based on the liability's discount rate at the start of the reporting period. The effect of changes in interest rate during the reporting period on the insurance liability would be presented in OCI.

[4] Under US GAAP, a reporting entity can elect to record pension gains and losses in net income.

(b) Assets backing insurance liabilities would be measured at fair value. Interest income reported in profit or loss would be based on the asset's discount rate at the start of the reporting period. Changes in the fair value of the assets would be reported in OCI.

33. This approach is illustrated in Appendix B.

34. The advantages of this approach are as follows:

(a) It reduces accounting mismatch in profit or loss as both the interest expense and the interest income recognised are based on interest rates at the start of the reporting period.

(b) Because the assets are measured at fair value and the liability is measured at a current value, the accounting mismatch in equity is minimised.

(c) Because the effect of duration mismatches and credit spreads is reported in OCI, volatility arising from those is presented separately in a useful manner from the rest of the activities of the insurer.

35. However, the staff do not recommend exploring this approach for the following reasons:

(a) This approach would require insurers to measure their assets at fair value. As noted in paragraph 9, some insurers believe that a requirement to measure their assets at fair value would put them at a competitive disadvantage compared to banks.

(b) The use of a current rate of interest in profit or loss for financial instruments carried at fair value is relatively untested.[5] In addition, cumulative amounts recognised in profit or loss over the life of the debt instrument do not equal the total contractual interest.

[5] In 2005, as part of the boards' joint project to address the presentation of changes in fair values of financial instruments, views of users were solicited on the types of information that would be useful to analyse changes in fair values. Related results indicate that there is little or no demand for interest income/expense to be reported on a "fair value" basis. Most users express a preference for interest information to be presented on an accruals basis.

(c) It would require the boards to define "assets backing insurance liabilities". Unlike funded pension plans, insurers do not back the majority of their portfolios with legally segregated assets.

(d) In addition, some have concerns with an approach that currently applies to a subset of an entity's activities, its pension liabilities, to insurance contracts. For most entities applying the forthcoming requirements, insurance will be a core business activity.

36. A variant of this approach has also been suggested. Under this approach:

(a) the measurement of the assets would be in accordance with the relevant IFRS/US GAAP guidance (ie there would be no requirement to measure the assets at fair value).

(b) Interest expense reported in profit or loss on the insurance liability, would be based on the discount rate at the start of the reporting period. The effect of changes in discount rate during the reporting period on the insurance liability would be presented in OCI.

37. Staff also do not recommend exploring reporting the interest expense for the insurance liability in profit or loss based on the discount rate at the start of the reporting period with the effect of changes in discount rate during the reporting period on the insurance liability presented in OCI because:

(a) It would introduce an accounting mismatch in profit or loss. This mismatch arises because the interest expense reported in profit or loss for the liability is calculated using the liability's discount rate at the start of the reporting period (ie a current rate). The rate reported in respect of the assets will be a locked in rate (if those assets are measured at cost or fair value through OCI).

(b) Amounts recognised in OCI do not automatically reverse out to profit or loss.

Appendix A: Operating income

Current practice

A1. There is diversity in practice in what is included or excluded from operating profit but typical adjustments to reconcile the net income balance to operating earnings of insurers include some or all of the following:

- Realized investment gains/losses
- Unrealized investment gains/losses
- Change in discount rate
- Gains/losses on derivatives (i.e. foreign currency, guaranteed life/death benefits)
- Impairment on investments
- Impairment on intangibles
- Non-recurring items
  - Litigation awards/settlements
  - Extinguishment of debt
  - Income/loss from discontinued operations
- Changes in expected cash flows of insurance contracts (a few insurers include these changes based on their determination that they are unusual in nature)

An example illustrating how operating income could be used

A2. This example illustrates how insurers might identify separately changes in financial market variables below an operating line. The example starts at the underwriting margin line because the use of operating income has no impact on items prior to the underwriting margin line.

	'000m
Underwriting margin [components not shown in this example]	17
Experience adjustments	12
	29
Investment income, excluding changes from financial market variables in assets backing insurance contracts	37
Interest on insurance liability	(23)
Net interest and investment	14
Profit before tax and changes in financial market variables (operating income)	**43**
Assets backing insurance contracts: fair value changes	17
Changes in insurance liability from changes in discount rate	(15)
Short-term fluctuations in financial market variables	2
Profit before tax	**45**

Appendix B: Approach similar to the pension liabilities

A3. The following example illustrates the pension liabilities approach described in paragraphs 31-33. We have used simplified assumptions to illustrate this approach in an understandable way:

(a) The reporting period is from 1 January to 31 December.

(b) A portfolio of term life insurance contracts with a duration of 5 years is written on 1 January of 20X0. Premiums collected are CU1,685.

(c) Estimated claims are 2,000. All claims are paid on 1 Jan of 20X6. Present value of the excepted claims is CU1,604.90.

(d) The margin is CU80.1 and is released in a straight-line pattern over the 5 years.

(e) No risk margin.

(f) At Year 0, the premiums are invested in three year zero coupon bonds. On maturity, the total proceeds are reinvested at market rates by purchasing two-year zero coupon bonds. These are measured at fair value through OCI (FV OCI).

(g) The discount rates for the insurance liability and the bonds, assuming a flat yield curve, are as follows:

Year	0	1	2	3	4	5
Insurance liability	4.5%	4.1%	2.5%	2.7%	2.8%	3.0%
Bonds	5.0%	4.6%	3.0%	3.2%	3.3%	3.5%

(h) Figures may not add up due to rounding differences.

A4. The following in the statement of comprehensive income:

Years	1	2	3	4	5	Totals
Interest income at current yield (Asset discount rate @1 Jan X assets at fair value @1 Jan)	84.3	81.7	56.8	62.4	65.4	350.6
Interest expense at current yield (Liability discount rate @1 Jan X liability carrying amount @1 Jan)	(72.2)	(69.8)	(46.4)	(51.2)	(53.5)	(293.2)
Net interest spread	**12.0**	**11.9**	**10.4**	**11.2**	**11.9**	**57.4**
Margin	16.0	16.0	16.0	16.0	16.0	80.1
Asset value changes (Fair value changes - interest income)	6.8	36.1	-	(1.0)	-	41.9
Liabilities value changes (value changes - interest expense)	(25.9)	(84.3)	7.4	0.9	(0.0)	(101.9)
Net value changes	**(19.2)**	**(48.3)**	**7.4**	**(0.0)**	**(0.0)**	**(60.0)**
Total comprehensive income	**8.9**	**(20.4)**	**33.8**	**27.2**	**27.9**	**77.4**

A5. Net interest spread is a measure of the net interest earned measured at current rates but less impairment losses. A gain here shows the result of risk taking and any additional amount earned on any surplus (deficiency of) assets.

A6. Net value changes represents the net value change for insurance liabilities and assets excluding that portion recognised as net interest income. The net gain or loss reflects the effect of any duration mismatch plus gains and losses arising from spread changes on the assets to the extent not reflected in the liability discount rate. This section could either be in the profit or loss but presented below operating income or in OCI.