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STAFF PAPER

FASB | IASB Meeting

Project	**Insurance Contracts**		
Paper topic	Loss recognition test		

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This paper is identical to AP2D/82D 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 The questions in this paper are superseded by the questions in AP2G/82G *Summary of questions and staff recommendations for using OCI for insurance contracts*.

Objective

1. Under both alternatives A and B discussed in Agenda paper 2C/82C[1], interest expense recognised in profit or loss (net income) is calculated using the rate at inception of the insurance contract[2]; the effects of changes in interest rate on the measurement of the insurance liability are recognised in OCI. This paper

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

[2] Under Alternative A the liability unwinds in profit or loss at the discount rate determined at the inception of the contract whereas under Alternative B, the liability unwinds at the current rate. The difference between the current discount rate and the discount rate determined at the inception of the contract is reclassified from OCI. The net impact on profit or loss is the same under both alternatives.

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discusses whether and when to accelerate to profit or loss the losses that are otherwise presented in other comprehensive income—a loss recognition test. Without a loss recognition test, losses would be recognised over the life of the insurance contract which may be later than when the insurer determines that they expect to have a loss on the contract.

2. This paper:
   - (a) provides background information on a loss recognition test (in paragraphs 5-14)
   - (b) discusses the arguments for and against requiring a loss recognition test (in paragraphs 15-34).
   - (c) outlines the issues that would need to be addressed in developing the mechanics of such a test (in paragraph 35).

3. This paper does not address:
   - (a) whether an insurer should reclassify gains and losses on the transfer of a portfolio of insurance contracts (ie on derecognition); or
   - (b) the mechanics of a loss recognition test (including the amount of the loss to recognise and whether to reset the locked in discount rate).

   We intend to discuss these issues in a future paper.

4. This paper 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.

Background

What is a loss recognition test?

5. If asset returns are lower than expected and the discount rate on the liability is locked in at the rate determined at the inception of the contract (as proposed in agenda paper 2B/82B), the insurer will record a negative interest margin in future

years. If the effects of the discount rate changes for the insurance liabilities are reported in OCI and the assets backing the insurance liabilities are measured at fair value through OCI, losses arising from the negative interest margin will be reported in OCI. These losses appear in profit and loss when the interest expense unwinds over the life of the contract and interest income is recognised.

6. For example, at inception, the discount rate of the insurance liability is 7%. The insurer prices its contracts assuming that it can earn interest of 7.5% on its investments, but expected returns (including consideration of reinvestment risks) are now 3.5% over the remaining life of the insurance contract. Under the proposals in agenda paper 2B/82B, the interest expense reported in profit and loss will be calculated using the discount rate at inception, ie 7%. However, interest rates have fallen, and the liability's discount rate is now 3% resulting in losses reported in OCI.

7. Because the discount rate in profit and loss is locked in at 7%, the insurer faces a negative interest margin in profit and loss of 4%, which would be recognised in OCI and unwound to profit or loss over the remainder of the insurance contract. Some believe that, if the losses are expected to exceed the residual/single margin, the insurance contract is loss making.

8. A loss recognition test accelerates the recognition of these future losses in profit or loss to periods in which management determines they expect to have a loss on the contract. The loss recognition test does not adjust the carrying amount of the liability.

Liability adequacy tests

9. Some think a loss recognition test is analogous to the liability adequacy tests currently required in many jurisdictions. The liability adequacy test is necessary because, applying the existing requirements in those jurisdictions, the insurance liability is not measured on a current basis (ie assumptions are locked-in), and/or the effect of the time value and/or intrinsic value of embedded options and

guarantees is not consistently recognised. The liability adequacy test checks that the insurance liability is not understated (or deferred acquisition costs overstated).

10. Most existing liability adequacy tests compare the carrying amount of insurance liabilities with current estimates of future cash flows. If this comparison reveals a loss:
    (a) cash flow assumptions and discount rates are unlocked and adjusted to reflect current conditions. (Under most jurisdictions the discount rate used is an adjusted asset return rate). The revised assumptions and discount rates are then relocked and remain unchanged until maturity (or a subsequent loss).
    (b) the loss is recognised immediately in profit or loss.

11. An example of this is current US GAAP which uses locked-in assumptions for specified products. The purpose for the loss recognition requirement is stated in ASC Topic 944-60-25.

> "Original policy benefit assumptions for long-duration contracts ordinarily continue to be used during the periods in which the liability for future policy benefits is accrued … However, actual experience with respect to investment yields, mortality, morbidity, terminations, or expenses may indicate that existing contract liabilities, together with the present value of future gross premiums, will not be sufficient to do both of the following:
>
> (a) Cover the present value of future benefits to be paid to[3] or on behalf of policyholders and settlement and maintenance costs relating to a block of long-duration contracts; and
>
> (b) Recover unamortized acquisition costs."

[3] For participating contracts insurers are also required to consider the requirement or constructive obligation to credit the policyholder with a specified or discretionary dividend.

12. Under current US GAAP the liability for future policy benefits is calculated as:

    (a) the present value of the remainder of future payments for benefits and related settlement and maintenance costs; minus

    (b) the present value of future gross premiums (also using the same revised assumptions); and

    (a) and (b) are determined using locked-in assumptions at inception or locked-in revised assumptions when a premium deficiency test is triggered.

13. The recognition of a premium deficiency may be triggered if the present value of future cash flows, less both the current benefit reserve and the carrying amount of unamortized deferred acquisition cost, is a negative amount. A premium deficiency is then determined as the difference between that negative amount and the liability for future policy benefits (reduced by unamortized deferred acquisition costs). That premium deficiency is recognized by a charge to profit and loss and either a reduction of unamortized deferred acquisition costs or an increase in the liability for future policy benefits.

14. Under the building block model, a liability adequacy test is unnecessary because the liability recognised on the balance sheet reflects current expectations and assumptions and the time value and intrinsic value of all embedded options and guarantees. However, some believe that if the change in the discount rate were to be presented in OCI and not in profit or loss (thus resulting in interest expense calculated using the discount rate at inception to be recognized in profit or loss), a loss recognition test is needed for the statement of comprehensive income. This would result in the insurer recognising a loss in profit or loss by accelerating losses from OCI, similar to the way insurers recognise losses in profit or loss when a liability adequacy test is triggered today. In contrast to a liability adequacy test there would be no effect on the carrying amount of the liability in the statement of financial position.

Should a loss recognition test be required?

15. The following paragraphs discuss the arguments for and against a loss recognition test.

Arguments for a loss recognition test

Provides useful information

16. Those that support the loss recognition test believe that the profit or loss statement is of primary importance[4]. Consequently, when a company believes that its contracts are expected to be loss making, that loss should be reclassified from OCI to profit or loss. A contract would be considered loss making if the expected cost to settle the liability and earn the unallocated residual/single margin is expected to exceed the total expected returns generated from the assets backing those liabilities. The total expected returns of the assets is calculated by reference to assets that are currently held, any assets that will be purchased from additional premiums on existing contracts (which is considered in the measurement of the insurance contract liability), and the expected returns on all those assets (including any expected reinvestments). It is important to note that expected returns on the assets are only considered when determining whether a loss has arisen. They are not included in the measurement of the liability in the statement of financial position.

17. In situations where the loss recognition test is triggered, the premium charged (which is used to purchase assets) is determined to have been insufficient. In addition, the loss recognition test would provide information that the insurer is not able to earn the balance of the residual/single margin and therefore expects to have to use its other assets or its shareholders' equity to fund the pay out of the liabilities. When the insurer expects to have to use its shareholder equity to fund

[4] Under US GAAP, OCI is normally used to exclude from profit or loss temporary changes in the value of assets or liabilities that are not expected to impact the ultimate amount reported in the profit or loss. IFRS does not have a consistent policy for amounts recognised in OCI. Sometimes OCI is used as a temporary storage for changes in value; sometimes amounts recognised in OCI remain in OCI.

the payout of the liabilities this would be a loss to the shareholders which should be transparent to users of the financial statements. Without such a test the losses on a specified portfolio of insurance contracts would be obscured by the returns of the insurers' profits emerging from other portfolios (eg assets backing the profitable portfolio will be used to pay liabilities on the loss portfolio). Some believe that recognising the losses when they occur (eg in the future as a negative interest margin) is "too late".

18. Those that support a loss recognition test believe that short-term fluctuations in the discount rate could have the effect of distorting the insurer's performance and are less relevant to understanding the long-term performance of the insurer. Hence, they believe that those short term changes should be reported in OCI. However, once the interest rate falls in the longer term, that long-term fall in interest rates becomes relevant to understanding the insurer's long-term performance. Recognising a loss in profit or loss provides signalling information that the interest rate has shifted to a lower level in the long-term.[5] Therefore the losses should be accelerated to when management knows about them. Some argue that recognising the long-term expectations of losses in profit or loss is consistent with recognising changes in the cash flow assumptions in profit or loss because those cash flow assumption changes are long-term expectations (eg insurers are not typically changing mortality assumptions quarterly or annually but rather make changes when the long-term expectations change).

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[5] Financial statement users are particularly interested in how life insurers manage the relationship between movements in the market yields on assets and the duration of the insurer's assets and liabilities (that is, duration gap) because it provides useful information for decision-making. For example, if bond assets have shorter duration than the related insurance liabilities, the insurer may not be able to reinvest the funds at a rate sufficient to fund the liability cash flows when the bond assets mature (reinvestment risk). Also, when interest rates are decreasing, the prices of bond assets increase but the insurer may not be able to sell the bond assets to realize the gains in time to pay for policyholder obligations as they become due (liquidity risk). As a result, insurers are required to provide information about the duration of assets and liabilities, reinvestment and liquidity risks and the strategies for managing these financial risks as interest rates change in the long-term.

Consistent with tentative insurance decisions

19. Some think a loss recognition test has an effect on profit or loss that is similar to the onerous contract test under the premium allocation approach, in that it recognises a loss in profit or loss when an insurer expects that a contract will be loss-making.

Consistent with other requirements

20. In addition, a loss recognition test can be viewed as similar to an impairment test for assets carried at amortised cost and fair value through OCI (Appendix A provides background information on when an impairment event is deemed to occur for an asset measured at fair value and cost, and the relevant decisions in the impairment project). Both tests deal with the same fundamental question—when it is appropriate to recognize in profit or loss that the expectations at origination have deteriorated.

21. Recent tentative decisions by the boards in the Financial Instruments project require entities to consider "full lifetime expected losses". The boards also tentatively decided that the assessment of whether recognition of lifetime expected credit losses is required should be based on the likelihood of not collecting all the cash flows as opposed to incorporating the "loss given default" in the assessment (See Appendix A).

22. When analogizing those impairment decisions to insurance, an insurer would recognise a loss when the likelihood that the total expected returns indicates that the insurer may no longer able to fund the liability and earn the unallocated margin. Some believe that if an insurer reflects impairment on its assets because of worsening market conditions, losses for the insurance contract should also be recognised because there may be insufficient reinvestment income to fund the liability. To be consistent with the impairment of those assets, losses for the insurance contract should be recognised when management determines that the likelihood of future events results in losses arising from expected asset returns.

23. Also, the US GAAP guidance on life settlement contracts, ASC topic 325-30-35-11, requires an impairment test. A life settlement contact is an asset that represents an investment in a life insurance contract.[6] That guidance requires a loss to be recognised and the carrying amount of the asset to be adjusted downwards, to its fair value, when the undiscounted cash inflows (the expected death benefits) from that investment are less than the total of the carrying amount of the asset and any undiscounted future premiums and specified costs.

24. Some would argue that recognizing a loss when assets are determined to be insufficient to fund the liabilities but not recognizing a gain when management expects that the assets will be in excess of the insurance contract liabilities does not meet the objective of neutrality. However, the staff note that this is consistent with other areas of accounting where losses are recognised but not gains. This is also consistent with the boards' tentative decisions in the insurance project that there should not be a day-one gain, however an expected loss should be recognized immediately.

Not costly to implement

25. Those that support a loss recognition test note that, because many jurisdictions currently require such a test it would be less burdensome then the current liability adequacy tests (see paragraphs 10-13). Because the proposed measurement model uses all updated assumptions, the loss recognition test will need to consider **only** an updated discount rate. This is less burdensome than the current liability adequacy test which uses updated information for **all** assumptions. In addition, several companies have indicated they currently perform economic-based evaluations which would have similar characteristics to the loss recognition test. Because of these points, the costs of implementing the test may not be in excess of the current costs.

[6] ASC topic 325-30-35-11 states: "an investor shall recognize an impairment loss if the expected undiscounted cash inflows (typically, the insurance proceeds) are less than the carrying amount of the investment plus anticipated undiscounted future premiums and capitalizable direct external costs if any." ASC topic 325-30-35-11 goes on to state: "If an impairment loss is recognized, the investment shall be written down to fair value."

Arguments against a loss recognition test

Signalling information on reinvestment risk is already provided

26. Some believe that a loss recognition test is unnecessary because losses arising from lower expected asset returns will ultimately appear in profit or loss when those returns are recognised according to the requirements in IFRS/US GAAP. For example, when market returns are falling, the interest expense for the insurance liability will remain the same but the investment returns recognised will fall—therefore, reducing net profit. Before those losses are recognised in profit and loss information about potential futures losses from falling asset returns is available from the carrying amounts of assets and liabilities in the statement of financial position and losses recognised in OCI.

27. If further disaggregated information is deemed useful, additional disclosures could be provided. For example, information on the changes of the insurance liability and margin, and the investment returns of the assets backing those liabilities, disaggregated by portfolios could be disclosed.

A loss recognition test results in less useful information

28. Some note that:

    (a) a loss recognition test takes into account only some losses as it fails to take into account losses before the test is triggered. In addition, any expected gains are not recognised (ie the test is not neutral).

    (b) some insurers do not designate assets to back specified insurance contracts. These insurers would need to segregate their assets to carry out a loss recognition test.

29. Consequently, some believe that the information provided by a loss recognition test may be confusing for users.

30. In addition, some believe that information provided by a loss recognition test is potentially misleading because the assets are independent of the insurance contracts (ie not contractually linked together). Hence, the performance of those

assets should not be considered in deciding whether a loss that should be recognised in profit or loss has occurred.

31. Some argue that the mechanics of the loss recognition test would either be subjective or costly and complex. Allowing a subjective/qualitative determination to trigger the test and determine the amount reclassified may allow earnings management. A more deterministic/quantitative test would reduce subjectivity, but would increase the costs and complexity of such a test for both preparers and users. (Paragraph 35 outlines some of the issues that would need to be addressed in developing a loss recognition test). Because some do not see the benefits of a loss recognition test, they believe that the costs outweigh the benefits of such a test.

32. Moreover, some are concerned that a loss recognition test would make the information in profit or loss and OCI more difficult to understand. For example, readers of the financial statements would need to understand that the interest expense in the profit or loss may be an amalgam of a 'cost' and 'current' discount rate, if the test has been triggered. To meaningfully compare the results before and after the trigger, users will need to understand the circumstances surrounding the triggering of the test and the reasons for the larger net profit (lower net losses) in subsequent periods after the loss recognition has been triggered.

Inconsistent with previous decisions

33. Some note that, if a loss recognition test is based upon the expected returns on the assets backing insurance contracts, it would be inconsistent with the fundamental view of the boards that the cash flows of the assets should not be considered in the measurement of the liability (and vice versa). In particular, a loss recognition test that is based upon expected returns on assets is inconsistent with the boards' decision that the objective of the discount rate is to reflect the characteristics of the insurance liability.

Inconsistent with financial instruments requirements

34. In addition, the loss recognition test is inconsistent with today's financial instruments requirements (and under any recent decisions that the boards have taken):

    (a) An impairment loss is **not** recognised for a financial asset (eg debt instrument), if it is funded by liabilities that have a higher than expected effective interest rate.

    (b) If the assets purchased by an entity are funded by a loan carried at amortised cost, the effective interest rate of that loan is **not** reset if those assets are subsequently generating lower than expected returns.

    Hence, such a test may reduce comparability between the insurers and entities in other industries.

Mechanics of a loss recognition test

35. Assuming that the boards require a loss recognition test , the following questions would need to be answered in developing a loss recognition test:

    (a) What triggers the recognition of a loss? Should the margin be considered to determine if a loss should be recognised?

    (b) What happens when the loss recognition test is triggered?

        (i) What amounts should be reclassified from OCI to profit or loss? Should those amounts reduce/eliminate the margin first?

        (ii) Should the unwind of the locked-in discount rate recognised in profit or loss be reset to a different discount rate? If so, to what rate?

    (c) When circumstances indicate that the total expected asset returns are now able to fund the liability, should the effects of the loss recognition

test be reversed (eg possibly resetting the discount rate and/or reversing the losses accelerated to profit or loss and building up the margin)?

36. We plan to discuss these questions at a future meeting.

Staff views

37. FASB staff supports a loss recognition test to reclassify losses to profit or loss from OCI primarily because they believe that accelerating losses to profit or loss signals to investors that the insurer expects that the assets backing the liability are insufficient to fund the liability and for the other reasons discussed in paragraphs 16-25.

38. IASB staff is of the view that a loss recognition test is not needed mainly because they think information on possible losses is already available by considering the amounts presented in both profit and loss and OCI. Because the loss recognition test accelerates losses to the period that the test is triggered, they are also concerned that the profit or loss results may be distorted in subsequent periods. In addition, they agree with the other reasons set out in paragraphs 26-34 against a loss recognition test.

Questions for the boards

Question 1—Requiring a loss recognition test
Should a loss recognition test be required? If so, what is the objective of such a test?

Appendix A: When impairment losses are recognised under current requirements and relevant tentative decisions from the impairment project

A1. This section provides background information on:

(a) when fair value gains and losses are reclassified from OCI on to profit or loss on an impairment event under existing IFRS and US GAAP;

(b) what occurs on an impairment event for assets carried at cost; and

(c) other applicable decisions from the boards impairment project

Impairment tests for assets carried at fair value

A2. Under IFRS and US GAAP, on the impairment of an available for sale (AFS) financial asset, IAS 39 requires accumulated losses in OCI to be reclassified to profit or loss. The amount of the cumulative loss that is reclassified is the difference between the amortised cost and current fair value, less any previously reclassified impairment losses in profit or loss. This treatment is consistent with U.S. GAAP for AFS equity securities (ASC Topic 320-10-35-34), which requires entities to recognise other than temporary impairments in profit or loss. However, ASC Topic 320-10-35-34A through 34E provides different guidance for debt securities; the amount of the other than temporary impairment related to credit loss should be recognized in earnings and the amount related to other factors should be recognized in other comprehensive income.

A3. Under IFRS, for property, plant and equipment and intangible assets remeasured at fair value, impairment losses are recognised in profit or loss once those losses have reduced the revaluation reserves for those assets to zero.

Impairment test for assets carried at cost

A4. An impairment test is also required in other areas of IFRS and US GAAP, including:

(a) IAS 36 *Impairment of Assets* (impairment of goodwill, intangible assets, and all other assets);

(b) ASC Topic 350 *Intangibles—Goodwill and Other* (impairment of goodwill and intangible assets); and

(c) ASC Topic 360 *Property, Plant, and Equipment* (the impairment of long-lived assets).

A5. Under ASC Topics 350-20 and 350-30, impairment losses related to goodwill and other intangible assets are recognized in profit or loss. Similarly, an impairment loss related to long-lived assets should be recognized in profit or loss under ASC Topic 360-10. Under IFRS, impairment losses are also recognised in profit or loss.

Reversals of impairment losses

A6. Under IAS 39, impairment losses on debt instrument reclassified in profit or loss can be reversed in specified circumstances. In contrast with IFRS, the new amortized costs basis shall not be adjusted for subsequent recoveries in fair value under US GAAP. Under US GAAP, impairment losses on securities are reversed through profit or loss over the remaining life of the debt instrument through accretion. However, impairment on purchased loans with bad credit quality can be reversed profit or loss, up to the previously established allowance through, when circumstances change.

A7. Reversals of impairment losses on available for sale equity instruments are prohibited under IFRS and US GAAP.

A8. For goodwill and long-lived assets, subsequent reversal of a previously recognized impairment loss is prohibited under US GAAP. IFRS allows the reversals of previously recognised impairment losses on property plant and equipment but does not permit reversal of losses for goodwill.

Current joint project

A9. Both boards have a current project to improve the alignment between their classification and measurement models for financial assets[7]. As part of that project, the boards will be considering the basis for and scope of a possible third classification category (debt instruments measured at fair value through other comprehensive income).

Impairment project

When should losses be recognised? When they are incurred or expected?

A10. At the 14-15 December 2011 meeting, the boards tentatively decided that recognition of lifetime losses would be appropriate (that is, financial assets would move out of Bucket 1) when there has been a more than insignificant deterioration in credit quality since initial recognition and the likelihood of default is such that it is at least reasonably possible that the contractual cash flows may not be recoverable. Regarding the recognition of lifetime expected losses, the boards also tentatively decided that the assessment of whether recognition of lifetime expected credit losses is required should be based on the likelihood of not collecting all the cash flows as opposed to incorporating the "loss given default" in the assessment.

[7] Under the FASB's financial instruments project, entities are required to recognize realized gains and losses and other than temporary impairments in profit or loss, thus recycling unrealized gains and losses originally recorded in OCI. Under IFRS 9, only equity securities are allowed to be recorded as fair value through OCI and any realized gains or losses on those equity securities is reclassified within equity.