IASB Agenda ref	**2M**
FASB Agenda ref	**83M**

STAFF PAPER

21 May – 24 May 2012

FASB | IASB Meeting

Project	**Insurance Contracts**		
Paper topic	Additional background on the use of OCI		
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Purpose of paper

1. The purpose of this paper is to provide additional information on the use of OCI to present changes in the insurance contract liability requested by Board members at the April Education session.

2. This paper covers the following topics:

   (a) How the recommendations in the other agenda papers meet the objectives of using OCI (paragraphs 3 - 5).

   (b) How amounts recognised in OCI reverse to profit or loss (paragraphs 6 – 12).

   (c) Recycling of amounts recognised in OCI in respect of insurance contracts when assets backing insurance liabilities are sold (paragraphs 13 - 19)

   (d) What happens if assets backing insurance liabilities are measured at amortised cost (paragraphs 20 - 23).

   (e) The tracking needed to make this approach operational (paragraphs 24 - 30).

How the staff recommendations meet the objectives of using OCI

3. The staff have identified the following objectives to using OCI for presenting relevant information about an insurer's performance:

   (a) Address short-term volatility which may reverse over time (due to the long-term nature of the insurance business);

   (b) Promote transparency regarding the insurer's core operating results; and

   (c) Reduce accounting mismatches between how the insurer accounts for its liability and the assets backing those liabilities.

4. The table below includes the questions that are asked in Agenda Paper 2G/83G and references the paper and paragraphs that contain the staff's analysis. The table also indicates which of the above objectives are met based on the staff's analysis and the relative complexity for insurers to implement.

	Objectives	
	Met	Not met
The Use of OCI		
Changes in discount rate presented in OCI (AP 2I/82I ¶13-38)	(a), (b), (c)	–
Changes in interest sensitive assumptions presented in • OCI (AP 2I/82I ¶40-56) • Profit or loss	 (a) (b)	 (b) (a)
Changes in discount rates presented in OCI unless presenting those changes in profit or loss would eliminate or significantly reduce an accounting mismatch (AP 2I/82I ¶59-78)	(b), (c)	(a)

	Objectives	
	Met	Not met
Unit of account for OCI		
Portfolio (AP 2I/82I ¶80-88)	(a)[1], (b), (c)[2]	–
Allocation of contracts – based on asset mix (AP 2I/82I ¶80-88)	(b), (c)[3]	(a)
Frequency of election		
Election is irrevocable if the unit of account is an allocation of individual contracts (AP 2I/82I ¶91-97)	(a), (b)	(c)
Election changes if the fundamental strategy for the portfolio were to change resulting in a new accounting mismatch (expected to be rare) (AP 2I/82I ¶91-97)	(a), (b), (c)	–
Mechanics		
Present interest expense in net income calculated using the discount rate locked in at inception. Present in OCI changes in the insurance liability arising from changes in the discount rate (AP2J/82J)	(a), (b)	–

5. The different staff views regarding a loss recognition test are discussed in agenda paper 2K/83K.

How amounts recognised in OCI reverse to profit or loss

6. This section illustrates how changes in the insurance liability recognised in OCI ultimately reverse to profit or loss.

[1] If the majority of assets backing a portfolio are FVPL, then changes in the insurance liability arising from changes in discount rate (which reverse) will be presented in profit or loss and objective (a) will not be met.

[2] Using the portfolio as the unit of account enables an entity to reduce accounting mismatch but, unless the assets backing insurance liabilities are all classified the same, the portfolio approach will not eliminate accounting mismatch

[3] While this approach will reduce accounting mismatch on day 1, subsequent changes in the asset portfolio mix (and market movements) could create accounting mismatches that might not be eliminated by the appropriate allocation of new contracts.

7. Using the approach proposed in AP 2J/83J the amount included in accumulated OCI is a function of the difference between the insurance liability discounted at the current rate and the insurance liability discounted using the locked in rate. As the expected payment date of the insurance liability approaches, the effect of discounting on the insurance liability (whether discounted at the current rate or the locked in rate) decreases. Once the insurance liability is paid off in full, the recognised insurance liability is zero and, therefore, the difference between the insurance liability discounted at the current rate and the insurance liability discounted at the locked in rate will also be zero. Consequently, the amount recognised in accumulated OCI is equal to zero (ie the amount recognised in OCI naturally reverses to profit or loss).

8. Example 1 in the appendix illustrates how this works for a simple example[4] where there are no changes in expected cash flows. The amount recognised in OCI in each period is made up of two components:

   (a) The effect of changes in interest rates in the current period; and

   (b) The unwind of amounts recognised in OCI in previous periods.

9. Example 2 illustrates how amounts unwind from OCI when there is a change in cash flows (in this case a change in the timing of expected cash flows).

10. The staff have also been asked to clarify whether recycling of amounts recognised in OCI is required when an insurance contract is derecognised (for example on a sale, transfer or substantial modification of an insurance contract).

11. Under the approach proposed in these papers the amount included in accumulated OCI is a function of the recognised insurance liability. If an insurance contract is derecognised it is no longer included in the liability. Consequently, there should be no amounts included in accumulated OCI in respect of derecognised contracts.

[4] Appendix A in AP 2J/83J illustrates an example based on of a portfolio of insurance contracts with expected pay outs of CU10 million over 15 years using actual movements in assets held to back an insurance portfolio (i.e., data of the bond and stock markets for the period from 1995-2010). Example 4 in that paper illustrates the impact for changes in discount rate in each year and the impact from the unwind of the discount rate.

12. The staff note that recycling amounts on derecognition of an insurance liability is consistent with the proposed approach to recycling on derecognition of assets measured at FVOCI inAP6A - *Mechanics of FVOCI measurement for debt instruments* and current US GAAP as well as that proposed in the FASB *Accounting for Financial Instruments* Project.

Recycling on sale of assets backing insurance contracts

13. Under the proposals in agenda paper 6A - *Mechanics of FVOCI measurement for debt instruments* and consistent with current US GAAP and the FASB proposal in the *Accounting for Financial Instruments* Project, when an insurer sells assets that are classified at FVOCI, gains and losses recognised in OCI in respect of the sold assets are recycled to profit or loss. Some board members have asked whether an equivalent amount included in OCI in respect of insurance liabilities that are linked to the sold assets, should be recycled when the assets are sold. Some believe that recycling in this way would avoid an accounting mismatch.

14. The staff do not believe that there is an accounting mismatch in this situation. Accounting mismatches arise when changes in economic conditions affect assets and liabilities to the same extent, but the carrying amounts of the assets or liabilities do not respond equally to those economic changes because different measurement attributes are applied. The change in economic condition here is the sale of the assets. A sale of the assets does not affect the liability.

15. Although the amounts recognised in OCI in respect of the liability are highly correlated with the amounts recognised in OCI in respect of the asset there are elements of the amounts recognised in OCI that are not correlated (for example, credit risk, the effects of hedging, reinvestment risk). Identifying, which parts of the change in the insurance liability recognised in OCI are correlated with the amounts recognised in OCI in respect of the sold assets in order to recycle would be challenging and potentially arbitrary.

16. In addition, insurers do not link individual assets to individual insurance contracts. Instead, a portfolio of assets back a portfolio of insurance liabilities. Therefore

determining the amount that should be recycled when individual assets are sold would be extremely complex and burdensome. This is particularly the case as insurers continually reposition their asset portfolios.

17. If proceeds from the sale of the asset are used to settle the liability then the amount recognised in OCI related to the liability is also automatically recognised in profit or loss (see paragraph 7).

18. Should the boards decide to require recycling of amounts in OCI in respect of the liability when assets are sold, the staff would need to consider various issues that have not been contemplated including:

    (a) the effect of impairment;

    (b) the treatment of transfers of assets between portfolios;

    (c) whether to reset the locked in discount rate on the insurance liability (if the discount rate is not reset, amounts included in accumulated OCI will not reverse to zero).

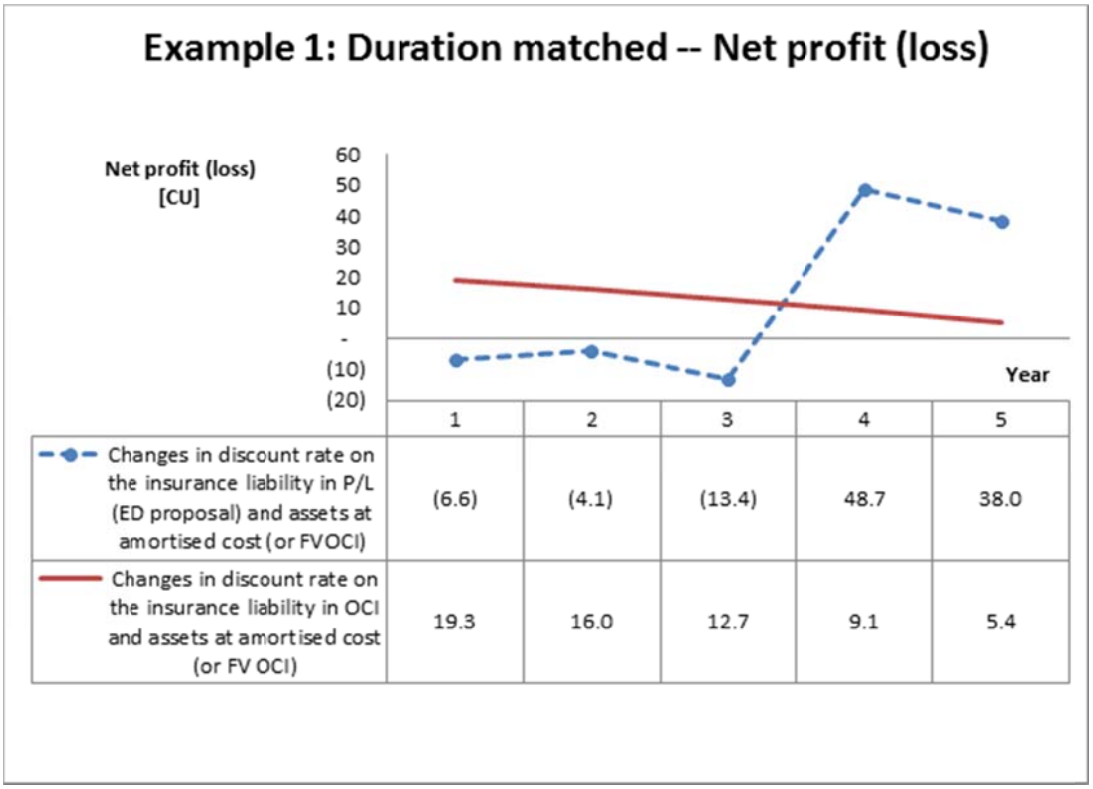
19. Based on these points, the staff do not believe that amounts included in OCI in respect of insurance liabilities that are linked to sold assets, should be recycled when the assets are sold.

Accounting when assets are held at amortised cost

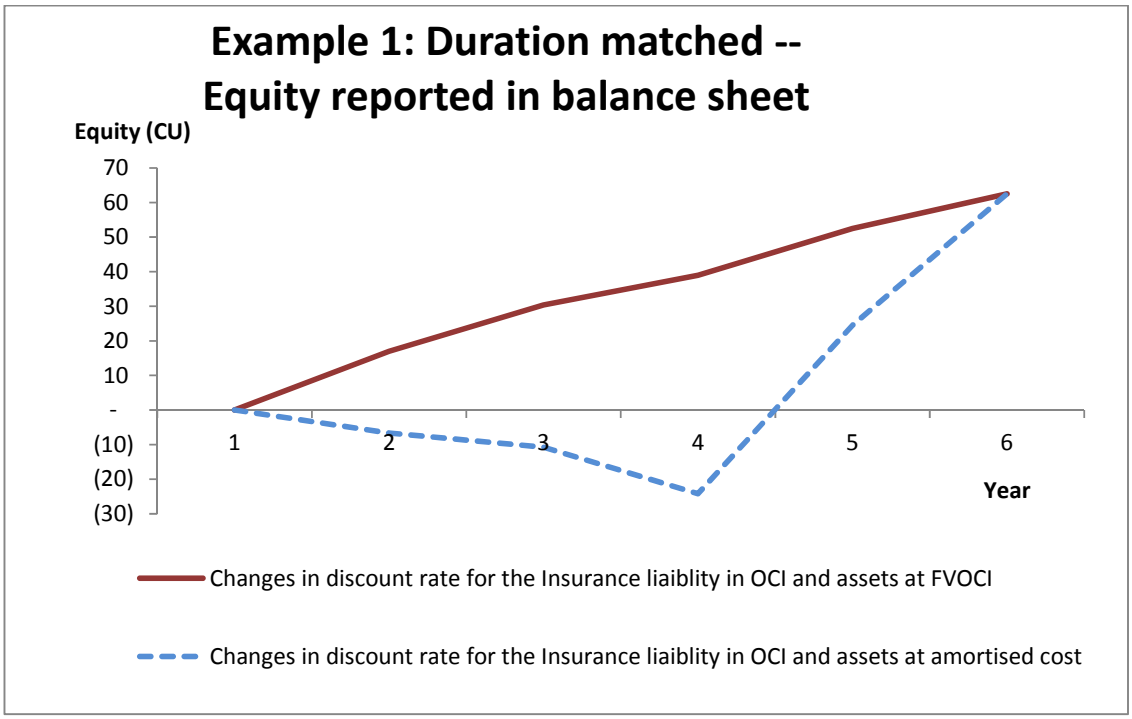
20. At the April Education session some board members asked the staff to clarify what would happen if assets backing insurance liabilities were measured on an amortised cost basis (rather than measured at FVOCI or FVPL).

21. When assets backing insurance liabilities are measured on an amortised cost basis and the changes in the insurance liability arising from changes in discount rates are presented in OCI, interest expense and interest income in profit or loss are based on locked in rates. Reported profit and loss is the same as when the assets are measured at FVOCI and no accounting mismatch arises in profit or loss.

22. However, because the assets are measured on a historic cost basis and the liabilities are measured on a current value basis an accounting mismatch arises in equity (amounts recorded in equity are different to when the assets are measured at FVOCI). This is illustrated in the following graphs (example 3 in the appendix provides the figures supporting these graphs):



	1	2	3	4	5
Changes in discount rate on the insurance liability in P/L (ED proposal) and assets at amortised cost (or FVOCI)	(6.6)	(4.1)	(13.4)	48.7	38.0
Changes in discount rate on the insurance liability in OCI and assets at amortised cost (or FV OCI)	19.3	16.0	12.7	9.1	5.4



23. As noted in paragraph 25(c) of AP2I/83I, most commentators place more weight on an accounting mismatch in profit or loss than on a mismatch in equity. In other words they suggested that the boards should not preclude the use of OCI if the only reason is that a mismatch remains in equity when assets are measured on an amortised cost basis.

Tracking of amounts recognised in OCI

24. Some board members have asked how the tentative decisions regarding the definition of a portfolio interact with the use of OCI. This section clarifies the systems and tracking implications of the proposed OCI approach.

25. In order to present changes in the insurance liability arising from changes in discount rates in OCI, an insurer will need to know the discount rate at the inception of each contract and compare it to current discount rates. The table below is a simplified example to illustrate how companies may track the discount rates. In this example, the staff have assumed that the insurer has written contracts for CU 100,000 in years 1 through 5, all of which pay out in year 6.

The staff assumed that the discount rate at inception of the contract (i.e., "locked in" discount rate) is always the rate at the beginning of the year.

26.

Contracts written in beginning of Year:	**1**	**3**	**3**	**4**	**5**	**Total cumulative amounts in OCI**
Year 1						
OCI: Total change in the liability (4.7% to 4.5%)	764					
Cumulative OCI at the end of Y1	764					764
Year 2						
OCI: Total change in the liability (4.5% to 4.1%)	1,172	1,296				
Cumulative OCI at the end of Y2	1,935	1,296				3,232
Year 3						
OCI: Total change in the liability (4.1% to 3.6%)	870	1,007	1,290			
Cumulative OCI at the end of Y3	2,805	2,304	1,290			6,398
Year 4						
OCI: Total change in the liability (3.6% to 2.5%)	1,153	1,305	1,614	2,010		
Cumulative OCI at the end of Y4	3,958	3,608	2,903	2,010		12,480
Year 5						
OCI: Total change in the liability (2.5% to 2.75%)	(2,145)	(1,979)	(1,641)	(1,212)	(237)	
Cumulative OCI at the end of Y5	1,813	1,630	1,262	799	(237)	5,266
Year 6						
OCI: Total change in the liability (2.75% to 3.0%)	(1,813)	(1,630)	(1,262)	(799)	237	
Cumulative OCI at the end of Y6	0	0	0	0	0	0

27. At the March joint board meeting, the boards tentatively decided on the definition of a portfolio of insurance contracts. While the boards came to different decisions

it is anticipated that the results will be similar. That is insures will group contracts that are subject to similar risks and priced similarly relative to the risk taken on. For the IASB, those contracts also must be managed together as a single pool. For the FASB, those contracts must have similar duration and similar expected patterns of release from risk (i.e., release of the single margin).

28. As the table shows, an insurer will need to track contracts at a lower level than the portfolio level as tentatively defined by the boards. When interest rates are stable, it may be possible to group together contracts with different start dates. However, this would not be possible when interest rates are volatile. In rare cases, the insurer may need to track contracts on an individual contract level.

29. The fact that contracts need to be tracked on a lower level than a portfolio should not affect the way in which the boards have defined portfolio. The concept of a portfolio is still needed for other purposes (eg to determine the residual margin, to perform the onerous contract test and the run-off of the single margin).

30. In regards to complexity, most preparers have stated that discount rates at the inception of contracts and the updated current discount rates can both be tracked. Indeed in some jurisdictions that account for insurance contracts using locked in assumptions, discount rates at inception are already tracked at an individual contract level[5].Some preparers have raised concerns about the additional complexity associated with tracking discount rates. However, many preparers have stated that the costs associated with this additional complexity are outweighed by the benefits of using OCI to present changes in the insurance liability arising from changes in discount rates.

[5] In most cases the locked in discount rate is an adjusted asset-based rate rather than the liability based rate proposed in this project.

Appendix – Illustrative examples

Assumptions

A1. The examples in this appendix use the following simplifying assumptions to highlight the interaction between the treatment of the financial assets and insurance liabilities:

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

(b) The only change in assumptions that will affect the measurement of the liabilities is the change in the discount rates.

A2. For the insurance liabilities, the assumptions are:

(a) A portfolio of term life insurance contracts with a duration of 5 years is written on 1 January of 20X1. Premiums collected are CU1,650.

(b) Estimated claims are CU2,000. All claims are paid on 1 Jan of 20X6. At inception, the present value of the expected claims is CU1,604.9.

(c) The following tables illustrates the cash flows for the insurance liability:

	Cash flows
1 Jan 20X1	CU1,650
31 Dec 20X1	-
31 Dec 20X2	-
31 Dec 20X3	-
31 Dec 20X4	-
31 Dec 20X5	-
1 Jan 20X6	-CU2,000

(d) The margin is CU45.1 (CU2,000 – CU1,604.9) and is released in a straight-line pattern over the 5 years.

(e) The risk margin is equal to zero.

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

Year	Discount rate at the end of year
0	4.50%
1	4.10%
2	3.60%
3	2.50%
4	2.75%
5	3.00%

(g) The following are the bond return rates, assuming a flat yield curve, for each period.

Year	Bond return rates at the end of the year
0	5.00%
1	4.60%
2	4.10%
3	3.00%
4	3.25%
5	3.50%

Example 1: Reversal of amounts in OCI – simple example

A3. This example illustrates how changes in the insurance liability recognised in OCI ultimately reverse.

A4. At inception, the insurer purchases 5 year bonds that pay interest at market rates (5%). The annual interest payments are held as cash and are assumed to earn no interest. All bonds are classified as FVOCI.

A5. The statement of financial position is as follows:

Year	At inception	1	2	3	4	5
Assets						
Bonds (FVOCI)	1,650.0	1,673.6	1,691.1	1,713.1	1,678.0	-
Cash	-	82.5	165.0	247.5	330.0	2,062.5
Total assets	1,650.0	1,756.1	1,856.1	1,960.6	2,008.0	2,062.5
Insurance liability	1,650.0	1,739.1	1,825.7	1,921.7	1,955.5	2,000.0
Equity	-	17.0	30.4	39.0	52.5	62.5
Total liabilities and equity	1,650.0	1,756.1	1,856.1	1,960.6	2,008.0	2,062.5

A6. The statement of comprehensive income is as follows:

Year	1	2	3	4	5	Total
Profit or loss						
Underwriting margin	0	0	0	0	0	0
Interest revenue	82.5	82.5	82.5	82.5	82.5	412.5
Interest expense	(72.2)	(75.5)	(78.9)	(82.4)	(86.1)	(395.1)
Net Interest income (expense)	10.3	7.0	3.6	0.1	(3.6)	17.4
Release of the margin	9.0	9.0	9.0	9.0	9.0	45.1
Net profit (loss)	19.3	16.0	12.7	9.1	5.4	62.5
Other comprehensive income						
Change in fair value - Bonds	23.6	17.5	22.0	(35.2)	(28.0)	0.0
Effects of disc rate changes - Ins liabilities	(25.9)	(20.1)	(26.1)	39.6	32.6	-
Net OCI	(2.3)	(2.6)	(4.1)	4.4	4.6	0.0
Total comprehensive income	17.0	13.4	8.6	13.5	10.0	62.5

A7. The amounts reported in OCI for the insurance liability can be explained as follows:

Year	**1**	**2**	**3**	**4**	**5**
Effects of changes in discount rate in the period (Row A)	(25.9)	(25.8)	(40.2)	4.7	-
Unwind of the liability at the current interest rate (Row B)	(72.2)	(69.8)	(64.8)	(47.6)	(53.5)
Unwind of the interest rate at inception (Row C)	72.2	75.5	78.9	82.4	86.1
Unwind reported in OCI (Row D = Row B + Row C)	-	5.7	14.1	34.8	32.6
Effects of changes in discount rates reported in OCI (= Row A + Row D)	(25.9)	(20.1)	(26.1)	39.5	32.6

A8. The following is the workings for the amount reported in the table above. It should be noted that these workings are not required to present changes in the insurance liability in OCI but may be needed if the boards decide to disaggregate amounts presented in OCI:

		Liability discounted using the discount rates in the column on the left					
Year	Discount rate at the end of periods	0	1	2	3	4	5
At inception	4.50%	**1604.9**	1677.1	1752.6	1831.5	1913.9	2000.0
1	4.10%		**1703.0**	1772.9	1845.6	1921.2	2000.0
2	3.60%			**1798.7**	1863.4	1930.5	2000.0
3	2.50%				**1903.6**	1951.2	2000.0
4	2.75%					**1946.5**	2000.0
5	3.00%						**2000.0**

A9. Each period:

(a) the effects of the changes in discount rate in the period is the discounted liability using the current discount rate minus the discounted liability using the discount rate of the previous period. For Year 2, 1798.7-1772.9=25.8.

(b) the unwind of the liability at the current interest rate, is the liability at the end of the period minus the liability at the start of the period, both

discounted using the discount rate at the start of the period. For Year 2, 1772.9-1703.0 = 69.8 [rounding error].

(c) the unwind of the liability at the interest rate at inception is the difference between the liability at the end of the period and the liability at the start of the period, both discounted using the discount rate at inception. For Year 2, 1752.6-1677.1=75.5. This amount is reported as the interest expense in profit or loss.

Example 2: Reversal of amounts in OCI - Change in cash flows

A10. This example illustrates how amounts reverse from OCI when there is a change in cash flows (in this case a change in the timing of expected cash flows). It uses the same assumptions as Example 1, except at the end of Year 3, 10% of the policyholders die unexpectedly. For simplification, those claims, CU200, are paid immediately. At the end of Year 3, the net present value of CU200 originally expected to be paid at the end of year 5 using the locked-in discount rate of 4.5% is CU183.1. Consequently, the liability decreases by CU183.1 upon payment of the claims. The difference between claims paid out (CU200) and the reduction of the liability (CU183.1) is a negative experience adjustment (CU16.9). That negative experience adjustment is recognised in profit or loss.

A11. In year 3, the following journal entries are made:

Year 3	Dr	Cr
Liability	183.1	
Experience adjustment	16.9	
Cash		200

To record the unexpected claim payment of CU200, the reduction in the liability of CU183.1 (calculated at the locked in rate – 4.5%), which yields a negative experience adjustment of CU16.9.

	Dr	CR
Interest expense (locked-in)	78.9	
OCI	18.9	
Ins liability		97.7

To record the increase in the liability in year 3 calculated using the current discount rate (CU97.7) and the interest expense reported in profit or loss using the locked-in rate at inception (CU78.9). The difference between the increase in the value of the liability and the interest expense reported in profit and loss is presented in OCI (CU18.9).

A12. The statement of comprehensive income is as follows:

Year	1	2	3	4	5	Total
Profit or loss						
Experience adjustment	-	-	(16.9)	-	-	(16.9)
Underwriting margin	-	-	(16.9)	-	-	(16.9)
Interest revenue	82.5	82.5	82.5	82.5	82.5	412.5
Interest expense	(72.2)	(75.5)	(78.9)	(74.2)	(77.5)	(378.3)
Net Interest income (expense)	10.3	7.0	3.6	8.3	5.0	34.2
Release of the margin	9.0	9.0	9.0	9.0	9.0	45.1
Net profit (loss)	19.3	16.0	(4.3)	17.3	14.0	62.5

Other comprehensive income

Change in fair value-bonds	23.6	17.5	22.0	(35.2)	(28.0)	0.0
Effects of disc rate changes-Ins liabilities	(25.9)	(20.1)	(18.9)	35.6	29.3	(0.0)
Net OCI	(2.3)	(2.6)	3.1	0.4	1.3	0.0
Total comprehensive income	17.0	13.4	(1.2)	17.7	15.3	62.5

A13. The statement of financial position is as follows:

Year	**At inception**	**1**	**2**	**3**	**4**	**5**
Assets						
Bonds (FVOCI)	1,650.0	1,673.6	1,691.1	1,713.1	1,678.0	-
Cash	-	82.5	165.0	47.5	130.0	1,862.5
Total assets	1,650.0	1,756.1	1,856.1	1,760.6	1,808.0	1,862.5
Insurance liability	1,650.0	1,739.1	1,825.7	1,731.3	1,760.8	1,800.0
Equity	-	17.00	30.4	29.3	47.1	62.50
Total liabilities and equity	1,650.0	1,756.1	1,856.1	1,760.6	1,807.9	1,862.5

A14. This example uses the same assumptions for the assets as Example 1. However, because CU200 is paid out at the end of Year 3 to settle the claims, the cash account is reduced by that amount.

Example 3: All bonds are classified as amortised cost

A15. This example illustrates the accounting when the assets backing insurance contracts are classified as amortised cost.

A16. At inception, the insurer purchases 5 year bonds that pay interest at market rates (5%). The annual interest payments are held as cash and are assumed to earn no interest.

A17. The statement of financial position, supporting the graph on page 7, is as follows:

Year	At inception	1	2	3	4	5
Assets						
Bonds (Amortised cost)	1,650.0	1,650.0	1,650.0	1,650.0	1,650.0	-
Cash	-	82.5	165.0	247.5	330.0	2,062.5
Total assets	1,650.0	1,732.5	1,815.0	1,897.5	1,980.0	2,062.5
Insurance liability	1,650.0	1,739.1	1,825.8	1,921.6	1,955.5	2,000.0
Equity	-	(6.6)	(10.7)	(24.2)	24.5	62.5
Total liabilities and equity	1,650.0	1,732.5	1,815.1	1,897.4	1,980.0	2,062.5

A18. The statement of comprehensive income, supporting the graph on page 8, is as follows:

Year	**1**	**2**	**3**	**4**	**5**	**Total**
Profit or loss						
Underwriting margin						
Interest revenue	82.5	82.5	82.5	82.5	82.5	412.5
Interest expense	(72.2)	(75.5)	(78.9)	(82.4)	(86.1)	(395.1)
Net Interest income (expense)	10.3	7.0	3.6	0.1	(3.6)	17.4
Release of the margin	9.0	9.0	9.0	9.0	9.0	45.1
Net profit (loss)	19.3	16.0	12.6	9.1	5.4	62.5
Other comprehensive income						
Change in fair value - Bonds						
Effects of disc rate changes-Ins liabilities	(25.9)	(20.1)	(26.1)	39.6	32.6	-
Net OCI	(25.9)	(20.1)	(26.1)	39.6	32.6	-
Total comprehensive income	(6.6)	(4.1)	(13.5)	48.7	38.0	62.5