IFRS™

STAFF PAPER

March 2014

IASB Meeting

Project	Insurance Contracts		
Paper topic	Use of OCI to present the effect of changes in discount rates		

CONTACT(S)	Conor Geraghty	cgeraghty@ifrs.org	+44 (0)20 7246 0553
	Andrea Pryde	apryde@ifrs.org	+44 (0)20 7246 6491

This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IASB and does not represent the views of the IASB or any individual member of the IASB. Comments on the application of IFRSs do not purport to set out acceptable or unacceptable application of IFRSs. Technical decisions are made in public and reported in IASB *Update*.

Purpose of paper

1. This paper asks the IASB to confirm the proposals in the 2013 ED *Insurance Contracts* ('the ED') that an entity should present in other comprehensive income ('OCI') the effect of changes in discount rates on the measurement of insurance contracts, subject to developing an option that would permit entities to present that amount in profit or loss ('P&L'), and to developing disclosures that provides information about the effect of changes in discount rate in the period.

2. Agenda paper 2E discusses an option that would permit entities to present the effect of changes in discount rate in P&L or OCI. Agenda paper 2F discusses disclosures.

3. The paper does not discuss:

   (a) The use of OCI for insurance contracts that provide policyholders with returns from underlying items (e.g., unit linked, universal life, variable annuity, etc.);

   (b) The reference date for determining locked-in discount rates for contracts measured using the premium allocation approach; or

   (c) The interaction between any optional use of OCI and unlocking the contractual service margin.

   These topics will be discussed at a future meeting

The IASB is the independent standard-setting body of the IFRS Foundation, a not-for-profit corporation promoting the adoption of IFRSs. For more information visit www.ifrs.org

Staff recommendation

4. The staff recommends that the Board confirm the use of OCI as proposed in the 2013 ED, subject to:

   (a) Developing an option that would permit entities to present the effect of changes in discount rates on the measurement of insurance contracts in P&L or OCI (see agenda paper 2E); and

   (b) Developing disclosures that provide information about the effect of changes in discount rate during the period (see agenda paper 2F).

5. After the IASB has considered the treatment of the contractual service margin for participating contracts, staff will consider the tentative decisions together to see if the tentative decisions reached for non-participating contracts should be revisited, or vice versa.

Structure of paper:

6. This paper is structured as follows:

   (a) In paragraphs 7 to 8 we describe background to the proposal for the use OCI to present the effect of changes discount rate on the measurement of insurance contracts.

   (b) In paragraphs 9 to 28 we summarise the feedback that the IASB has received in comment letters, field testing and other outreach on the proposals in the ED.

   (c) In paragraphs 29 to 36 we provide the staff analysis and recommendations on whether to confirm the ED's proposals for the use of OCI to present the effect of changes in discount rates.

Background

7. The ED proposed the mandatory use of OCI to present the effect of changes in discount rates on the measurement of insurance contracts. The ED proposed that, for

cash flows that are not expected to vary directly with returns on underlying items[1], interest expense in P&L would be based on discount rates that applied at the date that an insurance contract was initially recognised. The difference between discounting the carrying amounts of insurance contracts at discount rates locked-in at initial recognition and rates that applied at the reporting date ('current discount rates') would be presented in accumulated OCI.

8. The IASB's reasons for presenting the effect of changes in discount rates in OCI were to increase transparency of reporting about the performance of insurance contracts by segregating in OCI the effects of changes in discount rates that are expected to unwind over time from other changes in the measurement of insurance contracts (ie, the measurement of cash flows at discount rates locked-in at contract inception and current rates will converge on the nominal amount of expected cash flows as the settlement date approaches). Paragraph 119 of the Basis for Conclusions to the ED stated:

> ..the IASB was persuaded that entities should segregate the effects of changes in the discount rate that are expected to unwind over time from other gains and losses, so that users of financial statements could <u>better assess the underwriting and investing performance</u> of an entity that issues insurance contracts. The IASB believes that such segregation could be achieved by approximating an amortised cost view of the time value of money to be recognised in profit or loss.

Feedback received

The use of other comprehensive income

9. Many IASB constituents welcome the proposal to present the effect of changes in discount rates on the measurement of insurance contracts in OCI. Reasons given for this support include:

[1] The treatment of cash flows that are expected to vary directly with returns on underlying items are outside the scope of this paper.

(a) They consider the proposals to be an effective way to reduce short-term volatility on long-duration contracts, and to distinguish market noise from long-term trends.

(b) They agree that the proposed segregation provides additional transparency about underwriting results.

(c) They believe that changes in discount rates are beyond the control of the insurer. However, those with this view also believe that all assets backing insurance contracts should be measured at fair value through OCI ('FVOCI'), and that for equities measured at FVOCI, the amounts in OCI should be recycled to P&L.

(d) In addition, many constituents, particularly users of financial statements, agree with the IASB that an amortised cost view of insurance contracts and a current value view both provide useful information.

10. Accordingly, many support the proposal that insurers could present a statement of financial position measured at a current value while presenting in P&L amounts that they believe reflect the long-term nature of their contracts by excluding short-term market movements. In addition, those from jurisdictions that do not report based on current value information today believed that this proposal would mitigate their concerns about the effect of the volatility that arises in financial statements when insurance contracts are measured at a current value. However, even amongst the majority of the constituents that support the segregation of the effect of changes in discount rates in OCI, many believe there are circumstances when its costs outweigh the benefit and hence think its use should be optional rather than mandatory.

11. Some constituents did not support the use of OCI at all, including constituents in Australia, Scandinavia, South Africa, and the UK. Those with this view, including users of financial statements, generally came from jurisdictions that already incorporate elements of current value measurement in their existing accounting practices. Those who did not support the use of OCI generally supported the Alternative Views of Stephen Cooper. Their main arguments are as follows:

(a) Economic mismatches may be obscured by being reported in OCI. The proposal to use OCI to present the differences between discounting the insurance contract liability using locked-in and current discount rates would mean that economic mismatches arising from:

  (i) duration mismatches between assets and liabilities (reinvestment risk);

  (ii) credit spreads; and

  (iii) investment risk arising from receipt of regular premiums;

  would be reported in OCI rather than P&L. Some argue this would reduce transparency in the financial statements because users of financial statements place little significance on changes reported in OCI.

(b) Discount rates applicable when insurance contracts were initially recognised may not be relevant to an assessment of an insurer's performance, particularly when the liabilities are backed with assets acquired more recently. Those with this view include general insurers that actively trade the assets backing their insurance liabilities to achieve their objectives of broadly matching the changing patterns of expected claims settlement whilst managing the credit risk profile and investment return. In such cases, the investment income presented in P&L will reflect current rates of return – which will not necessarily match interest expense based on locked-in interest rates. A few constituents from Australia noted that for general insurance, depending on the risk tolerance of the entity, maintaining a level of duration mismatch may be a preferred approach, in which case such a mismatch is part of current business performance and should be reported in P&L.

12. Some of those that did not support the use of OCI suggest that an option for entities to present changes in the insurance contract in P&L would enable them to achieve what they believe to be better accounting.

13. Accordingly, both those that support the use of OCI and those that do not support the use of OCI think that the IASB should permit an option that would enable entities to

present the effect of changes in discount rate either in OCI or in P&L, depending on the circumstances, so that entities can avoid situations in which they believe the costs outweigh the benefits. Specific arguments presented by respondents against the proposed ***mandatory*** use of OCI to present the effect of changes in discount rate on insurance contract liabilities include the following:

(a) Accounting mismatches, see paragraphs 14 to 17

(b) Additional complexity for preparers and users, see paragraphs 18 to 20

Accounting mismatches

14. Because the accounting model for financial assets is a mixed-measurement-attribute model, accounting mismatches will inevitably arise from the proposal to ***require*** the use of OCI to present the effects of changes in discount rates as proposed in the ED. Those accounting mismatches occur:

    (a) In equity if the assets backing insurance liabilities are measured at amortised cost;

    (b) In P&L in respect of assets backing insurance liabilities measured at fair value through profit or loss ('FVPL');

    (c) In P&L upon the sale of assets measured at FVOCI and amortised cost; and

    (d) In P&L if the assets backing insurance liabilities are equity instruments held at FVOCI, because gains and losses on such equity instruments are not recycled to P&L.

15. As a result, almost all constituents that responded to the IASB's ED were concerned that there would be significant accounting mismatches because the assets they hold to back insurance contract liabilities are measured and presented in different ways. Appendix A describes the assets that entities typically hold to back their insurance contracts. In addition, because interest rates, and hence discount rates, tend to vary in line with inflation, some observe that accounting mismatches arise when changes in discount rates are recognised in OCI while changes in expected claims payments caused by inflation are recognised in P&L.

16. Respondents believed that the accounting classification of economically matched assets and liabilities should not lead to volatility on such items due to accounting mismatches. Some respondents claimed that such mismatches would incentivise insurers to hold assets that can be measured as FVOCI and penalise the use of derivatives to achieve economic matching of assets and liabilities. For example, a life insurer with a substantial portfolio of immediate annuity contracts, which have fixed liabilities may include derivatives in the portfolio of assets used to back those liabilities, to achieve an economic match between the duration of assets and liabilities. In this circumstance, the act of purchasing derivatives to manage economic mismatches would create accounting mismatches because the derivatives must be measured at FVPL.

17. Respondents noted that IFRS 9 provides an option for entities to designate financial assets that would otherwise be measured at amortised cost at initial recognition to be measured at FVPL if doing so eliminates or significantly reduces a measurement or recognition inconsistency ('accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising gains and losses on them on different bases. However they also noted that there would be no similar option in the ED for entities to avoid accounting mismatches.

Complexity

18. The proposals in the 2013 ED to use OCI increases operational complexity compared with the proposals in the 2010 IASB Exposure Draft *Insurance Contracts* because they would require entities to use locked-in discount rates for determining the interest expense presented in P&L. This would mean that entities would need to keep at least two measurement bases for each insurance contract. Furthermore:

    (a) Entities would need to associate each insurance contract with the yield curve that applied at the time of its initial recognition. As a result entities would need to maintain and track a large number of yield curves and link those curves to the related cash flows. The number of yield curves that are required will depend on factors such as the duration of contracts, the

number of currencies and the need to be split into cohorts of contracts with similar inception dates

(b) For contracts transferred to an entity by portfolio transfer or business combination, discount rates for the purpose of consolidated financial statements would be locked in at the date of the transaction. Thus:

(i) in a group of insurance companies different amounts in P&L and OCI may be reported for similar contracts because some were originated by the entity, while others were acquired through portfolio transfer or business combination;

(ii) The locked in discount rates used for the entity's financial statements would differ from the locked-in discount rates used for consolidated financial statements.

19. In addition to creating specific operational issues and complexity, the use of OCI to present the effects of changes in discount rates adds to the overall complexity in implementing and understanding of the proposals in the ED.

20. As noted in the paragraphs 11 onwards, some do not perceive significant benefits from using OCI to present the effect of changes in discount rates. Consequently they believe that the benefits of segregating the effects of changes in discount rates in OCI do not outweigh the effort and complexity that this approach involves.

What amounts should be presented in other comprehensive income?

21. Most respondents to the ED that agreed with the use of OCI also agreed with the mechanics proposed by the IASB, ie, to present in P&L interest expense determined using the locked-in discount rates and in accumulated OCI the difference between interest expense determined using the locked-in discount rates and interest expense determined using the current discount rates. However, a few respondents to the ED suggested alternative proposals for determining the amount of interest expense reported in P&L. These include the following:

(a) Current value interest;

(b) Book yield; and

(c) Effective interest rate

These approaches are explained in paragraphs 22 - 28.

Current value interest

22. Some respondents suggest that, instead of determining interest expense using the discount rate from the inception of the contract, entities should use the discount rate at the start of the reporting period. This would mean that movements in OCI in each period would be the effect of the current period change in discount rates, rather than the effect of the change in discount rates since the contract was initially recognised. Accumulated OCI is always equal to the difference between discounting expected cash flows at locked-in and current rates under the ED proposals. This would no longer always be true if a current value interest approach was adopted. Those proposing the current value interest approach argue that it would segregate the effects of changes in discount rates from P&L, and thus provide similar information to the IASB's proposals, but would dramatically decrease the costs, because it would mean that the entity does not need to store discount rates at a large number of points in time. Some also argue that this information would be more useful to users of financial statements, because the movements in OCI would reflect only the movement of discount rates in the current period, and there would be no amounts recognised in OCI in a period that discount rates do not change.

23. However, presenting the effect of changes in discount rates in the period in OCI would not meet the objective of segregating gains and losses in OCI that are expected to unwind over time. This approach would also lead to accounting mismatches in P&L because the interest expense in P&L would be based on discount rates at the beginning of an accounting period for insurance contracts, while interest income in P&L would be based on initial recognition for financial assets measured at amortised cost or FVOCI. Accordingly, in the light of the general support for the approach in the ED, the staff do not propose to consider this approach further.

Book yield

24. As part of their alternative approach for participating contracts, some preparers suggest that the amount that is recognised in P&L should be determined as the book

yield on the backing assets, ie, an amount based on the return on the assets backing insurance contracts that is recognised in P&L in the period.

25. We will consider the treatment of participating contracts at a later date. The staff notes that this approach would be difficult to apply when the insurance contracts are not backed by clearly defined assets, for example for non-participating contracts or some types of universal life contracts.

Effective interest yield

26. A few constituents have observed that interest income in P&L from fixed income securities measured at amortised cost or FVOCI would be calculated at a constant effective interest rate. In contrast, they note that the interest expense recognised in P&L for insurance contract liabilities would be determined on the basis of the yield curve at the date of inception. They believe that the differences between applying yield curves instead of an effective interest rate would result in an accounting mismatch and suggest that the Board should align the methods of determining interest expense for insurance contracts and financial assets.

27. This issue arises because there are different ways of implementing the ED's principle that interest expense recognised in P&L is determined using discount rates that applied at the date the contract was initially recognised, including:

    (a) Using spot interest rates[2] applicable to cash flows expected to take place following initial recognition

    (b) Using implied forward interest rates[3] derived from the spot rate yield curve

    (c) Using a level effective interest yield equal to the weighted average of discount rates that apply to the expected cash flows

28. The staff do not propose that the standard should specify which technique or techniques should be applied to meet the principle that interest expense recognised in

[2] Spot interest rates convert future values to present values

[3] Forward interest rates convert future values at one date to future values at a different date.

P&L is determined using discount rates that applied at the date the contract was initially recognised.

Staff analysis and recommendations

29. The staff's analysis of, and response to, the feedback is as follows:

    (a) There is clear support for the separation of underwriting results from investing results, using the mechanics proposed in the ED. However:

        (i) some are concerned that presenting underwriting results in P&L and investing results in OCI would report some economic mismatches in OCI. However, the staff notes that those economic mismatches would nonetheless be evident in total comprehensive income, and in the statement of financial position. In the staff's view, this would mean that, over time, users of financial statements would begin to place more weight on the information that is provided in OCI.

        (ii) Many users of financial statements observed that, although the separation of underwriting results from investing results would provide useful information, such information could be equally well provided in the notes.

    (b) Although some question the relevance of discount rates locked in at initial recognition to the financial statements for subsequent periods, many users think that there is useful information in comparing the insurer's expectations when contracts were written to subsequent performance. Such a comparison provides an indication of the entity's underwriting performance (an important metric for many users of financial statements).

    (c) Implementing the ED proposals would impose a high operational burden because of the need to track and maintain a large number of locked-in yield curves. This may also reduce the understandability of the interest expense presented in P&L, because that amount would be determined on the basis of a large number of different discount rates. However:

(i) many constituents in both the comment letters and in the field work, state that implementation of the proposals is feasible. The use of locked-in discount rates is also consistent with existing account practice in some jurisdictions.

(ii) the determination of interest expense is not the only proposal in the ED that would require the use of locked-in discount rates. Locked-in discount rates are also used for accreting interest on the contractual service margin and for determining the present value of cash flows that unlock the contractual service margin. Accordingly, the operational burden must be assessed in the context of the model as a whole. If the Board was to remove the need for locked-in discount rates for the purpose of determining interest expense, the staff would review the use of locked-in discount rates elsewhere in the model at a future date. The staff note that the cost-benefit assessment may differ for insurance contract liabilities measured using the premium allocation approach ('PAA'), which does not include an explicitly determined contractual service margin.

(d) Many constituents raise concerns about accounting mismatches, stating that the accounting mismatches that would arise would overwhelm the benefits of providing disaggregated information about underwriting and investing results. The staff notes that accounting mismatches are inevitable if there is to be consistent presentation of changes in insurance contract liabilities, because revised IFRS 9 will require financial assets to be measured as amortised cost, FVOCI or FVPL (ie, IFRS 9 has a mixed measurement attribute model). This could only be avoided if, as proposed in the 2010 ED, changes in insurance contract liabilities were presented in P&L, and mismatches are avoided through the use of the fair value option ('FVO') in IFRS 9. However, entities state that IFRS 9 allows them to avoid accounting mismatches for financial assets measured as amortised cost by using the FVO (Similar arguments could be made for assets that would qualify for FVOCI, according to the IASB's most recent decisions on IFRS 9). But, if assets are measured at other than FVPL, i.e., using the

measurement categories required by IFRS 9, there will be no equivalent option in the ED to allow them to avoid mismatches. Respondents to the 2010 ED disagreed that they should be forced to measure assets otherwise eligible for measurement at amortised cost and FVOCI, which comprise the majority of the assets held by the insurance industry, at FVPL. Accordingly, they seek an approach that would enable insurers to balance the appropriateness of accounting for financial assets as amortised cost or at FVOCI, with the need to avoid excessive accounting mismatches. If the Board is to accept these competing arguments, a single presentation approach for insurance contracts cannot address the concerns, and both an OCI and a P&L approach would be needed.

30. The staff also observes that, although some question whether a new use of OCI should be required before the Conceptual Framework discussion is complete, the proposal to present the effect of changes in discount rates in OCI are consistent with the IASB's July 2013 Discussion Paper *A Review of the Conceptual Framework for Financial Reporting*, which suggests that the Conceptual Framework:

    (a) Should require a profit or loss total or subtotal that results, or could result, in some items of income or expense being recycled from OCI to profit or loss.

    (b) Should limit the use of OCI to items of income or expense resulting from changes in current measures of assets and liabilities (remeasurements). However not all remeasurements would be presented in OCI.

31. The Conceptual Framework Discussion Paper describes items what could be included in OCI as follows:

    (a) Bridging items arise when the IASB decides that an asset or liability should be remeasured but that the information in the P&L should be based on a measurement that differs from the one used in the statement of financial position. The difference between these two measures would be presented as bridging items in OCI.

(b) Mismatched remeasurements may arise when an item of income or expense represents the effects of only part of a linked set of assets, liabilities or past or planned transactions. A mismatched remeasurement arises when the item of income or expense represent the linked set of items so incompletely that the item provides limited relevant information about the return that the entity made on its economic resources in the period.

(c) Transitory remeasurements arise when the IASB decides that the remeasurement of assets or liabilities can increase the relevance of profit or loss by reflecting those remeasurements outside of the P&L. Transitory remeasurements distinguish amounts in OCI from those in P&L because the assets or liabilities have a long-term horizon for realisation or settlement, amounts recognised in OCI are likely to fully reverse or significantly change, and the use of OCI enhances the relevance and understandability of items in profit or loss.

32. In the staff's view, the proposals in the 2013 ED would recognise in OCI items that could be described as bridging items as the amount in OCI is the difference between the insurance contract measured using the locked in discount rate (in P&L) and the current discount rate (for the statement of financial position).

33. In addition, when insurance contract liabilities have a long-term horizon for settlement, remeasurements of insurance contract liabilities could qualify as transitory remeasurement because the amount in OCI reverses over time, and some regard the recognition of that amount in OCI as improving the understandability and relevance of items in P&L.

34. Accordingly, the staff proposes that the Board should confirm that entities should be able to present the effects of changes in discount rates in other comprehensive income.

35. However, the staff are sympathetic to the criticism that, in some cases, difficulties in understanding reported information because of accounting mismatches might outweigh the benefits of disaggregating information in P&L and OCI. The Board's

discussion paper *A Review of the Conceptual Framework for Financial Reporting* states in paragraph 6.22 that:

> When deciding whether a particular measurement faithfully represents an entity's financial position and performance, the IASB may need to consider how best to portray any link between items. When assets and liabilities are related in some way, using different measurements for those assets and liabilities can create a measurement inconsistency (sometimes called an 'accounting mismatch'). Measurement inconsistencies can result in financial statements that do not faithfully represent the reporting entity's financial position and performance.

36. Accordingly, the staff proposes that the Board should balance the sometimes competing demands of understandability and comparability by adopting an approach that:

    (a) Continues to acknowledge that, when measurement inconsistencies do not result in a lack of faithful representation, it could be appropriate to measure financial assets at FVOCI or amortised cost and present the effect of changes in discount rates on the measurement of insurance contracts in OCI.

    (b) Allows entities to avoid accounting mismatches when they would result in financial statements that do not faithfully represent the reporting entity's financial position and performance. This would mean that the IASB would need to develop an option that would permit entities to present the effect of changes in discount rate on the measurement of insurance contracts in OCI or in P&L.

    (c) Ensures that the information sought by users of financial statements is provided in disclosures in a way that allows comparison, regardless of whether the effect of changes in discount rate is provided in P&L or in OCI.

Question for Board members
Does the Board agree to confirm the proposals in the ED that an entity should present in other comprehensive income the effect of changes in discount rates on the measurement of insurance contracts, subject to developing: (a) an option that would permit entities to present that amount in profit or loss, and (b) disclosure that provides information about the effect of changes in discount rates in the period?

Appendix A: Assets held by entities that issue insurance contracts

This appendix provides background information about the assets held by entities that issue insurance contracts.

Classification and measurement of assets typically used to back insurance contract liabilities

A1. Below is a table summarising some of the types of assets that insurers might hold and the classification and measurement of those assets in accordance with current tentative decisions regarding IFRS 9.

	IFRS	
Asset	**Current IFRS 9**	**Amended IFRS 9**
Debt investments	FVPL[4] Amortised cost[5]	FVPL FVOCI[6] Amortised cost
Loans	FVPL Amortised cost	FVPL FVOCI Amortised cost
Equity investments	FVPL FVOCI[7] (no recycling)	FVPL FVOCI (no recycling)
Derivatives[8]	FVPL	FVPL

[4] Under IFRS 9, debt investments and loans must be measured at FVPL if an entity manages them, and evaluates their performance, on a fair value basis

[5]Under IFRS 9, debt investments and loans can be measured at amortised cost if the business model is to hold the asset to collect the contractual cash flows and the contractual terms of the financial asset gives rise, on specified dates, to cash flows that are solely payments of principal and interest on the principal outstanding

[6]Under the proposed amended IFRS 9, debt investments and loans can be measured at FVOCI if the business model is to hold the asset to collect the contractual cash flows and for sale and the contractual terms of the financial asset gives rise, on specified dates, to cash flows that are solely payments of principal and interest on the principal outstanding

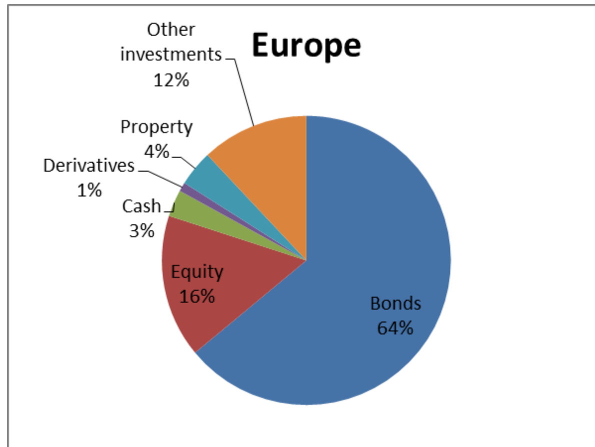
[7] Under IFRS 9, FVOCI applies to equity investments that are not held for trading and for which an irrevocable election is made for OCI classification; recycling of the realised gains/losses to P&L on disposal of the instrument is not permitted and dividends are recognised in P&L in accordance with IAS 18.

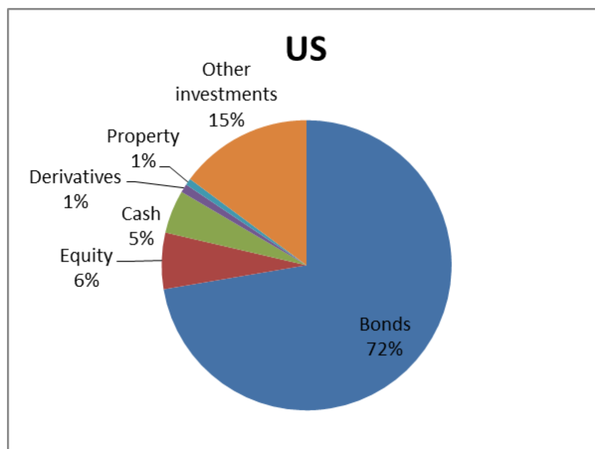
[8] FVPL unless qualifying hedge relationship

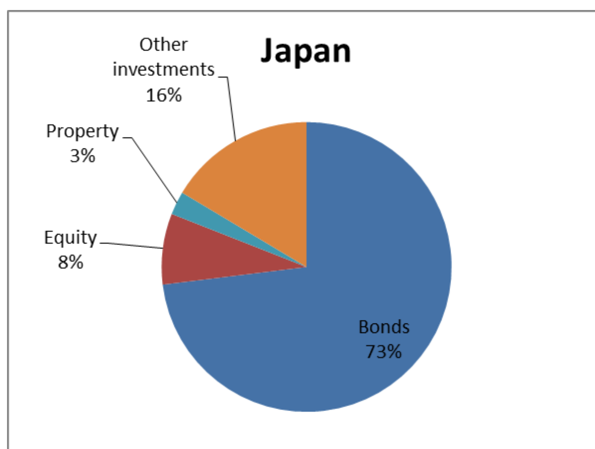
	IFRS
Real Estate	Amortised cost FVPL (IAS 40)

US and European Insurance Industry Investments

A2. Below are graphs showing the breakdown of investment types held by the insurance industries in Europe, the United States, and Japan in 2011.







	Europe in €bn	Europe %	US in $bn	US %	Japan in $bn	Japan %
Bonds	4,921	64%	3,500	72%	2,369	73%
Equity	1,231	16%	304	6%	256	8%
Cash	231	3%	233	5%	not itemised	0%
Derivatives	77	1%	46	1%	not itemised	0%
Property	308	4%	36	1%	84	3%
Other investments	923	12%	719	15%	533	16%
Total	**7,691**	**100%**	**4,838**	**100%**	**3,242**	**100%**

A3. United States data includes only investments held in the insurers general account and not investments that are segregated and directly linked to specific insurance contract portfolios. The mix within the segregated (separate) accounts may be substantially different given that the policyholders account is directly impacted by the performance of those assets (eg, more investments in equity securities and real estate).

A4. European data includes unit-linked contracts – which are similar to segregated accounts. This difference in investment data between the European and United States industry may mean that the United States proportion of equities is closer to that of Europe

A5. Data for the Japanese insurance market has been obtained from an OECD report that does not break down assets to the same level of detail as the sources for European and US data.

A6. It is clear from the graphs that the insurance industries in Europe, the United States and Japan hold a variety of types of investment with a preponderance of bonds. The bonds held are government and corporate.

A7. The European data has been sourced from a report published by Insurance Europe and Oliver Wyman in June 2013[9]. The report notes that the investment mix varies considerably between companies and countries in Europe to meet local requirements and conditions. At company level, it typically depends on the types of insurance products sold: that is, on the mix of protection products, life unit-linked and life guarantee-type products. For example, insurers from Europe with a higher

[9] http://www.insuranceeurope.eu/uploads/Modules/Publications/funding-the-future.pdf

proportion of traditional life business also held a higher proportion of bonds than insurers who had a high proportion of unit-linked business.

Appendix B: Relevant extract from the Basis for Conclusions to the 2013 ED

Interest expense in profit or loss (paragraphs 60(h) and 61–65)

BC117 The 2010 Exposure Draft proposed a current measurement for insurance liabilities with all changes in the liability recognised in profit or loss. However, many respondents were concerned that gains and losses from underwriting and investing activities would be obscured by more volatile gains and losses arising from changes in the current discount rate that is applied to the cash flows in insurance contracts. In particular, these respondents noted that, when the amounts paid to the policyholder do not depend on market interest rates, changes in discount rates cause changes in the present value of cash flows, even though the ultimate amount paid to policyholders does not change.

BC118 Furthermore, in the responses to the 2010 Exposure Draft, many preparers expressed the concern that the requirement to use a current value measurement for insurance liabilities, specifically to remeasure insurance contract liabilities for changes in interest rates, would mean that entities would be forced to exercise the fair value option for financial assets in order to avoid the accounting mismatches that would arise between assets measured at amortised cost and insurance contract liabilities. They noted that the IASB has indicated that amortised cost is an appropriate measure for financial assets in some circumstances and that IFRS would generally require an entity to measure financial liabilities at amortised cost. Accordingly, they believe that the volatility in profit or loss that would result from a current value measurement of insurance contracts would not result in a faithful representation of their economic performance and would not provide comparability across entities without significant insurance contract liabilities.

BC119 The IASB is unconvinced that entities that issue insurance contracts would be disadvantaged if insurance contracts were to be measured at current value. However, the IASB was persuaded that entities should segregate the effects of changes in the discount rate that are expected to unwind over time from other gains and losses, so that users of financial statements could better assess the underwriting and investing performance of an entity that issues insurance contracts. The IASB believes that such segregation could be achieved by approximating an amortised cost view of the time value of money to be recognised in profit or loss. Thus, an entity would:

(a) report a current view of performance in total comprehensive income; and

(b) recognise in other comprehensive income the difference between the effects of discounting the cash flows at a current rate at the end of the period and the amortised cost view of the time value of money.

BC120 This would separate the effects of changes in cash flow estimates from the effects of changes in discount rates and would provide users of financial statements with information about the time value of money that the entity determined at contract inception.

BC121 Similar to financial assets mandatorily measured at fair value through other comprehensive income in accordance with the 2012 Exposure Draft *Classification and Measurement: Limited Amendments to IFRS 9* (Proposed amendments to IFRS 9 (2010)), the amounts recognised in profit or loss and other comprehensive income would differ depending on the characteristics of the cash flows arising from the insurance contract:

(a) some payments to policyholders are not expected to vary with changes in interest rates. The interest expense recognised in profit or loss would be measured using the discount rate at contract inception. This is similar to the way the interest revenue is measured for a fixed-rate financial asset (see paragraph 9 of IAS 39 *Financial Instruments: Recognition and Measurement*). The difference between the effects of discounting those cash flows at a current rate at the end of the period and the effects of discounting those same cash flows at the rate that applied at initial recognition would be recognised in other comprehensive income and would unwind automatically over time. This is similar to recognising gains or losses in other comprehensive income for financial assets mandatorily measured at fair value through other comprehensive income (see paragraph 5.7.1A of the 2012 Exposure Draft *Classification and Measurement: Limited Amendments to IFRS 9* (Proposed amendments to IFRS 9 (2010))).

(b) some cash flows in a contract are expected to vary with returns on underlying items. Changes in interest rates for underlying items that affect the returns on those underlying items may cause changes in the cash flows in an insurance contract. These cash flows have similar economic features to floating rate interest payments on financial instruments. As a result, the IASB believes that portraying the interest expense as if it resulted from a financial instrument with a fixed

interest rate would not provide useful information. Accordingly, the IASB decided that, when the estimates of cash flows are expected to vary with returns on underlying items, the discount rate applied in determining interest expense recognised in profit or loss on those cash flows should be updated when the entity revises the estimates of those cash flows. This is similar to the requirement in IAS 39 that, for floating rate financial assets, movements in market rates of interest alter the effective interest rate (see paragraph AG7 of IAS 39).

Complexity

BC127 The IASB's revised proposals respond to comments on the 2010 Exposure Draft. However, they would introduce more reporting complexity than the 2010 Exposure Draft, which proposed to recognise all changes in the insurance contract liability in profit or loss. This reporting complexity could reduce the usefulness of the financial statements to users of financial statements, specifically:

(a) some are concerned that the effect of the accounting mismatches would obscure the entity's underwriting and investment performance. This is because, except in the limited circumstances described in paragraph BC46, entities would not be able to avoid accounting mismatches when the assets that back the insurance contracts are measured other than at fair value through other comprehensive income.

(b) some are concerned that information about the effect of duration mismatches and some options and guarantees embedded in insurance contracts would be obscured, because part of those effects would be recognised in other comprehensive income and part in profit or loss. This concern is exacerbated because this Exposure Draft would recognise changes in the value of some options embedded in insurance contracts wholly in profit or loss if the contract requires the entity to hold underlying items and specifies a link to those underlying items. Thus, there would be an inconsistent presentation of changes in the value of options and guarantees embedded in insurance contracts, depending on whether the options and guarantees are embedded in a contract that requires the entity to hold underlying items and specifies a link to returns on those underlying items.

(c) some believe that the amount recognised in other comprehensive income would be difficult to understand because it combines the effects of changes in discount rates for the period with the effect of the unwinding of the cumulative difference between the original and current rates. This is equally the case for amounts recognised in other comprehensive income when financial assets are measured at fair value through other comprehensive income, as proposed in the IASB Exposure Draft *Classification and Measurement: Limited Amendments to IFRS 9*.

BC128 Furthermore, the proposals would introduce costs for many preparers of financial statements. Preparers would be required to measure the insurance contract liability on a current basis in the statement of financial position and on a different basis for presentation in profit or loss. The presentation basis would require preparers:

(a) to apply different discount rates to different contracts according to their date of initial recognition, rather than applying only the current discount rate to all cash flows; and

(b) to update the discount rate when the cash flows are expected to vary with returns on underlying items.

BC129 As with the proposals for contracts that require the entity to hold underlying items and specify a link to returns on those underlying items, the IASB's proposals for interest expense would restrict the entity's ability to apply different approaches to measure the insurance contracts, described in BC57. This is because a single discount rate and a single approach to discounting may not represent faithfully the cash flows of a contract if that contract generates different sets of cash flows and those sets are expected to vary in different ways with returns on underlying items. As a result, entities would be required to identify the cash flows with different characteristics and:

(a) for the cash flows that are not expected to vary with returns on underlying items:

  (i) recognise interest expense in profit or loss using the discount rates that applied when the contract was initially recognised; and

  (ii) recognise in other comprehensive income the difference between discounting the cash flows using a current rate and discounting the cash flows using the rate in (i).

(b) for the cash flows that are expected to vary directly with returns on underlying items:

(i) recognise interest expense in profit or loss using the discount rates that applied when the contract was initially recognised. The discount rates are updated when the entity expects changes in the returns on underlying items to affect the amount of the cash outflows.

(ii) recognise in other comprehensive income the difference between discounting the cash flows using a current rate and discounting the cash flows using the rate in (i).

BC130 As noted in paragraph BC58, any decomposition of cash flows is, to some extent, arbitrary. The different ways in which an entity might identify which of the cash flows that are expected to vary directly with returns on underlying items would result in different amounts being recognised in profit or loss and other comprehensive income. Thus, to increase comparability, the IASB proposes a similar decomposition to determine the fixed cash flows in an insurance contract as would be applied in decomposing the cash flows in contracts that require the entity to hold underlying items and specify a link to returns on those underlying items. That approach:

(a) expresses the cash flows in a way that illustrates the extent to which they are expected to vary with returns on underlying items; and

(b) identifies the minimum fixed payment that the policyholder will receive.

BC131 As a result, the effects of changes in the discount rates that are recognised in other comprehensive income for fixed cash flows are comparable for all insurance contracts.

BC132 The IASB concluded that this operational complexity is justified because segregation of gains and losses that are expected to unwind over time from other gains and losses would enable users of financial statements to understand the underwriting and investing performance of an entity that issues insurance contracts.

Other approaches considered but rejected

BC133 Paragraphs BC117–BC121 explain that this Exposure Draft places greater weight than did the 2010 Exposure Draft on separating underwriting and investing performance from changes that unwind over time. Before concluding on the proposal in this Exposure Draft, the IASB also considered:

(a) other approaches for segregating changes that arise from movements in discount rates from other gains and losses (see paragraphs BC134–BC147); and

(b) other approaches for determining the amount to be recognised in other comprehensive income (see paragraphs BC148–BC159).

Segregating changes that arise from movements in discount rates

BC134 The IASB considered the following other approaches for segregating changes that arise from movements in discount rates from other gains and losses:

(a) segregating changes that arise from movements in discount rates within profit or loss (see paragraphs BC135–BC141);

(b) permitting an option to recognise in profit or loss the interest expense that is measured using the current rate (see paragraphs BC142–BC145); and

(c) recognising interest income in other comprehensive income for all assets that back insurance contracts (see paragraphs BC146–BC147).

Segregating changes that arise from movements in discount rates within profit or loss

BC135 Some suggest that the IASB's proposals for segregating underwriting and investing performance from changes that unwind over time would cause operational complexity that is not justified for some entities. For example, some entities manage asset and liability portfolios with limited interest and duration risks, and the users of the financial statements of these entities may not be concerned about the limited reported volatility that would arise. Furthermore, some entities are accustomed to explaining reported volatility under their existing accounting practices. Thus, the users of the financial statements of some entities may not be concerned about reported volatility. Nonetheless, all entities would be required to apply the proposals

in the proposed Standard and would be subject to the additional operational costs that would result from the proposal to disaggregate the effects of discounting in other comprehensive income.

BC136 Some maintain that the most effective way of reducing accounting mismatch would be to recognise all changes in the insurance contracts liabilities in profit or loss, as proposed in the 2010 Exposure Draft. Consequently, the reporting entity could reduce accounting mismatches by choosing to apply existing fair value options in IFRSs, for example, for financial assets or investment property.

BC137 Accordingly, some suggest that all entities should recognise all gains and losses in profit or loss, and those entities for which the distinction between underwriting and investing performance is important should instead use the flexibility offered in IAS 1 *Presentation of Financial Statements*, which permits entities to segregate information within profit or loss. For example, some suggest that useful, disaggregated information could be achieved by segregating components of the changes in the insurance liability within profit or loss. Some changes could be presented as operating profit. Other changes, such as the effects of changes in the discount rate, could be presented below the operating profit line, within profit or loss. Operating profit could be useful:

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

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

BC138 Those who support presenting all changes in profit or loss further believe that:

(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 entity's performance;

(b) while the recognition of changes in the discount rate in profit or loss may result in reported volatility in profit or loss, that volatility would be mitigated because accounting mismatches would not occur if an entity's assets were measured at fair value with changes recognised in profit or loss; and

(c) the use of other comprehensive income should be minimised, particularly because, at this time, there is no general principle for when it should be used, and because it adds complexity to reporting.

BC139 However, some responses to the 2010 Exposure Draft suggested that the operational and reporting complexity described in paragraphs BC127–BC132 would be outweighed by the benefits of more relevant and transparent information about the underwriting and investing performance of insurance contracts. In reaching the proposals in this Exposure Draft, the IASB placed greater weight on those arguments.

BC140 Furthermore, the IASB considered that it is beyond the reasonable scope of this project to develop a comprehensive definition of operating profit. That would require the IASB to consider whether to include or exclude many items that are not related only to insurance contracts. In addition:

(a) because operating profit is not defined elsewhere in IFRS, any such approach would create an industry-specific presentation for the statement of profit or loss and other comprehensive income, which would be inconsistent with the IASB's intention not to create an industry-specific Standard; and

(b) a separate presentation within profit or loss would not alleviate the operational complexity that is associated with the need to measure the components separately.

BC141 Accordingly, the IASB rejected this approach.

An option to recognise all gains and losses in profit or loss

BC142 The IASB considered whether it should make the presentation of changes in the insurance contract liability in other comprehensive income an option rather than a requirement. An option could either be unrestricted, or restricted to circumstances in which the exercise of the option would significantly eliminate accounting mismatches. Such options would ensure that preparers would not have to suffer the complexity that is inherent in the IASB's revised decisions if they believed that the information provided in their circumstances does not warrant the cost of the complexity.

BC143 However, the IASB concluded that an unrestricted option would result in a lack of comparability and could reduce transparency across entities that issue insurance contracts. The IASB's objective in requiring the presentation of the effects of changes in discount rates on the insurance contract liability in other comprehensive income is to separate underwriting and investing performance from the effects of the changes in those discount rates that unwind over time. That objective would not be achieved if entities were permitted an unrestricted option to recognise those changes in profit or loss.

BC144 Some suggested an approach similar to the existing option in IFRS 9 that permits an entity to measure a financial asset at fair value through profit or loss (the 'fair value option') if it reduces or eliminates accounting mismatches. However, the IASB observed that a similar option for insurance contract liabilities would be problematic because:

(a) applying such an option to an individual insurance contract is the best way to fully eliminate accounting mismatches. It is also consistent with the application of the fair value option for financial assets. However, applying such an option at an individual insurance contract level may be operationally complex and may not provide useful information. This is because insurance contracts and associated assets are typically managed at a more aggregated level. Nonetheless, it would be difficult to achieve the objective of reducing or eliminating accounting mismatches through the use of a fair value option for insurance contracts because accounting mismatches would not be eliminated overall if an entity applied an option to recognise in profit or loss all changes in the value of insurance contracts at:

(i) an entity level, because an entity may have different portfolios that it manages in different ways.

(ii) a portfolio level, because an entity may hold assets that are measured using a mix of measurement attributes (for example, at fair value through profit or loss, amortised cost or fair value through other comprehensive income) and the mix of measurement attributes in the portfolio may change over time. Accounting mismatches would be reduced only if the entity exercises the option to measure all the assets at fair value through profit or loss.

(b) it would be necessary to specify whether an entity should be permitted or required to invoke or revoke any such option, and in what circumstances. For financial assets, the application of the fair value option in IFRS 9 is available only at initial recognition and is irrevocable. This ensures that entities do not invoke or revoke the fair value option in a particular period to achieve a particular accounting result for that period. However, an irrevocable option would not necessarily reduce or eliminate accounting mismatches if the duration of insurance contracts and the assets backing the insurance contracts differed. An entity would only be able to assess whether the accounting mismatches would be reduced or eliminated when the duration of either the insurance contract or the backing assets ended. While the exercise of the option might reduce accounting mismatches in the short term, it could exacerbate those accounting mismatches in later periods. This would be especially of concern because of the extent of the duration mismatches that might arise between assets and liabilities.

BC145 Consequently, the IASB concluded that permitting an option for entities to recognise all gains and losses from insurance contracts in profit or loss would introduce additional complexity for preparers to operate the option and for users of financial statements to understand the result. Taken together with the lack of comparability that would result from an option, the Board concluded that the cost of that complexity is not justified by the benefits of reduced mismatches for some entities. This would be the case regardless of whether the option was unrestricted, or restricted to circumstances in which the exercise of the option would significantly eliminate accounting mismatches.

Assets that back insurance contracts

BC146 Some suggest that measuring and reporting both assets and liabilities at fair value through other comprehensive income would segregate the effects of changes in the discount rate from other gains and losses while avoiding accounting mismatches.

BC147 While the IASB believes that accounting mismatches should be eliminated or reduced to the best extent possible, it noted that this would only be possible if either all the changes in the insurance contracts were recognised in profit or loss, as discussed in paragraph BC136, or if all of the assets that the entity holds to back those contracts were measured at fair value through other comprehensive income. In the IASB's view,

it would not be appropriate to change the accounting for assets for an entity that issues insurance contracts, because:

(a) it would be undesirable to create industry-specific requirements for the accounting for assets, because doing so would reduce comparability between entities that issue insurance contracts and other entities; and

(b) identifying which of the entity's assets are held to back insurance liabilities introduces subjectivity and may be arbitrary.

Other approaches to measuring interest expense

BC148 The IASB's proposals would require an entity to recognise, in profit or loss, interest expense that is consistent with the interest revenue recognised for financial assets measured at fair value through other comprehensive income. The IASB also considered, but rejected, recognising in profit or loss interest expense measured:

(a) using the current discount rate at the start of each reporting period (see paragraphs BC150–BC153);

(b) using the discount rate at contract inception and accelerating the reclassification to profit or loss of amounts recognised in other comprehensive income when the entity expects that the assets viewed as backing the insurance contract liability will not produce sufficient returns to fulfil the entity's obligation (sometimes called a 'loss recognition test'; see paragraphs BC154–BC157); and

(c) using the book yield (see paragraphs BC158–BC159).

BC149 The FASB proposes updating the discount rates to rates that recognise estimated interest crediting on a level yield basis over the remaining life of the portfolio of contracts when the entity expects changes in the expected returns on underlying items to affect the amount of the cash flows to the policyholder. The IASB did not consider that approach. After the date that the cash flows are updated, the mechanics of that approach would recognise in profit or loss interest expense that is determined in a different way from how interest expense is determined in the period prior to the first updating of those cash flows. In addition, this approach would recognise some changes in cash flow estimates (ie those attributable to estimated interest crediting) in other comprehensive income or as an adjustment to the contractual service margin as appropriate. This is inconsistent with the recognition of other cash flow changes immediately in profit or loss.

Current discount rate at the start of each reporting period

BC150 The IASB considered an approach in which:

(a) interest expense recognised in profit or loss on the insurance liability would be based on the current discount rates at the start of the reporting period, applied to the carrying amount at the start of the period; and

(b) the effects of changes in the discount rate during the reporting period on the insurance liability would be recognised in other comprehensive income.

BC151 Proponents of this approach believe that it would provide useful information to users of financial statements, because it would isolate in other comprehensive income only the effects of changes in the discount rate in the current period.

BC152 However, the IASB rejected this approach for the following reasons:

(a) amounts recognised in other comprehensive income would not unwind over the life of the contracts that generated them.

(b) it would introduce accounting mismatches in profit or loss. These accounting mismatches would arise because the interest expense recognised in profit or loss for the insurance contract would be measured using the contract's discount rate at the start of the reporting period (the 'current rate'). The interest income for the assets would be based on a rate that is determined on initial recognition if those assets are required to be measured at amortised cost or at fair value through other comprehensive income.

(c) entities that issue insurance contracts would need to measure their assets at fair value through profit or loss to reduce accounting mismatches with insurance contract liabilities measured at current value. As noted in paragraph BC118, some entities that issue insurance contracts believe that a requirement to measure their insurance contracts at current value would mean that entities would be forced to exercise the fair value option for financial assets. These entities believe that amortised cost is the most appropriate measurement basis for assets held to collect principal and interest.

BC153 The IASB concluded that this approach has no advantage over an approach that recognises interest expense based on the current discount rate at the end of the reporting period, and would be more complex to implement.