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IFRS-FA – öffentliche SITZUNGSUNTERLAGE

Sitzung:	04. IFRS-FA / 27.04.2012 / 13:45 – 15:45 Uhr
TOP:	04 – Insurance Contracts
Thema:	Erfassung der Änderungen von Verbindlichkeiten
Papier:	04_05b_IFRS-FA_IC

Vorbemerkung

- Zielsetzung
  - Diskussion, ob / wie OCI zur Darstellung von Änderungen der Verbindlichkeiten aus Versicherungsverträgen genutzt werden kann
- Annahme
  - In der April Sitzung des IASB wird die Einführung einer dritten Kategorie für financial assets diskutiert: Fair Value through OCI for eligible debt instruments
  - Hier wird davon ausgegangen, dass diese neue Kategorie genutzt wird

ED proposals / feedback (1)

- ED proposals
  - Current measurement of insurance liability
  - All changes in the insurance liability reported in profit and loss
  - Assumed accounting mismatch could be minimised by using fair value option for financial assets
- Feedback
  - Short-term gains and losses due to market movements are not relevant because
    - they ignore long-term nature of insurance
    - they obscure underlying long-term performance
    - changes in interest rate reverse

ED proposals / feedback (2)

– Could use FVO to minimise accounting mismatch, but:
  - in effect removes ability to use amortised cost
  - does not address volatility arising from credit spreads
  - Places insurers at a competitive disadvantage compared to banks. Because banks can use amortised cost for some of their assets and liabilities (ie banking book) they do not have to report
    - credit spread movements
    - duration mismatches
    - the time value and intrinsic value of closely related options and guarantees

ED proposals / feedback (3)

- Users' feedback
  - Some users (particularly in US) are concerned about volatility in P&L
    - place emphasis on volatility that is outside management's control (eg market volatility)
    - market volatility can obscure "what is normal"
    - suggested use of OCI to present market volatility
  - Other users
    - can accept volatility if it reflects economic volatility
    - Would like to be able to isolate "real volatility" from short-term or one-off volatility

Reducing volatility: tentative decisions

- Discount rate
  - Clarified that discount rate could be determined using a top-down approach – reduces accounting mismatch arising from changes in credit spread
- Participating contracts
  - Mirroring approach eliminates volatility arising from accounting mismatches between assets and liabilities taht are contractually linked
  - However, volatility arises from embedded options and guaerantees (even if not bifurcated)
- Unlocking the residual margin
  - Residual margin should be unlocked for some changes in cash flows
  - To be decided
    - which cash flows
    - whether changes in discount rate should unlock the residual margin

Other requests from constituents

- Asset-based discount rate
  - Board has tentatively decided that discount rate used should reflect only the characteristics of the liability
- Locked-in discount rate
  - Board has tentatively decided that the discount rate should be current rate that is updated each reporting period
- Unbundling of deposit components
  - Deposit components should be disaggregated
- Use of hedge or macro hedge accounting
  - The staff believe this is unlikely to work (not considered further)
- Use of operating income
  - May not overcome concerns about volatility (not considered further)
- Use of pensions type approach
  - Would require different accounting for assets backing insurance contracts and the use of “fair value interest” (not considered further)

Some types of assets and classification and measurement

- Fixed income securities
  - US GAAP current: FVPL or FV OCI (rec); tentative FVPL or FV OCI (rec) or amortised cost
  - IFRS current: FVPL or amortised cost; assumed FVPL or FV OCI (rec?) or amortised cost
- Equity securities
  - US GAAP current: FVPL or FV OCI (rec); tentative FVPL
  - IFRS current: FVPL or FV OCI (no rec); assumed FVPL or FV OCI (no rec)
- Unsecuritised mortgage loans
  - US GAAP current: amortised cost, lower of cost or FV; tentative FVPL or FV OCI or amortised cost
  - IFRS current: FVPL or amortised cost; assumed: FVPL, FV OCI, amortised cost
- Equity method investments
  - US GAAP current: equity method or FVPL, tentative? / IFRS: equity method or FVPL
- Derivatives: US GAAP: FVPL / IFRS: FVPL
- Real estate: US GAAP: amortised cost / IFRS: amortised cost or FVPL (IAS 40)

When does accounting mismatch arise?

If an insurer is required to recognise the changes in the insurance contract liability in P&L (as proposed in the ED/DP) accounting mismatches will arise

- If the assets backing the insurance contracts are debt securities measured at fair value through OCI, the accounting mismatch arises in P&L because the changes in the carrying amount of the insurance contract liability would be presented in P&L. There would be little accounting mismatch in equity because both assets and liabilities would be measured at current value
- If the assets backing the insurance contracts are equities measured at FV OCI there would also be an accounting mismatch in P&L because changes in carrying amount of the insurance contract liability would be presented in P&L whereas most changes in the carrying amount of these assets would be presented in OCI. There is also an economic mismatch because the insurance contracts and the equities do not respond in the same way to changes in economic conditions.
- If assets backing the insurance contracts are measured at amortised cost, the accounting mismatch arises in equity and in P%L because changes in the measurement of the insurance contract liability do not react in the same way as changes in the assets.

Whether to use OCI (1)

- Constituents have stated that their concerns could be addressed if
  - Changes in the insurance liability arising from changes in discount rate are presented in OCI; and
  - Assets, some or all, are measured at FV through OCI
- Arguments for use of OCI
  - Accounting mismatches are reduced (assuming that assets are also measured at FV OCI)
  - Short-term movements in the discount rate do not affect profit or loss reflecting the long term nature of insurance (the discount rate effects reverse over time – other assumptions do not)
  - Underwriting results are not overshadowed by market movements and continue to be reported in profit or loss
  - Information about economic mismatches (duration / options and guarantees) presented in a transparent manner in OCI

Whether to use OCI (2)

- Arguments against
  - Economic mismatches arising from duration mismatches / credit spreads / options and guarantees are presented in OCI rather than profit or loss: some argue that this is less transparent
  - Presenting all changes in profit or loss is less complex for both users and preparers
  - Accounting mismatches arise in profit or loss for assets at FVPL / in equity for assets measured at cost; also, may not be able to apply macro-hedging proposals

What should be presented in OCI?

- If the effects of discount rate changes are presented in OCI, should changes in the insurance liability arising from changes in interest rate sensitive cash flow assumptions be presented in OCI?
  - For example
    - Embedded interest rate guarantees
    - Lapse assumptions (for interest-sensitive products)
    - Inflation assumptions

Building the model / practical implications

Inputs into the model

- Non-interest sensitive assumptions
- Interest rates
  - Discount rate
  - Interest sensitive assumptions

If the effects of discount rate changes and interest sensitive cash flows are presented in OCI, how are the calculated?

- Build model to calculate the liability
  - Inputs are (a) discount rate, (b) interest-rate sensitive assumptions, (c) all other assumptions
- Run the model using the current discount rate (CDR)
  - Liability CDR presented in balance sheet
- Run the model using the discount rate at t_0
  - Present in OCI = liability CDR – liability t_0; present in P&L unwind of liability t_0

Should changes in interest sensitive cash flows be presented in OCI?

- **In OCI?**
  - All amounts presented in P&L are based on interest rate at inception and all assumptions are internally consistent
  - Consistent with view that short term movements in interest rates are not representative of long-term nature of insurance
  - Separating the effects of interest sensitive cash flow assumptions from the effect of changes in interest rate is costly and complex

- **In P&L or residual margin?**
  - Consistent with the treatment of other cash flow assumptions
  - Sometimes , interest rates are a proxy for other variables
  - Including only changes in the insurance liability arising from changes in the interest rate in OCI is easier to understand

Should the use of OCI be permitted or required?

- **Approach**
  - Require the use of OCI in all circumstances
  - Require the use of OCI with an option to present changes in P&L if it reduces an accounting mismatch
  - Require the use of OCI when there si an accounting mismatch (eg when the majority of the assets are not at FVPL)
  - Permit use of OCI in all situations

- **Comments**
  - Results in accounting mismatches if assets are at FVPL
  - Consistent with FV option for financial instruments
  - An option reduces comparability
  - Insurer needs tom prove mismatch is reduced to present in P&L
  - Requiring the use of OCI when there si an accounting mismatch increases comparability
  - Insurer needs to prove mismatch is reduced to present in OCI
  - Unrestricted option reduces comparability but allows more flexibility in reducing accounting mismatch

Other issues

- Unit of account?
  - Contract (consistent with FV option)?
  - Portfolio (consistent with the measurement of the liability)?
  - Other, eg product level (would introduce a new unit of account)?
  - Entity?
- When should determination / election to use OCI be changed?
  - Never?
  - When asset strategy changes?
  - When an accounting mismatch no longer exists?

Mechanics – what should be presented in P&L?

Alternative A

- Present in
  - Profit or loss interest expense using the discount rate locked in at inception of the insurance contract
  - OCI the difference between the liability at the current rate and the liabilityn at the locked in rate

Alternative B

- Present in
  - Profit or loss interest expense using the current rate and an amount transferred to/from OCI
  - OCI difference between the liability at the current rate and the liability at the locked in rate

Note: A and B result in the same net answer in P&L and OCI

Example

- Assumptions
  - Insurance contract is for 5 years and claims of CU 2000 are paid on 0101x6
  - Premium received at inception is CU 1685
  - No risk margin
  - No assumption changes except for interest rates
  - Interest rates decline over the 5 years (not expected)
  - Assume a flat yield curve, discount rates for the liability are as follows:
    liability t_0 4,50%, t_1 4,10%, t_2 2,50%, t_3 2,70%, t_4 2,75%, t_5 3,00%
  - Margin is 80.1 at inception and released in a staright-line pattern
  - Assets measured at FV OCI
  - Investment 1 three-year zero-coupon bonds
  - Investment 2 proceeds of investment 1 reinvested in two-year zero-coupon bonds
  - Return on assets are as follows:
    assets t_0 5,00%, t_1 4,60%, t_2 3,00%, t_3 3,20%, t_4 3,25%, t_5 3,50%

Balance sheet

Years	0	1	2	3	4	5
Assets						
Investment 1 FVOCI	1685.0	1776.0	1893.8	1950.6		
Investment 2 FVOCI					2012.0	2077.4
Total assets	1685.0	1776.0	1893.8	1950.6	2012.0	2077.4
Liabilities						
Insurance liabilities	1604.9	1703.0	1857.2	1896.2	1946.5	2000.0
Margin	80.1	64.1	48.1	32.0	16.0	0.0
Total liabilities	1685.0	1767.1	1905.3	1928.3	1962.5	2000.0
Equity	-	8.9	(11.5)	22.3	49.6	77.4

Alternative A

Years	**1**	**2**	**3**	**4**	**5**	Totals
Int income	84.3	88.5	92.9	62.4	64.4	392.4
Int exp Ins liability @ 4.5%	(72.2)	(75.5)	(78.9)	(82.4)	(86.1)	(395.1)
	12.0	13.0	14.0	(20.0)	(21.7)	(2.7)
Margin	16.0	16.0	16.0	16.0	16.0	80.1
Net profit or loss	28.0	29.0	30.0	(4.0)	(5.7)	77.4
OCI						
Fair value changes assets	6.8	29.3	(36.1)	(1.0)	1.0	-
Disc rate effects Ins liab	(25.9)	(78.7)	39.8	32.2	32.6	-
Total OCI	(19.2)	(49.4)	3.8	31.2	33.6	-
Total comprehensive income	8.9	(20.4)	33.8	27.2	27.9	77.4

Alternative B

Alt	Years	1	2	3	4	5	Totals
A	**Int exp Ins liability @ 4.5%**	(72.2)	(75.5)	(78.9)	(82.4)	(86.1)	(395.1
B	**Int exp Ins liability @ CR**	(98.1)	(154.2	(39.0)	(50.3)	(53.5)	(395.1
	Discount rate effects	25.9	78.7	(39.8)	(32.2)	(32.6)	-
	transferred - OCI	(72.2)	(75.5)	(78.9)	(82.4)	(86.1)	(395.1

Alternative A	Alternative B
Some believe that alternative A is difficult for users to understand Alternative A is akin to the two-step presentation proposal in IASB's exposure draft *Fair Value Option for Financial Liabilities*, which was not supported by constituents	Some believe alternative B is more transparent as it shows the effect of: • Current interest rates in profit or loss; and • An amount transferred to/from OCI.

Mechanics – increases in cash flows

- If expected cash flows increase, what discount rate would you apply in P&L:
  - The discount rate at inception?
  - The current discount rate at the date the assumption changes?

Loss recognition test (1)

What is a loss recognition test?

- Some consider a contract to be loss making when asset returns are lower than expected
- For example, suppose an insurer prices its contracts assuming that it can earn interest of 7% on its investments, but now market returns are only 3%
- A loss recognition test accelerates the recognition of these future losses in profit or loss to the period in which management is first aware of these losses
- By reclassifying losses to profit or loss and, maybe, resetting the unwinding of the discount rate in P&L

1. Should there be a loss recognition test? Why? Why not?
2. When should the loss recognition test be triggered?
3. What should happen when the loss recognition test is triggered?
   - What amount should be reclassified to P&L
   - Do we reset the unwind of the discount rate in P&L? If yes, to what rate?

Loss recognition test (2)

Arguments for a loss recognition test

- Provides signalling information that the insurer will have to draw on its capital to fulfil the insurance liability
- P&L would reflect the performance of the insurer by taking into account its asset-liability management strategies

- Some think this is analogous to
  - the liability adequacy test conducted under current requirements
  - the onerous contract test and
  - the impairment of amortised cost/available for sale assets
- Profit or loss is of primary importance and losses should be recognised in P&L when they are likely

Arguments against a loss recognition test

- Information about mismatch between returns on assets and the liability is already provided in the financial statements
- Only partly: it fails to reflect when the asset-liability management strategies are positive and when the text is not triggered
- In addition the discount rate going forward in P&L is hard to explain
- Some do not believe so because the liability is at the correct amount. In addition, the onerous and impairment tests do not consider the performance of other assets (or liabilities)

- Gains and losses should be recognised only once in the statement of comprehensive income
- A test that considers the returns of the assets is inconsistent with the boards decision that the discount rate for the liability should reflect the characteristics of the liability

Loss recognition test trigger

Alternative 1	Alternative 2	Alternative 3
(Liability discounted at today's discount rate – liability discounted at the rate at inception) > margin	(liability discounted using return on investment (ROI)-liability calculated using discount rate at inception) > margin	When qualitative factors, to be specified, indicate that the expected return on the assets < the liability's discount rate at inception
Consistent with the objective that a loss should be accelerated when the interest rate has fallen below that at inception	Consistent with objective that a loss should be accelerated when the returns on the assets are lower than that priced in those premiums	Objective depends on specified factors
Quantitative type test – less subjective	Quantitative test – less subjective	Qualitative test – more subjective

Loss recognition trigger illustrated

Row	Year	0	1	2	3	4	5
A	Discount rate for the liability assuming flat yield curve	4.50%	4.10%	2.50%	2.70%	2.75%	3.00%
	Insurance liablity @ current rate (Row A)	1,604.9	1,703.0	1,857.2	1,896.2	1,946.5	2,000.0
	Assest at fair value	1,685.0	1,776.0	1,893.8	1,950.6	2,012.0	2,077.4
B	Insurance liability @ rate fixed on inception (4.5%)	1,604.9	1,677.1	1,752.6	1,831.5	1,913.9	2,000.0
C	Insurance liability @ ROI (Column Z from table below)	1,567.1	1,658.0	1,795.4	1,877.9	1,938.0	2,000.0
D	Row B-C	37.8	19.1	(42.8)	(46.4)	(24.1)	-
E	Margin	80.1	64.1	48.1	32.0	16.0	
	Margin + Row D	117.9	83.2	5.2	(14.4)	(8.1)	-
	If < 0, test is triggered	**No**	**No**	**No**	**Yes**	**Yes**	**No**

Illustrating a loss recognition test

- Workings to calculate the return on investment

Year	Expected investment strategy	Current rates	ROI Column Z
0	The total proceeds of investment 1 (HTC) reinvested at current rates	5.00%	5.00%
1	The total proceeds of investment 1 (HTC) reinvested at current rates	4.60%	4.80%
2	The total proceeds of investment 1 (HTC) reinvested current market rates	3.00%	3.66%
3	Hold to collect investment (HTC) 2 and assuming no reinvestment	3.20%	3.20%
4	Hold to collect investment 2 and assuming no reinvestment	3.25%	3.20%
5	Hold to collect investment 2 and assuming no reinvestment	3.50%	3.20%

Mechanics of the loss recognition test

- What should happen when the loss recognition test is triggered?
  - What amount should be reclassified to P&L?
  - Do we reset the discount rate in P&L? If yes, to what rate?

These questions are interrelated because (to avid double counting the loss in P&L) the amounts in OCI should reverse to zero

Illustrating the relationship between the amount reclassified and the reset of the discount rate

- Assume the loss recognition test is triggered if:
  Liability (ROI) – Liability (discount rate Y0) > Margin

The amount reclassified to profit and loss is:	Discount is:
The entire accumulated loss in OCI.	Reset to current discount rate of the liability
The total loss determined by the loss recognition trigger (L)	Reset to return on the investment (ROI)
The amount of loss above the margin (L-margin).	Recalibrate discount rate so that the amounts in OCI reverse to zero.
Either the total loss or the amount of the loss above the margin determined by the loss recognition trigger. However, these reclassifications between OCI and profit and loss will need to continue.	not reset

Mechanics of the loss recognition test

Following examples illustrate:

- Alternative 1
  - The loss recognised is equal to the amount calculated using the loss recognition trigger. The discount rate is reset so as to unwind the amounts in OCI to zero
- Alternative 2
  - The loss recognised is equal to accumulated losses in OCI. The discount rate is reset to the current liability discount rate
- Alternative 2b
  - The same as alternative 2 except the margin is released to profit or loss

Alternative 1: loss is amount determined by the test (ie 14.4) & discount rate reset

Int income	84.3	88.5	92.9	62.4	64.4	392.4
Int exp Ins liability @ 4.5% (before) / 4.3% (after)	(72.2)	(75.5)	(78.9)	(75.5)	(78.6)	(380.7)
Additional losses			(14.4)			(14.4)
	12.0	13.0	(0.4)	(13.1)	(14.2)	(2.7)
Margin	16.0	16.0	16.0	16.0	16.0	80.1
Net profit	28.0	29.0	15.6	2.9	1.8	77.4
OCI	-	-	-	-	-	
Fair value changes assets	6.8	29.3	(36.1)	(1.0)	1.0	-
Disc rate effects Ins liab	(25.9)	(78.7)	39.8	25.3	25.1	(14.4)
Losses reclassified to p/l			14.4			14.4
Total OCI	(19.2)	(49.4)	18.2	24.3	26.1	-
Total comprehensive income	8.9	(20.4)	33.8	27.2	27.9	77.4

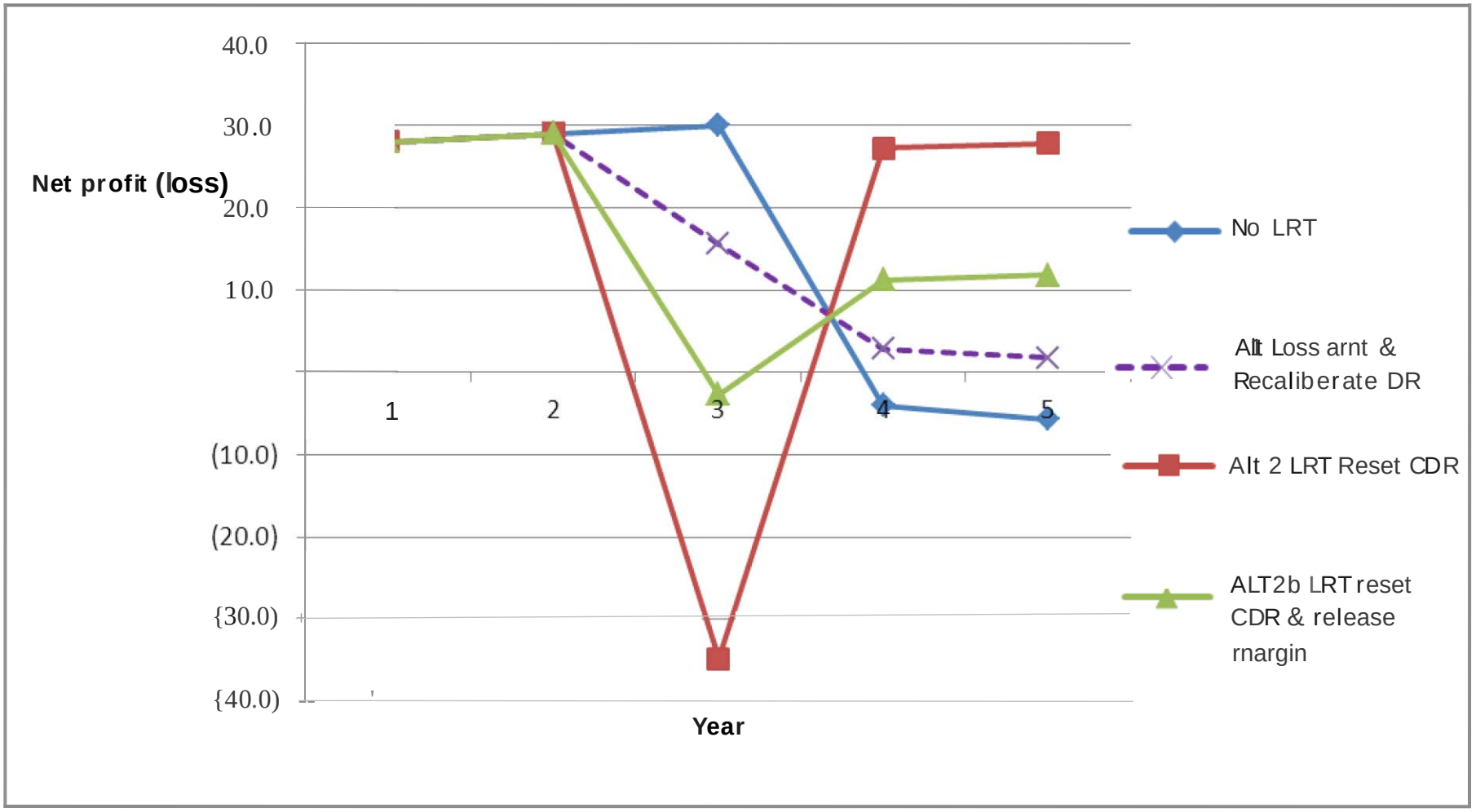
Alternative 2: reset the discount rate to the current rate

Years	**1**	**2**	**3**	**4**	**5**	Totals
Int income	84.3	88.5	92.9	62.4	64.4	392.4
Int exp Ins liability @ 4.5% (before) / 2.7% (after)	(72.2)	(75.5)	(78.9)	(51.2)	(52.6)	(330.3)
Additional losses			(64.8)			(64.8)
	12.0	13.0	(50.7)	11.2	11.8	(2.7)
Margin	16.0	16.0	16.0	16.0	16.0	80.1
Net profit or loss	28.0	29.0	(34.7)	27.2	27.9	77.4
OCI						
Fair value changes assets	6.8	29.3	(36.1)	(1.0)	1.0	-
Disc rate effects Ins liab	(25.9)	(78.7)	39.8	0.9	(0.9)	(64.8)
Losses reclassified to p/l			64.8			64.8
Total OCI	(19.2)	(49.4)	68.5	(0.0)	0.0	-
Total comprehensive income	8.9	(20.4)	33.8	27.2	27.9	77.4

Alternative 2b: release the margin

Years	1	2	3	4	5	Totals
Profit and loss						
Underwriting margin	0	0	0	0	0	-
Int income	84.3	88.5	92.9	62.4	64.4	392.4
Int exp Ins liability @ 4.5% (before) / 2.7% (after)	(72.2)	(75.5)	(78.9)	(51.2)	(52.6)	(330.3)
Additional losses			(64.8)			(64.8)
	12.0	13.0	(50.7)	11.2	11.8	(2.7)
Margin	16.0	16.0	48.1	0	0	80.1
Net profit or loss	28.0	29.0	(2.7)	11.2	11.8	77.4
OCI						
Fair value changes assets	6.8	29.3	(36.1)	(1.0)	1.0	-
Disc rate effects Ins liab	(25.9)	(78.7)	39.8	0.9	(0.9)	(64.8)
Losses reclassified to p/l			64.8			64.8
Total OCI	(19.2)	(49.4)	68.5	(0.0)	0.0	-
Total comprehensive income	8.9	(20.4)	65.8	11.2	11.9	77.4

Comparing the alternatives



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