Overview

During a joint meeting on 21 March 2012, the International Accounting Standards Board and the Financial Accounting Standards Board (respectively, the IASB and the FASB, or collectively, the Boards) re-deliberated decisions in the IASB’s Exposure Draft, *Insurance Contracts* (ED) and in the FASB’s Discussion Paper, *Preliminary Views on Insurance Contracts* (DP). The following topics were discussed:

1. Separation of investment components from insurance contracts
2. The definition of a portfolio and the unit of account

The IASB separately held an education session to consider recognising some of the changes in the insurance liability in other comprehensive income (OCI). This topic will be discussed at the joint April IASB/FASB meeting in consideration of the IASB’s proposed changes to IFRS 9, *Financial Instruments*, which would result in an additional (“third”) category for debt instruments meeting certain criteria (fair value through OCI).

Separation of investment components from the insurance contract

The Boards discussed whether to require separate presentation of an investment component included in an insurance contract in the statement of financial position and whether to exclude amounts received related to the investment component from comprehensive income. Based on both staffs’ understanding of the Boards’ preferences, the staff only considered models where the investment component would be measured as part of the insurance liability under the insurance standard, rather than unbundled from the insurance liability (i.e., split from the insurance component and measured under a different standard). The staff provided four alternatives when considering if and how to separate investment components from insurance components:

1. No separation of investment components from the insurance component
2. Separation of explicit account balances from insurance contracts

What you should know

- The Boards reached different conclusions on the definition of a portfolio and the use of a portfolio as the unit of account.
- The Boards agreed on a principle for the separation of an investment component from the insurance component and on how to treat the investment component in the statement of financial position. But differences remain on how to treat that component in the statement of comprehensive income.
- The IASB held an education session to discuss the use of OCI in the insurance model in anticipation of upcoming reconsiderations of OCI for debt instruments in IFRS 9.
3. Separation of amounts which the insurer is obligated to pay the policyholder or a beneficiary regardless of whether an insured event occurs

4. Separation of the amount of premium received that the insurer estimates it will return to the policyholder or its beneficiary

A majority of the IASB and all of the FASB voted in favour of the staff recommendation of separating amounts which the insurer is obligated to pay the policyholder or a beneficiary regardless of whether an insured event occurs. Additionally, the IASB decided it was necessary to develop a principle for the measurement of the separated investment component in the statement of comprehensive income, rather than using the insurance model. The FASB deferred making a decision on this topic.

At a future meeting, the Boards will discuss whether insurers would be required or permitted to separate the investment component on the basis agreed.

Statement of financial position presentation

The Boards discussed whether the statement of financial position should present separate line item amounts relating to the investment component and, if so, which principle to apply to separation. Four alternatives were considered, including: (i) separately presenting the component in an amount equal to the account balance; (ii) separately presenting the investment component in an amount equal to the amount currently payable on demand; (iii) presenting the investment component in an amount determined using the insurance contracts model; or (iv) no required separation in the statement of financial position.

IASB members were in favour of the staff recommendation that insurers should not be required to present investment components from the insurance contract separately in the statement of financial position. Instead, they should disclose both (i) the portion of the insurance contract liability that represents the aggregated portion of premiums received that were excluded from the statement of comprehensive income representing the investment component (see below); and (ii) the amounts payable on demand.

While a majority of the FASB members also supported the staff recommendation, a few were concerned about presenting the investment component as part of the insurance contract liability. Those individuals indicated that they felt it would be an unfaithful representation of an insurer’s balance sheet.

Disaggregation of the investment component from the premiums in the statement of comprehensive income

A majority of the IASB members were in favour of the staff recommendation that an insurer exclude from the aggregate premium those amounts to be paid to a policyholder or their beneficiaries regardless of whether an insured event occurs. This is measured consistently with the measurement of the overall insurance contract liability. Under the proposal, the insurance benefit recognised in comprehensive income would be reduced by the cash surrender values immediately prior to the occurrence of an insured event – a significant change from current practice.

The FASB members did not vote on this issue.

How we see it

The decisions on the measurement and presentation of investment components represent a dramatic change from earlier discussions. Previously, the Boards had discussed unbundling investment account balances and measuring them separately from the insurance contract liability under the financial instruments model. It appears the Boards are now moving towards measuring the entire contract liability under the insurance model. This approach may attract significant debate among constituents as some may feel the investment components are not an insurance liability and, therefore, should not be measured as such, while others believe measuring the entire contract is a better reflection of the economics of insurance contracts.

Definition of portfolio and the unit of account

The Boards continued deliberating the definition of a portfolio and when it should be the unit of account in the insurance standard. The discussions have far-reaching impact since the portfolio of contracts is referenced throughout the ED, including reference to the onerous test and determining the residual (IASB) or single margin (FASB). A majority of the IASB voted in favour of the following recommendation:

1. A portfolio of insurance contracts should be defined as contracts that are:
   a. Subject to similar risks and priced similarly relative to the risk taken on

And
b. Managed together as a single pool

2. The unit of account used to determine the residual margin and perform the onerous test should be the portfolio

3. The unit of account used to release the residual/single margin should not be prescribed. The release of the residual/single margin should be performed in a manner consistent with the objective of releasing the residual margin over the coverage period in which the service is provided.

However, the FASB decided unanimously on an alternative recommendation:

1. A portfolio of insurance contracts should be defined as contracts that:
   a. Are subject to similar risks and priced similarly relative to the risk taken on
   And
   b. Have similar duration and similar expected patterns of release of the single margin

2. The unit of account used to determine and release the single margin and perform the onerous test should be the portfolio

The Boards acknowledged the differences in their respective tentative decisions and expected that the differences would not yield significantly different results.

**How we see it**

The IASB appears comfortable with a portfolio level closer to the reporting unit or segment, while the FASB is discussing the portfolio at a lower level closer to individual lines of business. Some FASB Board members suggested the use of “sub-portfolios” for the run-off of the single margin and the onerous test. Mechanically this may add complexity and perhaps result in comparability issues between insurers. Under the FASB definition, it is likely that fewer loss-making contracts would be aggregated with profitable ones. Historically, a portfolio of insurance contracts was close to the reporting segment, but based on the discussions, it appears that the final standards for both the IASB and FASB may result in an increase in the number of portfolios.

**IASB education session: recognising changes in the insurance liability in OCI**

On 20 March, the IASB held an education session to explore how the use of OCI presents changes in the insurance liability. This was in anticipation of deliberations at the April joint meeting.

At this education session, the staff acknowledged the interaction of this topic with the ongoing Financial Instruments Classification and Measurement (FIC&M) project. The session was held with the assumption that eligible debt instruments will be measured using the fair value through OCI category.

IASB staff explained the background to this topic as being driven by:

1. The ED proposals of current measurement of the insurance liability with all changes in the insurance liability being reported in the profit and loss (P&L)

And

2. Feedback from respondents, including:
   a. Concerns about volatility in the P&L caused by short-term changes in the discount rate which are not representative of the long-term nature of insurance, and that presenting all the changes of the insurance liability in the P&L would obscure the underwriting results. Respondents also observed that the impact of interest rate changes reverses over time and questioned whether this would be a useful performance measure in the P&L
   b. Accounting mismatch that would arise if some financial instruments are not measured at fair value through P&L

Some tentative decisions made by the Board so far have attempted to resolve the respondents’ concerns on volatility. However, the staff explained that there is still concern, which has led to the staff considering the use of OCI to present changes in discount rates.

**Whether to use OCI**

The staff presented arguments for and against the use of OCI for changes in discount rates when measuring insurance liabilities. In addition to the effect of discount rate change,
there was discussion about the impact of changes in the insurance liability arising from interest-rate-sensitive cash flow assumptions (e.g., embedded interest rate guarantees, lapse assumptions for interest-sensitive products, inflation assumptions, etc.) and whether this should also be presented in OCI.

IASB members expressed differing views on whether to use OCI. Those who expressed concern observed that:

1. Economic mismatches arising from duration mismatches, credit spreads and options/guarantees would be presented in OCI rather than P&L. Although the main concern is volatility in the P&L, attempts to use OCI to reduce the accounting mismatch may result in other mismatches in equity.

2. Changes in discount rate do not reverse naturally in the same way as interest rate changes, for example, in a fixed income security. Given the contractual cash flows in a fixed income security, the changes in the fair value of such a security reverse over time and converge with the fair value at maturity. While it may make sense to present changes in the fixed income security in OCI, it may be less desirable to present the changes in the insurance liability in OCI because the discount rate changes do not reverse naturally.

3. There are complexities involved in identifying and reliably measuring effects of changes in an interest-rate-sensitive assumption separately from the effect of the change due to discount rates. The level of precision required disaggregating the changes in discount rates and interest-sensitive assumptions from other assumptions for purposes of presentation in OCI would, in some way, over-engineer the measurement process.

Those who were more supportive to using OCI observed that any analyst of a financial institution would need to look at the statement of financial position because of the significant information it contains. Considering that the statement of financial position is no less significant than the P&L, the proponents felt relatively relaxed about the use of OCI, so long as the changes in the insurance liability would be clearly visible and distinct.

On the issue of whether the use of OCI should be required or permitted, four options were proposed:

1. Require the use of OCI in all circumstances
2. Require the use of OCI with an option to present changes in P&L if it reduces an accounting mismatch
3. Require the use of OCI when there is an accounting mismatch
4. Permit use of OCI in all situations

Board members expressed a number of concerns around this test because it takes into consideration the return on assets, which would be inconsistent with the Board’s tentative decision that income recognition on insurance contracts should not be linked to return on assets backing the insurance liabilities.

**Loss recognition test under OCI variant**

The IASB staff noted that some constituents consider a contract to be loss making when asset returns are lower than expected, e.g., if an insurer prices its contracts assuming that it will earn interest at 7% on its investments, but the market returns are only 3%.

A loss recognition test would accelerate the recognition in profit and loss of future potential losses arising from a mismatch between insurance liabilities and assets backing them. The accelerated recognition would take place in the period that management first becomes aware of the losses.

The staff provided several arguments for and against a loss recognition test and offered three alternative loss recognition test triggers

1. **Alternative 1**: When the liability discounted at the current liability discount rate minus the liability discounted at the rate at inception is greater than the margin
2. **Alternative 2**: When the liability discounted using ROI minus the liability calculated using the discount rate at inception is greater than the margin
3. **Alternative 3**: When the qualitative factors to be specified indicate that the expected return on the assets is less than the liability’s discount rate at inception

The IASB members also reflected on the unit of account and noted that it would probably be best to consider the unit of account for the insurance liability and for the assets at the same time.

The Board acknowledged the difficulties arising from the proposal to use OCI and that it would be necessary to consider what the key objectives were and, therefore, the underlying principles. No formal decisions were reached because this meeting was educational.
How we see it
IASB members raised several issues and concerns on the use of OCI and an accompanying loss recognition test. This gave the impression that at least some of them are hesitant to introduce an OCI approach for insurance liabilities, even if the IASB were to introduce a third (Fair Value through OCI) category for financial assets in IFRS 9. This makes it difficult to predict the outcome of the forthcoming OCI discussion on insurance liabilities: whether it will be introduced, and if so, what the features will be.

Next steps
The IASB plans to issue a revised exposure draft or a review draft of the final standard in the second half of 2012. It will establish a publication date for the final standard in due course. The FASB currently aims to issue its exposure draft in the same period.

The Boards will have their next discussion on insurance during the April Board meetings, where they will address reinsurance, contract modifications, policy loans and riders. The Boards will also hold non-decision making sessions on the FASB’s single margin approach and various aspects of an OCI approach for insurance liabilities.
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