IFRS 4 PHASE II DRAFT INSURANCE CONTRACT STANDARD
OCI PRESENTATION AS 15.11.2012

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Rajoitettu käyttö (käyttäjäryhmä)

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TENTATIVE DECISION OF IASB

IASB

An insurer shall be required to present

- in OCI changes in the insurance liability arising from changes in the discount rate and
- in profit or loss interest expense using the discount rate locked in at inception of the insurance contract.

Comment

- This is well argumented for the purposes of the insurers which show in P/L cost based changes of assets
- Not an option as requested by the insurance industry.
- Not applied for certain participating contracts (see following slides).

MIRRORING APPROACH FOR CERTAIN PARTICIPATING LIFE CONTRACTS

IASB

- In case of par contracts the ***mirroring approach***:
  The measurement of the fulfilment cash flows relating to the policy-holder's participation should be based on the measurement in the IFRS financial statements of the underlying items in which the policyholder participates
- The mirroring decisions take precedence over the decision to present in OCI changes in the insurance liability arising from changes in discount rate (ie the mirroring decisions "trump" the OCI decision)

Comment

- Mirroring approach has the conditions that
  - there is direct link to the assets (the floor of the amount of the participation is not discretionary) and
  - the insurer has the assets.
- The change of the unit linked insurance liability is presented in P/L as would be the only possibility in order not show mismatch in the case where there is (almost) complete matching.

Rajoitettu käyttö (käyttäjäryhmä)

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TENTATIVE DECISION OF IASB ON CERTAIN PARTICIPATING LIFE CONTRACTS

- In case the mirroring approach doesn’t apply staff proposes for Nov 2012 IASB meeting the new exception from OCI presentation.
- See the next 2 slides and the Nov paper 2A
  - Discount rate – Contracts’ whose cash flows to which mirroring does not apply to but are affected by expected asset returns

PAR CONTRACTS NOT SUBJECT TO MIRRORING APPROACH

IASB staff

- **Question 1: Determination of the discount rate for cash flows contracts whose cash flows are not subject to mirroring and are affected by expected asset returns**
- Do the boards agree to clarify that for contracts whose cash flows are not subject to mirroring and are affected by asset returns, the discount rate that reflects the characteristics of the contract's cash flows shall reflect the extent to which the estimated cash flows are affected by the return from those assets. This would be the case regardless of whether the:
  - (i) transfer of the expected returns of those assets are the result of the exercise of insurer's discretion; or
  - (ii) the specified assets are not held by the insurer.

Comment

- The paper formulates the previous conditions to
  - there is a partial direct link to the assets and
  - the insurer doesn't need to have the assets.

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INTEREST EXPENSE OF PAR CONTRACTS NOT SUBJECT TO MIRRORING APPROACH

- **Question 2: Resetting the discount rate used to present interest expense**
  - Do the boards agree that for contracts whose cash flows are not subject to mirroring and are affected by asset returns, upon any change in expectations of the crediting rate used to measure the insurance contracts liability, an insurer shall reset the locked-in discount rate that is used to present interest expense?

FINNISH WITH PROFIT LIFE CONTRACTS

- The Finnish par contracts do not even fulfil the previous conditions. (Except unit-linked)
- The bonus of the Finnish wp contracts is usually linked to the market interest rates, not to any item in financial statement or any asset existing in the market
- The change should be presented in OCI.
- The Finnish life insurers usually must present their change arising from changes in the discount rate
  - of unit linked business in P/L and
  - of with profit business in OCI

  independently where the change of the investments are presented.
- Is this understandable solution and do we want this?
- Do we want to implement all these required and proposed complexities and are they cost effective in the case where the insurer manages its business by current values?

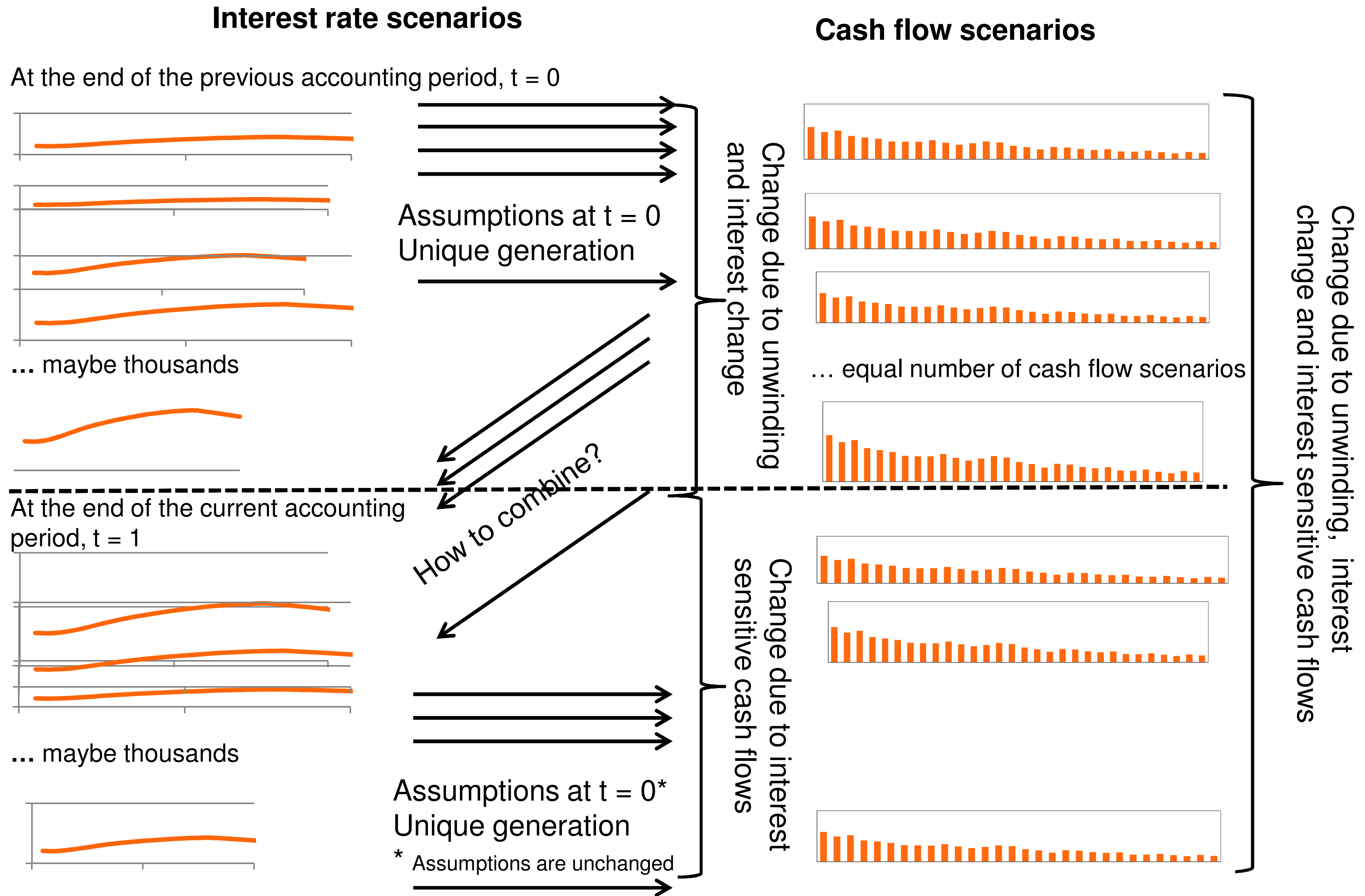
IASB TENTATIVE DECISION ON INTEREST RATE SENSITIVE CASH FLOWS

- The boards tentatively decided [May 2012 Update p.7-8] that an insurer should:
  1. present in OCI changes in the insurance liability arising from changes in the discount rate.
  2. not present in OCI changes in the insurance liability arising from changes in interest sensitive cash flow assumptions.
  - The boards will consider at a future meeting how the above decisions will apply to participating insurance contracts …
- The boards have tentatively confirmed the current value stochastic measurement.
- After the decision on the mirroring approach the question remains for the non-par contracts and certain par contracts.

POSSIBILITY TO IMPLEMENT DECISION ON INTEREST RATE SENSISTIVE CASH FLOWS

- The financial situation and their changes impact on the policyholder behavior and the decisions taken by the management of the insurer. The set of the discount rate scenarios is one and important factor in the financial situation. Its changes directly impact on the set of the cash flow estimate scenarios.
- How to combine the discount rate scenarios at the end of the reporting period to the cash flow scenarios at the start of the period generated by the discount rates at the start?
  - It is possible that the numbers of the scenarios at the start and end of the period are different.
- Conclusion: It is not possible to separate from the total change arising from the total changes in the discount rate as IASB has proposed. They must be reported in the same place, in OCI or P/L.

INTEREST SENSITIVE CASH FLOWS IN OCI-PRESENTATION



IASB TENTATIVE DECISION ON LONG P&C CLAIM LIABILITY

IASB

- When the liability for incurred claims is discounted the rate at the inception of the contract should be used to present the claims and interest expense?
- This was compromise to the FASB.

Comment

(a) The claim liability has often information on the accident year (AY) not on the inception year (IY).

- Forcing the P&C companies to trace the IY of the known claims is non-cost effective requirement and the insurers often don't manage the claim liability by IY but by AY so this requirement may force insurers to report in the way they don't manage their liability.

IASB TENTATIVE DECISION ON LONG P&C CLAIM LIABILITY - COMMENT

Comment

- All insurers don't manage claim liabilities using the underwriting year. Demanding this information would be against the principle to report the information as prepared and used by the management.
- This issue was discussed with the European Insurance and Occupational Pensions Authority (EIOPA) when EIOPA published its first Solvency II reporting draft requiring the use of underwriting year in the claim liability. After the discussion EIOPA accepted the use of accident year in the claim liability.
- In addition, IBNR claim liability is measured with the probability calculation and the liability may contain small amounts of probable assumed cash flows from every contract from several past years. When these incurred but not reported liabilities turn out to be few reported claims and the correct inception year is known only this information may cause irrelevant change to P/L and OCI.

HISTORICAL DISCOUNT RATES

IASB

- Ref to proposal 100B(c)
- (i) determine the yield curve using an observable yield curve …
- (ii) if the yield curve in (i) does not exist, apply to the observable yield curve that most closely approximates the yield curve determined in accordance with paragraphs 30–33 and B66A–B66F a spread (averaged over at least three years if possible) between that observable yield curve and the yield curve determined in accordance with those paragraphs.

Comment

- Neither proposed rate is possible nor useful:
- This can be done in large economies where these kinds of yield curves exist. In Finland, before the introduction of the Eurozone there were only government bond rates. In the first half of the 1990s the maturities were 2 years, 5 years and 10 years. Before that, but after the Second World War, only one maturity existed. The tentative decision of the Boards cannot be applied in economies like Finland because there is no required approximating yield curve before the Eurozone .
- Both Finnish life and non-life liabilities contain material amounts of obligations from the period before Eurozone.

THE FINNISH GOVERNMENT INTEREST RATE MARKET 1948-2012

Finland, Government Benchmarks, Bid, Yield, EUR

Percent

22.5
20.0
17.5
15.0
12.5
10.0
7.5
5.0
2.5
0.0
-2.5

48 50 52 54 56 58 60 62 64 66 68 70 72 74 76 78 80 82 84 86 88 90 92 94 96 98 00 02 04 06 08 10 12

5 Year, End of Period — 10 Year, Close — 2 Year, Close

Source: Reuters EcoWin

Rajoitettu käyttö (käyttäjäryhmä)

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IASB TENTATIVE DECISIONS ON ASSETS

IASB

- The insurers should be *permitted* to eliminate any … new mismatches by permitting insurers to designate financial assets under the FVO when the insurer applies the new insurance contracts standard.
- The insurer should follow the *reclassification* guidance in the relevant financial instruments standard with certain exceptions.

Comment

- However, these reclassifications don’t permit complete presentation through OCI eg. investment property (IAS 40) and forces the insurer to present equity investment result in OCI even though it wouldn’t indicate the insurer business model.

IFRS 9

- Following earlier application of IFRS 9, permitted to newly elect to use other comprehensive income for the presentation of changes in the fair value of some or all equity instruments that are not held for trading, or revoke a previous election if applicable.
- An insurer shall follow the reclassification guidance in IFRS 9 *Financial Instruments* except that an insurer should be:
  - permitted to designate eligible financial assets under the fair value option where new accounting mismatches are created by the application of the proposed new Insurance Contracts Standard;
  - required to revoke previous designations under the fair value option where the accounting mismatch no longer exists because of the application of the proposed new Insurance Contracts Standard;
  - following earlier application of IFRS 9, permitted to newly elect to use other comprehensive income for the presentation of changes in the fair value of some or all equity instruments that are not held for trading, or revoke a previous election if applicable.
- The Phase II IFRS 4 should be published before 1.1.2015 in order the insurers would have the best information for the classification of the assets for the consideration the future IFRS 4 / 9 matching.

BUSINESS MODELS

- If OCI presentation is mandatory, as a consequence the insurers cannot really select to report its business model fairly in case the model is fair value through P/L but is forced to select between
  - presenting the change arising from the discount rate change of the financial instruments in the way the business is not managed through OCI; or
  - showing accounting mismatch both in P/L and OCI.
- If the insurer uses FVtPL business model and has adopted it in IFRS 9 the OCI presentation doesn't present the result of an insurer according to its performance. The Board has tried to avoid this kind of accounting mismatch.
- In the case of hedging the interest rate risk this would lead to a situation the better the hedge is more accounting mis-match results under the proposed IFRS 4 standard. Lot of mis-match both in P/L and OCI.
- Some insurers effectively use a lot of interest derivatives.
  - In Nordic countries the insurers have lot of interest swaps eg. due to Solvency II and also in other respects their asset portfolios differ quite a lot of those insurers who have favoured OCI presentation for the reason of their business model: more risky assets.

REQUIREMENT VS OPTIONALITY

- IASB has recognised that there exist different business models or the ways the entities manage their assets and liabilities by allowing the options in IFRS 9. It would be only the consistent application of this recognition that this option will be allowed in other standards, too, now to IFRS 4; it would not be a new option or principle.

SCOPE OF USERS AND PREPARES

- Options of the standards create incomparability issues for the users of the financial reports but no options may give unfaithful presentation of the way the business is managed. Especially, if the reports partly depict the business model and partly mis-report it the understandability suffers.
- The required complexity of the implementation of the standard in certain cases without any benefit to the users or even causing incorrect message surely is not a cost effective way of reporting.
- OCI presentation would be very cost-ineffective for insurers who don't manage their business using the OCI presentation: in practice they would have to do a lot of work to present the results in a way that is not natural for their business and in order to show large accounting mis-matches.
- Those companies which favour OCI presentation for the sake of their business model see this workload worth of doing.