



The Locked-in Approach

Technical position of the HUB Group on Insurance Contracts

The following report on the “Locked-in approach” reflects a proposal by the HUB global insurance group. This technical paper is being provided to members and staff of the IASB and FASB to assist them in understanding the proposal prior to the Insurance Working Group meeting on 24 March 2011.

This paper provides additional detail on the Locked-in Approach that was outlined at a high level in the HUB Group’s Insurance Industry Proposal Discussion Paper dated 22 March 2011.

As with all our documents, comments from the public are welcome.

I. Objective

The objective of this paper is to describe how the HUB Group envisions the locked-in approach will work (an alternative to the “Current-current through OCI approach”¹). Specifically, it addresses the relevant insurance contract liabilities which may be measured using a lock-in of the initial discount rate, including the interrelationship with the IFRS 9 business model, the criteria under which insurance contract liabilities would utilize the locked-in approach, the treatment of options and guarantees, whether a liability adequacy test is necessary, and how the approach may apply to participating contracts.

An important element of the proposal is that it envisions insurance contract liabilities will be on a current basis except for the discount rate. All changes in estimated cash flows are reflected on a current basis and go through profit and loss. Only the discount rate is locked-in.

The proposals in this paper also take into consideration the recently issued IASB staff paper on locking in the discount rate. This paper does not address the definition or the composition of the discount rate.

II. Introduction

As explained in the HUB Group’s Industry Proposal Discussion Paper, the insurance industry will be placed at an unfair disadvantage relative to other competing financial institutions that can benefit from using the amortized cost category available to them under IFRS 9. This may lead to misrepresentation of the performance of insurers and a higher cost of capital, depending on the business model. Therefore, we recommend that the Board permit a locked-in discount rate alternative within the insurance contracts standard².

¹ Refer to HUB Group’s Insurance Industry Proposal Discussion Paper dated 22 March 2011

² If OCI is made available for value changes in both assets and liabilities as described in the technical paper on the OCI approach, then from a P&L perspective, under the OCI approach, we envision that the discount rate

We are also concerned about the potential volatility and mismatch of the changes in the value of assets measured at fair value and the change in the value of insurance liabilities measured at current fulfillment value. For example, where cash flows of the asset portfolio align with the cash outflows of the insurance liabilities, changes in interest rate spreads may not affect the assets and liabilities in the same way. Additionally, changes in credit spreads can have significant effects on the asset portfolio, and will not be offset by any change in the value of the liabilities, producing short-term mark-to-market movements stemming from illiquid markets that do not reflect the underlying economics of the insurance products.

Several important constituents share the concerns and recommended that the Board consider a locked-in approach (also referred to as a *mixed measurement model* or *cost option*) in the comment letters to the ED, as seen in the following excerpts:

- ❖ “The ACLI recommends that the Board add a cost option alternative within the insurance contracts standard.” (ACLI CL2C, page 19)
- ❖ “Where insurers are carrying their assets at amortised cost then the matching liabilities should be measured generally using a locked in discount rate to reflect their business model. This is consistent with IFRS 9 and the mixed measurement model applied by banks. In this regard IFRS 4 should reference back to the business model in IFRS 9 in order to ensure appropriate asset liability matching.” (CFO Forum CL46, page 4)
- ❖ “Permitting the use of discount rates established at the inception of the contract for the entire duration of the contract, to the extent the use of a locked-in interest rate would better reflect an insurer’s business model.” (KPMG CL149, page 3)
- ❖ “We therefore would suggest that the IASB considers permitting a cost option for insurance liabilities if the cost category is used for the underlying bonds (only for participating life business).” (The European Federation of Financial Analyst Societies (EFFAS) CL 140, page 1)
- ❖ “GASB supports the introduction of a mixed measurement model for insurance liabilities (following a similar logic to the approach contained in IFRS 9 for financial instruments).” (GASB CL 213, page 2)

We recognize that respondents also suggested other options, and a small number of respondents commented against the use of a locked-in approach, but we believe the comments from the small sample above reflects the fact that many prepares, users and investors support a locked-in approach. We fully support the views raised in these comment letters and have therefore worked to develop the specifics around how such an approach would work.

III. Proposal

In order to develop an approach under which insurance contract liabilities can be measured using a locked-in discount rate, it is important that appropriate criteria are established which adequately capture those contracts for which a locked-in discount rate approach could be used, while at the

would be locked-in. Thus, this paper provides additional detail on how the P&L would be achieved under the OCI approach.

same time addressing the IASB's concerns of including overly complicated principles and limiting the ability for abuse of the approach.

We believe the following criteria could be applied in the use of a locked-in discount rate.

1. Guiding principle

Upon initial recognition, an insurance liability may be designated by the insurer as an insurance liability with a locked-in discount rate. An insurer may use this designation only if it meets both of the following conditions:

- a) A portfolio of insurance liabilities is managed and its performance is evaluated in accordance with its business model considering **asset liability management** which is documented, and information about the portfolio is included on that basis (separately or with other portfolios) as part of the insurer's internal management reporting including information provided to the insurer's board of directors and chief executive officer, and
- b) The liability cash flows of the policy do not directly reflect **unrealized investment returns** on the assets supporting the policy.

If an insurance liability meets both of the conditions, an insurer is permitted to measure the insurance liability, in accordance with ED Insurance Contracts paragraphs 17 and following, and paragraphs 47 and following, with a discount rate that is locked-in at inception of the contract.

The election is irrevocable unless there is a change in business model (expected to be rare).

2. Application guidance

Classification

An insurer's **asset liability management** as part of the Integrated Insurance Business Model³, which is primarily used by life insurers, is where the insurer focuses on all cash flows of the business arising from both assets and liabilities. In some cases, an insurer's asset liability management strategy would include assets which are measured at amortized cost. If the requirements in (a) and (b) are met, this principle would enable insurers to utilize the amortized cost category in IFRS 9 and measure the insurance liabilities using a comparable measurement basis.

In order to qualify under criteria (b), for par and interest-sensitive contracts, the liability cash flows of the policy shall not directly reflect **unrealized investment returns** until realization or impairment (including reversal) takes place.

Unit linked and variable contracts are not eligible for the locked-in approach.

Measurement

Except for the discount rate (used for discounting and accretion), current inputs and assumptions are used for recognition and subsequent measurement of the insurance liability. Insurance contract liabilities will be on a **current basis except for the discount rate**. All changes in estimated cash flows are reflected on a current basis and go through profit and loss. Only the discount rate is locked-in.

³ Refer to HUB Group's Insurance Industry Proposal Discussion Paper dated 22 March 2011

Liability cash flows are **unlocked** if the future crediting rate changes, in which case the interest rate shall be unlocked and a new locked-in discount rate shall be established. Future credited rates change when prospectively declared credited rates deviate from previous assumptions. Retrospectively declared credited rates, which are set on an annual basis based on past year's investment income, do not trigger unlocking of the discount rate. Actual investment returns passed through to the policyholders are reflected in the liabilities in the current period.

Embedded **options and guarantees** (those which are deemed to be closely related to the insurance contract and do not meet the definition of a derivative, as described in ED Insurance Contracts paragraph 12 (a) and (b)) under the contract from which the insurer may bear financial risk shall be measured in accordance with ED Insurance Contracts B39 at each reporting period. Any value of options and guarantees would be reflected through the use of current cash flow projections.

As envisioned in the ED, **embedded derivatives** (for example, a policyholder's option to participate in an index or a guaranteed minimum withdrawal or accumulation benefit) which meet the criteria in paragraph 12 (a) and (b) shall be separated and measured at fair value.

An insurer shall perform a **liability adequacy test** at least annually to determine for a portfolio of insurance contracts whether the carrying amount of insurance liabilities is adequate in light of the current estimated future cash flows. If not, the insurer shall recognize the difference in the P&L. This would reach the right result from a financial position standpoint and yet be less complicated than the liability adequacy / loss recognition tests performed under current accounting regimes.

IV. IFRS 9

The proposal recommends clarification to the business model criteria in IFRS 9 in order to allow for the majority of an insurer's debt instrument portfolio to qualify for amortized cost measurement. Current IFRS 9 has only two extreme categories "hold-to-collect" and "trading", and does not reflect the long-term investment objective in many insurers' asset liability management strategies.

Many insurance companies have too much rebalancing in their portfolios and may not be able to meet the hold-to-collect criteria, yet these same companies are clearly not traders. There is a concern that many insurance entities may be unable to use the amortized cost category under this approach.

Additionally, since the release of IFRS 9, entities have had the opportunity to analyze the impacts and estimate how much of their debt portfolios meet the amortized cost category, especially with respect to the business model. The audit firms have also issued interpretive guidance of the business model criteria. In our view, the principle is sound, but the application guidance needs clarification in order to ensure that audit firms are not drawing bright lines, and that insurers whose business model or investing strategy is not a trading model, have the opportunity to use the amortized cost category according to the business model.

The FASB may have also recognized that by having only hold-to-collect and trading categories, there is a missing element of an entity's business model for managing financial assets. In the January discussions of the FASB, the board made a tentative decision which changed the course of its prior decisions on financial asset classification and measurement, by adding a category which would consist of assets managed for an entity's investing activity or being used to manage the interest or liquidity risk of an entity.

Notwithstanding the possibility of the two boards converging on a solution which meets the needs of all preparers, we have developed some suggestions for amending the application guidance. We would be pleased to share the full results of our analysis.

V. Disclosure

An entity would identify and disclose the products or range of products that are managed based upon their contractual cash flows for which the locked-in discount rate is used.

VI. Basis for Conclusions

The basis for conclusions for this proposal are laid out as Appendix 2 in the attached response of two HUB Group members, ACLI and GNAIE, to IASB agenda reference 3C and FASB agenda reference 58C on locking in the discount rate.

The HUB Group supports the views and believes they provide a strong basis for the conclusions of this proposal.

VII. Appendix 1

The following table gives an overview of various different types of insurance products, and which ones may be eligible for a locked-in discount rate with respect to criteria (b). The purpose of the table is to provide illustrative examples of how the principle described above would work, which could be included as an appendix to the application guidance.

Contract type	Business objective - Insurance protection or savings	Measurement approach- building blocks or unearned premium (UPR) approach	Lock-in discount rate measurement choice allowed
Term insurance, e.g., 10 year, 20 year (non-par)	Insurance protection	Building blocks or UPR approach (YRT contracts)	Yes
Traditional whole life (non-par)	Insurance protection	Building blocks	Yes*
Universal Life	Insurance protection	Building blocks	Yes*
Variable life, Variable UL	Insurance protection	Building blocks	No
Unit-linked contracts	Insurance protection	Building blocks	No
Participating contracts	Insurance protection	Building blocks	Yes*
Credit life	Insurance protection	Building blocks or UPR approach	Yes
Deferred annuities with guarantees	Savings	IFRS 9 for savings; building blocks or UPR approach	Yes*
Immediate life income annuities	Insurance protection	Building blocks	Yes
Disability income	Insurance protection	Building blocks	Yes

Long-term care	Insurance protection	Building blocks	Yes
P&C contracts	Insurance Protection	UPR approach for pre-claim or building blocks	Yes**
Financial Guaranty contracts	Insurance protection	Building blocks	Yes**

* Liability cash flows are unlocked if the future crediting rate changes, in which case the interest rate shall be unlocked and a new locked-in discount rate shall be established

** If liabilities are discounted

VIII. Appendix 2

See next page.



February 11, 2011

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30 Cannon Street
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Ms. Leslie F. Seidman, Chairman
Financial Accounting Standards Board
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Re: Insurance Contracts – IASB Agenda reference 3C and FASB Agenda reference 58C

Dear Sir David and Chairman Seidman:

The American Council of Life Insurers (ACLI) and the Group of North American Insurance Enterprises (GNAIE)⁴ would like to express our concern along with specific rebuttals to the staff paper submitted as Agenda Item 3C(IASB) and 58C(FASB) for the February 2011 joint IASB/ FASB Board Meeting. The agenda paper addresses the potential use of a locked-in discount rate within the building blocks. While there has yet to be a formal proposal put forward by industry, there is currently an effort being made to create a business model approach that will recommend locking in the discount rate for certain insurance contracts. The industry believes that a locked-in discount rate for non-interest sensitive contracts managed with a matched portfolio of assets held at amortized cost will provide meaningful operating results; will put insurance entities on a level playing with other financial institutions such as banks; and will address the concerns of analysts and regulators (key users of insurance company financial statements) regarding volatility. The use of a locked-in rate will also address additional concerns of the user community, by allowing them to analyze underwriting and investment results without the noise created by the fair value changes in assets and liabilities

The staff has concluded that a locked-in discount rate is not appropriate and has based that conclusion on several arguments that we believe are fundamentally flawed. We believe that the staff analysis is flawed both in terms of the facts and in the understanding of the insurance business model. For these reasons, we believe it is important that the IASB and FASB be presented with the industry views regarding some of the staff conclusions and have addressed those views herein. The following presents the staff views, as expressed in the agenda paper, along with our response to those views.

⁴ The American Council of Life Insurers represents more than 300 legal reserve life insurer and fraternal benefit society member companies operating in the United States. These member companies represent over 90% of the assets and premiums of the U.S life insurance and annuity industry. GNAIE consists of Chief Financial Officers of leading insurance companies including life insurers, property and casualty insurers, and reinsurers. GNAIE members include companies who are the largest global providers of insurance and substantial multi-national corporations.

Preparer-only Concern

Staff View: The agenda paper expressed in the “Background to the proposal”, paragraphs 5 and 10, that locking in the discount rate is mainly a preparer concern and a preparer recommendation. The paper states that users responded that they did not agree with a locked-in proposal.

Response: The user community, in particular the analyst community, has made it abundantly clear that they do not want noise from unlocking interest rates to interfere with operational analysis. They have also made it clear that duration mismatches could be disclosed just as effectively in the notes and it is not necessary for them to be on the face of the balance sheet or in the income statement. Specific to the feedback that was received through the comment letters and the Public Roundtables, reactions from users were generally mixed on the idea of a locked-in of the discount rate. At this time the concept of a locked-in discount rate has not been adequately vetted with the user community and it is premature to suggest that there is even moderate opposition to it for the limited liabilities we are proposing.

Use of the Fair Value Option

Staff View: The agenda paper, paragraph 11, suggests that the use of the fair value option (FVO) is available and should be used to address the industry’s concern regarding asset liability mismatch.

Response: We believe that the fair value option is best used in circumstances when either an unavoidable mismatch exists or when it represents a superior measurement basis due to management’s intent with regard to the use of the financial instrument. We strongly disagree with the belief that broad use of a FVO that is created by a significant asset and liability mismatch is an appropriate approach to standard setting, especially when fair value is not deemed to be the valuation basis that best aligns with management’s approach to managing the business. In addition, this solution to reducing accounting mismatches for insurers would create serious competitive imbalances, as other financial institutions with whom insurers compete with for capital and in financial markets would continue to use amortized cost for reporting many of their financial assets. Forcing insurers to use a fair value option also creates a perception that fair value is somehow superior to other attributes which are permitted for reporting financial asset values.

Analogous Accounting to Financial Instruments

Staff View: The agenda paper expressed the view, in paragraph 13, that insurance contracts do not share enough characteristics of financial assets or financial liabilities carried at amortized cost to support accounting for them at cost. They reference variability of cash flows as the primary reason for this.

Response: While we understand the need to separate cash flow volatility arising from credit losses for purposes of determining the use of amortized cost for financial instruments, we believe it is inappropriate to exclude them when comparing insurance contracts to financial instruments. The agenda paper suggests that insurance contracts have too much variability of cash flows to be analogous to financial instruments accounted for at amortized cost. We disagree with this view and believe that when viewed on a pooled basis, non-interest sensitive insurance contracts have cash flows that are as predictable as the cash flows of financial instruments carried at amortized cost (when considering all cash flows including credit).

Actuarial analysis can provide estimates that are more accurate than estimates of pre-payments on financial instruments, which are tied to current economic environments. Further, the variability of non-interest sensitive insurance cash flows is addressed through projecting cash flows using current assumptions, i.e., cash inflows, cash outflows and margins, not through the discount rate.

The management approach to insurance contracts is more consistent with the approach of financial instruments carried at amortized cost. The business model for many insurers (principally life insurers) is predicated on matching asset and liability cash flows. Relevant reporting of such business on the basis on which it is managed requires consistent reporting of asset and liability values. We agree with staff that these insurance contracts are fundamentally different than financial instruments carried at amortized cost. However, we disagree that these differences dictate that they shouldn't still have the same or similar accounting basis. In fact because both are managed with a similar approach, we believe that they should be measured on a similar basis.

Better Analogy is Contingent Liability

Staff View: The agenda paper, paragraph 29, suggests that insurance contracts share more similarities to contingent liabilities than financial instruments carried at amortized cost and use that view to conclude that an IAS No. 37 approach is more appropriate than an IFRS No. 9 approach.

Response: On a contract basis, we can understand the staff view on this issue. However, there are key differences in the understanding and management of insurance contracts when compared to contingent liabilities. Contingent liabilities generally emerge on a standalone basis making valuation difficult. In addition, contingent liabilities are rarely supported with asset cash flows due to their lack of predictability. Insurance contracts are managed on a portfolio basis (similar to financial instruments) and the cash flows at the portfolio level are generally predictable and most often managed with a portfolio of assets with matched cash flows. For that reason, we suggest a business model approach such as that provided for financial instruments.

Options and Guaranteed within Insurance Contracts

Staff View: The agenda paper states, in paragraph 28, that because IFRS does not require the bifurcation of many of the guarantees and options contained within insurance contracts, this would represent a significant flaw with the locked-in interest rate approach.

Response: It is unclear to us why staff believes the locked-in discount rate exaggerates this issue. To the extent that all non investment related cash flows are unlocked with current best estimate assumptions (including the cash flows associated with options and guarantees), we believe that the value of these provisions are sufficiently accounted for within the building blocks. Moreover, to the extent that the options or guarantees result in a different management model that would be better represented with current value, then the option to unlock the discount rate would exist in a business model approach as industry suggests. To the extent that the staff's concerns were specific to guarantees associated with interest rates, then we believe that the onerous contract test would adequately address those concerns.

Locking in the Discount Rate is NOT a Current Value

Staff View: The agenda paper suggests in paragraph 31 that by locking in the discount rate, that the measurement model would no longer be a current value model. They further suggest that it may not provide significantly more value than the current U.S. GAAP model where all assumptions, including cash flows, are locked in at inception.

Response: We are unclear why the agenda paper suggests that the unlocking of the discount rate is the single most critical component to the building blocks and that without it we would be applying a FAS 60 model. Generally speaking, for long-duration contracts, we are in a cash flow management business and it is the expectation of future cash flows that most dramatically impacts our performance. We believe that reflecting current best estimate of expected cash flows is potentially the most significant improvement in the proposed building blocks compared to current U.S. GAAP. The effect of discounting is largely expected to be offset through the acquisition of financial instruments for most insurance contracts. Hence, it is important to match the accounting for the financial instrument with the interest rate component of the insurance contract, i.e. the discount rate.

Complexity of a Locked-in Model

Staff View: The agenda paper expresses concern regarding complexity in a few places of the paper-paragraphs 28d, and 31. They reference it in the accounting for exchanges, the need for an onerous contract and in the administration of tracking the locked-in rates.

Response: The accounting for insurance contracts as required by the building blocks already contains complex data and modeling requirements. The added complexity of tracking discount rates at a cohort level or portfolio as well as an onerous contract test are not significant when compared to the existing challenges that the industry will face in implementing the proposed standard. Moreover, the benefit of isolating the changes in cash flows by locking in the discount rate will provide users with more pertinent financial analysis than a change in the obligation that contains the impact of changing discount rates. For onerous contracts where current reinvestment rates are insufficient to cover liability cash flows, recording a charge to reflect that expected loss is both appropriate and responsible as it will provide enhanced information to financial statement users.

As always, we welcome the opportunity to discuss these views with you in more detail at your convenience.

Sincerely,



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