



**Board Meeting Handout
Insurance Contracts
October 15, 2012**

PURPOSE OF THE MEETING

1. The purpose of this meeting is to ask the Board whether, upon the adoption of the proposed insurance contracts guidance, insurers should be permitted to redesignate their financial assets and/or reclassify their financial assets in accordance with other aspects of existing or proposed financial instruments guidance.

Existing Guidance—Financial Instruments Classification and Measurement

2. Under existing U.S. generally accepted accounting principles (GAAP), upon acquisition, most equity and debt securities are classified based on an entity's intent and ability in one of the following three categories:
 - a. Debt securities that the enterprise has the positive intent and ability to hold to maturity are classified as held-to-maturity securities and reported at amortized cost.
 - b. Debt and equity securities that are bought and held principally for the purpose of selling them in the near term are classified as trading securities and reported at fair value through net income.¹
 - c. Debt and equity securities not classified as either held-to-maturity securities or trading securities are classified as available-for-sale securities and reported at fair value through other comprehensive income.
3. Although *FASB Accounting Standards Codification*[®] Topic 320, Investments—Debt and Equity Securities, requires a reassessment of the classification at each balance sheet date and provides guidance on the accounting for transfers into each

¹ Section 825-10-25, Financial Instruments—Overall—Recognition, also grants entities the ability to elect the fair value option. The option is applied instrument by instrument, is irrevocable, and generally is available only upon an insurer's initial recognition of the eligible financial instrument.

category, it also notes that transfers from the held-to-maturity category and transfers into or from the trading category should be rare.

Proposed Guidance—Financial Instruments Classification and Measurement

4. Based on the Board’s tentative decisions, in order for a financial asset to be classified as other than fair value through net income, it must meet the following conditions:
 - a. The financial asset must give rise on specific dates to cash flows that are solely payments of principal and interest (consideration for time value of money and credit risk) on the principal amount outstanding.
 - b. The financial asset must be managed within a relevant business model.
5. The Board tentatively decided on the following principles for classification and measurement of financial assets:
 - a. Amortized Cost—Financial assets would qualify for amortized cost if the assets are held within a business model whose objective is to hold the assets to collect contractual cash flows.
 - b. Fair Value through Other Comprehensive Income—Financial assets would qualify for classification and measurement at fair value through other comprehensive income if they are managed within a business model whose objective is both to hold the financial assets to collect contractual cash flows and to sell the financial assets.
 - c. Fair Value through Net Income—Financial assets that fail the amortized-cost business model assessment and the fair-value-through-other-comprehensive-income business model assessment would be measured at fair value through net income. That is, fair value through net income would be the residual category.
6. The FASB tentatively decided to require an entity to reclassify financial assets if the objective of the entity’s business model for managing those financial assets changes. Such changes are expected to be very infrequent and should be as a result

of external or internal changes significant to the entity's operations and demonstrable to external parties.

Meeting the Reclassification Criteria

7. In the staff's view, there is a relatively high hurdle for a reclassification to occur under both the existing and proposed guidance for classification measurement of financial assets. Absent the restrictions on reclassification of financial assets, it would seem plausible that an insurer could reach different conclusions regarding classification when the relevant financial instruments standard is first applied than it would in reassessing the existing classification of financial assets on the effective date of proposed insurance contracts guidance. That could be the case if an insurer changes its investment and/or asset liability matching strategy as a result of comprehensive changes in accounting for insurance contracts.
8. Asset-liability management is a fundamental aspect of an insurer's business. While the asset-liability management is focused on the economics of the assets and liabilities rather than the accounting, should the accounting change result in an accounting mismatch, management may change its intent or business strategy.
9. The staff recognizes that new accounting guidance would not change an entity's ability to hold or sell a financial asset or the cash flow characteristics of a financial asset. However, the staff notes that while adoption of new insurance contracts guidance by itself would not result in a change in either an insurer's intent or its business model, it could in some cases be one factor that causes an insurer to review whether its existing intent or business model is still appropriate. If that review leads to a change in intent or a change in the business model, the financial instruments reclassification guidance will determine whether that change results in a change in classification, absent specific transition provisions for insurers.

Sources of and Potential Solutions to Mitigate Accounting Mismatches

10. After implementing the proposed insurance contracts guidance, insurers will be required to update all assumptions within the insurance contract liability, including the discount rate that will be reported in other comprehensive income and other

interest-sensitive assumptions that will be reported to net income. Some accounting mismatches between insurance contracts liabilities and financial assets will be driven or avoided depending on the classification of the financial assets that back insurance liabilities.

11. For example, currently insurers account for specific insurance contracts using locked in assumptions, which are similar to amortized cost. Continuing to hold financial assets at amortized cost after adoption of the proposed insurance contracts guidance could cause an accounting mismatch. If the changes in the discount rate are expected to cause the majority of the insurance contracts liability volatility (that is, the nonfinancial assumptions are not expected to be very volatile), recording financial assets that back those insurance liabilities at fair value through other comprehensive income may be the best option to reduce accounting mismatches.
12. If an insurer adopts the proposed accounting for financial instruments and insurance contract guidance on the same date, insurers would be able to assess the business model at that date taking into account the recognition and measurement of the insurance contracts that are managed together with specific portfolios of financial assets. Similarly, an election under an existing fair value option for financial assets might be based on reducing accounting mismatches for the life of the assets and related insurance contract liabilities. Such an assessment of the asset's classification being aligned with the change in the measurement model arising from the proposed insurance contracts guidance should allow for increased opportunity to minimize accounting mismatches.
13. If the new financial instruments guidance is initially applied before the new insurance contracts guidance, the reclassification guidance, rather than classification guidance, would apply (for determination of the classification of financial assets at and after the effective date of the new guidance on insurance contracts). Therefore, absent special transition provisions, the insurer would not be able to take into account the recognition and measurement requirements for insurance contracts when assessing classification and making classification choices for financial assets that back insurance liabilities.

14. The following paragraphs consider two alternatives.

Alternative 1—Permit insurers to classify financial assets at amortized cost, fair value through net income, or fair value through other comprehensive income, as if the applicable financial instruments guidance had been initially applied at the same time that the insurance guidance is applied.

15. This potential solution effectively fully removes the restrictions regarding reclassifications between different categories, including reconsidering classification options (for example, current U.S. GAAP's reference that some reclassifications are expected to be rare as well as the irrevocability of fair value options).
16. The transition guidance from Topic 815, Derivatives and Hedging (previously issued as FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*) provides a precedent for Alternative 1. Paragraphs 54 and 55 of Statement 133 permitted an entity, at the date of its initial application, to transfer any held-to-maturity security into the available-for-sale category or the trading category and an entity to transfer any available-for-sale security into the trading category. A reason noted for allowing this option was to permit an entity to designate a security transferred into the available-for-sale category as a hedged item, which would otherwise be prohibited by Topic 815 if it remained classified as a held-to-maturity security. Said another way, the basis was to eliminate accounting mismatches between hedged items and hedging instruments.
17. The ability to reassess the classification of financial assets reflects the fundamental significance of insurers' asset-liability management program and would allow insurers to make different classification decisions, particularly those that depend on the insurer's business model (under the proposed new guidance) or intent (under current U.S. GAAP), than initially made. This alternative would confirm explicitly that the insurer makes classification decisions in light of circumstances that exist when it adopts the new insurance contracts guidance.
18. This alternative also has the effect of giving insurers the ability to newly designate and/or revoke previous fair value option designations if the option exists under the

financial instruments guidance in effect at the date the new insurance contracts guidance becomes effective.

19. This alternative would allow insurers to better consider what classification decisions are most appropriate when they first adopt the new financial instruments guidance, rather than being *distracted* by whether that will lock them into decisions that may be suboptimal for subsequent adoption of the new insurance contracts guidance. Because this alternative involves a fresh-start classification both at the date of adoption of the financial instruments guidance and that of the insurance contract guidance, it arguably achieves a more relevant classification for both periods affected and would reduce diversity in classification and measurement of insurers' financial assets.
20. Casting aside the restrictions to reclassification, albeit as a one-time event, might be seemingly inconsistent with the basis for the restrictions having been originally voted on in the applicable financial instruments guidance. Such an exception applicable to insurers could similarly be argued as beneficial for many other industries. However, with the exception of other financial institutions whose assets and liabilities would both be subject to the financial instruments guidance, the staff is not aware of other industries whose contractual liabilities are as closely linked to financial assets and for which there is a significant change in accounting requirements.

Alternative 2—Permit insurers to newly designate and/or revoke previous fair value option designation.

21. Similar to Alternative 1, Alternative 2 recognizes the importance of asset-liability management in insurers' business. However, some note that the entity's business model is already reflected in the classification and reclassification requirements of the proposed FASB financial instruments guidance. That is, an entity classifies its financial assets based on the relevant business model (and contractual cash flow characteristics of the financial assets) and must reclassify financial assets if the business model changes. Therefore, an insurer would be required to reclassify its

financial assets if its business model for managing financial assets changes due to the adoption of the new insurance contracts guidance.

22. However, a disadvantage of this alternative is that insurers would need to meet specific conditions that need to be met to be able to reclassify their financial assets. While these conditions would be satisfied where there is a genuine change in the business model, in the staff's view, the additional costs and time to insurers to meet the reclassification requirements is not warranted when there is support that those assets would meet the initial classification criteria.
23. In addition, permitting insurers to newly designate and/or revoke previous fair value option designations (that exist within the financial instruments guidance in effect at the date of the adoption of the new insurance contracts guidance) effectively limits insurers from redesignating their financial instruments between amortized cost or fair value through other comprehensive income.
24. A variant of Alternative 2 would be to permit insurers to designate financial assets under an existing fair value option or to revoke previous designations under an existing fair value option in which new accounting mismatches are created by either not electing or not revoking the fair value option. However, existing U.S. GAAP does not contain the notion of *accounting mismatch* in its requirements to be able to elect a fair value option.

Impact of the Alternatives

25. The following table indicates the differences between the two alternatives and assumes that the financial classification requirements that are in effect at the time that the proposed insurance contracts guidance becomes effective would be met (see below for consideration of reclassification requirements).

Prior to adoption of new insurance contracts guidance, debt securities that meet the classification requirements for:	Potential classification subsequent to adoption of insurance contracts guidance using transition under:	
	Alternative 1	Alternative 2 ^b
Amortized cost (AC)	- Record at AC based on classification	- Record at AC based on carryover classification or by revoking previously elected fair value option (FVO)
	- Record at FVPL if business strategy changes and AC or FVOCI criteria are not met ^a	- Record at FVPL based on previous election of FVO or by currently electing FVO
	- Record at FVOCI if business strategy changes ^a	
Fair value through other comprehensive income (FVOCI)	- Record at FVOCI based on classification	- Record at FVOCI based on carryover classification or by revoking previously elected FVO
	- Record at FVPL if business strategy changes and AC or FVOCI criteria are not met ^a	- Record at FVPL based on carryover classification or by electing FVO
	- Record at AC if business strategy changes ^a	
Fair value through profit or loss (FVPL)	- Record at FVPL based on classification	- Record at FVPL based on carryover classification

^a Without demonstration of meeting reclassification criteria.

^b Redesignation under Alternative 2 also would occur if the reclassification criteria were met.

26. As indicated by the table, the difference between the two alternatives is that Alternative 1 allows insurers to reclassify their financial assets between amortized cost and fair value through other comprehensive income without having to demonstrate that the reclassification criteria are met. Alternative 2 would allow reclassification only if the reclassification criteria are met based on the criteria in the applicable financial instruments guidance.

27. The staff recommends Alternative 1.

Question 1: Redesignation of Financial Assets

Does the Board agree with the staff's recommendation that on initial adoption of the new insurance contracts guidance, the insurer should be permitted to classify its financial assets in the same way as if it had adopted the relevant financial instruments guidance in effect on that date (Topic 320 and related fair value options or the proposed financial instruments guidance) at that same date?

Limiting the Redesignation of Financial Assets to Those Related to Insurance Operations

28. If the Board tentatively decides to permit insurers to classify their financial assets in the same way as if the Board had adopted the relevant financial instruments guidance in effect on that date, the Board needs to consider how to limit the redesignation to only those financial assets *related* to insurance operations.
29. The Board could choose to do the following:
 - a. Limit the redesignation to financial assets that back insurance liabilities.
 - b. Limit the designation of financial assets to those held by insurance entities.
 - c. Limit the redesignation of financial assets to those designated to the insurance business.
30. The staff notes that a combination of the alternatives noted above should be used; that is, the financial assets that can be reclassified are those that are designated to the insurance business either by legal entity or by internal designation of a portfolio of assets.

Question 2: Limitation of Financial Assets That Can Be Redesignated

Does the Board agree with the following staff recommendation?

The financial assets that an entity can designate and classify on initial adoption of the insurance contracts guidance in the same way as if it had adopted the relevant financial instruments guidance in effect on that date should be limited to financial assets that are designated to the insurance business either by legal entity or by internal designation.