

STAFF PAPER

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Objective

1. This paper continues the IASB's discussions of the adaptations to the IASB's tentative decisions to date that it might consider for contracts with participating features. It discusses an approach for determining interest expense and, therefore, the amounts to be presented in profit or loss and Other Comprehensive Income (OCI). Understanding the mechanics for determining interest expense is essential in assessing whether presenting the effects of changes in discount rate in OCI would provide useful financial information.
2. For context, the staff suggest that the IASB members should refer to the papers for the May 2014 education session, namely:
 - (a) Agenda Paper 2A *Contracts with participating features: Background*, which provides background about contracts with participating features; and
 - (b) Agenda Paper 2B *Possible adaptations for participating contracts*, which provides an overview of the issues that the staff intend to consider relating to contracts with participating features.
3. The paper sets out:
 - (a) staff proposals in paragraph 4;

- (b) background, including the relevant proposal in the 2013 Exposure Draft *Insurance Contracts* (2013 ED) and the feedback received, in paragraphs 5-15;
- (c) staff analysis on:
 - (i) avoiding the need to apply different discount rates to different types of cash flows when the discount rate used to determine interest expense in profit or loss is reset, in paragraphs 16-25; and
 - (ii) whether to lock in the yield curve or use an approach similar to the effective interest rate for determining the interest expense presented in profit or loss, in paragraphs 26-32.

Staff proposals

4. The staff plan to ask the IASB at a future meeting whether the effects of changes in discount rate should, or may, be presented in OCI and if so, what approach should be used to determine the interest expense in profit or loss. Assuming that the IASB decides that the effects of changes in discount rates should be presented in OCI in some circumstances, the staff propose that the IASB should explore an approach in which:
 - (a) the discount rate for the presentation of interest expense in profit or loss should be reset for **all** the cash flows in the contract when the cash flows that vary with underlying items are a substantial proportion of the total benefits to the policyholder over the life of the contract. The rate should be reset whenever there are changes in estimates of investment returns that result in changes in the amounts paid to policyholders (ie cash flows that vary with returns of underlying items). This is instead of the 2013 ED proposal to split the cash flows and apply applicable discount rates for the presentation of interest expense in profit or loss; and
 - (b) the discount rate used for the presentation of interest expense in profit or loss should be determined using an approach similar to the effective

interest rate method. This is instead of the 2013 ED proposal to lock in the yield curve.

Background

5. At the June 2014 meeting, the IASB discussed one form of the book yield approach for determining the interest expense that would be recognised in profit or loss, if there are to be any circumstances in which an entity would present the effects of changes in discount rates on the measurement of an insurance contract with a participating feature in OCI. The IASB directed the staff to explore that book yield approach only for circumstances in which the returns passed to the policyholder arise from underlying items that the entity holds, and for which the policyholder will receive a substantial share of the total return on underlying items.
6. This paper seeks an alternative approach for determining interest expense, based on an effective yield. The staff expect that the approach described in this paper could be applied to all contracts with participating features, including those that would not meet the criteria for the book yield approach in paragraph 5.
7. If the IASB decides to allow, or require, entities to present effects of changes in discount rate in OCI, the mechanics discussed in this paper could be used to determine interest expense for:
 - (a) contracts with participating features as discussed in this paper; or
 - (b) contracts that do not meet the criteria for applying the book yield approach, if the IASB decides that there should be a book yield approach for some contracts with participating features.

2013 ED proposals

8. For contracts with participating features, the cash flows that arise as the entity fulfils the contract include the following:
 - (a) cash flows that vary with returns on underlying items. Such cash flows provide the policyholder with a return on underlying items and arise

only in contracts that have participating features. These cash flows include¹:

- (i) cash flows that vary directly with returns on underlying items, ie there is a direct correlation between the returns on underlying items and the returns to policyholders; and
 - (ii) cash flows that vary indirectly with returns on underlying items, for example they vary with returns on underlying items only when the returns from the underlying items exceed a specified floor.
- (b) cash flows that do not vary with the returns on underlying items. These cash flows arise when the amount paid to the policyholder does not change as a result of a change in the performance of the pool of underlying items. Such cash flows arise in all types of insurance contracts and include:
- (i) claims handling costs (ie the costs that the entity will incur in processing and resolving claims) and other expenses. Such cash flows also arise in all insurance contracts, including those that have no participating features.
 - (ii) fixed amounts that would be paid out on the occurrence of an insured event. Such cash flows also arise in contracts that have no participating features.
 - (iii) a fixed amount paid in all scenarios (ie a floor). For example, some insurance contracts contain embedded guarantees (for example, a guarantee that promises a minimum investment return).
9. Contracts with participating features:
- (a) have both types of cash flows (in contrast, contracts with no participating features contain only cash flows that do not vary with underlying items);

¹ The 2013 ED referred separately to the cash flows that vary directly and vary indirectly with returns on underlying items. However, this paper discusses all cash flows that vary with returns on underlying items together.

- (b) the proportions of those two types of cash flows can vary between contracts; and
- (c) the proportions between those two types of cash flows may change over time. It may also be difficult to predict the extent to which the proportions will vary over time.

10. The 2013 ED proposed that the interest expense recognised in profit or loss should be calculated as follows:

- (a) the discount rates applied to cash flows that do not vary with underlying items would be locked in at inception; and
- (b) the discount rates applied to cash flows that vary with underlying items would be reset every time there are changes in estimates of investment returns that result in changes in the amounts paid to policyholders.

Consequently, entities would need to split the cash flows into those that vary and those that did not vary, and to apply different discount rates to those two types of cash flow.

11. The IASB proposed that the discount rates applied to cash flows that vary with underlying items should be reset when there are changes in investment returns that result in changes in the amounts to be paid to the policyholder for the following reasons:

- (a) Changes in estimates of investment returns are generally caused by changes in market variables that are also reflected in changes in the discount rates. Thus, when the discount rates are reset, the interest expense reported in profit or loss would reflect the fact that the entity has assumed that changes in the returns from underlying items would result in changes in the present value amounts to be paid to the policyholder. Those changes in the returns from underlying items include changes in both discount rates and cash flows. In contrast, recognising interest expense in profit or loss using the rate locked in at inception would be inconsistent with the variable-rate nature of the financing of cash flows that vary with underlying items.

- (b) Updating the discount rates used to determine interest expense is consistent with the accounting for floating rate debt instruments that are not marked to market through profit and loss (for example, at fair value through other comprehensive income (FVOCI)). For floating rate debt instruments accounted at amortised cost, the ‘locked-in’ discount rate used to present interest expense is reset upon changes in interest rates.

Feedback

12. Many agree that, when entities present the effect of changes in discount rates in OCI, the discount rate used for determining the interest expense in profit or loss should be reset. However, as noted in paragraph 8, contracts with participating features include both cash flows that do not vary with underlying items as well as cash flows that vary with underlying items. Many would reset the discount rate for *all* the cash flows for contracts with participating features, rather than for only cash flows that vary directly with returns on underlying items.
13. Some note that splitting the cash flows of a contract into cash flows that vary and cash flows that do not vary would be arbitrary, because there are different ways to split the cash flows that would achieve the same objective for measurement purposes.² However, the different ways of splitting the cash flows would result in amounts reported in profit or loss and OCI that may not be comparable. The 2013 ED sought to address the problem by prescribing a specific approach for splitting the cash flows. However, feedback indicated that:
- (a) it would be difficult for entities to split the cash flows, and applying different discount rates to determine interest expense to be recognised in profit or loss because most entities do not split the cash flows in the way prescribed in the 2013 ED; and

² As discussed in Agenda Paper 2A for the May 2014 IASB meeting, there are actuarial approaches that allow all the cash flows to be measured using the same rate, which achieves the objectives of the 2013 ED that the inputs from the market do not contradict market information. Thus, using the general approach in the ED, there is no need for an entity to split the cash flows to measure an insurance contract. The IASB has yet to discuss whether there is any need to retain a form of the mirroring exception proposed in the 2013 ED. The discussion for this paper is based on the measurement model proposed if the mirroring exception is not applied.

- (b) some did not think that the costs of applying discount rates updated at different times to different sets of cash flows would be justified by the benefits of doing so, particularly because splitting the cash flows is not needed for measurement.
14. Accordingly, some suggest that the IASB should modify its 2013 ED proposals so that the discount rates applied to *all the* cash flows in the contract should be reset when there is a change in investment returns that result in changes in the amounts paid to policyholders.
15. There were also differences of opinion as to what the objective of the reset discount rate should be. While some agreed with the 2013 ED proposal that the discount rate at the date of the reset should equal the discount rate used to measure the liability at the date of the reset, others disagreed and instead recommended that the discount rate should be reset to a different discount rate. Some suggest that the discount rate should be reset to:
- (a) an effective interest rate, as described below. They believe that this approach is another application of the IASB's objective in the 2013 ED of presenting interest expense in profit or loss on an amortised cost basis; or
- (b) discount rates determined using a book yield approach, as described in Agenda Paper 2D for the May 2014 meeting. That approach has a different objective to the 2013 ED.

Staff Analysis

16. The following section discusses:
- (a) avoiding the need to apply different discount rates to different types of cash flows when the discount rate used to determine interest expense in profit or loss is reset (discussed in paragraphs 17-25); and
- (b) whether the discount rate should be updated or reset to a different objective (discussed in paragraphs 26-32).

Splitting of cash flows

17. The staff think that, conceptually, interest expense should be determined using locked-in discount rates that reflect the different characteristics of the cash flows, as proposed in the 2013 ED. The contract contains cash flows of different characteristics and, therefore, logically the interest expense that is appropriate should be consistent with the characteristics of those cash flows. However, the staff agree that it would be complex to apply different locked-in discount rates to different types of cash flows and that it would be costly to do so, particularly if only for presentation purposes.
18. The staff note that complexity could be reduced if the IASB allowed an entity to choose as its accounting policy that the effects of changes in discount rate are presented in profit or loss for contracts with participating features, as is the case for contracts with no participating features. This is because entities could avoid the complexities of using OCI entirely by choosing an accounting policy to present the effects of discount rate changes in profit or loss.
19. However, the staff think that the costs and benefits of different mechanics of determining the interest expense in profit or loss should still be considered in determining whether there should be an approach that presents the effects of changes in discount rates in other comprehensive income, and, if so, what that the mechanics should be. This is because the justification for an OCI approach is that it could provide useful disaggregated information about changes in the value of insurance contracts. Excessively complex mechanics, such as splitting the cash flows, may mean that entities do not use the OCI presentation even when such a presentation would produce useful information. This would undermine the IASB's objectives for specifying an OCI approach.
20. In addition, as discussed in in paragraph 13, the staff believe that the arbitrariness inherent in determining which cash flows should be discounted using locked-in or updated rates would undermine the usefulness of the information provided, because it may result in entities reporting different amounts as interest expense in profit or loss.
21. Accordingly, the staff propose that any requirement to update the discount rates should apply to *all* cash flows in the contract. In other words, the staff believe

that the IASB should not impose requirements that result in the need to split the cash flows for presentation purposes, as proposed in the 2013 ED.

22. The question then arises of when it would be appropriate to reset the locked-in rate for all the cash flows for the contract. The staff note that the purpose of resetting the discount rate is to reflect the variable nature of the returns on the underlying items. The proposed approach of applying reset rates to all cash flows could potentially apply the ‘wrong’ rate to some cash flows. Thus, the staff think that resetting the discount rates for all cash flows would be most appropriate when the majority of the cash flows in the contract are cash flows that vary with underlying items. Consequently, the staff think that an entity should reset the rate for all the cash flows in a contract for which the cash flows that vary with underlying items are likely to be a substantial proportion of the total benefits of the contract over the life of the contract.
23. Conversely, when the substantial proportion of the contract’s cash flows do not vary with underlying items, the entity should apply the locked-in discount rate at inception to all cash flows in the contract. In effect, the predominant nature of the cash flows in the contract would determine whether the rates are updated for all the cash flows.
24. The staff acknowledge that in some instances determining whether the substantial proportion of cash flows over the life of the contract are cash flows that vary or cash flows that do not vary could be difficult. In addition, the staff note that:
- (a) An approach based on a ‘substantial proportion’ of the cash flows may lead to an arbitrary distinction between contracts that qualify and those that do not. However, the staff think that in practice most contracts will have either a substantial proportion of cash flows that vary or do not.
 - (b) There may be also a few instances in which, during the life of the contract, the substantial proportion of the contract’s cash flows changes from cash flows that do vary to cash flows that do not vary or vice versa. The staff plan to consider at a future meeting whether there should be additional requirements for the OCI mechanics in those situations.

25. Consequently, if the IASB were to agree with presenting the effects of changes in discount rate in OCI, staff propose that the discount rate for the presentation of interest expense should be reset for all the cash flows in the contract when the cash flows that vary with underlying items are a substantial proportion of the total benefits to the policyholder over the life of the contract. This is also subject to further discussion on the requirements that should apply when the cash flows in the contract's cash flows change from cash flows that do vary to cash flows that do not vary or vice versa. Nonetheless, the staff think that these difficulties are no more significant than for any other approach for determining the interest expense to be presented in profit or loss. The next section discusses the discount rate that the interest expense should be reset to.

Rate after reset

26. The principle of the 2013 ED is that the discount rate should be consistent with the timing of the expected cash flows. Consequently, entities are likely to need to construct a yield curve for the measurement of the liability that assigns an appropriate discount rate to the appropriate time period at every reporting period so that the entity can apply the rate at the appropriate tenor to each cash flow. The slope of the yield curve reflects the gap between short- and long-term discount rates. Under the 2013 ED proposals, the entity would need to lock in the yield curve used to measure the liability on the date of any reset and apply that yield curve going forward.
27. An alternative approach suggested for the determination of interest expense is to use discount rates determined using the effective interest rate method (sometimes termed 'level yield').³ This approach was proposed in the FASB's Proposed Accounting Standards Update *Insurance Contracts* (Topic 834) and is the method used in IFRS 9 to determine the interest revenue/expense for financial instruments measured at amortised cost or at Fair Value through Other Comprehensive Income (FVOCI). Under IFRS 9, the effective interest rate method produces a single discount rate that exactly discounts the future cash flows to the fair value of the

³ Some suggest that a consistent application of this objective is to allow a locked-in yield curve that is consistent with the expected pattern of the future investment returns passed on to policyholders and that averages the slope of the yield curve (ie the difference in discount rates between periods).

instrument at inception. In essence, the effective interest rate method produces an average discount rate across the yield curve (ie it averages the slope of the yield curve so that it averages the difference between the discount rates for each period/tenor). If this approach were to be applied, when the locked-in discount rate is reset, the rate is recalculated at every reset as the rate that exactly reverses out any amounts recognised in OCI over the life of the contract.

28. Appendix A provides a simplified example of the differences between the two approaches.
29. The main argument for using the yield curve for presenting the effects of changes in discount rate in OCI as proposed in the 2013 ED (discussed in paragraph 26) is that it is simpler than the effective interest rate. This is because an entity applying the effective interest rate approach would need to start with a locked-in yield curve and perform an additional computation to derive an effective interest rate.
30. However, those who support using the effective interest rate argue that the benefits outweigh the costs of the additional computation. In particular, they argue that that the benefit of the effective interest rate approach is that it would further reduce the accounting mismatch in profit or loss when the underlying items are accounted for at cost, in particular at amortised cost. Under amortised cost, the difference between the discount rates for the assets for each period is averaged. Consequently, using a similar approach for the locked-in discount rate for the liability would also average the differences in rates between periods. The simplified example in Appendix A illustrates this. Consequently, an approach similar to the effective interest method may produce more understandable results than the 2013 ED proposal to lock in the yield curve for the presentation of interest expense.
31. The staff find the arguments in paragraph 30 for an effective interest rate method to be persuasive. Consequently, if the effects of changes in discount rates are presented in OCI for contracts with participating features, the staff propose that the IASB should consider mechanics similar to the effective interest rate approach which averages the discount rates differences between periods.

32. This approach could be applied to all contracts with participating features or those that do not meet the specified criteria to apply the book yield approach, if there is a book yield approach. This is discussed in paragraph 7.

Question 1: OCI mechanics for contracts with participating features

The staff plan to ask the IASB whether the effects of changes in discount rates should, or may, be presented in Other Comprehensive Income. The staff propose that the IASB should explore an approach in which:

- (a) the discount rate for the presentation of interest expense in profit or loss should be reset for *all* the cash flows in the contract when the cash flows that vary with underlying items are a substantial proportion of the total benefits to the policyholder over the life of the contract. The rate should be reset whenever there are changes in estimates of investment returns that result in changes in the amounts paid to policyholders (ie cash flows that vary with returns on underlying items). This is instead of the 2013 ED proposal to split the cash flows and apply applicable discount rates for the presentation of interest expense in profit or loss; and
- (b) the discount rate used for the presentation of interest expense in profit or loss should be determined using an approach similar to the effective interest rate method. This is instead of the 2013 ED proposal to lock in the yield curve.

Implications for contracts with no participating features

33. In Question 1, the staff recommend that the IASB should further develop OCI mechanics for contracts with participating features, by which the discount rate used for the presentation of interest expense would be determined using an approach similar to the effective interest rate method. This is intended to support the IASB's deliberations on whether the effects of changes in discount rates should, or may, be presented in OCI for contracts with participating features. If the IASB were to conclude that an effective interest method approach should be used to determine the amounts presented in OCI, the question arises as to whether

a similar approach to the effective interest rate method should also be applied for contracts with no participating features.

34. The arguments for applying such an approach to contracts with no participating features is similar to those discussed in paragraph 29 for contracts with participating features. However, the staff think that the cost and benefits assessment may be different for contracts with *no* participating features. Because the linkage with the assets is less important for contracts with *no* participating features, the staff think that the 2013 ED's proposal of locking in the yield curve, which is less precise and less costly, may be sufficient to reduce accounting mismatch.
35. However, the staff note that using the same approach for both contracts with participating features and those without them is likely to increase comparability and may actually reduce complexity for entities that issue both types of contracts, and for users of financial statements in understanding the interest expense presented in profit or loss for insurance contracts as a whole.

Question 2: Possible implications for OCI for contracts with no participating features

If the IASB directs the staff to explore an approach similar to the effective interest rate method for determining interest expense for contracts with participating features, should the staff also consider whether an approach similar to the effective interest rate method should also be applied to contracts with *no* participating features?

Appendix A: Simplified illustrative example

A1. The following is a simplified example to illustrate the difference between:

- (a) the proposal in the 2013 ED to lock in the discount rate, which in most cases would be to lock in the yield curve, for the presentation of interest expense. This is set out in paragraph A4; and
- (b) the staff recommendation to lock in the discount rate using a similar approach to the effective interest rate method for the presentation of interest expense. This is set out in paragraphs A5-A6.

A2. The following are the simplified assumptions:

- (a) The contract is a six-year insurance contract with premiums paid at inception. The policy repays the premium and 90 per cent of the return achieved on assets.
- (b) There is no guaranteed rate of return on the contract.
- (c) Risk adjustment assumed to be immaterial.
- (d) Contractual service margin (CSM) is released on a straight-line basis over the contract term. It is assumed that there is no accretion of interest on CSM.
- (e) The yield curve for bonds at inception is as follows:

Year	Discount rate
6	11.5%
5	11.0%
4	10.5%
3	10.0%
2	9.5%
1	9.0%

- (f) Assume that the differences between the discount rates for the insurance liability and the bonds are immaterial. The single premium of CU1,000⁴ paid at contract inception is immediately invested in zero coupon bonds with a six-year duration (ie the duration of the bonds is the same as the insurance liability). The bonds mature at CU1,921.50.

⁴ In this paper, currency amounts are denominated in 'currency units' (CU).

The bonds are accounted for at FVOCI. The effective interest rate for the bonds is: 11.5 per cent. It is assumed impairment losses are immaterial.

- (g) The expected payout to the policyholders at the end of Year 6 is CU1,829. This is determined from the return of the premium of CU1,000 plus 90 per cent of the expected returns on the underlying items ($90\% \times (\text{CU}1,921.50 - \text{CU}1,000)$).
- (h) There are no changes in assumptions over the life of the contract, including no changes in discount rates.
- (i) There are errors arising from rounding.

A3. On Day one, the margin is calculated as follows:

Present value of premiums	-CU1,000
Present value of cash outflows	CU952 ⁵
Risk adjustment	0
Contractual service margin	CU48

2013 ED proposal

A4. The following is an extract from the statement of comprehensive income under the 2013 ED proposal to present interest expense using locked-in discount rates, which is effectively locking in the yield curve:

⁵ [CU1,829 \times 11.5% (applicable rate for 6 years)] (see also footnote 6).

CU	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Insurance contract revenue ⁶	8	8	8	8	8	8
Interest income—EIR	115	128	143	159	178	198
Interest expense	-133 ⁷	-141 ⁸	-147 ⁹	-151 ¹⁰	-153 ¹¹	-151
Net interest income	-18	-13	-4	8	26	47
Profit	-10	-5	4	16	33	55
Movements in OCI						
Assets	25	20	12	-1	-17	-40
Liabilities	0	0	0	0	0	0
Net movement in OCI	25	20	12	-1	-17	-40
Total Comprehensive Income	15	15	16	15	16	15

Similar approach to the effective interest rate method

- A5. The staff propose that the locked-in discount rate for the presentation of interest expense should be determined using the effective interest rate method. Consequently, an internal rate of return is derived that exactly solves the present value of cash flows at inception of CU952 to accrete to the final cash flow amounts paid to the policyholder of CU1,829 at the end of Year 6. Consequently, the internal rate of return is 11.5 per cent. That rate of 11.5 per cent is used to present the interest expense in profit or loss.

⁶ The margin is assumed to be released on a straight-line basis with no accretion of interest (ie CU48/6 years).

⁷ $[\text{CU},1829 \times 11\% \text{ (applicable rate for 5 years)}]^5$ - last year's carrying amount: CU952

⁸ $[\text{CU},1829 \times 10.5\% \text{ (applicable rate for 4 years)}]^4$ - last year's carrying amount: CU1,085

⁹ $[\text{CU},1829 \times 10\% \text{ (applicable rate for 3 years)}]^3$ - last year's carrying amount: CU1,226

¹⁰ $[\text{CU},1829 \times 9.5\% \text{ (applicable rate for 2 years)}]^2$ - last year's carrying amount: CU1,374

¹¹ $[\text{CU},1829 \times 9\% \text{ (applicable rate for 1 years)}]^1$ - last year's carrying amount: CU1,525

A6. The following is an extract from the statement of comprehensive income:

CU	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Insurance contract revenue	8	8	8	8	8	8
Interest income—EIR	115	128	143	159	178	198
Interest expense [@11.5%]	(109) ¹²	(122) ¹³	(136) ¹⁴	(152) ¹⁵	(169) ¹⁶	(189)
Net interest income	6	6	7	7	9	9
Profit	14	14	15	16	17	17
Movements in OCI						
Assets	25	20	12	(1)	(17)	(40)
Liabilities	(24)	(19)	(11)	-	17	38
Net movement in OCI	1	1	1	-	(1)	(2)
Total Comprehensive Income	15	15	15	16	16	16

Staff observations

A7. The staff observe that the simplified example assumes that the underlying item (ie the bond) and the insurance contract liability are economically matched. This is because:

- (a) the duration of the underlying item and the insurance liability are the same;

¹² [CU,1829 × 11.5%] (see also footnote 5).

¹³ [CU,1829 × 11.5%] (see also footnote 4).

¹⁴ [CU,1829 × 11.5%] (see also footnote 3).

¹⁵ [CU,1829 × 11.5%] (see also footnote 2).

¹⁶ [CU,1829 × 11.5%] (see also footnote 1).

- (b) 90 per cent of the investment risk of the underlying item is passed on the policyholder; and
- (c) there are no minimum return guarantees issued.

A8. Consequently, in this simplified example, locking in the discount rate using a similar approach to the effective interest rate for the interest expense for the insurance liability (as set out in paragraphs A5-A6) produces, in the staff's view, more intuitive results than locking in the discount rate using the yield curve as (set out in paragraph A4). Locking in using the yield curve produces a net investment margin that is negative in some years (ie Years 1-2), which is counterintuitive, considering that the underlying item and the insurance liability are economically matched.