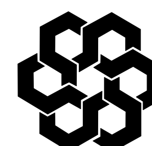

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**International Accounting Standards Board**

This document is provided as a convenience to observers at Insurance Working Group meetings, to assist them in following the discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
Note: These notes are based on the staff paper prepared for the Insurance Working Group Meeting. Paragraph numbers correspond to paragraph numbers used in the Insurance Working group paper. However, because these notes are less detailed, some paragraph numbers are not used.

**INFORMATION FOR OBSERVERS**

**IASB Meeting:** **Insurance Working Group, April 2008**
**Paper:** **Service margins (Agenda paper 7E)**

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**Purpose of this paper**

1. This paper considers whether the measurement of insurance liabilities should include a service margin.

2. This paper is divided into the following sections:

   (a) Introduction (paragraphs 3-5)

   (b) Summary of comment letters (paragraphs 6-11)

   (c) Is the service margin a plug? (paragraph 12 and 13)

   (d) Which services would give rise to a service margin? (paragraph 14)

   (e) Did the Board intend to require a separate service margin? (paragraph 15)

   (f) Questions for participants (paragraphs 16 and 17)

   (g) Comparison between service margin and IAS 18 (appendix)

## Introduction

3. Under the proposals in the discussion paper, the measurement of an insurance liability includes a margin. The margin is an explicit and unbiased measurement of the compensation that entities demand for providing the service of bearing risk and, if applicable, for providing other services.

4. When entities consider whether compensation is adequate, the most obvious factor that they would consider is risk, but they may sometimes consider other factors. For example, if the contract requires the insurer to provide other services, not just to bear risk, the insurer may sometimes require a reward for providing those services, especially if they are a significant part of the contract.

5. The Board therefore proposed in the DP that the measurement of an insurance liability should incorporate, in addition to the margin for the service of bearing risk (risk margin), an unbiased estimate of a service margin. The service margin is the profit (if any) that market participants require for providing services other than the service of bearing risk.

## Summary of comment letters

6. Most respondents did not understand the rationale for the service margin described in the discussion paper and several said that the *Frequently Asked Questions* (FAQs) posted by the IASB staff on the web site in October 2007 had not provided sufficient clarification. The FAQs can be downloaded from a link at [http://www.iasb.org/Current+Projects/IASB+Projects/Insurance+Contracts/Insurance+Contracts.htm](http://www.iasb.org/Current+Projects/IASB+Projects/Insurance+Contracts/Insurance+Contracts.htm)

7. Some respondents suggested that estimated cash flows should be based on the costs of outsourcing the services. In that case a separate service margin would be redundant because a service margin would already be part of the expected present value of the cash flows.

8. Some respondents saw the service margin as an attempt to provide a ‘plug’ that provides more continuity with the approach to revenue recognition in IAS 18 *Revenue*. Paragraphs 12 and 13 discuss this concern.

9. Most respondents commented that users would not benefit from a separation of risk margin from service margin. Paragraph 14 goes into this issue in more detail.

10. A number of respondents said that it is not clear which services should be considered for a service margin and asked for more guidance on this subject. Paragraph 15 comments on this.

11. If a contract contains a significant separate service component, one conceivable approach would be to unbundle the contract into an insurance component and a service component, with IAS 18 being applied to the service component. However, most respondents opposed unbundling.

**Is the service margin a plug?**

12. As mentioned before, some respondents saw the service margin as an attempt to provide a 'plug' that provides more continuity with the approach to revenue recognition in IAS 18. However, the purpose of the service margin is to ensure that the current exit value of the insurance liability reflects all factors that market participants would consider. Its purpose is not to prevent an insurer from recognising a net day one profit. If the contract provides a margin (contractual margin) that exactly equals the margin required by market participants (market margin), no net day one profit will arise. However, a net day one profit will arise if the contractual margin exceeds the market margin.

13. The appendix to this paper summarises the difference between the approach proposed in the discussion paper and the approach in IAS 18.

**Which services would give rise to a service margin?**

14. The carrying amount would include a service margin if the insurer estimates that market participants would require a service margin to induce them take over the contract. Whether market participants would require a service margin depends on the circumstances. Here are two examples the staff gave in the FAQs:

    (a) At one extreme, some insurance contracts have a significant savings element and require the insurer to provide significant investment management services. This is the case for many unit-linked, universal life and participating contracts. An investment manager would not willingly provide those services in a separate investment

management contract without adequate compensation. It seems unlikely that an insurer would provide the same services within an insurance contract without adequate compensation. In these cases, it is natural to assume that market participants would require some payment for providing those services within an insurance contract (ie a service margin).

(b) At the other extreme, consider the routine administration of a traditional life insurance contract. An outside entity would require compensation if the insurer outsourced the administration to it. Nevertheless, if market participants were taking on all the rights and obligations associated with the entire contract (as opposed to just the administration), it seems unlikely that any service margin for the administration would be material in practice. Similarly, it seems unlikely that the current exit value of a non-life insurance contract would include a significant service margin for loss adjustment activities.

**Did the Board intend to require a separate service margin?**

15. Many respondents read the discussion as proposing that insurers should estimate and disclose a service margin separately from the risk margin. However, as explained in the *FAQs,* the DP intended only to emphasise that risk may not always be the only driver of margins and that the margin should reflect all factors that market participants would consider. The Board has not discussed:

(a) whether an insurer could determine a single margin reflecting all those factors, without splitting the total into a separate service margin and a separate risk margin.

(b) whether an insurer should disclose the risk margin and service margin separately.

**Questions for participants**

16. **Should the cash flows for providing other services be based on the cost of outsourcing the services? Why or why not?**

17. **If not, should insurance liabilities include a service margin? Why or why not?**

**Appendix**

**Comparison between service margin and IAS 18**

For brevity, the table uses the following two informal terms:

- **market margin** is the estimated margin that market participants require
- **contractual margin** is the margin implied by the contract (ie the margin that produces no net day one profit or loss).

| | *Service margin* | *IAS 18* |
|---|---|---|
| **Initial measurement** | | |
| Does the initial carrying amount of the liability include a service margin? | Yes | Yes |
| How is the service margin measured initially? | Market margin | Contractual margin |
| Can a net day one profit arise? | Yes, if the contractual margin exceeds the market margin | No |
| Can a net day one loss arise? | Yes, if the market margin exceeds the contractual margin | Yes, if the contract is onerous[1] |
| How are acquisition costs treated? | Acquisition costs are recognised as an expense. | Incremental origination costs are deferred (ie recognised as an asset), if recoverable. |
| How does the issuer treat the part of the revenue from which acquisition costs are recovered? | The issuer recognises it as income at inception | The issuer defers it (ie recognises it as a liability) until the service is provided. |

[1] Under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, a contract is onerous if the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.

| | *Service margin* | *IAS 18* |
|---|---|---|
| Does a net day one profit or loss arise if actual acquisition costs differ from those incurred by market participants? | Yes (because the contractual margin reflects the issuer's actual acquisition costs but the market margin reflects the acquisition costs incurred by market participants) | No |
| **Subsequent measurement** | | |
| What margin does the carrying amount of the liability include? | The estimated (current) market margin for services still to be provided | The part of the (original) contractual margin attributed to services still to be provided |
| If there is a change in the estimated market margin for services still to be provided, does the carrying amount of the liability change? | Yes | No |
| Does the insurer recognise revenue as it provides services? | Yes | Yes |
| How does the insurer measure that revenue? | The estimated (current) market margin for services provided during the period | The part of the (original) contractual margin attributed to services provided during the period |