Margins

- Example in paragraph 25 of paper 2C (FASB Memorandum 45C)

Base Case	Inception	Period 1	Period 2
Premiums	100	90	80
Claims	80	72	64
Overall margin	20	?	?

Three issues on margins:

- (1) Direct measurement or calibrate to something
- (2) Subsequent adjustments to a margin amount per contract
- (3) Subsequent updates to the amortisation pattern of the amount per contract

Margins

Direct measurement or a calibration:

- Direct measurement:
  - measuring a component directly based on a specified objective (eg. exit price, entry price, amount rationally paid to be relieved of something).
  - Subsequently: remeasured- follows from the measurement method and deals with issues (2) and (3) from the previous slide.
  - Applies to: risk adjustment.
- Amount to eliminate a day-one gain (calibration):
  - the amount that calibrates initial measurement to zero day-one gain at inception
  - Subsequently: amortised- determine what to do about issues (2) and (3)?
  - Applies to: residual and composite margin.

Margins

- Composite margin

Base Case	Inception	Period 1	Period 2
Premiums	100	90	80
Claims	80	72	64
Composite margin	20	18	16
Profit or loss (*)	-	2	2

(*) For this example, release of the composite margin is defined as [(current actual premiums + current period claims and benefits) / (expected value of premiums + expected value of future claims and benefits)].

- For period 1: [(10 + 8) / (100 + 80)] * 20 = 2

- For period 2: [(10 + 8) / (90 + 72)] * 18 = 2

Margins

- Risk adjustment plus residual margin

Base Case	Inception	Period 1	Period 2
Premiums	100	90	80
Claims	80	72	64
Risk adjustment (*)	10	8	7
Residual margin	10	9	8
Total margin	20	17	15

(*) Not in included in the fact pattern of the example paper 2C, but assumed numbers for this example.

Margins

- Risk adjustment plus residual margin (continued)

Release of Risk adjustment	-	2	1
Release of Residual Margin (*)	-	1	1
Profit or loss	-	3	2

(*) Follows pattern of expected claims over the coverage period.

- For period 1: (8/80) * 10 = 1
- For period 2: (8/72) * 9 = 1

Margins

- Subsequent adjustments to the margin amount per contract:
  a) Freeze amount per contract to the amount determined at inception:
     – Determine margin per contract at inception
     – Subsequent amortisation of the amount determined at inception
  b) Adjust amount per contract at inception subsequently:
     – Determine margin per contract at inception
     – Adjust amount per contract at inception subsequently for some changes in estimates each reporting period
     – Subsequent amortisation of adjusted amount
- For residual margins, the boards decided tentatively to apply (a).

Margins

- Freeze amount per contract to the amount determined at inception

Case 1	Inception	Period 1	Period 2
Premiums	100	90	80
Claims (*)	80	78	69
Composite margin	20	18	16
Release Comp. (*)	-	2	2
Remeasurement (**)	-	(6)	-
Profit or loss	-	(4)	2

(*) The expected claims at the end of period 1 is increased by 6 from 72 in the base case to 78 as a result of adverse claims development.

Margins

- Freeze amount per contract to the amount determined at inception (continued)

Release Comp. (*)	-	2	2
Remeasurement (**)	-	(6)	-
Profit or loss	-	(4)	2

(*) Release of the composite margin is:

- For period 1: [(10 + 8) / (100 + 80)] * 20 = 2

- For period 2: [(10 + 9) / (90 + 78)] * 18 = 2 (rounded)

(**) Remeasurement reflects the increase of the expected remaining claims at the end of period 1: 72 (base case) - 78 (revised).

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Margins

- Adjust amount per contract subsequently

Case 1	Inception	Period 1	Period 2
Premiums	100	90	80
Claims	80	78	69

Composite margin(*)	20	12	11

(*) The remaining balance of the composite margin at period 1 includes an adjustment (decrease) for the increase of the expected claims (18 (from base case) – 6 remeasurement).

Margins

- Adjust amount per contract subsequently (continued)

Release Comp. (*)	-	2	1
Remeasurement (**)	-	-	-
Profit or loss	-	2	1

(*) Release of the composite margin is

- For period 1: [(10 + 8) / (100 + 80)] * 20 = 2
- For period 2: [(10 + 9) / (90 + 78)] * 12 = 1 (rounded)

(**) The increase in the expected claims of 6 is adjusted against the remaining balance of the composite margin. Therefore, no remeasurement is recognised in profit or loss.

Margins

- Subsequent updates to the amortisation pattern of the amount per contract
  - Relevant to both residual margins and composite margins
  - Release pattern based on ‘driver’, for example
    - expected claims and benefits
    - combination of (i) expected premiums and (ii) claims and benefits
  - More contracts have extinguished than expected (eg due to more lapses)
    - Immediate ‘release’ of residual/composite margin to profit or loss (‘true-up’)