Project **Insurance Contracts: Phase II**

Topic **Residual and composite margins: Locked in or remeasured**

Objective

1. The purpose of this discussion is to consider whether the residual / composite margin should be locked-in at initial recognition or remeasured in periods after initial recognition.

Background

2. The objectives of a residual margin and a composite margin are similar because both margins are calibrated to the present value of consideration received or receivable from the policyholder (i.e., the premiums and other cash inflows) to eliminate any gain at initial recognition of an insurance contract. However, a fundamental difference between the two margins is that the residual margin is calibrated at initial recognition after the inclusion of a separate risk adjustment in the measurement of a contract, whereas the composite margin at initial recognition is determined by comparing the expected cash inflows with expected cash outflows (both discounted). Therefore, a risk adjustment would be reflected implicitly in the composite margin rather than explicitly as a separately measured and reported amount.

3. The boards propose that the residual / composite margin determined at initial recognition of the contract would not be remeasured in later periods as a result of changes in estimates of cash flows or risk. Instead:

   (a) The composite margin would be recognized in earnings over both the coverage and claims handling periods. Agenda paper 4C discusses issues relating to how the composite margin is amortised.

This paper has been prepared by the technical staff of the IASB and the FASB for the purposes of discussion at a public meeting of the IASB working group identified in the header of this paper.

The views expressed in this paper are those of the staff preparing the paper and do not purport to represent the views of any individual members of the IASB or the FASB.

The meeting at which this paper is discussed is a public meeting but it is not a decision-making meeting of the Boards.

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(b) The risk adjustment would be remeasured each reporting period during the coverage and claims handling periods while the residual margin would be recognized in earnings entirely over the coverage period.

Locked-in or remeasured

4. Some stakeholders suggest that the residual / composite margin should not be locked-in upon initial recognition of a contract, but rather should be adjusted for changes in estimates each reporting period. They further suggest that this might be a way to reduce the effects of accounting mismatches. Appendix A discusses the arguments for and against locking-in the residual and composite margins.

5. If the residual / composite margin were not locked-in upon initial recognition, the boards would need to consider which changes in estimates should be considered in the remeasurement or adjustment of the margins, including whether this should include:

   (a) changes in financial market inputs (eg discount rates); and

   (b) changes in inputs related to the probability-weighted estimate of net cash flows (eg mortality and lapse rates or frequency and severity rates).

6. Adjusting the margins for changes in financial market inputs (rather than recognizing those changes immediately in earnings) may result in an accounting mismatch if the assets used to fund those liabilities are measured at fair value with changes recognized immediately in earnings. To avoid such accounting mismatches, some argue that the margins should be adjusted only for changes in non-financial inputs. The following paragraphs discuss two approaches for remeasuring the residual / composite margin. These approaches are illustrated in Appendix B.

Retrospective cumulative remeasurement

7. The residual and composite margins could be remeasured each reporting period by recalibrating the consideration received or receivable to the present value of the expected future cash flows plus, in the case of the residual margin, the risk adjustment, updated for changes in future estimates. Such remeasurement would be consistent with the objective of measuring the expected profit and would represent a retrospective cumulative adjustment approach to contract

measurement. The insurer would adjust the residual or composite margin to the amount that would have remained if the new assumptions had been used upon initial recognition of the contract. The insurer would then amortize that remaining amount over the coverage period (residual margin) or over the coverage and claims handling periods (composite margin). If, by using the new assumptions, the contract would have resulted in a loss upon initial recognition, that loss would be recognized immediately.

Prospective remeasurement

8. Alternatively, a prospective approach could be applied. Under this approach, the residual and composite margins would be adjusted by the amount resulting from changes in future estimates. For example, if estimates of claims payments increase by 10 (discounted), the carrying amount of the insurance liability for expected cash outflows would increase by 10 and the carrying amount of the residual / composite margin would decrease by 10 (that is, the total insurance liability would be unaltered). The insurer would amortize the remaining residual margin over the coverage period or the remaining composite margin over the coverage and claims handling periods.

9. If experience adjustments resulted in a loss in excess of the remaining residual margin or composite margin, that excess amount would be recognized in earnings immediately, because the approach specifies that the residual or composite margin cannot be negative. It would be necessary to specify the level of aggregation for this purpose (eg portfolio level or cohort level), because within that level of aggregation, positive and negative margins would offset.

Locked-in ratio

10. The ratio[1] for subsequent recognition of the composite margin in earnings contained in the FASB's Discussion Paper, *Preliminary Views on Insurance Contracts*, could be regarded as remeasuring the composite margin each period. That calculation recalibrates the components included in the ratio based on experience, although the composite margin is capped at the amount initially

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[1] $\frac{\text{(Premiums allocated to date + claims and benefits paid to date)}}{\text{(Total expected premiums + Total expected claims and benefits)}}$

recognised. Thus, although the amount of the composite margin would be locked-in upon initial recognition of a contract, the amount recognized in later periods would reflect changes in estimates that affect the total profit on the contract.

Other considerations

11. Another consideration is whether the residual and composite margins would be remeasured only for adverse changes in estimates or for all changes. A related issue is whether the remaining amount of the residual or composite margin could be greater than the amount determined at initial recognition of the contract and whether the remaining amount could be positive again if previously reduced to zero.

Questions

1. Do you think that the residual and/or composite margin should be (a) locked-in upon initial recognition of a contract, (b) remeasured only for unfavourable changes, or (c) remeasured for favourable and unfavourable changes? If remeasured for favourable changes, should the resulting remeasurement be allowed to be greater than the amount initially recognised?

2. If the residual and/or composite margin are remeasured, do you think all changes in estimates should result in remeasurement of the residual and/or composite margin or only changes in estimates of inputs related to the probability-weighted estimate of net cash flows?

3. If the residual and/or composite margin are remeasured, do you think that remeasurement should be retrospective or prospective?

4. Do you think the proposed ratio for subsequent recognition of the composite margin in earnings contained in the FASB's Discussion Paper could be regarded as, in effect, remeasuring the composite margin each period? Why or why not?

Appendix A

Arguments for and against locking-in the residual and composite margins

1. The arguments for locking-in the residual and composite margin are as follows:

   (a) Current measurement is integral to understanding and reporting insurance contracts and therefore, all changes in estimates should be recognized in earnings as those changes occur without an offset from adjusting another liability (the margin). Therefore, changes in circumstances would be reflected promptly and transparently in earnings to reflect current expectations of the contract.

   (b) Remeasurement of the residual and composite margins after initial recognition of a contract would have no intrinsic meaning because the margins represent a mixture of elements inherent in the insurance coverage. Subsequent recognition of the margins in earnings is an allocation reflecting those elements and therefore, any remeasurement of the margins would lack substance.

   (c) If the residual and composite margins are remeasured in subsequent reporting periods, the margins would function as "shock absorbers" (that is, changes in assumptions in the current period would not be reflected in current period earnings, but rather, would be reflected through recognition of the margin in future periods.) Though not applicable to the residual margin, in theory, an insurer using a composite margin could measure a highly uncertain liability at the same amount as a fixed liability if the entire margin has been expended to absorb losses.

2. The arguments against locking-in the residual and composite margins are as follows:

   (a) If the fulfilment value of an insurance contract changes after initial recognition, the amount of any residual or composite margin (that is, expected profit on the contract) should change accordingly.

   (b) If the residual or composite margins are locked-in at initial recognition, an insurer could recognize expense in one period only to reverse in a

later period, which would not faithfully represent the profit earned by the insurer as a result of that contract.

(c) Reporting changes in estimates and the impact those changes have on the residual or composite margin could be achieved through disclosure (for example, by disclosing period-to-period changes in the margin).

(d) Remeasuring the residual and composite margins is more consistent with the allocated transaction price approach proposed for revenue recognition . All components of an insurance liability are integral; thus, later changes in estimates should adjust (reallocate) the remaining residual or composite margin.

Appendix B

Examples

3. An insurer initially recognizes a contract with premiums of CU1,000, and expects cash flows to be CU700, resulting in a residual or composite margin of CU300. The contract covers four reporting periods. During the third reporting period, the insurer's estimates change such that the expected cash flows are as follows:

    (a) Scenario 1: CU800

    (b) Scenario 2: CU900

    (c) Scenario 3: CU600

4. Four alternatives are presented for each scenario. Those alternatives are:

    (a) Locked-in residual margin

    (b) Locked-in composite margin

    (c) Retrospective remeasurement

    (d) Prospective remeasurement

5. The *insurance liability - CF* used in this example represents the present value of the probability-weighted cash flows. If not specified, *margin* refers to either the residual or the composite margin. This example contains significant simplifications and assumes the composite margin would be recognised evenly over the coverage period. For simplicity, the time value of money is ignored and the risk adjustment is zero. Claims are assumed to be incurred and paid evenly over the coverage period and there are no claims expected after the coverage period.

Scenario 1:

Locked-in residual margin	Period 1		Period 2		Period 3		Period 4		Total
Insurance liability - residual margin	75		75		75		75		
Residual margin - P&L		75		75		75		75	
Change in estimates - P&L					100				
Insurance liability - CF						100			
Net Income		75		75		(25)		75	200

Locked-in composite margin	Period 1		Period 2		Period 3		Period 4		Total
Insurance liability - composite margin	75		75		71		79		
Composite margin - P&L		75		75		71		79	
Change in estimates - P&L					100				
Insurance liability - CF						100			
Net Income		75		75		(29)		79	200
Calculation of composite margin:									
Premiums allocated to date		250		500		750		1,000	
Claims and benefits paid to date		175		350		575		800	
Total expected premiums		1,000		1,000		1,000		1,000	
Total expected claims and benefits		700		700		800		800	
Ratio		25%		50%		74%		100%	

Retrospective remeasurement	Period 1		Period 2		Period 3		Period 4		Total
Insurance liability - margin	75		75		-		50		
Margin - P&L		75		75		-		50	
Insurance liability - margin					100				
Insurance liability - CF						100			
Net Income		75		75		-		50	200

Prospective remeasurement	Period 1		Period 2		Period 3		Period 4		Total
Insurance liability - margin	75		75		25		25		
Margin - P&L		75		75		25		25	
Insurance liability - margin					100				
Insurance liability - CF						100			
Net Income		75		75		25		25	200

Scenario 2:

Locked-in residual margin	Period 1		Period 2		Period 3		Period 4		Total
Insurance liability - residual margin	75		75		75		75		
Residual margin - P&L		75		75		75		75	
Change in estimates - P&L					200				
Insurance liability - CF						200			
Net Income		75		75		(125)		75	100

Locked-in composite margin	Period 1		Period 2		Period 3		Period 4		Total
Insurance liability - composite margin	75		75		67		83		
Composite margin - P&L		75		75		67		83	
Change in estimates - P&L					200				
Insurance liability - CF						200			
Net Income		75		75		(133)		83	100
Calculation of composite margin:									
Premiums allocated to date		250		500		750		1,000	
Claims and benefits paid to date		175		350		625		900	
Total expected premiums		1,000		1,000		1,000		1,000	
Total expected claims and benefits		700		700		900		900	
Ratio		25%		50%		72%		100%	

Retrospective remeasurement	Period 1		Period 2		Period 3		Period 4		Total
Insurance liability - margin	75		75		-				
Margin - P&L		75		75		-			
Change in estimates - P&L					(50)				
Insurance liability - CF						(50)			
Net Income		75		75		(50)		-	100

Prospective remeasurement	Period 1		Period 2		Period 3		Period 4		Total
Insurance liability - margin	75		75						
Margin - P&L		75		75					
Change in estimates - P&L					(50)				
Insurance liability - CF						(50)			
Net Income		75		75		(50)		-	100

Scenario 3:									
Locked-in residual margin	**Period 1**		**Period 2**		**Period 3**		**Period 4**		**Total**
Insurance liability - residual margin	75		75		75		75		
Residual margin - P&L		75		75		75		75	
Insurance liability - CF					100				
Change in estimates - P&L						100			
Net Income		75		75		175		75	400
Locked-in composite margin	**Period 1**		**Period 2**		**Period 3**		**Period 4**		**Total**
Insurance liability - composite margin	75		75		80		70		
Composite margin - P&L		75		75		80		70	
Insurance liability - CF					100				
Change in estimates - P&L						100			
Net Income		75		75		180		70	400
Calculation of composite margin:									
Premiums allocated to date		250		500		750		1,000	
Claims and benefits paid to date		175		350		475		600	
Total expected premiums		1,000		1,000		1,000		1,000	
Total expected claims and benefits		700		700		600		600	
Ratio		25%		50%		77%		100%	
Retrospective remeasurement	**Period 1**		**Period 2**		**Period 3**		**Period 4**		**Total**
Insurance liability - margin	75		75		150		100		
Margin - P&L		75		75		150		100	
Insurance liability - CF					100				
Insurance liability - margin						100			
Net Income		75		75		150		100	400
Prospective remeasurement	**Period 1**		**Period 2**		**Period 3**		**Period 4**		**Total**
Insurance liability - margin	75		75		125		125		
Margin - P&L		75		75		125		125	
Insurance liability - CF					100				
Insurance liability - margin						100			
Net Income		75		75		125		125	400