IFRS
FASB

IASB/FASB Meeting February 2011

IASB Agenda reference 3B

FASB Agenda reference 58B

Staff Paper

Project	**Insurance contracts**
Topic	**Day one gains and losses**

What is this paper about?

1. The purpose of this paper is to ask the boards to decide whether:

   (a) an insurer should recognise a gain at inception of an insurance contract.

   (b) an insurer should recognise a loss at inception of an insurance contract.

   (c) a residual or composite margin can become negative on subsequent measurement.

2. This paper will not discuss other issues related to margins, which will be subject to future Board discussions. Those are:

   (a) Whether the residual or composite margin should be unlocked or remeasured.

   (b) Whether the aggregation level of the residual or composite margin should be the cohort or the portfolio level.

   (c) The possible release pattern for the margins.

   (d) Accretion of interest on the margins.

   (e) Whether a cedant should recognise gains or losses at the initial recognition of a reinsurance contract.

This paper has been prepared by the technical staff of the IFRS Foundation and the FASB for discussion at a public meeting of the FASB or the IASB.

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

Comments made in relation to the application of U.S. GAAP or IFRSs do not purport to be acceptable or unacceptable application of U.S. GAAP or IFRSs.

The tentative decisions made by the FASB or the IASB at public meetings are reported in FASB *Action Alert* or in IASB *Update*. Official pronouncements of the FASB or the IASB are published only after each board has completed its full due process, including appropriate public consultation and formal voting procedures.

Staff recommendation

3. The staff recommends that the boards confirm the proposal in the Exposure Draft *Insurance Contracts* that an insurer should not recognise any gain at inception of an insurance contract. Further, the staff recommends the residual/composite margin should not be less than zero, so that a loss at initial recognition would be recognised immediately when it occurs.

Issue

4. The Exposure Draft *Insurance Contracts* proposes that the measurement of an insurance liability should include a residual margin, calibrated to eliminate gains at inception. Similarly, in the FASB's preliminary views, the measurement of an insurance liability should include a composite margin, also calibrated to eliminate gains at inception. The residual margin in the IASB's proposal differs from the composite margin in the FASB's preliminary views because the IASB's proposal includes a separate risk adjustment.

5. The residual/composite margin is one component of the measurement of the insurance contract that emerges from a day one measurement that calibrates back to an observable benchmark, which is the premium (customer consideration). The residual/composite margin is the difference between the direct measurement of the individual, separable components and the customer consideration (premium). This treatment effectively eliminates any positive day one differences and reports the release of that difference to the statement of comprehensive income over an appropriate period.

6. The exposure draft and discussion paper propose that the residual/composite margin cannot be negative at initial recognition and cannot become negative subsequently. It follows that if the expected present value of the cash outflows (plus risk adjustment, in the case of the IASB's proposal) exceeds the expected

present value of the cash inflows, the insurer would recognise that difference immediately in profit or loss as an expense.

Relevant questions in the exposure draft / discussion paper

7. Question 6 of the ED asked respondents the following:

> (a) Do you agree that an insurer should not recognise any gain at initial recognition of an insurance contract (such a gain arises when the expected present value of the future cash outflows plus the risk adjustment is less than the expected present value of the future cash inflows)? Why or why not?
>
> (b) Do you agree that the residual margin should not be less than zero, so that a loss at initial recognition of an insurance contract would be recognised immediately in profit or loss (such a loss arises when the expected present value of the future cash outflows plus the risk adjustment is more than the expected present value of future cash inflows)? Why or why not?
>
> (c) to (f) […]

8. The DP did not contain a specific question related to whether an insurer should recognise a gain or loss at initial recognition. However, respondents addressed this in their comments to other questions on the composite margin.

Overview of comments on the ED / DP

9. The overwhelming majority of the respondents supported the boards' decision not to report day one gains and to record differences between the expected present value of future cash outflows, plus the risk adjustment (in the case of the IASB's proposal), and the expected present value of future cash inflows in a residual or composite margin. Mostly, the commentators also agreed that this margin should not become negative.

10. Very few commentators disagreed and argued that not showing day one gains undermines the objective of the measurement model (direct measurement of an

insurance liability) and is inconsistent with the prescribed measurement on day two (immediate recognition in profit or loss). They also argued that day one gains would normally not occur and are triggered by the model only because non-incremental acquisition costs and overheads are not included in the cash flows of the insurance contract. The exceptions were some actuaries and where the current accounting rules permit day one gains, for example in Canada.

11. Views amongst all commentators were mixed on what this margin represents. Some note that the residual margin will include margins to recover all acquisition costs that are not incremental at a contract level, general overheads, risk of unknown uncertainties not identified and hence not captured by a risk adjustment, costs of infrastructure and IT, assumption errors, income taxes, etc and the insurer's expected profit.

12. Not one commentator disagreed with recognising an immediate loss when a loss at inception occurs. Some supporters of a composite margin, however, disagree with how a day one loss under the explicit risk margin approach is calculated. The reason being that the additional risk adjustment could result in a loss being recorded at inception of a contract that is expected to be profitable from an expected cash flow perspective. There is also a general agreement that the residual or composite margin should not become negative.

Staff analysis and recommendation

13. The staff recommends that the residual/composite margin should be calibrated at inception to an amount that precludes the recognition of a net gain at initial recognition of a contract. The staff thinks that a day one gain might arise when the expected present value of cash outflows required to fulfil the insurance contract is less than the expected present value of the consideration received or receivable. The staff believes that recognising a day one gain would be inconsistent with the proposals in the exposure draft Revenue from Contracts with Customers. At inception, the insurer has not satisfied any of its performance

obligations. In addition to that, there may be a risk that the amount identified as a day one gain has been identified incorrectly.

14. In addition, the staff's view is that the residual margin is a blend of several components, for example: overheads, servicing costs, unknown or unidentifiable uncertainties, etc. and expected profits. Therefore, it does not seem to be correct to recognize the entire margin as a day one gain. It is also not inconsistent with a day two gain, because one can say that the profit on day two follows from the direct measurement of the liability, while the residual/composite margin covers the blend of other components as described above.

15. The commentators' and the staff's view is that day one losses should be recognised as such and shown immediately in profit or loss. They think that recognising a loss at inception is appropriate if the amount paid by the policyholder is insufficient to cover the expected present value of the policyholder benefits and claims. The supporters of the risk adjustment believe that the policyholder consideration also needs to cover the compensation to the insurer for bearing the risk.

16. The staff also thinks that the residual/composite margin should not become negative – not only at day one, but also subsequently, because it is consistent with the proposed treatment on day one.

17. The proposals in the ED/DP regarding the described issues found general support in the comment letters. The staff thinks there is no reason for the boards to revise their conclusions as proposed in the ED/DP.

Questions to the boards
Do the boards confirm that a) an insurer should not recognise any gain at initial recognition of an insurance contract? b) an insurer should recognise any loss at initial recognition of an insurance contract immediately in profit or loss? c) a residual or composite margin should not become negative on subsequent measurement?