IASB/FASB Meeting February 2011

IASB Agenda reference **3L**

FASB Agenda reference **58L**

Staff Paper

Project **Insurance contracts**

Topic **Margins**

What is this paper about?

1. The purpose of this paper is to educate the boards to prepare them for a future decision whether the residual or composite margin should be unlocked or remeasured. This paper does not seek any decisions from the boards.

2. The methods on unlocking the residual or composite margins are illustrated in examples in agenda paper 3M.

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

   (a) Whether any gain can arise at inception of an insurance contract (see agenda paper 3B).

   (b) Whether the residual or composite margin can ever be negative, either at initial recognition or subsequently.

   (c) Whether the aggregation level of the residual or composite margin for the purpose of amortisation (and potential unlocking) should be the cohort or the portfolio level.

   (d) The possible release pattern for the margins.

   (e) Accretion of interest on the margins.

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Background

4. The Exposure Draft *Insurance Contracts* proposes that the measurement of an insurance liability should include a residual margin, calibrated as the difference between the present value of the expected cash flows plus a risk adjustment and the expected premium.

5. In contrast, in the FASB's preliminary views, the composite margin is calibrated to the difference between the present value of the expected cash flows (without a risk adjustment) and the premium. Risk and uncertainty would be reflected implicitly within a single composite margin rather than through a separate risk adjustment.

6. The residual or composite margin would mean that no gain can arise at inception of an insurance contract.

Relevant questions in the exposure draft / discussion paper

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

> (a) to (c) […]
>
> (d) Do you agree with the proposed method(s) of releasing the residual margin? Why or why not? If not, what do you suggest and why (see paragraphs 50 and BC125–BC129)?
>
> (e) Do you agree with the proposed method(s) of releasing the composite margin, if the Board were to adopt the approach that includes such a margin (see the Appendix to the Basis for Conclusions)? Why or why not?
>
> (f) […]

8. Question 16 of the DP asked respondents the following:

> Do you think that the composite margin should be recognized in earnings in subsequent periods using the ratio described in paragraph 83? If not, how would you recognize the composite margin in earnings?

Overview of comments on the ED / DP

9. Views amongst commentators were mixed on what the residual margin or the composite (without the risk component) margin should represent. Some note that the margin would include amounts attributed 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, other similar costs and the insurer's expected profit.

10. Many raised concerns about the proposal that the residual or composite margin should be fixed at inception of the contract and allocated in a systematic way over the coverage period (as proposed in the ED) or the period of coverage and claims payment (as the DP proposes). One consequence would be that any non-cash changes in the insurance liability would be recognised immediately in profit or loss. Many commentators disagree that the margin should be fixed at the inception of the contract for the following reasons:

    (a) Fixing the margin at inception introduces an inconsistency between measurement on day one and the subsequent measurement. There is a general agreement that day one gains should not be permitted, and therefore many question why a day two gain would be allowed.

    (b) It could lead to a situation in which an insurer recognises losses in a period, even though there will be gains from the release of the margin in future periods. Many believe this effect is counterintuitive and will be difficult to explain to users.

    (c) It results in a hybrid approach in which only part of the insurance contract is measured at a current value.

    (d) It appears inconsistent with the proposals in ED *Revenue from Contracts with Customers*, which do not account for changes in estimates of cash flows arising from unsatisfied performance obligations unless a contract becomes onerous.

(e) It might introduce an ability to influence profit for the period by manipulating assumption changes.

11. Although many commentators on the ED and the DP urged the boards to unlock the residual or composite margin, few provided any details on how the mechanism for such an unlocking could work.

12. Some commentators argue that unlocking the margin could help to dampen the volatility in the measurement of the insurance liability. They suggest different ways for how to unlock the margin. The two basic approaches are either to 'consume' the margin or to adjust the margin for both favourable and unfavourable changes, which will be called 'float' the margin in this paper.

Issue

13. The issue is whether the boards think that the residual or composite margin is just a plug created to fill in the gap between the present value of cash inflows and cash outflows, plus the risk margin according to the IASB's ED, or whether the margin actually represents something, which would be at least a blend of many different components that might or might not be able to be distinguished. This raises the question whether the residual or composite margin could be remeasured (in the true sense of the word) or, if not, whether the initial margin could be used somehow and should be unlocked.

14. However, if the residual or composite margin is a blend of several components, it would be hard to remeasure these margins in aggregate. It also seems to be very difficult to split such a margin into its components, distinguish them from each other and remeasure them individually. The staff thinks that any replication of the calculation of a margin after day one would have no intrinsic meaning, and that any measurement would lack substance and would not lead to a faithful representation of the economics of the contract.

15. The arguments for unlocking the margin, without the attempt to remeasure the margin according to its nature, but merely reflecting some or all changes that occurred in the other building blocks, can be summarised as two distinct positions:

   (a) If the boards believe that the current measure is integral to understanding and reporting insurance contracts and therefore needs the most emphasis, they should select an approach that reports all changes in estimates in comprehensive income.

   (b) If the boards believe that the guidance in revenue recognition is integral to all components of the insurance liability and therefore the allocation part needs the most emphasis, then they should select an approach that recognises (some) changes in the insurance liability by adjusting the remaining residual margin, provided that this margin does not become negative.

The proposed solutions

Consuming the residual margin

16. 'Consuming' is a term used in this paper to describe an approach that reduces the margin to offset unfavourable changes in the carrying amount of the insurance liability. Consuming the margin could serve to solve the concerns and counterintuitive effects of the obligation to report losses while a profit margin remains. The margin under this approach would be absorbed by unfavourable changes until there is nothing left. Favourable changes would flow through profit or loss. The commentators differ in their views about which (unfavourable) changes should consume the residual margin. The ideas are:

   (a) All unfavourable changes.

   (b) Unfavourable changes in financial inputs, such as a decrease in interest rates. The purpose of limiting this approach to changes in financial inputs would be to absorb volatility arising from changes in, for example,

(c) Unfavourable changes in non-financial inputs, such as changes in mortality and morbidity or frequency and severity. The purpose of limiting this approach to changes in non-financial inputs would be to enable the measurement of the liability to respond to changes in, for example, interest rates to avoid any accounting mismatches with changes in the carrying amount of those assets carried at fair value.

(d) 'Unrealised' unfavourable changes, which means that changes in assumptions and estimates regarding the future are reflected in the residual margin whilst the difference between the previously expected and current actuals would flow through profit or loss.

17. This approach can also be modified so that favourable changes would result in an adjustment to the residual margin to the extent they reverse previous unfavourable changes.

Floating the residual / composite margin

18. Floating the residual / composite margin follows the view that the residual / composite margin is 'something' and not just a plug to prevent day one gains. Some people say that the residual or composite margin is a distinct component of the measurement model and should be remeasured just like all the other building blocks. They suggest remeasuring by floating the margin by adjusting the margin for changes (both favourable and unfavourable) in the value of the other building blocks (cash flows, discounting, risk adjustment), without limiting the margin to the amount initially recognised. The proposals in the comment letters were quite vague on how this should be done, but the proposals could be summarised as broadly distinguishing floating the margin for:

(a) All changes, or

(b) Changes in financial inputs, or

(c) Changes in non-financial inputs, or

(d) 'Unrealised' changes.

19. Unlocking the residual or composite margin also raises the question how the remaining residual margin should be allocated over the remaining coverage period or coverage plus claim handling period. There are suggestions for a retrospective adjustment, which means that the margin would be adjusted as if that fact would have been known at inception and accordingly spread over the remaining period. The other option could be to adjust prospectively the remaining margin over the remaining period.

Discussion points

Question to the boards
Do you have questions or comments? When formulating your comments you may want to consider the following questions: Would you consider unlocking the residual or composite margin in principle? If yes, what sounds more appealing to you: a) to consume the residual or composite margin for unfavourable changes? b) to try to remeasure (in the true sense of the word) the residual or composite margin? c) to adjust the residual or composite margin for all changes? d) to adjust the residual or composite margin for some changes?