**IASB/FASB Meeting**
**Week commencing 13 June 2011**

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| IASB Agenda reference | **3B** |
| FASB Agenda reference | **70B** |

Staff Paper

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| Project | **Insurance Contracts** |
| Topic | **Whether to unlock the residual margin** |

## What is this paper about?

1. This paper discusses whether the residual margin should be locked-in at inception of the contract (as the Exposure Draft *Insurance Contracts* proposes).

2. This paper does not discuss:

   (a) How to unlock the residual margin, if the boards decide it should be unlocked (see agenda paper 3C/70C).

   (b) Allocation of the residual margin (see agenda paper 3D/70D).

   (c) Accretion of interest on the margin (to be discussed at a future meeting).

   (d) The single margin approach that the FASB decided to explore at the May meeting.

## Summary of staff recommendations

3. The staff recommends that the residual margin should not be locked in at inception, but adjusted for specified changes in estimates as explained in agenda paper 3C/70C.

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.

## Background

### *Proposals in the ED*

4. The Exposure Draft *Insurance Contracts* proposes that the measurement of an insurance contract 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. Paragraph BC125 of the Basis for Conclusions to the ED gives some background about what the Board thought the residual margin represents:

> The residual margin could be viewed as an aggregation of several factors, including:
>
> (a) compensation for the cost and effort of originating the contracts and assembling them into the portfolio.
>
> (b) compensation for providing ancillary services that are not unbundled (and so are not treated as arising from a separate service contract within the scope of standards on revenue recognition).
>
> (c) compensation for product development.
>
> (d) additional returns if the insurer has significant pricing power, or conversely discounts if the insurer is seeking to build or maintain market power.
>
> (e) the risk that the insurer might not satisfy its obligation to perform under the contract.

6. The ED did not propose that an insurer should try to separate the individual components of the margin, but sought a release pattern that corresponds in a reasonable way and at an acceptable cost to the pattern of the factors that generated those margins at inception. In other words, the ED proposed that the residual margin would be locked-in at inception and allocated to future periods.

7. Appendix A reproduces paragraphs BC125-BC129 of the Basis for Conclusions on the ED, which describe the Board’s reasons for its proposals in the ED.

***Previous Board meetings***

8. In their meeting in the week commencing 14 February 2011, the boards tentatively confirmed that:

    (a) there would be no day one gains. Thus, the measurement model will include a residual (or composite) margin to calibrate the difference between expected cash inflows and expected cash outflows (plus a risk adjustment).

    (b) day one losses should be recognised immediately in profit or loss.

9. During that meeting the boards also considered some examples of how the unlocking of the residual (or composite) margin could work (Agenda paper 3M/58M).

10. The boards tentatively decided in their February and March 2011 meetings that acquisition costs and contract cash flows should be calculated on a portfolio level and include all costs that the insurer will incur and that are directly attributable to acquiring and fulfilling that portfolio[1]. Those tentative decisions reduce, maybe significantly, the size of the residual margin. The remainder of the margin would then include the expected profit on the contract (other than that arising from bearing insurance risk), as well as other components that are priced in the premium, such as implicit payments by policyholders for general business risk and other overheads. The margin, therefore, still includes a blend of different components that it might or might not be possible to distinguish.

11. On 28 March 2011, the boards discussed the unlocking of the margin with the benefit of the feedback received from the Insurance Working Group, which met on 24 March 2011. See paragraphs 16 and 17.

12. Since then the staff received more feedback from the field test participants and other unsolicited comments on whether the boards should decide to unlock the residual margin. See paragraphs 18-19.

[1] The FASB would restrict acquisition costs to direct costs and those relating to successful efforts only.

***Overview of comments on the ED***

13. The Invitation to Comment on the ED asked whether commentators agreed with the proposed methods of releasing the locked-in residual margin in profit or loss. There was no specific question on whether the residual margin should be unlocked.

14. Many commentators disagreed that the residual margin should be fixed at inception of the contract and allocated in a systematic way over the coverage period (as proposed in the ED). Those commentators challenged the reasoning for the lock-in and the consequence that any non-cash changes in the insurance liability after inception would be recognised immediately in profit or loss. Their reasons are discussed in paragraph 22.

15. Some commentators would like to remeasure the residual margin every reporting date just like the other building blocks (cash flows, risk adjustment, discount rate). However, in order to remeasure the residual margin in the true sense of the word, it would need to have a specific meaning. Views amongst commentators were mixed on what the residual margin represents. Some stated that the residual margin would include amounts intended to recover all acquisition costs that are not incremental at a contract level[2], general overheads[3], 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.

***Feedback received from the Insurance Working Group and the field test participants***

*Insurance working group*

16. At their meeting on 24 March 2011, Insurance Working Group (IWG) members generally favoured unlocking the residual margin over the life of the

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[2] At their 1-2 February meeting, the boards tentatively decided that the contract cash flows should include those acquisition costs that relate to a portfolio of insurance contracts, rather than only those that are incremental to the contract as proposed in the ED. The FASB would restrict acquisition costs to direct costs and those relating to successful efforts only. The IASB would include in acquisition costs all costs directly attributable to acquiring a portfolio of contracts.

[3] At their meeting in the week commencing 14 February, the boards tentatively decided that the cash flows used in measuring a portfolio of insurance contracts should include all costs that the insurer will incur in ***fulfilling*** the contracts in that portfolio, including costs that relate directly to the fulfillment of the contracts in the portfolio and costs that are directly attributable to contract activity as part of fulfilling that portfolio of contracts and that can be allocated to those portfolios.

contract and adjusting it prospectively for favourable and unfavourable changes to estimates and assumptions in non-financial inputs that relate to future periods. Some IWG members would like to see the residual margin adjusted for all changes to estimates and assumptions that relate to future periods. However, IWG members agreed that the residual margin should not become negative.

17. A few IWG members were concerned that unlocking the residual margin would create complexity and practical problems that outweigh the potential benefits, while other IWG members stressed that the Margin on Services (MoS) approach used in Australia[4] for life insurance contracts uses an unlocked margin and that unlocking should therefore be feasible. The MoS approach is discussed in paragraphs 26-29.

*Field test participants*

18. We received feedback from 10 field test participants. 8 agreed that the residual margin should be unlocked. Some would like to see changes in financial inputs adjusting the residual margin in cases when this could eliminate an accounting mismatch (if assets are measured at amortised cost).

19. Two field test participants disagreed with unlocking the residual margin on the following grounds:

   (a) Unlocking adds an additional layer of complexity and needs tracking as well as computing without providing improved information. This holds particularly true if interest is accreted on the residual margin. This respondent believes, in contrast to other field test participants, that the residual margin will be very small.

   (b) The premium charged to the policyholder presumably covers not only direct costs, but indirect costs as well. The margin, therefore, implicitly covers the anticipated indirect costs. If the residual margin is allocated on the basis of the passage of time as proposed in the ED (and locked in), it implies that the part of the margin covering those indirect costs would be recognised in profit or loss evenly over time

[4] The staff can provide board members on request with a write up of the Australian Margin on Services approach to which those IWG members referred.

(whereas in practice the costs would occur and be expensed on a different pattern). Unlocking the margin might result in a pattern of recognition of the residual margin in profit or loss that does not reflect when those indirect costs occur and may consume amounts needed to cover those indirect costs in future periods.

(c) Gains and losses from changes in estimates should be recognised in the period when they occur. The recognition of changes in estimates should not be deferred to future periods.

## Staff analysis

20. In the analysis that follows, we assume that experience adjustments (ie differences between actual outcomes and previous estimates of those outcomes) are recognised in profit or loss. This is because such changes do not relate to future periods or future expected profitability.

21. The proposed treatment of the residual margin in the ED is based on the view that the current measurement of the insurance contract liability is integral to understanding and reporting insurance contracts. Those with this view believe that:

(a) Changes in estimates included in the measurement of the insurance liability provide relevant information to users about changes in circumstances for insurance contracts. Accordingly, all changes in estimates need to be recognised in profit or loss.

(b) The residual margin incorporates parts of the premium charged to policyholders for some overheads and for unknown uncertainties and is a blend of many components that are not separately identifiable. Although the residual margin can be considered to represent the future profit of the contract on day one, it does not represent any economic phenomenon at later dates. Therefore, any release pattern of the residual margin that attempts to exactly match those components is inevitably arbitrary.

***Why unlock the residual margin?***

22. However, as noted in paragraphs 14, many comment letters disagreed that the residual margin should be locked in. Their reasons were that locking in the margin at inception:

    (a) would introduce an inconsistency between measurement of the insurance contract on day one (no day one gain, but immediate day one loss) and the subsequent measurement. This is because the measurement of the insurance contract liability on day 1 includes, through the residual margin, a measure of the expected profitability (other than profit for bearing risk) of the insurance contract. As estimates change during the life of the contract, the expected profitability of that contract changes. Locking in the residual margin at inception does not show the changes in expected profitability. In addition, some observe that day one gains are prohibited on the basis that the estimates may be unreliable, but required on day two on the basis of similar estimates.

    (b) could lead to a situation in which an insurer recognises losses in a period, even though there are gains allocated from the release of the margin in the current and future periods. In other words, locking in the residual margin would mean that its release over time is not affected by changes in expected profitability. Some state that it would not be a faithful representation of the profit an insurer earns over time if the insurer recognises expense in one period because of a change in estimates, only to reverse it in a later period through release of the residual margin. Many believe this effect is counterintuitive and will be difficult to explain to users.

    (c) might introduce an ability to influence profit for the period by manipulating assumption changes and also allows some degree of subjectivity. Some are concerned that insurers might overstate the estimates of cash flows at inception with a subsequent benefit to profit or loss in later periods.

23. Furthermore, some believe that the pattern of revenue recognition arising from insurance contracts is integral to understanding and reporting insurance contracts, and therefore believe that the board's focus should be on the allocation of the residual margin to achieve a pattern of profit recognition that reflects how the insurer performs under an insurance contract.

24. Those with this view believe that the major component of the residual margin represents expected profit from the services provided by an insurance contract other than for bearing risk, and that this expected profit should be recognised in profit or loss as the insurer performs those services. As a result, those with this view look to the boards' project on revenue recognition to determine how to allocate the residual margin to profit or loss.

25. In the boards' tentative decisions on the revenue recognition, an entity would not account for changes in estimated costs to fulfil performance obligations unless the obligations become onerous (although the onerous contract tests might differ between the insurance contracts and revenue recognition models). Applying the revenue recognition treatment to the insurance contract, changes in estimates of the insurance contract liability would not be recognised in profit or loss. This could be achieved by adjusting the residual margin for such changes (subject to the condition that this margin does not become negative). Thus, changes in expectations of profitability would be recognised in profit or loss over the time in which the insurer performs under the contract, rather than in the period in which the change in expectations occurs.

***Feasibility: the margin on services approach***

26. Some express concerns about the feasibility of unlocking the residual margin, but suggest that the Margin on Services (MoS) approach used for the accounting of life insurance contracts in Australia since the mid 1990's demonstrates that unlocking the residual margin should be feasible.

27. The MoS approach governs the release of profit of an insurance contract and adjusts/unlocks the profit margin, which is determined at inception. Similarly to the approach proposed in paper 3C/70C, the MoS approach compares the present value of the expected probability-weighted cash inflows and cash

outflows at inception. A day one loss is recognised immediately, a day one gain establishes the profit margin.

28. In MoS, the profit margin is released on the basis of the services provided using one or more appropriate profit carriers selected by the insurer. Commonly used profit carriers are, for example, expected claims or expected premiums, expected annuity payments, supportable bonuses or crediting rates for participating contracts. (More details can be found in agenda paper 3D/70D.) The profit margin is adjusted for changes in non-financial estimates, whereas changes in financial estimates and current experience adjustments are recognised in profit or loss.

29. The Australian model currently uses a composite margin without an explicit risk adjustment and is managed on a portfolio level. However, proponents of MoS state that it could be equally applied to an approach that includes a risk margin. The staff can provide board members on request with a write up of the Australian Margin on Services approach.

### *Arguments against unlocking*

30. The staff notes arguments against unlocking the residual margin as follows:

    (a) Some argue changes in estimates of the cost of fulfilling the contract should affect the carrying amount of the insurance contract liability when those changes take place. They believe that recognising the effect of those changes in estimates in profit or loss in the period in which they occur would provide more transparent and relevant information about changes in the insurer's circumstances than spreading those effects over future periods that those changes do not refer to. (The effects on profit and loss and the statement of financial position can be seen in the example in agenda paper 3M/58M of the February joint Board meeting.)

    (b) Unlocking the residual margin would introduce a further level of complexity that might be less understandable for users of financial statements and more costly for preparers of financial statements to apply.

***Conclusions***

31. The staff recommends that the residual margin should not be locked in at inception, but adjusted for specified changes in estimates (as explained in agenda paper 3C/70C). In reaching the staff recommendation, the staff puts the greatest weight on the following factors:

    (a) Unlocking the residual margin avoids the counterintuitive effects described in paragraph 22

    (b) The boards' previous decision not to recognise day 1 gains creates a residual margin. Unlocking the margin reflects that the expected profitability of an insurance contract does not necessarily stay the same over the life of the contract. Accordingly, unlocking the residual margin permits a more meaningful interpretation of that residual margin, because it presents the current assessment of the expected profitability of the contract.

| **Question: Whether to unlock the residual margin** |
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| Do you agree that the residual margin should be adjusted for specified changes in estimates (as explained in agenda paper 3C/70C)? |

## Appendix A: Extract from the Basis for Conclusions to the ED

***Release of residual margin***

BC125 The residual margin could be viewed as an aggregation of several factors, including:

(a) compensation for the cost and effort of originating the contracts and assembling them into the portfolio.

(b) compensation for providing ancillary services that are not unbundled (and so are not treated as arising from a separate service contract within the scope of standards on revenue recognition).

(c) compensation for product development.

(d) additional returns if the insurer has significant pricing power, or conversely discounts if the insurer is seeking to build or maintain market power.

(e) the risk that the insurer might not satisfy its obligation to perform under the contract.

BC126 The draft IFRS does not propose that an insurer should measure any of those factors separately. Instead, the Board's objective is to seek a release pattern that corresponds in a reasonable way and at an acceptable cost to the pattern of the factors that generated those margins at initial recognition. Because those margins are a blend of various factors not separately identifiable, any such release pattern inevitably will be arbitrary to some extent. Because the risk adjustment reflects the risk in the contract, the Board thinks that risk should not drive the release pattern for the residual margin (unless risk is used as a convenient and reasonable proxy for another factor).

BC127 Instead, the Board proposes to determine the release pattern for the residual margin on the basis of an insurer's performance under the contract. Since insurance risk is present in every insurance contract and the insurance coverage from this type of risk represents a predominant factor for the performance under the insurance contract, the Board believes that the insurance coverage can be used as the basis for release across all types of contracts.

BC128 The Board believes that the factors implicitly included in the margin would no longer be relevant after the end of the coverage period. Therefore, the Board proposes that the residual margin should be recognised as income over the coverage period in a systematic way that best reflects the exposure from providing insurance coverage, as follows:

(a) on the basis of passage of time, but

(b) on the basis of the expected timing of incurred claims and benefits, if that pattern differs significantly from the passage of time.

BC129 The draft IFRS proposes that the residual margin recognised in profit or loss for the period should be adjusted to reflect the portion of any contracts that are no longer in force at the end of the reporting period. This is consistent with recognising the residual margin over the coverage period of a contract. For similar reasons, no adjustment should be made if more contracts than expected are in force at the end of the period.