Staff Paper

Project **Insurance contracts**

Topic **Composite margin**

What is this paper about

1. The purpose of this paper is to present to the boards alternatives to how the composite margin is recognized ("run-off") in the statement of comprehensive income. The staff will ask for the boards to discuss the various approaches and provide guidance for the staff to consider as we further develop the models. The staff is not asking for decisions at this point, and will bring this back to the boards at a later date.
2. This paper does not address :
   - (a) issues related to reinsurance contracts or to insurance contracts that may be accounted for under a modified approach.
   - (b) unlocking of the composite margin.
   - (c) at what level (that is, at the portfolio level or within the portfolio) the run off of the composite margin should be determined.
   - (d) how the premium would be allocated during the coverage period.
   - (e) whether to use a composite margin rather than a risk adjustment plus residual margin.

Structure of this paper

3. The remainder of this paper is organized as follows:
   - (a) Background (paragraphs 4—13)
     - (i) Summary of the proposals in the IASB's exposure draft *Insurance Contracts* (ED) and the FASB's discussion paper *Preliminary Views on Insurance Contracts* (DP)

(ii) Basis for decisions

(iii) Relevant questions in the ED and DP

(b) Overview of comments received on the ED and DP (paragraphs 14—24)

(c) Staff analysis (paragraphs 25—51)

(d) Appendix A – Example, one year coverage period with five year pay out

(e) Appendix B- Example, five year coverage period with five year pay out

Background

Summary of the proposals in the DP and the ED

4. The DP states that, at initial recognition, an insurer would measure an insurance contract initially as the sum of the following:

   (a) The present value (unbiased estimate) of the expected cash outflows less cash inflows that are expected to arise as the insurer fulfils the insurance contract

   (b) A composite margin that represents the excess of the expected present value of cash inflows over the expected present value of the cash outflows.

5. The DP also states that an insurer would determine the composite margin at a level that aggregates insurance contracts into a portfolio of insurance contracts and within a portfolio, by similar date of initial recognition of the contract and coverage periods. Further, a portfolio of insurance contracts would be made up of insurance contracts that are subject to broadly similar risks and managed together as a single pool. The definition of a portfolio will be addressed at a future meeting.

6. The composite margin would be recognized to eliminate any gain at initial contract recognition and to recognize the margin over the life of the contract and would not be remeasured in subsequent periods. Risk and uncertainty would be reflected implicitly in the composite margin rather than explicitly through a separate risk adjustment margin.

Therefore, in subsequent periods, the composite margin would be recognized in earnings over the coverage and claims-handling periods to reflect the insurer's exposure to uncertainties related to the amount and timing of net cash flows.

7. The DP states that an insurer would apply the following ratio to the composite margin determined at initial recognition of the insurance contract:

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

The resulting amount less the composite margin recognized in earnings in previous periods would be recognized in earnings of the current period. The components of the above formula are further explained in paragraphs 8-10.

8. The total expected premiums would be allocated over the coverage period in a systematic manner on the basis of the passage of time unless the pattern of expected claims and benefits indicates that another allocation would be more appropriate to best reflect the exposure from providing insurance coverage.

9. Each of the four components included in the ratio would be updated each reported period to reflect experience (backward-looking) and changes in estimates (forward-looking). Thus, the amount of the composite margin recognized in earnings each period would be a cumulative-catch up amount reflecting current estimates and experience under the contract.

10. Premiums would be included in the calculation to reflect the protection component of the contract while claims and benefits would be included to reflect the insurer's exposure to risk from uncertainties related to cash flows. The intent was that the ratio would result in a greater amount of the composite margin recognized during the coverage period to reflect the insurer's exposure to risk during that period.

[1] The ratio is described as the following formula in the appendix to the Basis for Conclusions of the IASB's Exposure Draft:

$$\frac{\text{(Premium allocated to current period + Current period claims and benefits)}}{\text{(Total contract premium + Total claims and benefits)}}$$

11. The ED proposed that an insurer would also recognize an explicit risk adjustment upon initial recognition of an insurance contract and therefore, would not recognize a composite margin, but instead would recognize a residual margin. The residual margin would be recognized in earnings over the coverage period either on the basis of the passage of time, or on the basis of the expected timing of incurred claims and benefits, if that pattern differs significantly from the passage of time.

Relevant questions in the DP and the ED

12. 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?

13. Question 6(e) of the ED asked respondents the following:

> 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?

Overview of comments received on the DP and the ED

14. Some respondents agreed with the pattern of recognition in the DP and noted that the ratio would recognize the margin based on the rate at which premiums are earned (and losses incurred) and the rate at which losses are paid. Those respondents believe that the majority of the composite margin would be recognized as premiums are earned and that the remainder would be recognized over the claims handling period, which would be systematic and rational.
15. Some respondents suggested modifications to the pattern of recognition of the composite margin, primarily related to the following:

(a) Unlocking or remeasuring the composite margin after initial recognition. (This issue was addressed in another paper and is therefore not addressed further in this paper.)

(b) Period of recognition in earnings—that is, solely over the coverage period or over both the coverage and claims-handling period.

(c) Method of recognition in earnings—that is, based on the ratio in paragraph 83 of the DP or another method.

16. Stakeholders' comments regarding the period and method of recognition were often intertwined because the method of recognition implicitly determines the period over which the composite margin will be recognized unless the method specifies otherwise (i.e., straight-line over the coverage period).

17. Many respondents indicated the obligation to provide insurance should be the primary driver of the recognition of the composite margin and recommended that the margin be recognized over the coverage period only to reflect the insurance provided. Some respondents indicated that they viewed the insurance provided as a performance obligation, and that they believed that the performance obligation is fulfilled by the insurer by providing insurance during the coverage period. Some respondents noted recognition of the composite margin over only the coverage period is more consistent with how the performance obligation is fulfilled. They acknowledge the potential uncertainty in final cash flows in the claims handling period. However, they argue that the change in the expected cash flows would be better reflect the economics of the circumstances, without any margin offsets.

18. Some respondents suggested that the period for recognition of the margin should not be specified, but rather should be a principle, such as the period of risk exposure. Respondents that preferred a principle for recognizing the margin stated a single formula would not be economically relevant for every type of insurance. Some respondents suggested different recognition patterns based on the type of insurance provided or the nature of the contract.

19. In addition, some of these respondents commented that the formulaic approach expressed in the DP would not necessarily be appropriate for all contracts because it would delay profit recognition beyond the period in which all risk protection services are provided and the majority of the costs and efforts to settle the claims have been expended. An example of this would be contracts where the final amounts to settle the claims are known but they will not be paid immediately (i.e. structured settlements). Some would argue in these situations the obligation to provide insurance coverage is completely performed when there is no longer uncertainty about the amount that will be paid, not when payment is made. Releasing the margin as benefits are paid would not appropriately reflect the economics of the transaction. An alternative the boards could consider would be to include claims settled (where the ultimate payout amount has been agreed to) in both the numerator and denominator instead of paid claims.

20. Some respondents suggested that premiums should not be incorporated into the recognition of the margin because they believe that premiums are not representative of the insurer's performance under the contract. Rather they believe that claims are more representative of that performance. Those respondents noted insurance coverage is provided (that is, the insurer is exposed to risk) for insured events. For the insurer, there is no risk for the receipt of premium payments because the insurer would not provide coverage if premiums are not received. The insurer's exposure to risk relates to the probability of insured events occurring, not the risk that a policyholder will fail to make premium payments. Therefore, if an insurer recognizes income for the primary operating activity of assuming risk, premiums should not be used in the pattern of recognition because the insurer earns income by providing coverage, not by receiving premiums. Other respondents suggested premiums should not be included in the recognition of the margin because insurers either did not know how premiums would be allocated or any allocation of premiums would be arbitrary and would not provide useful information.

21. One respondent expressed that the recognition of the composite margin as proposed in the FASB's DP would result in previously earned composite margin potentially being reversed

in a subsequent period if the estimate of ultimate cash flows increases because this will affect the denominator of the ratio. In that respondent's view, this would add volatility to the results and would not represent the underlying economics.

22. The variables in the proposed ratio also raised several concerns with respondents. Several noted no method of premium allocation was provided. For annual premium contracts this would not be a significant issue but the allocation of premium for limited pay contracts, (i.e. contracts where premiums are not received throughout the coverage period) would likely introduce another arbitrary factor into the recognition of the margin. Certain contracts with variable premium features (universal life) would have a similar problem that may be further complicated based on any unbundling decisions.

23. Because of the issues described above, respondents suggested revising the model to (a) amortize the composite margin over the coverage period, (b) amortize the composite margin over the risk period, or (c) provide a weighting to the inflows (premiums) and outflows (claims).

24. The ED proposed an explicit risk adjustment and a residual margin. The majority of the comments received on the ED were in favour of this proposal and did not support the composite margin. Most responses to Question 6(e) of the ED – while often qualified with opposition to the composite margin – were consistent with the responses to the DP that opposed a formula for the run-off of the composite margin. Because this paper is about the run-off of the composite margin, we do not further address comments received on the ED.

Staff analysis

Principle-based guidance

25. The staff identified the following alternatives for incorporating the principle for recognition of the composite margin into the recognition criteria:

(a) Approach 1—Provide only a principle for recognition, without illustrative examples using recommended or required ratio(s) for recognition ; or

(b) Approach 2—Provide a principle with illustrative examples using recommended or required ratio(s) for recognition;

A recognition principle only (Approach 1)

26. Several constituents noted that including any type of ratio or "bright-line" recognition pattern for the release of margins would not be consistent with a principle-based standard. Issues with operability of a ratio-based recognition pattern were also mentioned.

27. Some of the principles for recognition of the composite margin suggested by respondents include the following:

    (a) Alternative 1—As exposure to risk decreases;

    (b) Alternative 2—As the insurer performs under the contract;

    (c) Alternative 3—In proportion to the exposure to risk;

    (d) Alternative 4—In proportion to insurance protection provided.

Advantages of a principle-only release method

28. The staff believes a principle could be that the composite margin should be run off as the entity is released from risk. By using the release from risk, this principle would recognize the composite margin over the coverage period and over the claims handling period. If the margin is released according to a principle, insurers could develop release patterns specific to the products pertaining to the margin. Disclosure of the accounting policy could lead best practices to emerge and eventually improve comparability between insurers and across industries.

29. Some would say a defined ratio or set of ratios would cause the release of margins to become more arbitrary than if insurers developed their own methods to measure their performance under a principle-only approach.

Disadvantage of a principles-only release method

30. Some note that it could be difficult to verify a release pattern that an entity creates for a certain insurance product. While some think comparability could improve under a principle-only approach, others think it would perpetuate the 'black box' some associate with insurance accounting.

Formula guidance

31. Respondents suggested several alternative formulas for the subsequent recognition of the composite margin in earnings. Some respondents indicated that they were opposed to a ratio or formula but if one were included in the guidance, improvements could be made to that currently proposed. Based on the respondents' feedback, the staff developed several alternatives. Some of those alternatives are as follows and are discussed further below:

    (a) Formula 1—Recognize the composite margin over the coverage and claims-handling period using the ratio in the DP.

    (b) Formula 2—Recognize the composite margin over the coverage and claims-handling period using a ratio similar to the DP, but weight the protection component (premiums) and the risk exposure components (claims and benefits) relative to components within the composite margin to recognize a relative proportion of the composite margin to the coverage period and the claims handling period.

    (c) Formula 3— Recognize the composite margin over the coverage and claims-handling period using a ratio similar to the DP, but include a risk based

measurement for the outflows (claims and benefits) reflecting the nature (risk profile) of the contract.

(d) Formula 4— Recognize the composite margin based on the ratio of claims and benefits paid (or settled) to total expected claims and benefits

(e) Formula 5-Recognize the composite margin based on the ratio of premiums allocated to total expected premiums

32. See Appendix A and B for examples demonstrating the alternatives in the preceding paragraph. The appendixes reflect how the alternatives would be applied and the outcomes achieved in each approach. Appendix A illustrates the alternatives for a policy with a short (1 year) coverage period and Appendix B illustrates the alternatives for a longer (5 year) coverage period. The payout assumptions for both appendixes are the same. A more detailed discussion of the alternative formulas is below.

33. With respect to Formula 3, the staff notes that some have suggested that changes could be made to the pattern of the run off of the composite margin and the unlocking of the composite and residual margins decisions to achieve a similar result as the dual margin approach. The staff will explore this idea further in a separate paper.

Formula 1—Recognize the composite margin over the coverage and claims-handling period using the ratio in the DP

34. The ratio proposed in the DP was intended to recognize the margin based on the protection component (measured using the premiums allocated and expected) and the exposure to risk component (measured using the claims paid and expected). This was done to recognize the composite margin in earnings over the same period that the insurer is exposed to uncertainties related to the amount and timing of net cash flows.

Formula 2— Recognize the composite margin over the coverage and claims-handling period using a ratio similar to the DP, but weight the protection component (premiums) and the risk exposure components (claims and benefits) relative to components within the composite margin to recognize a relative proportion of the composite margin to the coverage period and the claims handling period.

35. Suggested by a few respondents, this approach would weight the elements within the proposed formula to allow the entity to reflect the recognition of the margin relative to how the entity fulfills its obligations over coverage period and claims handling period.

36. As noted earlier in this memo, respondents did not believe a single formula for releasing the composite margin could accurately reflect the economics of the portfolio of insurance contracts because different portfolios have different characteristics in the coverage period and in the claims handling period. As such, some would argue that an insurer fulfills its obligations differently in the coverage period and claims handling period and this should be reflected in the recognition of the composite margin. This approach allows companies to make judgments as to how to reflect this difference in relative terms over the coverage and claims handling periods.

37. For example, for a portfolio of contracts with relatively high uncertainty in the claims handling period, an entity could more heavily weight the claims in the numerator and denominator of the proposed formula and recognize more margin during the claims handling period than the ratio proposed by the DP. Alternative 2 of the Appendix illustrates how this approach would delay the release of the margin into later periods. Alternatively, a portfolio of contracts with less uncertainty in the claims handling period could be weighted such that more of the margin would be recognized in the coverage period.

38. For contracts with very little uncertainty after the coverage period the weighting could potentially place the entire emphasis on the premiums component of the equation. This would usually result in a release of margin over the coverage period only, which may be appropriate in some situations (for example, for claims made contracts).

39. Factors actuaries and management may consider in determining the weighting could include:

(a) The entity's relative experience with the types of contracts,

(b) The entity's past experience in estimating expected cash flows,

(c) Inherent difficulties in estimated expected cash flows,

(d) The relative homogeneity of the portfolio and within the portfolio, and

(e) Past experience not being representative of future results.

Formula 3—Recognize the composite margin over the coverage and claims-handling period using a ratio similar to the DP, but include a risk based measurement for the outflows (claims and benefits) reflecting the nature (risk profile) of the contract.

40. Formula 3 places a risk-based measurement on the claims and benefits portion of the numerator and denominator. This method could result in a pattern of runoff which is similar to Formula 2, however, as further described below; the focus in formula 3 is on risks related to claims.

41. Formula 2 allocates the release of margin on a relative basis between the coverage period and the claims and coverage period. This is done using the premiums allocated and claims paid (or settled), respectively. Formula 3 focuses more on quantifying the absolute quantity of risk present in the uncertainty of the cash outflows.

42. The measurement of this risk could involve the adaptation of various statistical techniques to the formula proposed.

43. Some possible methods for determining the coefficient are similar to those proposed for calculating a risk adjustment in a dual margin approach. Theoretically, the coefficient could be defined in such a way that it achieves the same result. This would effectively convert the composite margin into a risk component and a residual component (i.e. the dual margin approach). The IASB ED proposed three methods for determining a risk adjustment:

(a) Cost of capital

(b) Conditional tail expectation

(c) Confidence level

44. Feedback received on determining the risk adjustment indicated these methods may not produce the same result and this would compromise comparability across insurers. This is one of the arguments in support of a single (composite) margin approach.

45. The staff discussed other alternative methods of determining the coefficient to apply in this method. The staff considered using a measure of historical deviation from estimated cash outflows, for instance, a variable based on the 10 year claims development table. An advantage of this approach is that it is objectively determinable, is based on available information already available, and is based on information that users of financial statements have indicated is useful. Some staff do not believe this would be an appropriate alternative because it implicitly assumes the future will be the same as the past, so it runs the risk that the result will not be a faithful representation.

46. Further development of this method, either based on a measure consistent with the risk margin or a measure of historical deviation, or a measure quantifying the distribution of possible outcomes in determining the estimated cash flows, would be required if the boards decided this was an alternative to pursue.

Formula 4 - Recognize the composite margin based on the ratio of claims and benefits paid (or settled) to total expected claims and benefits

47. One way to consider the release from risk is the proportion of claims settled to total expected claims. This method is responsive to those respondents that indicated that premiums should not be incorporated into the recognition of the margin because premiums are not representative of the insurer’s performance under the contract in the same way that claims are representative of that performance.

48. Again, an alternative the boards could consider would be to include claims without uncertainty about the amount that will be paid in both the numerator and denominator instead of paid claims. This would address concerns about a possible delay in profit

recognition beyond (a) the period in which all risk protection services are provided, and (b) the majority of the costs and efforts to settle the claims have been expended.

49. While this approach maybe appropriate in some circumstances, in some circumstances some would argue that this approach would not recognize any profit until the claims are made and settled, and would not be consistent with the economics of providing protection during the coverage period.

Formula 5-Recognize the composite margin based on the ratio of premiums allocated to total expected premiums

50. Several respondents indicated they believed that the composite margin should be recognized only over the period of coverage. They argue that insurance protection during the period of coverage is the primary purpose of insurance and the pattern of recognizing the composite margin should reflect this purpose.

51. These respondents acknowledge the potential uncertainty in final cash flows in the claims handling period. However, they argue that the change in the expected cash flows would better reflect the economics of the circumstances, without any margin offsets. However, "management's best estimate" of the cash flow generally differs from the actuarially calculated unbiased expected cash flows due to uncertainty. If the margin were to be fully recognized before that uncertainty was resolved, it would not be consistent with the economics of the transaction.

Discussion points

Questions for the boards
1) What do the boards think about the use of a formula approach in the recognition criteria for the run off of the composite margin? 2) Do the boards prefer any of the formula presented in this paper? 3) Should the boards articulate a principle for the recognition criteria for the run off of the composite margin and use one or more of the formulas presented in this paper as an illustrative way the principle could be applied?