



Project	Insurance contracts
Topic	Composite Margin – Overview

Purpose of this paper

1. This agenda paper provides:
 - (a) An overview and the basis for support of the composite margin contained in the FASB's DP
 - (b) General feedback received on the composite margin from comment letter respondents to the FASB's DP
 - (c) Feedback received on the calculation of the risk adjustment from field test participants
 - (d) Feedback received from recent outreach activities with users conducted by the FASB staff
2. This agenda paper does not discuss the following issues:
 - (a) Potential changes to the profit realization of the composite margin
 - (b) A conceptual analysis of the composite margin

These issues are discussed at agenda papers 3F/68F and 3G/68G respectively.

3. We do not ask the boards to make any decisions as part of this agenda paper.

Background

Summary of the FASB's preliminary views about risk

4. Paragraph 69 of the FASB's discussion paper (DP) states:

Risk associated with the uncertainty in net cash flows of an insurance contract would be considered in that contract's pricing and, therefore, would be implicit in the composite margin. The composite margin also would implicitly include the potential profit on the contract, measured as the difference between the present value of expected premiums and benefits, claims, and expenses.

5. According to paragraph 70 of the DP, board members that favoured the composite margin approach did so because of the level of judgement required in selecting a methodology for calculating a risk adjustment and the potential lack of comparability.
6. Paragraph 71 of the DP described the benefits of the composite margin as follows:
- (a) The approach would be more consistent with the allocated transaction price approach in the proposed Accounting Standards Update on revenue recognition, because both a composite margin and a residual margin are allocations of the customer consideration, whereas a risk adjustment margin is the compensation the insurer requires to bear the risk that the ultimate cash flows could exceed those expected and would be subsequently remeasured.
 - (b) A composite margin would eliminate the need to use subjective methods for measuring the risk adjustment margin that may decrease comparability. Furthermore, changes in those subjective measurements from period to period would be recognized immediately in earnings.
 - (c) A composite margin would provide a simpler and more understandable approach to account for the difference between the expected cash inflows and outflows. The method for subsequent recognition of the composite margin in earnings would be simpler to calculate and more transparent to users of financial statements than the IASB's proposed techniques for subsequent recognition of changes in the risk adjustment margin.
7. To accomplish the objective of implicitly embedding an element of risk and uncertainty within the composite margin, the FASB provided a run-off mechanism that would run off/amortize the composite margin over both the coverage period and

claims payment period. It did so by considering both premiums allocated and claims paid relative to expectations for those same amounts in the following prescribed ratio:

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

8. The DP dictated that the above ratio would be applied to the composite margin determined at initial recognition, and the resulting amount less the portion of the composite margin recognized in earnings during previous periods would be recognized in the current period. Additionally, the allocation of the premiums would occur in a systematic manner based upon the passage of time unless the pattern of expected claims and benefits indicated that another methodology would be more appropriate.
9. The FASB expressed in paragraph 87 of the DP that the portion of the composite margin recognized in the current period would reflect the protection component of the contract as well as the insurer's exposure to risk and uncertainty related to cash flows that may arise from claims and benefits.

Relevant questions in the DP

10. Question 15 of the DP asked respondents the following:

Do you agree with the use of either the composite margin approach or two-margin approach to measure the net insurance contract? Does either approach faithfully represent the economics of the insurance contracts? Is either approach an improvement over the measurement used in current US GAAP?

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

Do you think 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 DP

12. Given that the DP specifically asked a question regarding the use of a composite margin vs. a two-margin approach and that many of the responses were framed in this context, the staff provide relevant responses received about the risk adjustment from respondents to the DP as part of this overview.

Risk Adjustment

13. Many respondents to the DP did not support an explicit risk adjustment. Many of the respondents commented that the determination of the risk adjustment generally would involve significant set-up costs, be difficult to account for, and add an element of judgment and subjectivity that may impair comparability and allow for potential manipulation of results. Specifically, respondents were concerned that an explicit risk adjustment could give users a misleading impression about the precision of liability measurement.
14. Other respondents commented that the risk adjustment is not observable, making it difficult to determine whether the assumptions were reasonable to meet the objective of its measurement. Consequently, some respondents commented that the amount determined as a risk adjustment would be arbitrary and therefore not contain decision-useful information.
15. Some respondents commented that the risk adjustment cannot be back-tested; changes in assumptions are recorded directly to the expected cash flows and may potentially be offset against the residual margin and changes in actual versus estimates are recognized immediately. Therefore, the risk adjustment, which is remeasured each reporting period, has no direct relation to the updated assumptions. It will eventually be eliminated and it will not be determinable whether the “protection” it was providing was sufficient or deficient.
16. Other respondents questioned whether the amount calculated for the risk adjustment would indicate whether an entity was conservative in making assumptions or genuinely had a different risk profile. For example, does a large risk adjustment indicate the unbiased expected cash flows are understated, the company is conservative or the company is risk averse? Likewise, does a small risk adjustment indicate that management is more certain of the unbiased expected cash flows, the company is aggressive or the company is willing to accept more risk and therefore future volatility resulting in a small risk adjustment?

Composite Margin

17. Although many respondents to the DP supported the use of a composite margin because they did not support the recognition of a gain at inception of an insurance contract or because of opposition to the risk adjustment as discussed above, many did not necessarily agree with the run-off methodology prescribed in the DP. Some 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 1) the period that the insurer provides risk protection services and 2) the period in which the insurer expends the majority of costs and efforts to settle the claims. Additionally, a few respondents requested guidance about how to allocate the premiums for particular life and financial guaranty contracts.
18. More generally, many respondents commented that one consequence of recognising the composite margin on an allocated basis is that an insurer could recognise losses in a period while still running off profit from the composite margin in future periods. One respondent took this notion a step further by explaining that the recognition of the composite margin as proposed in the DP could result in reversing previously earned composite margin in a subsequent period if the estimate of ultimate cash flows increased significantly due to its effect on the denominator of the ratio. Taken together, some respondents commented these effects would be difficult to explain to investors.
19. Due to these issues, respondents suggested revising the model. Those suggestions included:
 - (a) Amortizing the composite margin over the coverage period
 - (b) Amortizing the composite margin over the risk period, or
 - (c) Provide a mechanism to weight the inflows (premiums) and outflows (claims) to better reflect how the profit is earned.
20. Although suggestions were provided for changing the run-off pattern, several respondents commented the final standard should not provide a rules-based methodology for determining run-off but rather a principles-based approach that aligns the amortization of the composite margin with the insurers release from risk.

Remeasurement of the Composite Margin

21. Some respondents suggested the recognition of the composite margin on a basis other than allocation to reflect current measurement. Specifically, they commented that the composite margin should absorb changes (both positive and negative) in cash flow estimates relating to non-financial variables. Many commented that it appeared inconsistent to base the entire model on a current value notion yet leave the composite margin locked.

Overview of feedback received from field test participants specific to the risk adjustment

22. The FASB staff reviewed the feedback received from five of the entities that participated in the field test of the ED. Our review consisted of those entities included from North America.
23. The staff notes that one of the field test participants highlighted that they used the methodology prescribed by their current requirements to calculate the risk adjustment and believe this methodology meets the requirements as specified in the IASB's ED.
24. Our review of the field test results for the US participants revealed the following primary concerns:
 - (a) Difficulty and complexity of the calculation
 - (b) Variation in results depending on the methodology used
 - (c) Results that are not meaningful or easily explained to the users of financial statements
25. The difficulty and complexity of the calculation appeared to gravitate toward the application of correlation benefit between states, coverages and accident years. Some of the participants in the field test appeared to struggle with how to allocate the correlation benefits to properly determine the diversification within the portfolio.
26. Some participants obtained different results with the same data set depending on the methodology used. There is a belief by some participants that particular methodologies (eg cost of capital) would always result in a higher risk margin than the other methodologies available. Additionally, this difficulty prompted a request to provide more guidance to determine which methodology would be more appropriate given the facts and circumstances.

27. Finally, there is a belief that results obtained are arbitrary and provide results that are not meaningful and/or difficult to explain to users. The arbitrariness of the calculation appears to stem from the assumptions selected by the individual entities as these can vary widely depending on the entity while the results are difficult to explain to users because of the complexities inherent in the measurement. These of course lead to the logical conclusion that the results produced by the calculations are not meaningful for the users of financial statements.

Overview of feedback received from recent outreach with users specific to the risk adjustment

28. In recent weeks, the FASB staff conducted various outreach sessions with both buy-side and sell-side analysts for insurance entities. These outreach activities included attending conferences, conducting phone interviews with groups or individual analysts, and individual contact with the FASB's investor relation group.
29. The feedback received from users indicated that they are not convinced the information provided would be useful. In particular, they are concerned with comparability given the entity specific nature of the estimate and the different methodologies that could be employed to calculate the risk adjustment. Some suggested that comparability could be aided through disclosure but expressed doubts as to whether the disclosures would be detailed enough to mitigate the issue.
30. Additionally, because of these concerns, some users expressed the difficulty they could possibly encounter in attempting to perform benchmarking analysis across the sector. This, in turn, could make it more difficult for a broader population of investors to understand insurance company financial statements, thus increasing the cost of capital for these entities.
31. Other users have pointed out that the boards are mixing "reserve" concepts with "capital" concepts thus confusing the issue of what the risk adjustment is supposed to represent. In general, these users see the "capital" concept as a cushion for an adverse event whereas a reserve is an obligation. These users commented that a risk margin does not reflect the economics of the business but rather is for regulatory purposes.

Finally, the staff have been told repeatedly that many investors in the insurance space are not considered to be insurance industry experts and therefore one of the goals of the project should be to make the industry less complex to analyze than it is today.