STAFF PAPER

14 -18 November 2011

IASB Meeting

Project	**Insurance contracts**		
Paper topic	Residual margin series: cover note		
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Purpose of paper

1. This paper introduces the papers for the education session on the residual margin. It provides background information and describes the remaining decisions to be taken. The papers for this meeting do not ask for any decisions. However, we ask Board members to indicate leanings and indicate if there is further analysis they would need to make decisions.

Background

The residual margin in the exposure draft

2. The residual margin is recognised to eliminate any gain at the inception of an insurance contract. It is thus measured on initial recognition at an amount that offsets, and equals difference between the expected cash inflows and the present value of the expected cash outflows (plus, for the IASB, a risk adjustment).
3. Paragraphs 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."

4. In the comment letters, field tests and subsequent outreach, some also identified the following additional elements in the residual margin:

(a) Measurement error, including failure of the risk adjustment to capture all risks fully and failure of the estimate of expected cash flows to fully capture all the expected cash outflows.

(b) Cash flows excluded from the measurement of the liability by the proposals but which the insurer nonetheless takes into consideration in setting the premium. This might include the profit charged on costs included in the cash flows that the insurer includes in pricing the contract.

(c) Some genuine day 1 gain that arises because the insurer has better information than the policyholder or because it has market power.

(d) Some genuine day 1 gain that arises because the insurer can charge a higher price for risk than it costs the insurer to assume the risk. For example, the risk adjustment is the price charged for taking on risk but in determiningg the price the insurer requires, it might allow for diversification benefits. A policyholder may be willing to pay more than that amount if the reduction in the policyholder’s risk, which does not reflect any diversification benefit, is greater than the net risk assumed by the insurer.

5. In other words, the residual margin includes all things that are not readily (or cost effectively) identified separately.

6. The ED did not propose that an insurer should try to separate or remeasure the individual components of the margin, but sought a release pattern for the residual margin that corresponds in a reasonable way and at an acceptable cost to the pattern of the factors that generated those margins at inception. Because the components of the residual margin cannot be readily (or cost effectively) identified, the ED proposed that the residual margin would not be remeasured, but would instead be locked-in at inception and allocated to future periods.
7. We reproduce the comment letter analysis relating to residual margin in the appendix.

The IASB's previous tentative decisions

8. 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, for the IASB, a risk adjustment).
   (b) Day one losses should be recognised immediately in profit or loss.
9. In June 2011, the IASB tentatively decided that an insurer should:
   (a) Adjust the residual margin for all favourable and unfavourable changes in the estimates of future cash flows used to measure the insurance liability (with no upper limit). Experience adjustments would be recognised in profit or loss.
   (b) Recognise changes in the risk adjustment in profit or loss in the period of the change (ie changes in the risk adjustment would not unlock the residual margin).
   (c) Make any adjustments to the residual margin prospectively.[1]

[1] We note that adjusting the residual margin prospectively is consistent with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. IAS 8 requires changes in accounting estimates to be recognised prospectively by including them in profit or loss in the period of change (if the change affects that period only) or the period of the change and future periods (if the change affects both). Accordingly, we do not propose to revisit this decision.

10. The IASB also decided that:

(a) The residual margin should not be negative.

(b) Insurers should allocate the residual margin over the coverage period on a systematic basis that is consistent with the pattern of transfer of services provided under the contract.

11. The IASB did not conclude on whether changes in the discount rate should unlock the residual margin (see agenda paper 6A). In addition, the IASB noted that it would need to consider at a future meeting:

(a) The unit of account for unlocking the residual margin. In June 2011, the Board discussed an approach to unlocking the residual margin that uses the portfolio as the unit of account.[2] The Board indicated that it accepted that this approach could be used to make unlocking of the residual margin operational. For these papers we will assume that the unit of account for unlocking the residual margin is the portfolio and will consider this issue in a future meeting together with other issues relating to unit of account.

(b) Presentation of the residual margin in the statement of financial position. We will consider this in a future meeting. In the June 2011 meeting, the staff also noted that we would consider in a future meeting whether an unlocked residual margin should be presented:

(i) As an offset to the change in the other building blocks with no effect in the statement of comprehensive income. This view would be consistent with the view that the building block approach measures a single, combined liability. If this presentation is adopted, the change in estimate and the offsetting unlocking of the residual margin would be visible only in the roll-forwards proposed by the IASB's exposure draft.

(ii) Gross in the statement of comprehensive income, ie with the changes in estimate recognised in profit or loss and an

[2] [2] Agenda paper 3D *Allocation of the residual margin* for the June 2011 meeting

equal and opposite change in residual margin also
recognised in profit or loss.

(c) How to distinguish experience adjustments from changes in estimate. We discuss this in agenda paper 6A *Which changes adjust the residual margin?*

(d) Disclosures. We will consider this in a future meeting.

The papers for this meeting

12. In this meeting we ask the board to consider in aggregate its past and future decisions on the residual margin with a view to confirming or modifying the June 2011 decision on unlocking the residual margin. The papers for this meeting:

(a) reconsider whether all changes in estimates should adjust the residual margin (Agenda paper 6A). Although this paper would be irrelevant if the board decides not to unlock the residual margin, we believe it is necessary to understand how the residual margin would be unlocked in its entirety before asking the Board to decide whether to confirm or modify its previous tentative decision to unlock the residual margin.

(b) consider the rationale for unlocking the residual margin and contrast the approaches of locking or unlocking the residual margin (Agenda paper 6B).

(c) consider the allocation of residual margin to profit or loss, for both a locked in and an unlocked margin. The board's decisions on allocation were taken in the context of its previous decisions to unlock the residual margin only for changes in estimates of future cash flows. We consider in agenda paper 6C how the analysis in agenda paper 6B would apply to the allocation of the residual margin.

(d) Consider the accretion of interest on the residual margin, for both a locked in and an unlocked margin (agenda paper 6D).

Appendix: Feedback on unlocking the residual margin

Overview of comments on the ED

A1. 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.

A2. 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 agenda paper 6B.

A3. 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[3], general overheads[4], risk of unknown uncertainties and not captured by a risk

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[3] At their meeting on 13-15 June, the boards tentatively decided that the acquisition costs to be included in the initial measurement of a portfolio of insurance contracts should be all the direct costs that the insurer will incur in acquiring the contracts in the portfolio, and should exclude indirect costs such as software dedicated to contract acquisition, equipment maintenance and depreciation, agent and sales staff recruiting and training, administration, rent and occupancy, utilities, other general overhead and advertising. In addition, the IASB tentatively decided that no distinction should be made between successful acquisition efforts and unsuccessful efforts. The FASB tentatively decided that the acquisition costs included in the cash flows of insurance contracts will be limited to those costs related to successful acquisition efforts.

[4] 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.

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

A4. At their meeting on 24 March 2011, Insurance Working Group (IWG) members generally favoured unlocking the residual margin over the life of the 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.

A5. 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[5] for life insurance contracts uses an unlocked margin and that unlocking should therefore be feasible. The MoS approach is discussed in [Agenda paper 3D for the June 2011 meeting/ FASB memo 70D].

Field test participants

A6. We received feedback from 10 field test participants. Eight 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).

A7. Two field test participants disagreed with unlocking the residual margin on the following grounds:

[5] Agenda paper 3D/70D for the June meeting described the Australian Margin on Services approach to which those IWG members referred.

(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 (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.