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STAFF PAPER

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Project	**Insurance contracts**		
Paper topic	Which changes in estimate adjust the residual margin?		
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Purpose of paper

1. As noted in agenda paper 6 *Residual margin series: Cover note*, the board previously decided to adjust the residual margin for changes in estimates of future cash flows used to measure the insurance contracts liability. The board did not decide whether changes in the insurance contracts liability resulting from changes in the discount rate should adjust the residual margin or be recognised in the statement of comprehensive income.

2. This paper discusses all the changes in estimate that would adjust an unlocked residual margin. This session is educational and we do not ask the board for decisions. Instead we ask you to indicate any leanings you might have or if there is any further analysis you would need before making a decision.

3. This paper assumes:

   (a) That the board confirms its tentative decision made in June 2011 that the residual margin should be unlocked to reflect changes in cash flows. However, in agenda paper 6B *Residual margin - two approaches*, we discuss an alternative approach in which the board does not unlock the residual margin. If the board pursues that approach, this paper would be irrelevant. However, we believe it is necessary to understand how the residual margin would be unlocked in its entirety before asking the boards to discuss agenda paper 6B.

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(b) That the rationale for unlocking the residual margin is that described in agenda paper 6B, ie because the board views the residual margin as primarily representing the unearned profit that will arise from the insurance contract.

(c) That both favourable and unfavourable changes in estimates would adjust the residual margin. This is consistent both with the board's previous tentative decision and with the view of the residual margin as the unearned profit that will arise from the insurance contract.

(d) That recognition in the statement of comprehensive income means profit or loss. However we will consider in a future meeting whether any component of the change in the insurance contract liability should be recognised in other comprehensive income.

Staff analysis

4. We note that there are differing views on which changes should unlock the residual margin. For example:

   (a) Feedback from preparers and users of financial statements indicates that many believe that an insurer should be held to account for changes in non-market variables such as mortality and morbidity rates, because managing the risks associated with those assumptions is the core business of an insurer. Accordingly they believe that recognising those changes in profit or loss would provide useful information about how the insurer has performed in the period. However, others observe that those inputs relate to the long term, almost never have a quoted market price and some would say they do not fluctuate significantly over a short time period unless there is a significant change in the environment of the insured risk. Accordingly they would argue that those assumptions always relate to future expectations and should adjust the residual margin.

   (b) Some note that the effects of changes financial estimates, in particular changes in interest rates have a significant effect on measurement of the

insurance contract liability. Some argue that reflecting the full effects of those changes in measurement of the insurance liability is not useful to users of financial statements because they could reverse over the remaining contract term. Accordingly, using the residual margin to absorb changes in interest rates and other financial inputs would dampen the volatility of the results in profit or loss of those contracts, to the extent that the changes do not consume the entire margin. In contrast, others argue that adjusting the residual margin to reflect changes in the discount rate would reduce transparency because the measurement of the liability and the recognition in profit and loss of interest expense would reflect a discount rate determined at inception rather than current market rates of interest. Furthermore, some believe that concerns about volatility arising from the use of current market rates of interest could be addressed through the use of other comprehensive income.

5. As stated in paragraph 3(b), we assume for this paper that the justification for an unlocked residual margin is that the residual margin represents primarily unearned profit that will arise as the insurer fulfils the insurance contract. To be consistent with that notion, the residual margin should as much as possible, be adjusted so that it represents the remaining profit in the contract at any given time. This leads to the conclusion that the residual margin should be adjusted to reflect all changes in estimate that affect the future profit in the contract. This also avoids the inconsistency that the amount representing unearned profit would differ had the insurer made different estimates at inception

6. This reasoning implies that there would be no distinction between types of changes in estimate used to determine the insurance contract liability. Thus:

   (a) There would be no distinction between estimates that relate to market variables (such as inflation or discount rates) and estimates that relate to non-market variables (such as mortality and morbidity rates, and expectations about the frequency and severity of claims). Thus, changes in discount rate (which are estimates of the time value of money) would also adjust the residual margin.

(i) Changes in the risk adjustment, being an estimate of a component of the insurance contract liability should also adjust the residual margin. In June 2011, the Board concluded that it should not make the current estimate of risk less transparent by absorbing changes in the risk adjustment against the residual margin. Thus, we think the consistency with the reasoning in paragraph 5 would require the Board to reverse its June 2011 tentative decision that insurers should recognise all changes in the risk adjustment in profit or loss.

7. Some argue that changes in the discount rate should not adjust the residual margin because doing so would create an accounting mismatch when the assets backing insurance contracts are measured at fair value through profit or loss. This is because discount rate changes would change the carrying amount of the assets, but such changes would not change the overall measurement of the insurance contract liability, unless the residual margin has been fully consumed.

8. However, the staff note that if changes in the discount rate *do* adjust the residual margin there would be no accounting mismatch when the assets backing insurance contracts are measured at amortised cost (assuming residual margin remains to be absorb changes in discount rate). We note that the default measurement basis for many assets that insurers hold to back insurance contracts is amortised cost..

9. One approach to deal with the accounting mismatches would be to adjust the residual margin when a mismatch exists, and not in other cases. However, the staff thinks that it is difficult to justify adjusting a current measure of unearned profit in a contract based on the accounting basis used to measure the assets held to back the insurance contracts, even if the relevant contracts and assets creating the mismatch could be identified. Furthermore, an approach which adjusted the residual margin on such a basis would be difficult to explain and understand.

10. Some argue that changes in the risk adjustment should not adjust the residual margin (at least in part, see paragraph 12) because to do so would undermine one of the practical advantages of the risk adjustment – that it is measured directly.

11. The risk adjustment represents a current value of the estimated risk in a contract. Conceptually, changes in the risk adjustment from one reporting date to the next can arise from:

    (a) The expected release from risk for that period (as the coverage period elapses, the exposure to risk declines, and as time passes, the insurer gains more knowledge of risk); or

    (b) An unexpected change during the period in the risk adjustment, whether because the amount of risk has increased temporarily, the amount of risk has decreased more than expected, or because the price of risk has changed.

12. In June 2011, the board placed weight on the argument that bearing risk is a key service provided by an insurer in an insurance contract. As the insurer satisfies its performance obligation by providing insurance coverage (ie by bearing risk), the amount of risk declines (ie the insurer is released from risk) and the amount of the risk adjustment decreases accordingly. Because the expected release from risk for the period is triggered by the provision of the service of bearing risk in the period, the resulting decrease in the risk adjustment represents the earning of profit in the period. As a result that decrease in the risk adjustment should be recognised in profit or loss. However, unexpected changes in the risk adjustment are an estimate that affects the amount of unearned profit and should adjust the residual margin. Because of the difficulties in identifying which of the two drivers described in paragraph 11 has caused the change in risk, the Board decided to treat them in the same way.

13. Furthermore, the board was persuaded that a key advantage of the risk adjustment is that it is measured directly and reflects any unexpected changes during the period in the amount of risk. As a result, the board concluded that it would be counterintuitive to make this current estimate of risk less transparent by absorbing some or all changes against the residual margin.

14. However, in the staff's view, unlocking the residual margin for some changes in estimates but not for others would mean that the residual margin would no longer represent something understandable, except by reference to the way it has been

calculated. If the board thinks that the residual margin should be a measure of the unearned profit remaining in the contracts, all changes relating to future estimates should adjust the residual margin.

Distinguishing changes in estimate and experience adjustments

15. Some argue that only changes in future expectations should adjust the residual margin, while experience adjustments would be recognised in profit or loss.

16. At its June 2011 meeting, the board indicated that experience adjustments should be recognised in profit or loss, and changes in estimates affecting future periods should adjust the residual margin. However, the Board also indicated that it would consider further how to distinguish experience adjustments and changes in estimates. In the staff's view, this is already considered and discussed in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

17. IAS 8 distinguishes between:

    (a) Changes that affect the period of change only; and

    (b) Changes that affect the period of change and future periods.

18. IAS 8 also states:

    "A change in an accounting estimate may affect only the current period's profit or loss, or the profit or loss of both the current period and future periods. For example, a change in the estimate of the amount of bad debts affects only the current period's profit or loss and therefore is recognised in the current period. However, a change in the estimated useful life of, or the expected pattern of consumption of the future economic benefits embodied in a depreciable asset affects depreciation expense for the current period and for each future period during the asset's remaining useful life. In both cases, the effect of the change relating to the current period is recognised as income or expense in the current period. The effect, if any, on future periods is recognised as income or expense in those future periods."

19. Applying paragraphs 15-18 to the estimates used to measure insurance contract liabilities:

    (a) Only changes in future expectations, which would affect the profit that will be earned in future periods, should adjust the residual margin. This includes changes in the discount rate and unexpected increases in risk (unexpected decreases in risk suggest that the profit has been earned).

    (b) Experience adjustments, which would affect profit earned in the period, rather than unearned profit of future periods, would be recognised in profit or loss. (However, changes due to experience adjustments may also cause the insurer to revise estimates about the future and those changes would adjust the residual margin.)

20. For example, a change in estimate of lapse rates in one period could affect cash flow estimates for the current and all future periods. The effect on current period cash flows that arises because of the difference between the previous estimate of lapse rates for the current period and the lapse rate actually observed is an experience adjustment. The effect on future period cash flows that arises because of the difference between the expected and observed lapse rates would be a change in future estimates. In contrast, the difference between an actual cash flow in a period and the previous estimate of that cash flow would affect only the current period.

21. Some, including many users, support the approach in IAS 8 because they regard effects that arise in one period only as different from effects that will affect the profit earned in future periods. This is because changes that affect profits in future periods add predictive information about future profits, while changes that affect the current period only provide no information that will help users to predict future periods' profits.

22. However, others note that distinguishing between changes in future estimates and experience adjustments would result in a different profit pattern depending on whether the change is identified initially as a change in estimate, or only subsequently as an experience adjustment. This creates an inconsistency depending on when the change in estimate is identified in advance (and therefore

treated as a change in estimate) or subsequently (and therefore treated as an experience adjustment). Some view this effect as incongruous, given that one of the key reasons to unlock the residual margin is to avoid an inconsistency between measurement of the insurance contract on day 1 and subsequent measurement.

Questions for discussion: changes in estimate
If the residual margin is unlocked, do you think that: (a) all changes in estimate used to measure the insurance contract liability should adjust the residual margin? If not, which changes in estimate should not adjust the residual margin and why? (b) differences between actual cash flows and previous estimates of those cash flows (ie experience adjustments) should be recognised in profit or loss?