STAFF PAPER

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Project	**Insurance contracts**		
Paper topic	Allocation of residual margin		
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Purpose of paper

1. In the June 2011 meeting, the Board tentatively decided that 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.
2. At that meeting, some Board members asked the staff to consider whether there was a need to specify the allocation pattern for an unlocked residual margin. In this paper we review the allocation of the residual margin in the light of the analysis in agenda paper 6B. We also consider if there is a need to adjust the allocation of the residual margin in some circumstances.
3. We do not ask for decisions in this paper, but ask you for any tentative leanings you might have and to indicate if there is further analysis you would need before making a decision.

Staff analysis

4. The Exposure Draft *Insurance Contracts* proposed that an insurer would allocate a locked-in residual margin over the coverage period of the insurance contract. The Basis for Conclusions to the ED discussed the allocation of the margin as follows:

   BC126 The draft IFRS does not propose that an insurer should measure any of [the factors making up the residual margin] 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

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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.

5. In the comment letters, most respondents agreed that the residual margin should be allocated over the coverage period as they agree the significant services of the

insurer are provided within the coverage period. A few asked the Board either not to be prescriptive about the allocation pattern (and leave it to the insurer to determine which period is most appropriate for individual contract types) or to extend the allocation period for the claims handling period[1] for contracts that require the insurer to render significant services within that period. Some questioned the reasons that an adjustment would be made to the residual margin if there are fewer contracts than expected in force at the end of the reporting period, but not if there are more contracts than expected in force at the end of the reporting period.

6. In this paper we assume, following the analysis in agenda paper 6B, that:

    (a) a locked in residual margin represents an obligation for the insurer to perform any activities needed to fulfil the contract, other than making net cash payments for insured events and other costs of fulfilling the contract ('the residual obligation').

    (b) an unlocked residual margin represents the unearned profit remaining in the insurance contract.

7. We note that some Board members questioned in the June 2011 meeting whether there would be a need to specify the allocation of an unlocked residual margin. We think that there is: although unlocking is a proxy for the remeasurement of unearned profit, it is not a true remeasurement. Adjustments to the residual margin resulting from changes in estimates affect the total amount of residual margin in the contract and would not result in recognition of the residual margin in profit or loss.

8. Applying the two views of the residual margin:

    (a) For a locked-in residual margin, the pattern of allocation of the residual margin should, conceptually, follow the pattern of the satisfaction of the residual obligation. In agenda paper 6B, we described that obligation as comprising a mixture of things, including:

[1] The claims handling period is the period during which an insurer will be fully released from the risk of variability in the cash flows. Settling claims and claims processing services are part of the normal operating activities of an insurer.

(i) Insurance services other than paying claims and benefits, in particular absorbing the policyholders' risk through pooling of those risks in a portfolio. This is a service delivered over the coverage period.

(ii) Ancillary services that are related to the type of coverage provided and that do not meet the criteria for unbundling. For example, negotiating prices with suppliers or other third parties, providing advice, administrative support. These services may be delivered in the coverage or settlement period.

This implies it might be appropriate to allocate the residual margin over both the coverage and settlement period.

(b) For an unlocked residual margin, the pattern of allocation should, conceptually, be the same as the expected pattern in which the insurer will earn the profit. The insurer earns the profit in the contract overall by (predominantly) providing insurance coverage. Because the allocation of an unlocked residual margin reflects the way the profit for the whole contract is earned, it is more likely that the coverage period is an appropriate period because providing insurance coverage is the predominant service provided by all insurance contracts.

9. We think that in most cases, if there is no indication to the contrary, the passage of time would be a reasonable basis for measuring the pattern in which the insurer earns profit (for an unlocked margin) and the pattern in which the insurer satisfies the residual obligation (for a locked in margin).

10. However, some insurance contracts oblige the insurer to provide services in addition to insurance coverage, and the Board's tentative decisions on unbundling goods and services mean that not all these services would be unbundled (eg if they are integrated with the insurance coverage). In some cases, the pattern of delivery of the auxiliary service may differ from the passage of time. This may mean that the pattern in which the insurer earns profit from the insurance contract would also differ from the passage of time. For example, where the contract involves investment management and there are recurring premiums. A reasonable pattern

for the profit would be one that tracks the build-up of the assets over time as new money comes in.

11. As a result, for both a locked in and an unlocked margin, we agree with the Board's previous tentative decision that insurers should allocate the residual margin on the basis of the pattern of transfer of the services in the contract. This approach accommodates contracts that provide different services in different patterns, or that some provide service over the coverage period only and some over the coverage and settlement period. The insurer would be required to determine one, or more than one driver, that best reflects the pattern of transfer of those services and allocate the residual margin over the allocation period.

Question for discussion: allocation period and pattern
Do you think that an insurer should recognise the residual margin on a systematic basis that is consistent with the pattern of transfer of the services represented by the residual margin?

Adjustments to allocation pattern: Contracts no longer in force at end of reporting period

12. The ED proposed that:

    (a) the residual margin recognised in profit or loss should be adjusted to reflect the portion of any contracts that are no longer in force at the end of the reporting period; and

    (b) no adjustment should be made if more contracts than expected are in force at the end of the reporting period.

13. This approach is consistent with the recognition of the residual margin over the period in which the insurer earns profit (for an unlocked margin) or satisfies the residual obligation (for a locked in margin). If the contracts are no longer in force, then the insurer would have no further obligations relating to those contracts and could be said to have earned the whole of the remaining residual margin for those contracts. The residual margin recognised for the contracts that were previously expected to continue in force, but did not continue in force, should therefore be

eliminated. However, when more contracts are in force than expected, the residual margin is allocated over a longer period and therefore no adjustment is needed at the end of the reporting period.

14. We note that in FASB memo 72B for the FASB only meeting on 7 September, the FASB staff considered the situation where the ultimate profitability of a contract could be zero or less while profit (represented by unallocated single margin) remains to be recognised in subsequent periods. We reproduce their analysis in the appendix. The FASB did not discuss this issue at their meeting and noted they would discuss at a future meeting the accounting for the single margin when a contract is deemed onerous. In FASB memo 72B, the staff proposed that once an insurer knows that a contract has become onerous (ie loss-making), the remaining single margin should be written off with an expense taken for the remaining portion above what is left of the single margin. This situation might occur when there is a significant increase in expected cash outflows.

15. In the staff's view, an equivalent requirement is not needed for the residual margin because:

    (a) For a locked in residual margin, the insurer remains obliged to fulfil the contract even if it is onerous. The residual margin represents its obligation to fulfil the contract, and that obligation remains even if the contract is onerous.

    (b) For an unlocked residual margin, any changes in estimate that affect the future profitability of the contract would adjust the residual margin automatically (subject to the condition that the residual margin cannot be negative).

Question for discussion: adjustments to the allocation pattern
Do you think that an insurer should adjust the residual margin recognised in profit or loss to reflect the portion of any contracts that are no longer in force at the end of the reporting period?

Appendix: Extract from FASB memo 72B[2]

Mechanics under a significant increase in risk making the contract onerous

92. While the single margin approach will ultimately result in the recognition of the correct amount of profit over time, there is a concern that a contract could become onerous resulting in zero profit while the methodology would show profit recognition in quarterly periods. For instance, under scenario 3 [in which there is an increase in expected cash outflows accompanied by no immediate reduction in the variability of cash flows], if the increase in the expected cash flows were to occur at the same points as presented above accept for larger amounts and all other assumptions held equal, scenario 3 would produce results that were not indicative of the economics of the contract.

93. Maintaining the same risk profile would result in the following:

Risk

Time(t)	Initial	Qtr1	Qtr 2	Qtr 3	Qtr 4	Yr 2	Yr 3	Yr 4	Yr 5
Ending Risk (Std deviation)	60	60	50	50	40	30	20	10	0
% Remaining (beginning)	100%	100%	100%	83%	83%	67%	50%	33%	17%
% Remaining (ending)	100%	100%	83%	83%	67%	50%	33%	17%	0%
Change in risk	0%	0%	17%	0%	17%	17%	17%	17%	17%

94. Changing the assumptions for the expected cash flows to result in an onerous contract would yield the following results for claims development:

Time(t)	Initial	Qtr1	Qtr 2	Qtr 3	Qtr 4	Yr 2	Yr 3	Yr 4	Yr 5
% loss ratio	0%	80%	95%	110%	110%	110%	110%	110%	110%
Total claims expected (ending)	960	960	1140	1320	1320	1320	1320	1320	1320
Total claims incurred (ending)	0	240	570	990	1320	1320	1320	1320	1320

95. While the claims development and expected cash flow estimates clearly indicate the contract has become onerous, this particular situation would result in a remaining amount of margin that would otherwise need to be recognized in subsequent periods. Following the example through results in the following partial balance sheet and income statement:

[2] This is an extract from a FASB staff memo. We can supply the full memo to Board members on request.

Partial balance sheet

Time(t)	Initial	Qtr1	Qtr 2	Qtr 3	Qtr 4	Yr 2	Yr 3	Yr 4	Yr 5
Liability for remaining coverage	1,200	900	600	300	-	-	-	-	-
Liability for incurred claims	-	240	570	990	1,320	1,320	1,320	1,320	1,320
Single margin	-	60	62	62	38	28.5	19	9.5	-

Income statement

Time(t)	Initial	Qtr1	Qtr 2	Qtr 3	Qtr 4	Yr 2	Yr 3	Yr 4	Yr 5
Earned Premium	-	300	300	300	300	-	-	-	-
Release of single margin	-	-	13	-	24	9.5	9.5	9.5	9.5
Change in reserve	-	-	(45)	(90)	-	-	-	-	-
Claims Expense	-	(240)	(285)	(330)	(330)	-	-	-	-
Increases in exp. to variability	-	(60)	(15)	-	-	-	-	-	-
Profit	-	-	(32)	(120)	(6)	9.5	9.5	9.5	9.5

96. What can be seen from the results is that the ultimate profitability of the contract is in a negative position, however there is remaining profit left to be recognized in subsequent periods that provides erroneous results.

97. The staff do not believe it would be appropriate in this instance to continue to recognize profit in subsequent periods once the contract has become onerous. Although the ultimate profitability of the contract is captured correctly mathematically, the staff believe it is misleading to continue to recognize profit in the subsequent periods. Therefore, the staff believe that once the insurer knows that the contract has become onerous, the remaining single margin should be written off with an expense taken for the remaining portion above what is left of the single margin.

98 In practical terms, for the example above, this action would result in the following journal entries during the 3rd quarter when the insurer determines that the contract has become onerous:

Dr. Single margin $62

Cr. Liability for incurred claims $62

To write off remaining margin

Dr. Change in reserve $28

Cr. Liability for incurred claims $28

To record an expense for the amount above what remains for a single margin

99. This accounting treatment results in the following partial balance sheet and income statement:

Partial Balance Sheet

Time(t)	Initial	Qtr1	Qtr 2	Qtr 3	Qtr 4	Yr 2	Yr 3	Yr 4	Yr 5
Liability for remaining coverage	1,200	900	600	300	-	-	-	-	-
Liability for incurred claims	-	240	570	990	1,320	1,320	1,320	1,320	1,320
Single margin	-	60	62	-	-	-	-	-	-

Income statement

Initial	Qtr1	Qtr 2	Qtr 3	Qtr 4	Yr 2	Yr 3	Yr 4	Yr 5	
Earned Premium	-	300	300	300	300	-	-	-	-
Release of single margin	-	-	13	-	-	-	-	-	-
Change in reserve	-	-	(45)	(28)	-	-	-	-	-
Claims Expense	-	(240)	(285)	(330)	(330)	-	-	-	-
Increases in exp. to variability	-	(60)	(15)	-	-	-	-	-	-
Profit	-	-	(32)	(58)	(30)	-	-	-	-

100. Although we have only provided an example of an onerous contract using the example for contracts that meet the eligibility criteria for the premium allocation approach, the staff believe that conceptually the accounting treatment for the single margin in an onerous situation would be the same for the building block model as well. In each instance, at the time the insurer estimates that the cash outflows will exceed the cash inflows, the single margin should be written off to reflect that the contract is no longer profitable. In practical terms, the entries would be the same for either approach.

Staff Recommendation

101. The staff believe that the write off and subsequent recognition of expense are a more faithful representation of the economics when the contract becomes onerous. Moreover, we believe this eliminates the issue that many respondents noted during the comment letter process as a deficiency with the single margin approach. Namely, that the methodology prescribed in the DP could result in recognizing profit in subsequent periods despite the fact the contract has clearly become onerous and will result in a negative profit position by the end of the life cycle.

102. Therefore, the staff are recommending that an insurer write off the remaining profit of a contract once it has determined that contract to be onerous and record an expense for the remaining portion of the change in reserve in excess of that margin.