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What is the purpose of this paper?

1. This paper discusses the accounting for *amendments and modifications* and *commutations*[1] of insurance contracts[2]. Specifically, this paper addresses the following issues:
   (a) Which, if any, modifications of the terms of insurance contracts should be accounted for as a substantial modification for which insurers derecognise the old contract and recognize the new contract under the applicable guidance for the new contract? **(Issue 1).**
   (b) What measurement basis (e.g., entity specific current fulfilment value or fair value) should be applied to an amended insurance contract for purposes of determining gains and losses upon an extinguishment of insurance contract liabilities and initially measuring the amended contract? **(Issue 2)**.

[1] A commutation is a modification to a reinsurance contract that, in essence, is an agreement between the cedant and reinsurer that provides for the valuation, payment, and complete discharge of all obligations between the parties under a particular reinsurance contract.

[2] The issues and staff recommendations discussed in this paper apply to insurance and reinsurance contracts. The term insurance includes reinsurance.

The IASB is the independent standard-setting body of the IFRS Foundation, a not-for-profit corporation promoting the adoption of IFRSs. For more information visit www.ifrs.org

The Financial Accounting Standards Board (FASB), is the national standard-setter of the United States, responsible for establishing standards of financial accounting that govern the preparation of financial reports by nongovernmental entities. For more information visit www.fasb.org

(c) How should an insurer account for non-substantial modifications? **(Issue 3).**

(d) How should an insurer present gains and losses arising from commutation of reinsurance contracts on the statement of comprehensive income (i.e., on a gross vs. a net basis)? **(Issue 4).**

2. This paper does not address whether the policy loans, riders and other features of insurance contracts shall be unbundled. The staff recommendations in this paper are intended to apply individually to any unbundled components (i.e., as if they were separate contracts).

Summary of Staff Recommendations

3. The staff recommends that:

(a) *Issue 1*: Insurers shall consider whether a contract modification would have resulted in a different assessment of any of the following items if the amended terms had been in place at the inception of the contract:

(i) Whether the insurance contract is within the scope of the insurance contract standard;

(ii) Whether an insurance contract should be accounted for under the premium allocation approach or the building block approach; or

(iii) Which portfolio the insurance contract would be included in.

Any modification that would have changed one or more of these conclusions would be deemed a substantial modification for which insurers shall extinguish the old contract and recognize the new contract under the applicable guidance for the new contract.

(b) *Issue 2*: When an insurer makes a substantial modification to an insurance contract, the gain or loss on extinguishment of the original contract should be determined by measuring the existing insurance contract using the current entity-specific price that the insurer would

hypothetically charge the policyholder for a contract equivalent to the newly recognized insurance contract.

(c) *Issue 3*: Insurers should account for non-substantial modifications as follows:

(i) If the modification eliminates the insurer's obligation to provide some of the benefits that the contract would previously have required it to provide, the insurer shall derecognise that portion of its obligation (including any related portion of the residual/single margin).

(ii) If the modification entitles the policyholder to further benefits, the insurer shall treat the modification as if the amendment was a new standalone contract (i.e., the margin is determined in the same way as for a new standalone contract with no effect on the measurement of the original contract)

(d) *Issue 4*: Reinsurers and cedants shall present any gains or losses on commutations as an adjustment to claims or benefits but should not gross up the premiums, claims, or benefits in recognising the transaction on the statement of comprehensive income.

Background

Proposals in the exposure draft and discussion paper

4. The following proposals in the IASB exposure draft *Insurance Contracts* (the 'ED') and the FASB discussion paper *Preliminary Views on Insurance Contracts* (the 'DP') are pertinent to the discussions on the issues presented in this paper.

Derecognition

5. Paragraph 67 of the ED, which is virtually equivalent to paragraph 93 of the DP, states that:

> 'An insurer shall remove an insurance contract liability (or a part of an insurance contract liability) from its statement of financial position when, and only when, it is extinguished—i.e., when the obligation specified in the insurance contract is discharged or cancelled or expires. At that point, the insurer is no longer at risk and is therefore no longer required to transfer any economic resources to satisfy the insurance obligation'.

6. Paragraph B33 of the ED also states that "a contract that qualifies as an insurance contract remains an insurance contract until all rights and obligations are extinguished (i.e. discharged, or cancelled or expires)."
7. Paragraph BC227 indicates that the proposal in the ED/DP is that insurance liabilities should be derecognised on the same basis as financial liabilities, is consistent with the requirements in IFRS 4, and provides symmetrical treatment for the recognition and derecognition of insurance contracts.
8. Although the FASB DP did not explicitly solicit feedback on derecognition, most respondents to the ED/DP did not express views on the criterion and the respondents did not explicitly disagree with it. The IASB ED did ask respondents for views on the contract boundary proposal, but most respondents chose to focus their comments on initial recognition, rather than on derecognition. Some respondents indicated agreement with the criteria for derecognition.

Amendments and Modifications

9. The ED/DP did not specifically address the topic of amendments or modifications of insurance contracts. Nevertheless, some respondents to the DP shared their opinions regarding amendments or modifications. Three respondents expressed the view that further guidance would be needed regarding when a change to a contract should be treated as a modification with changes captured in the current accounting period and when changes should be recognized as an extinguishment of one contract (with derecognition) and the issuance of a new contract, as this could impact earnings recognition patterns through the elimination of the single margin (or residual margin if it were locked) upon termination of a contract. Two comment letters to the ED said that guidance on amendments and modifications

would be necessary if the margin was locked in. Notwithstanding the limited number of comment letter responses on the matter, the staff believe that it is important to address the accounting for modifications for two reasons:

(a) Firstly, the staff believe that lack of guidance on this issue will create diversity in practice. (e.g., some insurers might analogize to financial liabilities and derecognize substantially modified insurance contracts pursuant to the related application guidance while other insurers might instead account for the change as if it were any other change in assumptions).

(b) Secondly, some substantially modified insurance contracts that no longer have significant underwriting or timing risks will continue to be accounted for under the insurance contract standard whereas a comparable newly issued contract would be out of the scope of the insurance contracts standard.

Current Guidance under U.S. GAAP and IFRS

10. Readers should refer to Appendix A which provides a summary of relevant existing U.S. GAAP and IFRS guidance that are pertinent to the analysis of the issues presented in this section:

(a) Subtopic 470-20, Extinguishment of Liabilities,

(b) IAS 39 *Financial Instruments: Recognition and Measurement,*

(c) IFRS 9 *Financial Instruments,*

(d) Subtopic 470-40, *Modifications and Exchanges of Debt*

(e) Subtopic 944-30-35 or SOP 05-1, *Amendments and Modifications,* and

(f) Subtopic 944-20-15, *Reinsurance*.

11. As discussed further in Appendix A, existing US GAAP guidance in ASC 944-30-35 includes concepts of separate accounting for "integrated" and "non-integrated" features of insurance contracts. The staff chose not to introduce that terminology into our recommendations in order to avoid complexity and in a desire to maintain

as much consistency as possible in the evaluation of amendments and modifications with the various unbundling decisions that an insurer would be required to make pursuant to tentative decisions reached by the boards (e.g., unbundling of goods and services) or pursuant to topics the staff are considering (e.g., unbundling of some investment components). Appendix B includes a flowchart summarizing the ASC 944-30-35 accounting model and Appendices A and C include additional information on ASC 944-30-35 that is pertinent in the discussions in this paper.

Staff Analysis of Issue 1: Which modifications should be accounted for as extinguishments?

12. Issue 1 asks the boards to decide on the significance threshold (e.g., substantial modification) that should be met to trigger extinguishment accounting for amendments of insurance contracts. The issue is important because, based on the boards' tentative decisions, some assessments that are made only at contract inception would also be made upon recognition of the "new" (amended) contract recognized upon extinguishment of the original contract. These determinations include:

    (a) whether an insurance contract is within the scope of the insurance contract standard;

    (b) whether an insurance contract should be accounted for under the premium allocation approach or the building block approach;

    (c) the portfolio for which the insurance contract would be included in; and

    (d) the establishment of a single margin to avoid a day 1 gain[3] and the run-off of the margin.

[3] As it relates to an amendment or modification after the initial recognition of the contract, this issue relates to whether an insurer should increase the single margin in an amount equal to the excess, if any, of the incremental present value of expected cash inflows over the incremental present value of the expected cash outflows that result from the amendment (i.e., defer any "day 1" gain from the amendment). Because the residual margin is "unlocked", this particular issue regarding margins is not applicable for the IASB.

13. Reassessment of the determinations noted in the previous paragraph would better ensure that modified or amended insurance contracts are accounted for pursuant to the accounting model considered to best reflect the economics of the contract and help prevent the opportunity for circumventing (by way of contract modification subsequent to the assessment date) the rules that exist related to scope and the measurement model. Absent reassessment, a contract that is significantly different than what was originally issued might be subject to an accounting model that would not be applied had the contract been issued originally in its modified form. Therefore, the staff believes that there will be circumstances where it is appropriate to re-assess these sort of judgments. For example consider a one year term life insurance contract that an insurer concludes qualifies for accounting under the premium allocation approach and that is subsequently amended into a twenty year level term life insurance contract. Such a contract had it been issued in its amended form originally might not qualify for accounting under the premium allocation approach (i.e., the insurer may conclude that significant judgment is required to allocate the premium to the insurer's obligation to each reporting period and that the premium allocation approach is not a good proxy for the building block approach under these circumstances). In addition, the portfolio for which the contract would be included would differ between a one-year term life insurance contract and a twenty-year level term life insurance contract.
14. The staff notes that the modification of lease agreements under ASC subtopic 840-10-35 and paragraph 13 of IAS 17, *Leases*, provides a precedent for reassessment of accounting models upon modification. Specifically, in circumstances when changes would have resulted in a different classification of the lease under the lease classification criteria had the changed terms been in effect at lease inception, this guidance requires extinguishment of the original lease and recognition of a new agreement pursuant to the applicable classification (e.g., capital or operating lease). Similarly, as part of the current leases project, the boards tentatively decided that "a modification to the contractual terms of a (lease) contract that is a substantive change to the existing contract should result in the modified contract being accounted for as a new contract. The change is a substantive change if it results in a different determination of whether the contract

is, or contains, a lease or, if applicable, whether the contract transfers substantially all of the risks and rewards incidental to ownership of the underlying asset."

15. As noted above, the ED's basis for conclusions paragraph BC 227 indicates that: insurance liabilities should be derecognized on the *same basis as financial liabilities* and it provides symmetrical treatment for the recognition and derecognition of insurance contracts. Under both US GAAP and IFRS, a substantial modification of the terms of an existing financial liability is accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. Accordingly, a question arises as to whether this financial liability guidance for modifications should also be applied to amendments of insurance contracts.

16. The staff considered two alternatives as follows:

    (a) Alternative 1: Insurers should apply existing guidance for substantial modifications of financial liabilities to determine whether amendments and modifications of insurance contracts should be accounted for as extinguishments; or

    (b) Alternative 2: Insurers should consider any change to an existing insurance contract to be a substantial modification and thus accounted for as an extinguishment if the existence of the modified terms at the inception of the contract would have resulted in a different determination as to:

        (i) whether the insurance contract is within the scope of the insurance contract standard;

        (ii) whether an insurance contract should be accounted for under the premium allocation approach or the building block approach; or

        (iii) which portfolio the insurance contract would be included in.

17. Alternative 1 would use a consistent principle and guidance to assess whether insurance contract modifications and debt modifications should be accounted for as extinguishments. Under application guidance in paragraph B3.3.6 of IFRS 9 and ASC 470-50-40-10 through 40-12, debt instruments are deemed to be

substantially different if the change in the present value of cash flows between the original financial liability and the modified financial liability is "at least 10 percent". The bright line test decreases the subjectivity in assessing which modifications in the terms of an insurance contract would trigger derecognition. However, similar to other bright line tests, it can be easily manipulated to attain a desired accounting outcome by making subsequent amendments (or a series of them) to a contract that fall just short of the bright line. Unlike the accounting for most debt instruments, which are generally carried at amortized cost, the accounting under the insurance contract standard is based on a current measurement where assumptions are constantly updated. Accordingly, the effect (i.e., extinguishment gain or loss) of any such "manipulation" would be mitigated because the consideration received and the carrying value will both be based on current measurement bases. The measurement of the gain or loss is further described in Issue 2 of this paper.

18. The assessment required under Alternative 1 should be based on assumptions consistent with the expected cash flows notion under the building block approach (BBA) and, in some circumstances, may not entail additional cash flow analysis beyond what would be done at each reporting period (although most amendments will likely occur at dates that do not coincide with the statement of financial position date). However, it may be costly and burdensome in practice to apply the financial liability extinguishment notion to insurance contracts because unlike the cash flows of a typical debt instrument, which are often fixed based on the terms of the instrument, the determination of the cash flows of an insurance contract requires consideration of whether insured event occurs, when it occurs, and/or how much the insurer will need to pay if it occurs (i.e., assessment of multiple probability-weighted scenarios). Furthermore, in practice, insurers measure their insurance contract liabilities at a portfolio level requiring an allocation of the cash flows to the amended contract. Accordingly, there will be a much lower degree of precision in measurement of the estimated cash flows surrounding an insurance contract amendment than exists in measurement of the estimated cash flows surrounding a debt instrument amendment. The staff notes that the volume of insurance contract amendments that exist in practice is significant and it is not

uncommon for a contract to be amended several times (e.g., many contracts will clarify terms and intent, etc.). As noted above, existing US GAAP requires a reassessment of risk transfer for any reinsurance contract amendments except for the "most trivial" changes and notes an insurer should not distinguish between changes to financial and nonfinancial terms. The confluence of the volume of amendments and the existing criteria has led some preparers to criticize the existing thresholds as being too low. Alternative 1 should alleviate much of this criticism.

19. The complexity of many insurance contracts, subjectivity of assumptions used in insurance cash flow modelling, and the potential for opportunistic application of the 10 per cent test were partly the reasons why the AICPA Accounting Standards Executive Committee (AcSEC) in the basis for conclusions on SOP 05-1 preferred a qualitative approach (see Alternative 2) to this quantitative approach.

20. The application of Alternative 1 might be even more burdensome for insurance contracts that are measured under the premium allocation approach (PAA) because insurers would need to analyse future cash flows associated with claims not yet incurred (i.e., for the portion of the insurance contract liability represented by the liability for remaining coverage). However, the estimated loss ratios that are used for pricing the contract could also be used, in many circumstances, as a proxy for determining the amendment date estimate of cash flows of the original contract.

Example 1

Assume the original premiums and losses on one year insurance contract accounted for under the premium allocation approach were $1,200 (all paid on day 1) and $960 (i.e., an 80% loss ratio), respectively. The contract was amended on June 30, 20X2 leading to a 20 percent increase in premiums to $1,440 (i.e., $240 of additional premium) and a 20% increase in losses to $1,152 (assume no losses have been paid and the liability for incurred claims has been recorded based on an 80% loss ratio). In applying Alternative 1, the insurer should be able to apply the 80% loss ratio used in pricing the original contract to the $600 liability for remaining coverage as a proxy for the estimated cash flows associated with the liability for remaining coverage. Thus the estimated cash

flows on the original contract would be $960, which would be compared to the net $912 (i.e., $1,152 less $240) of estimated cash flows on the amended contract.

21. Under Alternative 2, insurers should consider whether any of the assessments that were made at contract inception (i.e., those described in paragraphs (i) through (iii)) would have resulted in a different conclusion had the amended terms been in place at the inception of the contract. Any modification that would have changed one or more of these conclusions would be deemed a substantial modification, for which insurers shall extinguish the old contract and recognize the new contract under the applicable guidance.

22. Some of the factors insurers should consider in their determination as to whether any of the assessments that were made at contract inception would have changed if the amended terms were in effect at that time include any changes to:

    (a) The insured event, risk, or period of coverage of the contract.

    (b) The nature of the investment return rights (for example, whether amounts are determined by formulae specified by the contract, pass through of actual performance of referenced investments, or at the discretion of the insurer) between the insurer and the contract holder.

    (c) Deposits, premiums, or charges relating to the original benefit or coverage, in excess of amounts specified or allowed in the original contract.

    (d) The investment component of a contract, other than distributions to the contract holder or beneficiary or charges related to newly purchased or elected benefits or coverages.

    (e) The participation or dividend features of the contract, if any.

23. Alternative 2 would not require an explicit analysis of the present values of future cash flows for the entire contract, although it might require an estimate of the cash flows associated with the amendment for purposes of adjusting the single or residual margin created by the amendment.

24. Directionally, Alternative 2 would generally be consistent with existing US GAAP on the reassessment of risk transfer for reinsurance contracts which is done

for any amendments except for the 'most trivial' changes without distinguishing between changes to financial and nonfinancial terms.

Staff recommendation

25. The staff recommends Alternative 2, that insurers shall consider whether any of the assessments that were made at contract inception (i.e., those described in paragraphs (b)(i) through (b)(iii)) would have resulted in a different conclusion had the amended terms been in place at the inception of the contract. Any modification that would have changed one or more of these conclusions would be deemed a substantial modification for which insurers shall extinguish the old contract and recognize the new contract under the applicable guidance.
26. The staff believes that this recommendation should provide insurers with the opportunity to assess the economic substance of modifications to insurance contracts and report the relevant information to financial statement users.
27. The staff thinks that the recommendation will help ensure that modified or amended insurance contracts are accounted for pursuant to the accounting model considered to best reflect the economics of the contract and help prevent the opportunity for circumventing (by way of contract modification subsequent to the assessment date) the rules that exist related to scope and the measurement model. Those considerations do not apply where a modification would not affect the assessment of scope and accounting model (i.e., BBA or PAA).

Question 1 – Which modifications should be accounted for as extinguishments

a) Do the boards agree with the staff recommendation that:

1) Insurers shall consider whether any of the following assessments that were made at contract inception would have resulted in a different conclusion had the amended terms been in place at the inception of the contract:

i) Whether the insurance contract is within the scope of the insurance contract standard;

(ii) Whether an insurance contract should be accounted for under the premium allocation approach or the building block approach; or

(iii) Which portfolio the insurance contract would be included in.

2) Any modification that would have changed one or more of these conclusions would be deemed a substantial modification for which the insurer shall extinguish the old contract and recognize the new contract under the applicable guidance for the new contract.

Staff Analysis of Issue 2: Measurement of gain or loss recognized upon substantial modifications

28. Issue 2 requests the boards to decide on how, the case of a substantial modification, an insurer should measure an amended contract (assuming it qualifies for accounting under the insurance contract standard) on initial recognition. The new contract's initial measurement will also affect the determination of any gains and losses upon extinguishment (i.e., substantial modification) of the original insurance contract liabilities. The amount of any such gains or losses will based on the difference between the measurement of the original contract immediately before the modification, and the initial measurement

of the new contract (and any other consideration paid by an insurer as a result of the modification).

29. Existing U.S. GAAP and IFRS for the extinguishment of financial liabilities generally estimates the gain or loss on the extinguishment of debt or other financial liabilities as the difference between: (a) *consideration paid, including any non-cash assets transferred or liabilities assumed*, and (b) the carrying amount of the extinguished financial liability.

30. When consideration paid to a creditor to extinguish a liability includes non-cash assets transferred or liabilities assumed we believe practice generally considers the *fair value* of these assets transferred and liabilities assumed is treated as an amount paid to extinguish the debt and, therefore, the fair value is included in determining the debt extinguishment gain or loss to be recognized. For many transferred assets or assumed liabilities, for example a warrant, an option, or preferred stock (each of which the initial measurement basis is fair value), treating the fair value of the assets or liabilities as the consideration paid feels appropriate and doesn't present any particular issues.

31. However, the staff examined whether determining gains or losses at fair value is appropriate when an insurer's consideration paid to extinguish existing insurance contract liabilities takes the form of assuming "new" insurance contract liabilities, given that the fair value of insurance contracts may not be readily determinable. In addition, because the insurance contract measurement basis is not equivalent to fair value, the costs of providing such fair value information may exceed the benefits to financial statement users.

32. Therefore, the staff would like to ask the boards to clarify whether the "*consideration paid, including any non-cash assets transferred or liabilities assumed*" for any insurance contract liabilities assumed in a substantial modification should be:
    (a) the hypothetical entity specific current value [Alternative 1],
    (b) fair value [Alternative 2], or ,
    (c) the carrying amount of the contract before modification, adjusted for the effect of the modification on the discounted cash flows (and, for the IASB, the risk adjustment) [Alternative 3].

Alternative 1 :Entity specific price

33. Alternative 1 is to measure the extinguishment gain or loss as the difference between the current **entity-specific price** that the insurer would hypothetically charge the policyholder for a contract equivalent to the substantially amended or modified contract and the carrying value of the insurance contract liability. Stated differently, this alternative would measure the new or amended or modified insurance contract liability at the current entity specific price that is obtained through hypothetical re-pricing of the remaining insurance risks including those arising from the amendments and modifications. The example included within Appendix D illustrates the accounting under this alternative.
34. An argument for Alternative 1 is that the boards have determined that an insurance contract measurement based on the insurer specific assumptions and a margin based on the price the insurer charges is the most relevant measurement basis for insurance contracts. Thus if the amended or modified contract remains in the scope of insurance, it is logical to use the current entity specific price of a contract equivalent to the amended contract to initially record the "new" (amended) contract and, thus, to determine the gain or loss upon modification. This would allow for better comparability of the amended contract with other insurance contract liabilities. Additionally, because the current fulfilment value uses entity-specific rather than market participant assumptions, it would minimise the 'noise' that arises from using unobservable market inputs under level 3 fair value measurement.
35. The insurance contract standard measurement basis is broadly consistent with fair value. Both application of the building blocks and fair value measurement bases measure contracts by discounting the expected cash flows at a current market-consistent discount rate that adjusts the cash flows for the time value of money and reflects the risks characteristics associated with those cash flows reflecting an (explicit or implicit) adjustment to represent the compensation required/sought to bear the uncertainty/risk inherent in the cash flows etc. However, there are some notable differences between the BBA measurement and fair value including the following:

(a) the BBA uses entity specific assumptions for some inputs, including the degree of risk aversion, whereas fair value uses market participant assumptions in all cases;

(b) the BBA excludes the insurer's own non-performance risk, whereas fair value would include own non-performance risk;

(c) the BBA includes a residual margin (IASB) or single margin (FASB), whereas fair value includes no such margin (although fair value does implicitly include a risk adjustment and a current value for any additional profit or other margin, if any, that market participants would require); and

(d) the insurance contracts measurement approach, as tentatively decided by the FASB, excludes an explicit risk adjustment (which, as noted, is implicitly included in fair value).

36. Opponents of Alternative 1 argue that estimating the entity specific price of the modified insurance contract relies on a "hypothetical repricing" that involves too much subjectivity. On the other hand, fair value seeks an objective market participant view on the modifications and amendments.

Alternative 2: fair value

37. Alternative 2 would measure the extinguishment gain or loss as the difference between the fair value of the amended or modified contract and the carrying value of the insurance liability immediately before the amendment or modification. Stated differently, this alternative would measure the new or amended or modified insurance contract liability at fair value, which would most likely be level 3 fair value.

38. Arguments in favour of Alternative 2 are as follows:

(a) fair value, because it is based on market participants' rather than entity-specific assumptions and estimates of future cash flows, may be less subjective than the entity specific price that the insurer would charge for the amended contract under Alternative 1. Therefore, the use of fair value should ensure greater comparability among insurers on how to measure extinguishment gains and losses; and

(b) Fair value of consideration received is used to measure gains and losses for extinguishment of financial liabilities and most other extinguishments (e.g., sales of assets, etc). This would allow for broader comparability of the gain or loss amount.

39. Alternative 2 would require measurement of the modified contract at both fair value (to determine the extinguishment gain or loss), and based on the insurance contract standard measurement basis (i.e., to compare to the fair value for purposes of determining a single or residual margin). Because there is not an active observable market to transfer most insurance contracts, the fair value estimate will likely be a level 3 estimate. Accordingly, opponents of Alternative 2 argue that the costs of determining both fair value (i.e., with market participant expectations of cash flows, etc.) and insurance contract standard measurement will exceed any benefits, especially given the subjective measurement of the gain or loss. Alternative 2 opponents further argue that the use of fair value will impair the comparability between the liability for the amended insurance contract and other insurance contract liabilities.

Alternative 3: use margin implicit in carrying amount of derecognised liability

40. Alternative 3 is similar to Alterative 1, but rather than requiring the insurer to estimate a hypothetical price for a contract equivalent to the substantially modified contract, it modifies the measurement of the existing contract with revised estimates to reflect the cash flows (and risk adjustment, if applicable) resulting from the amendment. In doing so, it carries forward the remaining residual/single margin that was included in the measurement of the original contract. Two notable effects of this alternative are:

(a) it does not result in any gain or loss upon the derecognition (unless the amended contract is onerous); and

(b) the initial margin on the amended contract is equal to the sum of the estimated margin on the amendment and the remaining margin on the

insurance contract liability that existed immediately before the amendment.

41. Many of the arguments in favour of Alternative 1 are equally applicable for Alternative 3. Specifically,

    (a) Because the measurement of the amended contract is based on the insurer specific assumptions and, in this case, a margin based on the actual prices the insurer charged for each of the two components (i.e., the original contract and the amendment), it is consistent with the measurement of other insurance contracts (and thus facilitates comparability with other insurance contract liabilities);

    (b) As compared to Alternative 2, which requires estimates of unobservable market participant assumptions, there is less subjectivity required for measurement.

42. Proponents of Alternative 3 also argue that:

    (a) Alternative 3 is also less subjective than Alternative 1 because it doesn't require determination of a hypothetical price the insurer would have charged for the remaining risks under the original contract.

    (b) in circumstances where the original contracts rights and obligations remain, recognition of extinguishment gains and losses (i.e., as might exist under the other two alternatives) is not reflective of the continuing obligations of the insurer.

    (c) the measurement of the contract would be consistent whether issued as a single modified contract or affected through issuance of a standalone contract and continuation of the original contract.

43. Opponents argue that, under some circumstances where the substantial modification eliminates some of the original obligations the insurer has settled at least some of its original obligations for an economic gain or a loss and this Alternative would inappropriately result in a deferral of this gain or loss on the derecognized liability.

Staff recommendation

44. The staff can see merits in both alternative 1 and alternative 3. The staff believes that both alternatives 1 and 3 are superior to alternative 2 because the lack of observable market for insurance contracts after issuance would render any level 3 fair value measurement of the contracts less reliable, and not cost-beneficial to financial statement users.
45. In determining the staff recommendation, the staff assigned different weights to the reasons for and against provided in paragraph 42 and 43. On balance, the staff recommends alternative 1 for the reason in paragraph 43
46. Appendix D of this paper includes an example of how gains and losses might be determined based on the recommendations within this paper.

Question 2 – Measuring gain or loss on substantial modifications of insurance contracts
Do the boards agree that when an insurer makes a substantial modification to an insurance contract, the gain or loss on extinguishment of the existing insurance contracts should be determined by measuring that contract using the current entity specific price that the insurer would hypothetically charge the policyholder for a contract equivalent to the newly recognized insurance contract?

Issue 3: Accounting for non-substantial modifications of insurance contracts

47. As noted above, the ED/DP's proposals regarding derecognition include the concept of partial derecognition (i.e., an insurer shall remove a part of an insurance contract liability from its statement of financial position when, and only when, it is extinguished). Because this proposal is consistent with existing IFRS for derecognition of financial liabilities, for which the staff are not aware of any issues in practice, and comment letter respondents did not raise any objections or concerns specifically related to partial derecognition, the staff do not plan to further address partial derecognition of insurance contract liabilities, but asks the

boards to confirm the proposals in the ED (ie that if the modification eliminates the insurer's obligation to provide some of the benefits that the contract would previously have required it to provide, the insurer shall derecognise that portion of its obligation (including any related portion of the residual/single margin).

48. The remainder of this section discusses any additional rights or obligations incorporated into an insurance contract as a result of non-substantial modifications. The staff view there to be two broad alternatives for accounting for such additions:

    (a) Alternative 1 – To account for the modification as a continuation of the old contract (i.e., as any other change in estimates of cash flows); or

    (b) Alternative 2 – To account for the modification as if it were a new contract for purposes of the margin (i.e., with no effect on the measurement of the original contract).

49. Alternative 1 benefits from simplicity, in that it considers the amendment only in the context of its effect on cash flows (and risk adjustment for the IASB). Alternative 1 would not involve any *direct* adjustment to the margin that result from the amendment itself. However, it will result in differences in the amount of net income depending on which model (i.e., PAA vs. BBA with a locked in margin vs. BAA with an unlocked margin) is used to account for the insurance contract. These differences would create further stress on the model determination and impair comparability of insurance contracts.

50. For example, under the PAA the additional cash flows (and risk adjustment) would generally result in adjustments to the liability for remaining coverage, which would be amortized over the coverage period, or to the liability for incurred claims as claims are incurred during the coverage period (i.e., for prospective amendments there would be no "day one" gain or loss recognized on the amendment date assuming no recognition of an onerous contract). Under the BBA with a locked in margin, the full profit or loss arising from the amendment would be recognized at the date of the amendment (i.e., an amendment day one gain or loss). Under the BBA with an unlocked margin, the margin would be adjusted to offset changes in cash flows, but the changes in risk adjustment will be recognized

in profit or loss at the date of the amendment. Additionally, the outcomes under the BBA would also differ from the accounting of an economically equivalent new contract issued (i.e., day one gains deferred but day one losses recognized in profit and loss).

51. On the other hand, Alternative 2 would treat non-substantial modifications that add rights or obligations to an insurance contract in the same manner as an economically equivalent new contract. Accordingly, for profitable amendments, an additional amount of single margin would be established, determined by the cash flows (and risk adjustment, if applicable) related to the added rights and obligations. For unprofitable amendments, a loss would be recognized based on those cash flows (because the margin cannot be negative).

52. Benefits of Alternative 2, in addition to the consistency in measurement with economically comparable standalone contracts, include:

    (a) Its symmetry with the treatment of contract modifications that eliminate rights and obligations (i.e., the creation of a margin as if the amendment represented a new standalone contract is the inverse of the unwinding of the margin in a partial amendment as if an equivalent standalone contract was extinguished).

    (b) Consistency in the recognition of expected gains amongst the BBA and PAA and amongst models with locked and unlocked margins.

Staff recommendation

53. The staff recommends Alternative 2, that insurers should account for non-substantial modifications that result in rights or obligations being added to an insurance contract as if the amendment was a new standalone contract for purposes of determination of the margin (i.e., with no effect on the measurement of the original contract).

Question 3 – Accounting for non-substantial modifications of insurance contracts
Do the boards agree with that insurers should account for non-substantial modifications as follows:

(i) If the modification eliminates the insurer's obligation to provide some of the benefits that the contract would previously have required it to provide, the insurer shall derecognise that portion of its obligation (including any related portion of the residual/single margin).

(ii) If the modification entitles the policyholder to further benefits, the insurer shall treat the modification as a new standalone contract (i.e., the margin is determined in the same way as for a new standalone contract with no effect on the measurement of the original contract)?

Issue 4: Presentation of commutations of reinsurance contracts

54. A reinsurance[4] commutation is, in essence, an agreement between the cedant and reinsurer that provides for the valuation, payment, and complete discharge of all obligations between the parties under a particular reinsurance contract. Commutations might either be pursuant to a specific existing contractual provision in a reinsurance contract or separately negotiated at the date of commutation. There are several reasons for commutation including the following:

(a) A strategic goal of the reinsurer to exit a particular line of business;

(b) Insolvency or credit concerns surrounding the reinsurer; and

(c) Uneconomic administrative costs associated with keeping the contract in-force (e.g., at a point when the remaining insurance risk is minimal).

55. The effect of commutation is that:

(a) The cedant continues to be responsible for the policyholder obligations but no longer has a reinsurance recoverable asset and will need to measure, recognise, and present gain/loss on the financial statements.

(b) The reinsurer pays cash to be relieved of its obligation to the cedant for past, current, and future unpaid claims. In addition to removing its

[4] Because commutations are most frequently encountered related to (property and casualty) reinsurance transactions, this paper discusses them in that context. However, albeit less frequently, commutations or 'policy buy-backs' also exist for direct insurance business and the staff analysis and recommendations included herein are equally applicable for direct insurance commutations.

liability for incurred losses from the statement of financial position, the reinsurer also needs to measure, recognise, and present gain/loss on the commutation transaction.

56. The issue this paper addresses for commutations is how the reinsurer and cedant should present any gains or losses arising from these transactions on the statement of comprehensive income. There is diversity in practice that exists today regarding presentation of gains and losses from commutations. Essentially some entities present the transaction net and some entities present the transaction gross on the statement of comprehensive income. As discussed in the following paragraphs, the two practices result in different amounts of premiums and claims recorded in the statement of comprehensive income. Accordingly, the loss ratios (i.e., a key performance indicator for non-life insurance) of an insurer will be affected by their use of gross vs. net presentation of commutations.

Net presentation

57. Under a *net* presentation of a commutation of a reinsurance contract, the reinsurer and cedant will present in the statement of comprehensive income the net gain or loss from the transaction within the claims or benefits line (i.e., in whichever line the reinsurer records changes in the liability for incurred claims and the cedant records changes in the reinsurance recoverable). This gain or loss represents the difference between the cash settlement and the now extinguished liability for incurred claims (for the reinsurer) and the now extinguished reinsurance recoverable (for the cedant).

58. The net presentation reflects the transaction in the same manner as the settlement of claims, which is how proponents of the net presentation view the transaction. The staff considers the result to be consistent with those of any other settlement of a liability: the original reinsurance agreement is replaced with a new agreement which defines the reinsurer's liability (i.e., in terms of the amount of consideration it transfers to the cedant) and which is enforceable by both parties. The agreement by the two parties to commute does not change the fact that the reinsurer previously satisfied some of its obligations to provide reinsurance coverage under the reinsurance contract.

Gross presentation

59. Under a *gross* presentation of a commutation of a reinsurance contract, the cedant will record the total cash it receives as part of the settlement as a reduction of ceded premiums (i.e., as if it is being refunded ceded premium it originally paid to the reinsurer) and take down the reinsurance recoverable asset it is no longer entitled to with an offsetting entry to the claims or benefits line in the statement of comprehensive income (i.e., the line it would have originally recorded the reinsurance recoveries to). The difference between the premiums and claims recorded in this transaction represent the gain or loss to the cedant. The reinsurer would record the transaction, essentially, in the inverse (i.e., it would recognise the cash paid as a reduction in previously recorded assumed premium and take down its liability for incurred claims through a credit to the claims line in the statement of comprehensive income).

60. A gross presentation is analogous to how a manufacturer might present a customer's return of its product as a reduction in sales. Proponents of gross presentation view commutations as an 'unwinding' of the original reinsurance contract. Because the cedant had originally recognised ceded premium contra revenue or expense for the reinsurance contract and the reinsurer had originally recognised assumed premium earned for the reinsurance contract, they argue that the cash commutation consideration paid to the cedant is an adjustment of the original premiums paid by the cedant.

61. Opponents of gross presentation consider it to lead to a counterintuitive result in its depiction of the termination of the contract as generating revenue for the cedant (and reducing revenue for the reinsurer) given the reinsurer has fulfilled its obligation to stand ready that is associated with the premiums it had previously earned. To the extent that the reinsurance contract's ceded premium was expensed in a previous year (and earned in a different year by the reinsurer), the gross presentation's reflection of the 'refunded' premium as current year premium earned (negative premium earned for the reinsurer) is also considered by gross presentation opponents as leading to a statement of comprehensive income that is not representative of the current year's performance.

Staff recommendation

62. The staff notes that requiring either of the presentation options would enhance the comparability of insurers' financial statements. Maintaining diversity complicates understanding of insurers' performance because of the effect the two different presentations have on loss ratios, a key performance indicator for non-life insurers. The staff recommends that cedants and reinsurers present commutations on a net basis (as described above) because it provides a more faithful representation of the economic substance of commutations (i.e., a negotiated settlement of the cedant's reinsurance recoverable / reinsurer's liability for incurred claims).

Question 4 – Commutations, Assumptions and Novations
Do the boards agree that reinsurers and cedants shall present any gains or losses on commutations as an adjustment to claims or benefits but should not gross up the premiums, claims, or benefits in recognizing the transaction on the statement of comprehensive income?

Appendix A: Summary of Existing U.S. GAAP and IFRS

Derecognition and derecognition threshold

A1. ASC Subtopic 470-20, *Extinguishment of Liabilities,* and IFRS 9, *Financial Instruments,* provide similar guidance for derecognition of financial liabilities. IFRS 9 (par. 3.3.1) require an entity to remove a financial liability (or part of a financial liability under IFRS) from its statement of financial position, when, and only when, it is extinguished – that is, when the obligation specified in the contract is discharged or cancelled or expires. U.S. GAAP does not include a concept of partial derecognition of liabilities.

A2. Consistent with U.S. GAAP on debt extinguishments, paragraph 3.3.2 of IFRS 9 provides that an exchange between an existing borrower and lender of debt instruments shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.

A3. Further, U.S. GAAP and paragraph 3.3.3 of IFRS 9 provide that the difference between the carrying amount of the extinguished financial liability and the consideration paid, including any non-cash assets transferred or liabilities assumed, shall be recognised in profit or loss and shall not be amortized to future periods.

Extinguishment of Debt

A4. ASC Subtopic 470-40, *Modifications and Exchanges,* provides that an exchange of debt instruments with substantially different terms is a debt extinguishment. A debtor could achieve the same economic effect as an exchange of a debt instrument by making *substantial modification* of terms of an existing debt instrument. Accordingly, a substantial modification of terms shall be accounted for like an extinguishment.

A5. From the debtor's perspective, an exchange of debt instruments between or a modification of debt instruments by a debtor and a creditor in a nontroubled debt situation is deemed to have been accomplished with debt instruments that are

substantially different if the present value of the cash flows under the terms of the new debt instrument is at least 10 per cent different from the present value of the remaining cash flows under the terms of the original instrument. If the terms of a debt instrument are changed or modified and the cash flow effect on a present value basis is less than 10 per cent, the debt instruments are not considered to be substantially different.

A6. The basis for conclusions in American Institute of Certified Public Accountants' (AICPA) Statement of Position (SOP) 05-1 notes that the Executive Committee of the AICPA (AcSEC) considered the quantitative test, which provides that debt instruments are substantially different if the present value of the cash flows under the terms of the new debt instrument is at least 10 per cent different from the present value of the remaining cash flows under the terms of the original instrument. However, AcSEC ultimately concluded that such analysis would not be reliable in reaching a conclusion concerning contract similarity because of the potential subjectivity of assumptions and complex nature of many insurance and investment contracts. AcSEC adopted a qualitative analysis to be used in determining whether the replacement or modification of an insurance or investment contract results in the contract being considered substantially unchanged. AcSEC believes that the use of a qualitative analysis will result in an improvement in practice by providing a framework to evaluate internal replacements.

A7. IFRS 9 paragraph 3.3.2 requires an exchange between an existing borrower and lender of debt instruments with substantially different terms to be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. Similarly, a *substantial modification* of the terms of an existing financial liability, or a part of it, (whether or not due to the financial difficulty of the debtor) is accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. Paragraph B3.3.6 of IFRS 9 provides some guidance on whether there is any substantial modification to the terms. It states that the terms are substantially different if the discounted present value of the cash flows under the new terms, including any fees received and

discounted using the original effective interest rate, is at least 10 per cent different from the discounted present value of the remaining cash flows of the original financial liability.

Amendments and Modifications and Commutations of Insurance Contracts

A8. In discussing reinsurance, ASC paragraphs 944-20-15-62 and 15-63, *Amendments* (formerly, EITF Topic D-34), describe the term *amendment* to include all but the *most trivial changes* and without distinction between financial and nonfinancial terms. Examples of amendments include, but are not limited to:

A9. Replacing one assuming company with another (including an affiliated company), or

A10. Modifying the contract's limit, coverage, premium, commissions, or experience-related adjustable features.

Summary of ASC 944-30-35-24 through 35-63 (SOP 05-1)

A11. Insurance contract amendments and modifications that relate to non-integrated features of insurance contracts are separately accounted for in a manner similar to amendments and modification to separately issued contracts (i.e., with no effect on the "base" contract). Also, amendments and modifications that do not lead to a *substantial change* in the existing contracts are accounted for as a continuation of the existing contract without derecognition of the base contract; and there is no gain or loss recognized. On the other hand, contract modifications and amendments that involve integrated features, and lead to a *substantial change* in the existing contracts, are accounted for as a derecognition of contract elements with possible gains/losses recognized in the financial statements.

A12. ASC paragraph 944-30-35-7 includes the following guidance regarding determination of substantial changes to insurance contracts:

(a) An internal replacement (other than those described in paragraphs 944-30-35-26 through 35-29) is determined to involve contracts that are substantially unchanged only if all the following conditions exist:

(i) The insured event, risk, or period of coverage of the contract has not changed, as noted by no significant changes in the kind and degree of mortality risk, morbidity risk, or other insurance risk, if any.

(ii) The nature of the investment return rights (for example, whether amounts are determined by formulas specified by the contract, pass through of actual performance of referenced investments, or at the discretion of the insurer), if any, between the insurance entity and the contract holder has not changed.

(iii) No additional deposit, premium, or charge relating to the original benefit or coverage, in excess of amounts specified or allowed in the original contract, is required to effect the transaction; or if there is a reduction in the original benefit or coverage, the deposit, premiums, or charges are reduced by an amount at least equal to the corresponding reduction in benefits or coverage.

(iv) Other than distributions to the contract holder or contract designee or charges related to newly purchased or elected benefits or coverages, there is no net reduction in the contract holder's account value or, for contracts not having an explicit or implicit account value, the cash surrender value, if any.

(v) There is no change in the participation or dividend features of the contract, if any.

(vi) There is no change to the amortization method or revenue classification of the contract.

(b) If any of the conditions are not met, an internal replacement is determined to involve a replacement contract that is substantially changed from the replaced contract.

A13. The basis for conclusions for SOP 05-1 discusses the following regarding a qualitative threshold:

(a) Paragraph A-27: AcSEC concluded that significant changes in the kind or degree of mortality, morbidity, or other insurance risks would result in a replacement contract that is substantially changed from the replaced contract, as these risks are defining components of the substance and classification of a contract. An example of a significant change in the degree of mortality risk would be an internal replacement of a variable annuity with a minimal death benefit to a variable annuity with a "rich" death benefit, which would result in a replacement contract that is substantially changed from the replaced contract. AcSEC concluded that an exchange of a contract with one type of death benefit for a contract with another type of death benefit requires review of the terms to determine whether the degree of mortality is similar. An example of an insignificant change in the degree of mortality risk would be an internal replacement of a variable annuity with a roll-up death benefit to a variable annuity with a ratchet death benefit of similar relative expected cost, which would not result in a substantial change to the mortality benefit, as both variable annuities contained significant and similar levels of mortality risk related to premature death. An example of a significant change in the type of mortality risk would be an exchange of a life insurance contract for a solely life-contingent payout annuity. AcSEC noted that, in determining whether a change in the degree and kind of risks of a contract is significant, the focus should be on the substance of the risks of the contract, and not the form of the contract. Factors to consider in determining whether there are significant changes in insurance risks may include changes in actuarially estimated costs for that benefit feature or the SOP 03-1 [section 10,870] benefit ratio related to that benefit feature. Reunderwriting the entire contract generally would indicate a substantial change resulting from a change in the kind or degree of mortality, morbidity, or other insurance risk.

(b) Paragraph A25: AcSEC also concluded that certain changes would always result in an internal replacement with a substantially unchanged replacement contract. Examples of these types of changes would include:

(i) Changes in the allocation of the contract holder's account balance among investment alternatives provided for in the contract, even if reallocated 100 percent to a specific investment alternative.

(ii) Additional investment allocation alternatives added to a contract with multiple investment alternatives

(c) Paragraph A-33: AcSEC concluded that a change in the participation, including experience refund, or dividend features of a contract indicates a substantial change to the replaced contract. For example, the addition of an experience refund rider to a LTC contract is an integrated benefit and results in a substantially changed contract. AcSEC also noted that the substance of the contract, not just its legal classification, must also be evaluated.

(d) Paragraph A-31. AcSEC believes that the requirement of an additional deposit, premium, or charge relating to the benefit or coverage provided under the replaced contract, in excess of amounts contemplated in the replaced contract, whether explicit or implicit, indicates that the replacement contract is not a continuation of the replaced contract because of the change of the underlying economics of the replaced contract as a result of the internal replacement. For example, an increase in premiums in excess of the amount that is commensurate with an increase in the contractual benefits or coverages is an implicit additional premium for the original benefit or coverage.

Reinsurance

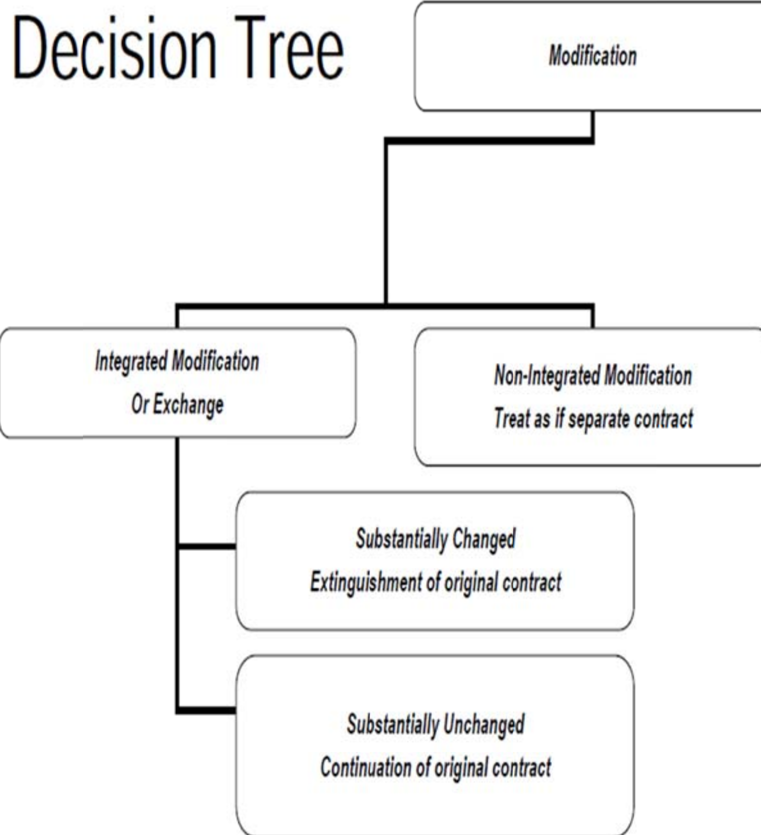
A14. ASC Section 944-20-15, *Reinsurance,* notes that a reinsurance contract that, upon its inception, met the conditions for reinsurance accounting could later be amended so that it no longer meets those conditions. The contract shall then be reclassified and accounted for as a deposit.

Leases

A15. Subtopic 840-10-35, *Reassessing Lease Classification,* indicates that if at any time the lessee and lessor agree to change the provisions of the lease, other than

by renewing the lease or extending its term, in a manner that would have resulted in a different classification of the lease under the lease classification criteria had the changed terms been in effect at lease inception, the revised agreement shall be considered as a new agreement over its term, and the lease classification criteria shall be applied for purposes of classifying the new lease. This is broadly consistent with paragraph 13 of IAS 17, *Leases.*

Appendix B: Treatment on modification of Insurance Contract Features applying ASC 944-30



Appendix C: Application Examples from ASC 944-30-55 Using Product Features

A1. The following examples relating to modification of product features have been selected from ASC 944-30-55 to illustrate the application of the qualitative criterion. Staff believes that these examples provide the boards with good discussion points on the notions of integrated versus non-integrated contract features that are referenced in this paper.

Contract Modification to Increase the Face Amount of a Traditional Life Insurance Contract

A2. The increased face amount (death benefit) of a traditional life insurance contract effectuated through an amendment or rider to the original contract is considered a *nonintegrated* feature that should be accounted for separately from the existing life insurance contract, provided that the additional premium charged for that incremental insurance coverage is not in excess of an amount that is commensurate with the incremental insurance coverage and does not result in the explicit or implicit re-underwriting or re-pricing of other components of the contract.

Addition of a New Car to an Automobile Contract

A3. An automobile insurance contract generally provides coverage for personal injury and automobile damage sustained by the insured and liability to third parties for losses caused by the insured. A newly purchased car being added to an existing automobile policy with no change in the other vehicles covered or the premium related to the other vehicles under the contract results in additional *nonintegrated* contract coverage that should be accounted for separately from the existing automobile contract coverage, assuming the underwriting and price for coverage of the new car is determined separately and there is no change, explicit or implicit, in the pricing of the base contract.

Deletion of a Car from an Automobile Contract

A4. If one of the existing automobiles under the contract described above is removed from the automobile contract, it is considered the extinguishment of *nonintegrated* contract coverage and should be accounted for as an extinguishment of only the balances related to that nonintegrated coverage. The amount refunded to the contract holder from the change in the coverage is determined in accordance with terms that are fixed in the contract or applicable state law or regulation and no re-underwriting is required for other coverage.

Increasing Face Amount of Universal Life Contract through Amendment

A5. The face amount of a universal life contract is increased from $500,000 to $750,000 through a contract amendment. The additional face amount of $250,000 was underwritten and approved for an additional premium. This is a modification of an *integrated* feature of the universal life contract (coverage amount).

Exchanging Universal Life Contract 1 for another Universal Life Contract 2 with No Lapse Guarantee

A6. Universal life contract 1 is exchanged for another universal life contract 2 with no lapse guarantee. This is a modification of an integrated feature of the universal life contract.

Appendix D – Example of a contract amendment or modification

A1. Assume that an insurer issued a 30-year term life insurance contract to Mrs. XYZ and that this contract also insured against the death of Mr. XYZ. Information about the terms of each component of the contract immediately before an amendment made subsequent to issuance appears in the table below:

	Mrs. XYZ (Component A)	**Mr. XYZ (Component B)**
Maximum death benefit	CU500,000	CU250,000
Level premium per month	CU36	CU25
Expected present value of fulfilment cash flows (assume no risk adjustment for this example)	CU5,000	CU4,000
Residual/single margin	CU1,000	CU500

A2. At the date of the amendment, the benefit payable upon the death of Mr. XYZ is lowered from CU250,000 to CU200,000. Accordingly, the level premium which Mr. XYZ is required to pay each month is lowered from CU25 to CU20. The insurer's estimate of the entity-specific fulfilment value of the amended contract is CU9,500, including a margin of CU1,300.

How should this amendment be accounted for?

Scenario 1 – Assume the insurer concludes the modification constitutes a substantial modification

A3. The insurer would derecognize the entire original contract and recognize the whole of the amended contract as a new contract.

A4. The insurer would debit its insurance contract liabilities balance for CU10,500 to account for the derecognition of the contract. The insurer would then credit its insurance contract liabilities balance for CU9,500. The difference of CU1,000 would be recorded as a gain.

Scenario 2 – Assume the insurer concludes the modification does *not* constitute a substantial modification

A5. The insurer would account for the change as a partial derecognition. and, in doing so, would record a favourable change in future estimated cash flows of CU800 as a result of the partial derecognition and release a portion of the margin, say CU100. The difference between this CU900 of net income and the CU1,000 of extinguishment gain in Scenario 1 is a result of the insurer's hypothetical re-pricing of the remaining insurance risks differing from the price it had originally charged for the same risk (i.e., its willingness to now accept a lower margin due to a softening of the market or any other reason).