STAFF PAPER

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REG IASB Meeting

Project	**Insurance contracts**
Paper topic	Unlocking the residual margin

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Paper overview

1. The IASB has tentatively decided that the residual margin recognised applying the building block approach should be 'unlocked' for changes in estimates of future cash flows. This means that changes in estimates of future cash flows would not be recognised in profit or loss immediately. Instead, they would be added to, or deducted from, the residual margin, and thereby recognised in profit or loss in future periods when the residual margin is released to profit.

2. This paper examines some consequences of this tentative decision and recommends that the decision is refined to avoid some unintended consequences.

3. The staff recommend that the residual margin should be unlocked for differences between current and previous estimates of cash flows relating to future coverage or other future services.

Content of this paper

4. This paper:

   (a) recaps the previous tentative decisions on unlocking (paragraphs 5-6);

   (b) illustrates the main decision in a simple example (paragraphs 7-11);

   (c) discusses the objectives of the decisions (paragraphs 13-15);

   (d) identifies some possibly unintended consequences (paragraphs16-17); and

   (e) recommends a refinement to avoid those unintended consequences (paragraphs 18-20).

Recap of previous tentative decisions on unlocking

5. In June 2011, the IASB (but not the FASB) tentatively decided that the residual margin recognised applying the building block approach should not be 'locked' at initial recognition. Instead, an insurer should subsequently adjust the residual margin for favourable and unfavourable changes in the present value of the fulfilment cash flows.

6. The IASB further tentatively decided that:

   (a) there should not be a limit on the amount by which the residual margin could be increased as a result of favourable changes.

   (b) there *should* be a limit on the amount by which the residual margin could be decreased as a result of unfavourable changes. The residual margin recognised by the insurer should not be negative[1]. Any unfavourable changes in excess of the residual margin remaining at the date of the change should be recognised immediately in profit or loss. (This proposal would have the same effect as the proposed requirement for the immediate recognition of onerous contract losses in the premium allocation approach.)

[1] The residual margin recognised by the cedant in a reinsurance contract may be negative.

(c) the residual margin should be adjusted only for changes in estimates of *future* cash flows. Experience differences (ie differences between the actual cash flows for the period and previous estimates of those cash flows) should be recognised immediately in profit or loss.

(d) the residual margin should be adjusted only for changes in estimates of *cash flows*. All changes in the risk adjustment should be recognised immediately in profit or loss. (The main justification for treating changes in risk differently from changes in cash flows is a practical one. Unlocking the residual margin for changes in estimates of risk would require insurers to disaggregate components of the overall change in the risk adjustment each period, to separately identify:

   (i) the expiry of risk as coverage is provided, and

   (ii) changes in estimates of risk associated with future coverage.

   The board has concluded in the past that disaggregating the overall change in risk in this way could be difficult.)

(e) adjustments to the residual margin should be recognised *prospectively*. In other words, any changes should be recognised in profit or loss as the residual margin is released in the periods after the adjustments are made.

Simple example to illustrate unlocking

Initial estimates of future cash flows

7. The initial estimates for a portfolio of contracts are:

   (a) Premiums 200 currency units (CU200) per year for 5 years

   (b) Expected claims CU100 per year for 5 years

   (c) Time value of money, risk, deposit component and expenses are all immaterial.

Table 1: Initial estimates – statements of comprehensive income

	Year					
	1	*2*	*3*	*4*	*5*	*Total*
	CU	*CU*	*CU*	*CU*	*CU*	*CU*
Insurance contract revenue	200	200	200	200	200	1,000
Incurred claims	(100)	(100)	(100)	(100)	(100)	(500)
Underwriting result (Initial allocation of residual margin)	100	100	100	100	100	500

Change in estimates of future cash flows

8. At the end of year 2, the insurer revises its estimates. It estimates that claims in years 3, 4 and 5 will increase by CU40 each year. The insurer adjusts its measure of the present value of the fulfilment cash flows—increasing expected future outflows by CU120 (= CU40 + CU40 + CU40).

Exposure draft proposal – recognise change immediately in profit or loss

9. The exposure draft proposed that changes in estimates of future cash flows should be recognised immediately in profit or loss.

Table 2: Change in estimate recognised immediately in profit or loss – statements of comprehensive income

	Year					
	1	2	3	4	5	Total
	CU	*CU*	*CU*	*CU*	*CU*	*CU*
Insurance contract revenue	200	200	200	200	200	1,000
Incurred claims	(100)	(100)	(140)	(140)	(140)	(620)
Change in estimates	-	(120)	-	-	-	120
Unwind of change in estimates as higher claims are incurred	-	-	40	40	40	(120)
Underwriting result (Allocation of locked residual margin minus change estimate in year 2)	100	(20)	100	100	100	380

Revised proposal – unlock residual margin

10. Applying the tentative decisions to 'unlock' the residual margin, the change in estimates of future cash flows would be offset against the residual margin instead of being recognised immediately in profit or loss. The *total* liability remains the same.

Table 3: Change in estimate offset against residual margin – liability at end of year 2

Liability	Original estimate *CU*	Change in estimate *CU*	Adjusted estimate *CU*
Present value of fulfilment cash flows (years 3-5)	300	120	420
Residual margin (years 3-5)	300	(120)	180
Total liability	600	-	600

11. The adjusted residual margin of CU180 would be recognised in profit or loss prospectively, with CU60 being recognised in each of years 3, 4 and 5.

Table 4: Change in estimate offset against residual margin – statements of comprehensive income

	Year					
	1 *CU*	2 *CU*	3 *CU*	4 *CU*	5 *CU*	Total *CU*
Insurance contract revenue	200	200	200	200	200	1,000
Incurred claims	(100)	(100)	(140)	(140)	(140)	(620)
Underwriting margin (Allocation of residual margin, as adjusted prospectively at end of year 2)	100	100	60	60	60	380

Objectives of tentative unlocking decisions

13. The proposal that the residual margin should be unlocked reflects a view of the residual margin as the unearned profit in the contract. Applying this view, the residual margin should be measured as the difference between the present value of the premiums and the present value of the fulfilment cash outflows. If there is a change in the cash flows, the contract becomes more or less profitable. If the change relates to estimates of *future* cash flows (as opposed to experience adjustments), it increases or decreases the *unearned* profit. Therefore, the remaining residual margin should be adjusted.

14. As illustrated in Table 3 (below paragraph 10), the effect of unlocking is that a change in estimates of future cash flows gives rise to a transfer between the components of the liability, instead of a change in the *total* amount of the liability. In other words, unlocking the residual margin has the effect of 'locking' the total liability. The total liability is re-measured only if there is an unfavourable change that exceeds the remaining balance of the residual margin, ie if the contract has become onerous.

15. Thus, the effect of offsetting changes in estimate against the residual margin—and locking the total liability— is that the liability measured applying the building block approach becomes more like that measured applying the premium allocation approach. The similarity is demonstrated in the example in the previous section of this paper—the amounts recognised as income and expenses in Table 4 (below paragraph 11) are the same as the amounts that would have been recognised for those contracts if they had been accounted for using the premium allocation approach.

> Footnote: although the tentative unlocking decisions make the measurements required by the building block approach more similar to those required by the premium allocation approach, they do not make the two approaches identical. The unlocking decision for the building block approach applies only to changes in estimates of cash flows – it does not apply to the effects of changes in estimates of risk or discount rates.

Possibly unintended consequences of tentative unlocking decisions

16. The staff think that there is a need to refine the tentative unlocking decision so that the revised proposals meet the objectives set out in the previous section.

17. Unless the decision is refined, problems could arise because the proposed requirements seek to distinguish purely between *past* cash flows and *future* cash flows. All differences in past cash flows (ie experience adjustments) are recognised immediately in profit or loss, whereas all changes in estimates of future cash flows are added to or deducted from the residual margin. Although this distinction works well for changes in estimates of claims for future insured events, it could have unintended consequences for other changes in estimate. For example:

    (a) *For incurred claims*

    Claims are sometimes incurred in one period but settled in a later period. A change in estimate of the amounts required to settle claims that have been incurred in current or previous periods is a change in estimate of future cash flows. The tentative unlocking decision implies that insurers should offset such changes against the residual margin. However, these changes relate to coverage already provided, not future coverage, so they should be recognised immediately in profit or loss.

    (b) *For experience differences in premium receipts*

    Insurers that experience higher-than-expected lapse rates have lower-than-expected income in the current period but, as a result, might have lower-than-expected claims in future periods. The tentative unlocking decision implies that the insurer should recognise the reduction in income (an experience difference) immediately in profit or loss, but should add to the residual margin any resulting reduction in future claims (a change in estimate of future cash flows). There could be a mismatch between the timing of the loss (recognised immediately) and the related gain (recognised over the remaining contract terms).

(c) *For repayments of investment components*

Some insurance contracts have an investment component, ie an amount that is repayable to policyholders or to their beneficiaries, regardless of whether an insured event occurs. The actual repayments in a reporting period might differ from previous estimates. In the absence of other changes in assumptions, fewer repayments in the current period are likely to result in more repayments in later periods. The tentative unlocking decision implies that the insurer should recognise a reduction in repayments in the current period (an experience difference) as an immediate gain, whilst offsetting the increased future repayments (a change in estimate of future cash flows) against the residual margin. However, a delay in repaying an investment component should not give rise to a gain in the current period and a loss in a future period. It should not affect profit or loss at all, except to the extent that any change in timing results in a change in the *amount* of repayments (which could affect the profitability of the services provided in the contract).

(d) *For contracts with asset-dependent cash outflows*

Some contracts require the insurer to pay amounts to policyholders that are dependent on asset returns[2]. A higher-than-expected gain in the assets in the current year could result in an increase in estimates of the cash outflows in future periods. The tentative unlocking decision implies that the increase should be offset against the residual margin, instead of being recognised immediately in the statement of comprehensive income. However, the increase relates to asset gains in the current period—it is not an indication of reduced profitability in future periods.

Furthermore, if the insurer holds the assets on which the outflows depend, and recognises gains and losses on those assets immediately, the tentative decision would lead to a mismatch between the recognition of the higher-than-expected

2 Such contracts could include both contracts in which the payments to policyholders are contractually linked to the performance of underlying items (participating contracts) and contracts in which there is no such contractual link.

asset returns (immediate) and the recognition of the increased future outflows to policyholders (over the remaining contract term).

A possible solution

18. The staff think that the objectives of the unlocking decision could be met, and the unintended consequences avoided, by refining the tentative decision. Instead of distinguishing between past and future cash flows (ie experience differences versus estimates of future cash flows), the requirements should distinguish between past and future coverage, and between investment and service components:

> The residual margin should be unlocked for differences between current and previous estimates of cash flows relating to future coverage or other future services.

19. Applying this refined decision to the examples listed in paragraph 17:

(a) *Incurred claims*

The residual margin would not be adjusted for changes in estimates of incurred claims, because these claims relate to past coverage. Such changes would be recognised immediately in profit or loss. (Applying an 'earned premium' presentation, the changes would be presented in the statement of comprehensive income as part of the incurred claims expense. The total incurred claims expense would be disaggregated in the notes to separately identify claims incurred in the period and adjustments to estimates of claims incurred in previous periods.)

(b) *Experience differences in premium receipts*

The residual margin would be adjusted for experience differences if those differences relate to future coverage, for example if they relate to premiums received for future coverage. The insurer would adjust the residual margin for both the change in premiums *and* any resulting changes in future outflows.

(c) Repayments of investment components

A delay or acceleration of repayments of investment components would not necessarily lead to the residual margin being adjusted. The residual margin would be adjusted only for any resulting changes in the cash flows relating to future *coverage or other services*. This would be no more than any net effect of the delay or acceleration on the eventual cash flows, eg any difference between lower repayments in one period and consequently higher repayments in future periods. It could be measured by identifying that net effect explicitly, or by adjusting the residual margin for both the experience difference for the current period and the corresponding change in estimates for future periods.

(d) Contracts with asset-dependent cash outflows

If a contract includes asset-dependent cash outflows, the present value of the fulfilment cash flows could change if, for example:

(i) the asset gains or losses in the period are higher or lower than previously expected; or

(ii) the insurer changes its estimates of *future* asset gains or losses; or

(iii) the insurer changes its estimate of the participation percentage, ie the proportion of the gains that will be paid to participating policyholders.

In these situations, the net change in the estimates of future cash outflows to policyholders could include both changes attributable to asset gains or losses, and changes in estimates of profits for services (eg explicit fees for management services, or shares of gains expected to be allocated to shareholders).

The insurer would adjust the residual margin only for changes in estimates of the profit for *future* services. Changes in the profits for services in the current period would be recognised immediately in profit or loss. Changes attributable to asset gains or losses would be recognised immediately. If such changes related to contracts to which mirroring applied, the changes would be recognised and presented in a way that mirrored the recognition and presentation of the asset gains or losses.

Staff recommendation

20. The staff recommend that the residual margin should be unlocked for differences between current and previous estimates of cash flows relating to future coverage or other future services. Possible drafting for this requirement is set out in the appendix to this paper.

Question for the Board
Do you agree that the residual margin should be unlocked for differences between current and previous estimates of cash flows relating to future coverage or other future services?

Appendix: Proposed drafting for unlocking decision

A1. This appendix sets out the way in which the tentative decisions on unlocking the residual margin could be drafted. The unmarked text is that proposed in the previous exposure draft. The underlined additions include the changes required to implement the previous 'unlocking' decisions summarised in paragraph 6 of this paper, as refined to reflect the staff recommendation in paragraph 20.

A2. The added paragraph also summarises all of the inputs into the 'remaining balance' of the residual margin. The measurement of these other inputs is prescribed in later paragraphs of the exposure draft. However, the staff think that a paragraph summarising the inputs would provide a useful overview.

Subsequent measurement

47 The carrying amount of an insurance contract at the end of each reporting period shall be the sum of:

(a) the present value of the fulfilment cash flows at that date; and

(b) the remaining amount of the residual margin.

<u>**47A The remaining amount of the residual margin is the carrying amount at the start of the reporting period:**</u>

<u>**(a) plus interest accreted on the carrying amount, determined in accordance with paragraph 51;**</u>

<u>**(b) minus the amount released as income in respect of coverage and other services provided in the period, determined in accordance with paragraph 50; and**</u>

<u>**(c) plus or minus a favourable or an unfavourable change in the present value of the fulfilment cash flows, if and to the extent that:**</u>

(i) the change is attributable to a difference between current and previous estimates of the cash flows relating to future coverage and other future services; and

(ii) the residual margin is sufficient to absorb an unfavourable change. The residual margin shall not be negative.