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Project	**Insurance Contracts**		
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Introduction

1. In June 2011, the IASB (but not the FASB) tentatively decided that the residual margin recognised applying the building block approach should be 'unlocked', ie that insurers should adjust the residual margin for favourable and unfavourable changes in the estimates of future cash flows. Accordingly, changes in estimates of future cash flows would not be recognised in profit or loss immediately. Instead, they would be recognised in subsequent periods when the adjusted residual margin is allocated to income.

2. This paper explains the IASB's decisions and asks for your views on them.

Background – exposure draft proposals

3. The IASB exposure draft *Insurance Contracts* proposed that on initial recognition of an insurance contract, an insurer would measure its liability at the sum of:

   (a) *the* present *value of the fulfillment cash flows*, which would include both the expected present value of the future cash flows and an adjustment for risk; and

   (b) *a* 'residual *margin',* an additional amount that eliminates any gain at inception of the contract.

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4. The exposure draft further proposed that the insurer should:

   (a) update the estimate of the present value of the fulfillment cash flows each reporting period, with any experience adjustments[1] and changes in estimates of future cash flows being recognised in profit or loss for the period; and

   (b) 'lock' the residual margin at the amount determined at initial recognition, gradually recognising that amount as income in profit or loss over the coverage period.

5. The following example illustrates the exposure draft proposals. For simplicity, it ignores risk adjustments and discounting.

Estimates at contract inception

An insurer issues contracts for five years' insurance cover. At inception, the insurer estimates the expected claims to be 100 per year (500 in total), which will be paid as soon as they are incurred. The insurer prices the premiums at 200 per year (1,000 in total).

The residual margin at inception is 500—ie the difference between the total premium of 1,000 and the estimated future claims of 500. Because the expected claims are the same each year, the insurer allocates the residual margin at a constant rate, ie 100 per year.

Initial estimates	Year					
	1	**2**	**3**	**4**	**5**	**Total**
Underwriting margin (allocation of residual margin)	100	100	100	100	100	500

Exposure draft - changes in estimates of future cash flows

At the end of year 2, the insurer revises its estimates. It estimates that claims in each of years 3, 4 and 5 will be 40 higher than originally estimated. The insurer revises its liability at the end of year 2—increasing expected future outflows by 120 (= 40 + 40 + 40). It recognises the increase in the liability as an expense in year 2.

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[1] Experience adjustments are differences between actual cash flows and previous estimates of those cash flows.

Revised estimates	Year					
	1	2	3	4	5	Total
Underwriting margin (allocation of residual margin)	100	100	100	100	100	500
Change in estimates	-	(120)	-	-	-	(120)
Net profit/(loss)	100	(20)	100	100	100	380

6. The 120 expense recognised in year 2 represents the estimated increase in the insurer's obligations when the insurer identifies the additional costs.

Subsequent IASB decision

7. In June 2011, the IASB tentatively decided to revise the proposals relating to changes in estimates of the fulfillment cash flows. It tentatively decided that, whilst experience adjustments should be recognised in profit or loss immediately, changes in estimates of *future* cash flows should be offset against or added to the residual margin. (Unfavourable changes would be offset against the residual margin only until the residual margin had been used up. Any further unfavourable changes would be charged to profit or loss immediately.)

8. Accordingly, except to the extent that unfavourable changes exceeded the remaining residual margin, the changes in estimates would result in a transfer between the components of the total liability, rather than as a change in the total liability—the total liability would be locked at the amount received from the policyholder for the remaining coverage. The changes would be recognised in profit or loss in future periods, when the adjusted residual margin is allocated to income.

Tentative decision - change in estimates of future cash flows

Estimates at end of year 2	Original estimate	Change	Revised estimate
Present value of fulfillment cash flows (years 3-5)	300	+120	420
Residual margin (years 3-5)	300	-120	180
Total liability	600	-	600

The revised residual margin of 180 is released over the remaining 3 years of the contract. In other words, the increase in expected claims is recognised in profit or loss when the claims are incurred.

Profit	Year					
	1	**2**	**3**	**4**	**5**	**Total**
Underwriting result (allocation of residual margin)	100	100	60	60	60	380

9. The FASB has not reached the same tentative decision as the IASB. Instead, the FASB has tentatively affirmed its original proposal that the single margin[2] should be locked at the amount estimated on initial recognition of the insurance contract. The FASB has tentatively decided that this amount should be allocated to income as the insurer is released from risk, as evidenced by a reduction in the variability of the cash outflows. However, any change in expected cash flows may have an impact on the recognition pattern of the single margin prospectively.

The rationale for the revised proposals

10. The objective of the IASB's original proposals—ie those proposed in the exposure draft—was to measure insurance contract liabilities at a current value. The residual margin could be viewed as an estimate of the return (above the return for bearing risk) that the insurer requires for providing its services, including the amount required to cover indirect costs. Taking this view, any increase in estimates of the fulfillment cash flows does not reflect a reduction in the residual margin. Rather, it reflects an increase in the liability. Consequently, it should be recognised in profit or loss.

11. The IASB's revised approach reflects a different view of the residual margin. It 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 premiums and the estimates of the cash outflows. If that difference increases (or decreases), the contract becomes more (or less) profitable and the residual margin increases (or decreases accordingly). If the change relates to

[2] The FASB proposes to require insures to recognise a single margin instead of the separate risk margin and residual margin proposed by the IASB.

estimates of *future* cash flows (as opposed to experience adjustments), it changes the unearned component of the residual margin. Consequently, the residual margin should be adjusted.

12. There are other advantages to an approach that offsets changes in estimates against the residual margin:

    (a) it avoids outcomes that some people regard as counterintuitive. As the example in paragraph 5 of this paper illustrates, immediate recognition of adverse changes in estimates can make contracts that are profitable overall appear to be loss-making in some years. It can also make contracts that actually become loss-making overall appear to be profitable in later years. Many respondents to the exposure draft viewed such outcomes as counterintuitive.

    (b) an approach that offsets changes in estimates against the residual margin could help prevent manipulation of profits. Applying the original proposals, an insurer might over-estimate the fulfillment cash flows on 'day 1' of the contract. On 'day 2' it could revise the estimates down and recognise the difference as an immediate gain. In contrast, applying the revised approach, the insurer would recognise the difference as an adjustment to the residual margin. The outcome would be the same as if the insurer had correctly estimated the fulfillment cash flows on day 1. The insurer would not recognise an immediate gain.

Potential challenges if revised approach

13. The revised approach would require good disclosure to ensure that all changes in estimates are transparent, especially in situations in which unfavourable changes exceed the balance on the residual margin, with only the excess being charged to profit or loss. In the absence of good disclosure, changes in estimates that are offset against the residual margin (ie transferred between the components of the liability) might be less understandable or transparent than those recognised immediately in profit or loss.

14. The revised approach might be more complex to apply in practice. For example:

    (a) the IASB has not yet considered in detail which changes in estimates of future cash flows should be offset against the residual margin. Arguably, changes that indicate a change in the profitability of *future* coverage should be offset, whilst all other changes are recognised in profit or loss immediately. Those other changes could include, for example:

        (i) changes in estimates of the amounts required to settle claims that have already been incurred; and

        (ii) changes in estimates of participating benefits, if these changes reflect recognised gains or losses in the underlying assets.

        An approach that required insurers to treat some changes in estimates of future cash flows differently from others could be more complex and subjective than the exposure draft approach (which requires the same treatment for all changes in cash flows).

    (b) it could be argued that, to accurately reflect the profit for the period, insurers should recognise the adjustments to the residual margin as income in the period of coverage to which the adjustments relate (eg when the changes in cash outflows occur). This would mean allocating the adjustments separately from the originally estimated portion of the residual margin. Separate allocation would require insurers to track more information about the timing of the changes in cash flows and thereby add complexity.

    (c) if the revised approach also applied to changes in estimates of *risk*, insurers would need to separate overall changes in risk into two components: changes arising from expiry of risk relating to coverage in the period (which would be recognised as income) and changes in estimates of the price or quantum of risk associated with remaining coverage (which would be offset against the residual margin and reverse subsequently). The need to separate the components would introduce more subjectivity and complexity to the approach.

15. The revised approach could also result in counterintuitive results in some circumstances. Suppose, for example, that there is a change in the timing of claims—there is a reduction in claims in the current period, as a result of which there will be an increase in the estimated future claims. Applying the original proposals, the insurer would recognise both the gain (an experience gain) and compensating loss (a change in estimates) in the statement of comprehensive income at the same time. Applying the revised proposals, the insurer would recognise only the experience gain in the statement of comprehensive income. It would recognise a gain for the period, despite no overall change in the profitability of the contract.

16. Further difficulties might arise if the requirement to offset some changes in estimates against the residual margin applied also applied to the effects of changes in *discount rates*. Offsetting the effects of changes in discount rates against the residual margin could lead to accounting mismatches if the assets used to fund the liabilities are measured at fair value (with the effects of changes in discount rates being reflected in the statement of total comprehensive income). To avoid the mismatches, an insurer would need to treat changes in discount rates differently, depending on whether it measures the corresponding assets at amortised cost or fair value.

17. Because of the challenges associated with applying the revised approach to changes in estimates of risk and changes in discount rates, the IASB has so far tentatively decided that only changes in estimates of the future *cash flows* should be offset against the residual margin. Regarding the other components of the liability:

    (a) the IASB has tentatively decided that, for reasons of practicality, all changes in estimates of the *risk* adjustment should be recognised immediately in profit or loss.

    (b) the IASB has not yet reached a decision on whether any of the effects of changes in *discount rates* should be offset against the residual margin. It will need to consider this matter taking into account its recent tentative decision to present changes in insurance contract liabilities attributable to changes in discount rates in 'other comprehensive income'.

18. A possible disadvantage of a hybrid approach (ie one in which some changes in cash flows are offset against the residual margin whilst all changes in risk are recognised immediately in profit or loss is that the overall measurement objective is less clear. It could be more difficult to explain exactly what the liability recognised in the financial statements represents.

Next steps

19. The IASB's next steps will be to develop the proposals more fully, considering matters such as:

    (a) whether the effects of changes in discount rates should be offset against the residual margin, and if so, in what circumstances;

    (b) which changes in estimated cash flows should be offset against the residual margin; and

    (c) how an insurer should allocate a revised residual margin to the statement of total comprehensive income in subsequent periods.

Questions for discussions

Tentative decisions to date.

20. The IASB has tentatively decided:

    (a) to require changes in estimates of future cash flows to be offset against the residual margin, and

    (b) to require all changes in estimates of the risk adjustment to be recognised immediately in profit or loss.

Questions on tentative decisions to date
Are you aware of any potential operational difficulties that might arise for insurers applying those requirements? Do you have any other questions or comments on these tentative decisions?

Next steps

21. The IASB intends to further develop the proposals by considering matters such as those listed in paragraph 19.

Question on next steps
Are there any other matters that you think the IASB should consider as it develops its proposals?