STAFF PAPER

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IASB Meeting

Project	**Insurance Contracts**		
Paper topic	Should the IASB change its tentative decisions on the risk adjustment and residual margin?		
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What is this paper about?

1. At its April 2012 meeting the FASB held an education session for the IASB to explain the FASB's single margin approach. This paper examines the key differences identified at that session and asks the IASB whether, in the light of that session, it would consider changing its existing tentative decisions on the risk adjustment and residual margin.

2. This paper sets out:

   (a) An overview of the steps the staff will follow in asking whether the Board would like to change any of its tentative decisions on the risk adjustment and residual margin (paragraphs 3-8).

   (b) Background information about the board's previous tentative decisions and the response to its proposals in its July 2010 Exposure Draft *Insurance Contracts* (the ED) (paragraphs 9-23).

   (c) A summary of the differences between the IASB and FASB on the topic of risk adjustment, residual margin and single margin, followed by a review of those differences (paragraphs 24-45).

   (d) Other considerations (paragraphs 50-60).

   (e) Questions for the Board.

Overview

3. At this meeting, the staff asks the Board whether, in the light of the information about the single margin approach it obtained at the April 2012 meeting, it wishes to change some or all of its existing tentative decisions on the key differences that were identified at the April 2012 meeting:

   (a) Should the amount attributed to risk at the inception of an insurance contract be remeasured at each reporting date for changes other than the release of risk?

   (b) Should the residual margin be allocated to profit or loss on the basis of a driver other than risk?

   (c) Should changes in estimates of future cash flows be offset in the margin or should they be recognised in profit or loss?

4. The staff has not repeated the analysis previously provided to board members when they were originally asked to confirm or amend the approach in the ED. However, the staff has provided, in Appendix A, the list of previous board papers on this subject. Board members should refer to those previous papers in forming their views on this paper.

5. The staff would like to ask this question in two steps:

   (a) Whether the Board wishes to change any of its previous decisions with the objective of developing an approach that Board members believe would result in a more relevant and faithful representation than would result from the existing tentative decisions?

   (b) If not, should the IASB nevertheless consider changing any of those decisions if that would reduce differences with the FASB's model, even if some or all of the other differences between the boards, described in appendix B, remain?

6. If there are tentative decisions that the Board does not want to change, the staff propose that we ask the FASB whether they will consider, fully or partly, their tentative decisions on that topic. Depending on the answer to that question:

   (a) If the FASB agrees to consider amendments to its approach on an issue on which the IASB would not change its view, then the staff will ask the boards to discuss jointly those topics and any topics on which the IASB is willing to change its view.

   (b) If the FASB does not agree to consider amendments to its approach on an issue on which the IASB would not change its view, then the staff will not explore that issue.

7. Regardless of the reason for the change, the staff plan to consider for a future meeting the consequences of any change and the follow up questions that would need to be answered.

8. The staff plan to consider the differences other than risk adjustment and residual margin at future meetings. A list of existing differences between the boards is set out in appendix B.

Background

Summary of the IASB's proposals and the FASB's preliminary views

9. The ED and the FASB's Discussion Paper, *Preliminary Views on Insurance Contracts* (the DP) differed in their conclusions about whether the measurement model should include an explicit risk adjustment.

10. The ED proposes that the measurement of an insurance contract liability should include an explicit adjustment to reflect the risk inherent in the insurance contract. Paragraph BC109 of the Basis for Conclusions of the ED provides the IASB's reasoning for including a risk adjustment in the measurement of insurance liabilities as follows:

> **In the Board's view, the resulting measurement would:**

(a) convey useful information to users about the amount of risk associated with the insurer's insurance contracts because the management of risk is integral to the insurance business model.

(b) reflect the insurer's view of the economic burden imposed on it by the presence of that risk.

(c) be broadly consistent with existing requirements in IAS 37, and with the refinements of, and extensions to, those requirements proposed in the exposure draft *Measurement of Liabilities* in IAS 37.

(d) reduce the amount of the residual margin for which a release pattern is somewhat arbitrary.

11. We also note that including a risk adjustment in the measurement of an insurance contract liability is consistent with the measurement of fair value. The only difference between the two risk adjustments is that the perspective for the measurement of an insurance contract is that of the insurer, while the perspective for fair value measurement is that of a market participant. We do not think that these different perspectives would lead to significant differences in the measurements, because insurance contracts are not generally transferred in secondary markets.

12. The FASB took a different approach in its preliminary views document. Instead of including an explicit measure of risk in the measurement of the insurance liability, the FASB preferred to depict risk within a single margin. The FASB's preliminary view was that an explicit risk adjustment is unnecessary because the pricing of the insurance contract reflects the risk and uncertainty about the net cash flows. Therefore, any uncertainty would be implicitly included in a single margin that also implicitly includes any potential profit.

13. FASB members supporting a single margin were concerned about the level of judgment required to determine the explicit risk adjustment and the loss of comparability that this might cause.

14. Therefore the FASB concluded that the single margin provided benefits that an explicit risk adjustment could not. Those benefits were expressed in paragraph 71 of the DP, as follows:

> **a. The approach would be more consistent with the allocated transaction price approach in the proposed Accounting Standards Update on revenue recognition, because both a composite margin and a residual margin are allocations of the customer consideration, whereas a risk adjustment margin would be subsequently remeasured.**
>
> **b. A composite margin would eliminate the need to use subjective methods[1] for measuring the risk adjustment margin that may decrease comparability. Furthermore, changes in those subjective measurements from period to period would be recognized immediately in earnings.**
>
> **c. A composite margin would provide a simpler and more understandable approach to account for the difference between the expected cash inflows and outflows. The method for subsequent recognition of the composite margin in earnings would be simpler to calculate and more transparent to users of financial statements than the IASB's proposed techniques for subsequent recognition of changes in the risk adjustment margin.**

Feedback on the proposals

15. Commentators on the IASB's ED and the FASB's DP had differing views on whether risk in an insurance contract should be represented explicitly, via a risk adjustment, or implicitly, in a single margin.

16. Respondents to the IASB's ED generally agreed with an explicit risk adjustment (some with specific caveats e.g. about whether the techniques for measuring the risk adjustment should be mandated, the unit of account and the role of diversification benefits). Those that responded to the DP (primarily US respondents) generally did not support a separate, explicit adjustment for risk.

[1] However, the staff notes that since the end of the comment period, the FASB has changed its decision so that the single margin is released from exposure to risk as evidenced by a reduction in the variability of cash out flows, rather than according to a specified formula.

17. In general, the level of support for including a separate and explicit risk adjustment in the measurement of an insurance contract liability varied along geographical lines:

    (a) In Europe, respondents were largely in favour of an explicit risk adjustment; general arguments for support were that they believe an explicit risk adjustment promotes transparency about the profitability of the contract over time; that risk margins are already calculated for internal management purposes and that they would produce relevant and comparable information especially as this practice will spread and market discipline will drive consistency in its application. Some respondents noted that the inclusion of a risk adjustment was also consistent with the measurement of insurance contract liabilities for regulatory purposes in Solvency II[2], and supported the notion that financial reporting and regulatory reporting should be based on consistent underlying economic perspectives.

    (b) In Asia, different views were expressed. The regional group of standard setters in general favoured the risk adjustment. In Japan, the local standard setter favoured the single margin, while the general insurance industry group[3] and local accountancy and actuarial professional bodies in general favoured the risk adjustment. In China, the standard setter and the insurance regulator favoured the inclusion of a risk adjustment, while the local actuarial association and the association of life insurers preferred a single margin because they thought that it is counterintuitive that at initial recognition a risk adjustment might result in showing onerous contracts and also because they were concerned by the judgement involved in making risk adjustment estimates. In the Republic of Korea, there was general disagreement with the inclusion of the risk adjustment for reasons similar to those given by those

[2] Solvency II requires an explicit risk adjustment using the cost of capital approach and would allow the residual margin to be included as part of capital.

[3] The life insurance industry group noted in its response that both approaches had advantages and disadvantages.

Chinese respondents who favoured a single margin. Finally, in India the local actuarial association supported an explicit risk adjustment while the insurance regulator favoured a single margin.

(c) In Oceania and especially in Australia, respondents were widely in favour of a risk adjustment approach which they thought would provide more relevant and therefore more useful information than a single margin approach. In Australia, an explicit risk adjustment is currently required to be calculated and recorded in general purpose financial statements.

(d) In North America there were two different positions. In Canada, where an explicit risk adjustment is currently required to be calculated and recorded in general purpose financial statements, respondents were largely in support of an explicit risk adjustment.[4] In contrast, in the US, respondents to the ED, with sporadic exceptions, were generally against the measurement of an explicit risk adjustment. In these commentators' view, a risk adjustment would be an arbitrary measure that provides a false impression of precision and that is difficult to compare. Also, these respondents thought that there should be consistency with the Revenue Recognition project, which does not include a risk adjustment in determining whether there is an onerous contract.

(e) In Africa (mainly South Africa) and South America respondents were largely in favour of a risk adjustment approach which, they believed, would provide more relevant information.

18. Finally, there were also trends in the respondent type, as follows:

(a) Users of financial statements in general favoured a risk adjustment approach (with the exception of those in the US). One rating agency stated that '[a risk adjustment] allows us to better understand the risks as seen by management. We would then apply our analytical judgment about the risks affecting an insurer's financial strength.' However, some

[4] However some Canadian respondents preferred an explicit risk adjustment and no residual margin, but thought that day one gains and losses would be small if we included all the relevant cash flows.

users of financial statements, while noting the importance of information about risk, suggested that an explicit measurement of risk might imply a spurious level of precision and that a single margin would be a simpler approach.

(b) The actuarial profession and the major accounting firms were generally in agreement with a two-margin approach, although these respondents acknowledge that the risk adjustment poses questions of comparability and complexity that need to be considered by the boards.

(c) The regulators were divided and the International Association of Insurance Supervisors reports split views on whether a two-margin approach should be preferred or a single margin approach that some suggest could be defined as a risk margin calibrated to the premium at inception.

Tentative decisions since the ED/DP was published

The IASB's risk adjustment decisions

19. Since the end of the comment period the IASB:

(a) Confirmed that the measurement of an insurance contract should contain an explicit adjustment for risk, but modified the objective so that it is to measure the "compensation the insurer requires for bearing the uncertainty inherent in the cash flows that arise as the insurer fulfils the insurance contract".

(b) Confirmed that the risk adjustment would be:

(i) determined independently from the premium; and

(ii) remeasured in each reporting period. Changes in the risk adjustment would be recognised in profit or loss in the period of the change.

(c) Added additional guidance that, in measuring the risk adjustment, an insurer should:

(i) use a unit of account consistent with the objective.

(ii) use a measurement technique consistent with the objective. In other words, the Board decided that it would not limit the permitted techniques for measuring the risk adjustment to three as proposed in the Exposure Draft. However, the board would carry forward as application guidance the discussion of the three risk adjustment techniques, namely confidence levels, conditional tail expectation, and cost of capital, that had been included in the Exposure Draft.

(iii) That the risk adjustment measures the compensation that the insurer would require to make it indifferent between (i) fulfilling an insurance contract liability that would have a range of possible outcomes and (ii) fulfilling a fixed liability that has the same expected present value of cash flows as the insurance contract. For example, the risk adjustment would measure the compensation that the insurer would require to make it indifferent between (i) fulfilling a liability that has a 50 percent probability of being 90 and a 50 percent probability of being 110 and (ii) fulfilling a liability of 100. In determining the amount of this compensation, an insurer should consider both favourable and unfavourable outcomes in a way that reflects its degree of risk aversion.

(d) In addition, the Board confirmed that it would specify the characteristics that a risk adjustment technique should exhibit, as proposed in the ED, if that technique is to meet the objective of the risk adjustment.

(e) Confirmed the requirement for insurers to disclose the confidence level equivalent. In the Board's view, this disclosure would allow users to understand how the entity-specific assessment of risk aversion might differ from insurer to insurer. Said differently, the confidence level equivalent disclosure will provide information about the relative risk-aversion of the insurer, even if that information is imperfect. Disclosures of the other methods and inputs used to develop the measurements would be required under the general requirements for methods and inputs proposed in the ED.

The IASB's residual margin decisions

20. The IASB tentatively decided:

    (a) To confirm that an insurer should recognise a residual margin that eliminates any gain at inception.

    (b) To confirm that the residual margin should not be negative and any loss on day one or subsequently determined at portfolio level should be recognised immediately in profit or loss.

    (c) To amend its proposal that all changes in estimates would be recognised in profit and loss. Instead, the residual margin would be adjusted to offset favourable and unfavourable changes in the estimates of future cash flows used to measure the insurance liability. These adjustments would be made prospectively. Experience adjustments would be recognised immediately in profit or loss.

    (d) To amend the release pattern for the residual margin to be over the coverage period on a systematic basis that is consistent with the pattern of transfer of services provided under the contract. The ED had proposed that the residual margin would be released on the basis of the passage of time but on the basis of the expected timing of incurred claims and benefits, if that pattern differs significantly from the passage of time.

The FASB's single margin decisions

21. In previous meetings, the FASB tentatively decided:

    (a) To confirm that:

        (i) An insurance contract measurement model should use a single margin approach that measures risk implicitly at inception by reference to the premium.

        (ii) An insurer should not remeasure or recalibrate the single margin to recapture the previously recognized margin.

    (b) To amend its proposal in its discussion paper that an insurer should release the single margin according to a specified formula. Instead, an

insurer would release the single margin as it satisfies its performance obligation to stand ready to compensate the policyholder in the event of an occurrence of a specified uncertain future event that adversely affects that policyholder. The insurer's performance obligation is satisfied as it is released from exposure to risk as evidenced by a reduction in the variability of cash outflows. This means:

(i) if the variability of the cash flows of a specified uncertain future event is primarily due to timing of that event, an insurer is released from risk on the basis of reduced uncertainty in the timing of the specified event.

(ii) if the variability of the cash flows of a specified uncertain future event is primarily due to the frequency and severity of that event, an insurer is released from risk as variability in the cash flows is reduced as information about expected cash flows becomes more known throughout the life cycle of the contract.

(c) To require an insurer to disclose the methodology used to calculate the profit realization of the single margin.

(d) To provide implementation guidance that:

(i) an insurer should consider specific facts and circumstances to qualitatively determine if a reduction in the variability of cash flows has occurred to the extent an insurer is released from risk. Those facts and circumstances should include the following:

1. the entity's relative experience with the types of contracts
2. the entity's past experience in estimating expected cash flows
3. inherent difficulties in estimating expected cash flows
4. the relative homogeneity of the portfolio and within the portfolio

5. past experience not being representative of future results

(ii) a reduction in the variability of the cash flows such that an insurer is released from risk is a matter of judgment and should be based on facts and circumstances unique to the entity and the nature of the insurance contracts. Different insurers may define a reduction in variability of cash flows in different ways, as further information is obtained about the expected cash flows during the life cycle of an insurance portfolio. The points in the life cycle that should be considered for examination and assessment, among other points in the life cycle, include the following:

1. when an insurer incurs a claim but that claim has not yet been reported
2. when a claim has been reported
3. as additional information becomes known
4. the point at which the parties to the contract have agreed upon a settlement amount
5. the point at which the claim has been paid

22. The FASB has yet to discuss whether the remaining single margin would be released when a contract becomes onerous to reflect that there is no more profit in the contract.

Relevant board papers

23. The board papers leading to these decisions are listed in appendix A.

Differences identified in the single margin education session

24. At the single margin education session, the boards discussed the key areas of differences in the building block approach as proposed by the IASB and the FASB. In addition, the staff believe that the IASB should also consider the difference that arises because the residual margin is unlocked while the single margin is locked.

25. The following table provides an overview of the key differences. In describing these differences, we focus on those between the building block approach proposed by the IASB and that proposed by the FASB because the IASB views the building block approach as the main model to account for all insurance contracts (and would permit the premium allocation approach only when that approach would produce measurements that are a reasonable approximation to those that would have been produced by the building block approach). Accordingly, we discuss the differences that would arise on applying the building block approach to selected insurance contracts, regardless of whether those contracts are likely to be eligible for the premium allocation approach. We acknowledge that, because the FASB has reached different conclusions on how to account for the liability for incurred claims in the building block approach and in the premium allocation approach, any decisions which bring the two models closer together for the building block approach may not do so for the premium allocation approach[5].

[5] The main difference between the proposed requirements for the premium allocation approach relates to the liability for incurred claims. The IASB proposes to include a risk adjustment in the liability for incurred claims, whereas the FASB proposes not to include a single margin, i.e. there would be no component relating to risk in the liability for incurred claims. This could result in significant differences between the IASB and FASB approaches for the measurement of long-tail short-duration contracts. In such contracts there can be significant uncertainty about whether the insured event will occur and how severe it will be. That uncertainty extends beyond the coverage period. This difference could be reduced or eliminated if the FASB were to extend the period over which the single margin is released to include the settlement period, e.g. by estimating how much of the single margin runs off during the coverage period.

	Risk adjustment approach	Single margin approach	Where it makes a difference	Where it doesn't matter	Key objectives of IASB's approach
Remeasurement	Reflects increases and decreases in risk through absolute calculation • Can increase above previous amount, with no cap	Reflects only decreases in risk through relative calculation • Capped at premium received, but amortisation can be 'slowed down'[6]	Contracts where uncertainty about the occurrence or non-occurrence of the insured event and the eventual claim amount can vary significantly over the coverage and settlement period. E.g. insurance cover for asbestosis, where the risk increased significantly in the settlement period. (However, most contracts' actual outcome become more certain in each period.)	Contracts where uncertainty about the occurrence or non-occurrence of the insured event and the eventual claim amount will not vary significantly over time. E.g. 10-year term life contract, where the risks are stable and relatively low.	• Depict the amount of risk remaining in the contract. • Recognise profit as the insurer is released from risk. • Reflect increases and decreases in risk when such changes are significant, for example when: o There is a significant change in expected risk, for instance the start of a pandemic. o The outcome is inherently highly uncertain (high severity, low frequency type of contracts).
Release pattern for residual margin (one driver vs. two drivers)	Residual margin allocated on a systematic basis in line with the pattern of services provided under	The single margin (part of which is equivalent to the residual margin) is allocated in line with release from	Life contracts which have a large investment component relative to the insurance risk. The service under such contracts may not be provided in the same	Contracts that are predominantly driven by insurance risk, especially contracts of a shorter coverage period, for example	• Release the difference between the expected present value of cash outflows and the expected present value of cash inflows in a way that reflects the way(s) that the insurer provides

[6] The FASB have not discussed explicitly the exact mechanism by which the release of the single margin is sped up or slowed down. In some cases this mechanism can approximate remeasurement downwards and (because the risk is locked in to the amount charged in the premium), it may also operate as a partial unlocking.

	Risk adjustment approach	Single margin approach	Where it makes a difference	Where it doesn't matter	Key objectives of IASB's approach
	the contract	risk. Thus risk is regarded as the only driver of profitability.	pattern as the risk in the contract (e.g. the service can increase over time, especially for regular premium contracts).	most non-life contracts.	services under the contract. • The information obtained from the IASB's approach could be presented separately in the statements of comprehensive income and financial position, or disclosed in the notes.
Adjustments to residual margin	Changes in estimates of future cash flows are offset in the residual margin	Changes in estimates of future cash flows do not adjust the single margin. However, the FASB will consider whether to release the remaining single margin if the contract is onerous.	Long duration contracts for which there are changes in cash flow estimates, e.g. from changes in mortality or lapse assumptions.	Contracts for which changes in estimates are not expected to be significant during the coverage period. For example many short duration contracts, such as many motor insurance contracts.	• To ensure consistency with day 1 measurement. • To avoid changes in estimates leading to an insurer recognising a loss in one period, even if the insurer expects the contract to be profitable overall. • To avoid a change in estimates leading to the insurer recognising profit in one period even if the contract is known to be loss-making overall.

26. We consider the significance of each key difference shown in the above table in the paragraphs that follow.

Remeasurement

27. The IASB tentatively decided that risk should be remeasured and that the changes in the risk adjustment should be recognised in profit or loss. In contrast, the FASB would not remeasure the single margin determined at inception, but could speed up or slow down the amortisation pattern of the single margin. The change in amortisation pattern could, to some extent, reflect some changes in risk.

28. Risk can fluctuate up and down over time, and may not just decline over time. A risk adjustment varies for three possible reasons:

    (a) It **decreases** due to a release from risk (i.e. a reduction in the amount (quantum) of risk).

    (b) It may **increase** or **decrease** temporarily due to an increase (or decrease) in the amount (quantum) of risk. That increase would be temporary, because the amount of risk will ultimately reach zero.

    (c) It may **increase** or **decrease** due to a change in the price of an unchanged amount of risk, including changes that result from changes in the degree of risk aversion.

29. An explicit remeasurement of the risk adjustment would capture all of the above changes. In contrast, while the single margin would capture decreases in the quantum of risk due to the release from risk, it would not capture an increase in the quantum of risk, nor would it capture a change in the price of risk.

30. In previous discussions, board members have been persuaded that measuring increases in the amount or quantum of risk in particular, would provide useful and relevant information to users of financial statements. This difference between risk adjustment and single margin approaches is illustrated in the example below.

Example

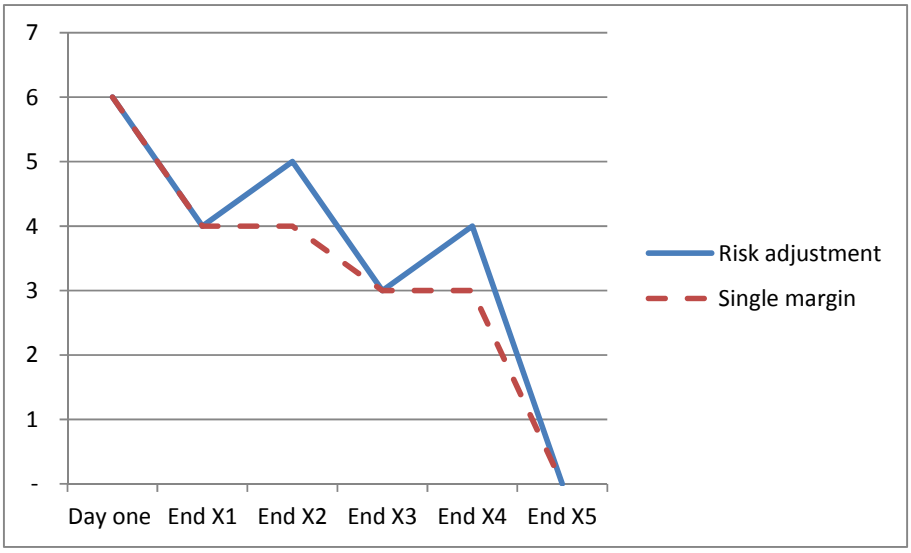
31. Assume an insurer issues personal indemnity insurance coverage. The risk of a policyholder being found guilty of misconduct is affected by factors such as the fact pattern, complexity of legislation, the litigious nature of clients and the macroeconomic environment. To permit easy comparison, assume that the insurer

decides that the compensation it requires for bearing risk is an amount equal to the 90th percentile (if using the risk adjustment approach) and that the 90th percentile is also the appropriate way to determine the release from risk (if using the single margin approach). The aggregate effect of these factors means that the insurer's estimate of risk changes as follows over a 5 year period. (Assume the change in the quantum of risk is the result of new incriminating evidence becoming available over the settlement period).

CU	Day one	End x1	End x2	End x3	End x4	End x5
Risk (90th percentile)	6	4	5	3	4	0

In the risk adjustment approach, the insurer would remeasure the liability to reflect increases in risk in years x2 and x4. Under a single margin approach, the same amount of risk would be reported in years x1 and x2 (namely CU 4), and x3 and x4 (namely CU 3).

The carrying amount of the insurance contract liability would reflect the following different factors for risk under the two approaches (single margin and risk adjustment):



32. The remeasurement of risk is important for contracts where the ultimate outcome is uncertain and the amount of the uncertainty varies over the coverage and settlement periods. This would be the case for example for:

(a) Contracts that cover, for instance, asbestos, catastrophe, environmental liability or health (e.g. long term care). The risk in such contracts can vary significantly over time as new information is obtained about the insured risk. For example, the amount of risk in a long-term health contract will significantly increase when policyholders become symptomatic for an unknown reason. As more information becomes available about the full effect and extent of the pandemic, the amount of risk will decrease. Similarly, the development of new treatments may increase the risk of disability contracts, if it is unclear whether the treatment can cure policyholders (so that they no longer claim) or merely prolong their lives (while leaving them in need of expensive ongoing treatment). Another typical example is when a new fault line is discovered in case of earthquake insurance with the potential effect not known until detailed studies could be performed.

(b) Lapse sensitive contracts, if there is a sudden trend which affects policyholder behavior. This will result in an increase in uncertainty if the full effect is unknown. For instance, in some parts of the world fewer policyholders surrendered long term care insurance contracts than initially estimated when life expectancy started to increase.

(c) Contracts dependent on changes in economic factors (e.g. in periods of higher inflation, inflation-sensitive cash flows tend to be more uncertain as inflation is more volatile; credit spreads become very volatile during a financial crisis). A typical example is mortgage insurance contracts. During an economic crisis there will be more uncertainty on property values and policyholder behaviour (e.g. policyholders defaulting to service their bonds due to job losses) than during a period of stability.

(d) Contracts for liability when there are potential changes in laws or regulations (e.g. when a new enacted law is vague, future cash flows will be more uncertain than when a new enacted law's requirements are clear). A typical example is newly enacted laws reforming health care and causing an impact on the measurement of health insurance contracts.

33. In such cases, the remeasurement of an explicit risk adjustment provides relevant information to users and can add to the understandability of the amount reported as insurance liabilities.

34. In contrast, the remeasurement of risk is less important when the amount of risk, even if significant, remains relatively constant or declines at a steady rate. For example, in a term life contract, while the amount of risk may be significant, it typically does not fluctuate during the coverage period because mortality and lapse assumptions tend to be stable or change only very slowly.

35. Because risk can vary, both between different types of contracts and for the same contract over time, some think that more relevant information is provided to users of financial statements when risk is remeasured.

Release pattern of the residual margin

36. The IASB's model allocates the residual margin on a systematic basis in line with the pattern of services provided under the contract. This means that two drivers determine the amount of profit recognised in an accounting period. This approach reflects a view that the insurer may earn profit from the contract in more than one way. In contrast, in the FASB's single margin approach the single margin is viewed as unearned profit that should not be recognised until the associated cash flows become more certain. Risk, taken in conjunction with entity-specific factors, is the primary driver for the release of the whole of the single margin.

37. Some believe the risk adjustment and residual margin both represent unearned profit and that there is limited value in separating the component of deferred profit that is earned from release of risk and that from other factors. However, others argue that a more faithful representation of the ways the insurer earns profit from the contract can be achieved by applying different drivers to the release of margin in some cases. This is typically true for life contracts where the service relating to investing activities is significant relative to risk protection[7], especially in contracts

[7] We note that the boards have tentatively decided to unbundle goods and services that are distinct from the insurance component in an insurance contract. However, where the goods or services are not distinct, the contract as a whole would be measured in accordance with the insurance contracts standard.

of a longer duration, such as 30 year term life contracts, or in many participating contracts. For example in a regular premium life contract with significant asset management services that are not unbundled:

(a) part of the insurer's profit derives from its ability to charge the policyholder for asset management services. If it were providing those services in a separate contract the insurer would typically charge a fee based on the amount of funds under management, which increases over the life of the contract as the policyholder increases the amount of assets under management.

(b) the rest of the insurer's profit derives from its ability to charge for mortality protection. If it were providing that coverage in a separate contract, the insurer's margin would over time typically decline (as the risk decreases the closer to the end of the contract) or stay level (because the risk increases with the age of the policyholder, while simultaneously decreasing the closer the policyholder gets to the end of the contract).

38. In the FASB's model the whole of the profit in the contract is released to profit and loss as an insurer is released from exposure to risk as evidenced by a reduction in the variability of cash flows. For some contracts, it could be appropriate to release the single margin in a manner which reflects the release from risk. This would be the case when "release from risk" is the predominant driver for the profit the insurer earns. That is typically true for contracts with a significant risk component and of short duration, for instance many motor and catastrophe contracts.[8] However, for other contracts—such as those in which the asset management services dominate and increase over time—it could be argued that recognising profit by reference to release from risk could be misleading and could result in income being released to inappropriate accounting periods

[8] However, the staff notes that the insurer would be required to apply the premium allocation approach to many such contracts, and this would mean that the single margin would be allocated over the coverage period only and not over the whole period for which the insurer is at risk.

39. Because insurance contracts combine different features, in different proportions, some believe that users of financial statements would receive better information about the drivers of the insurer's profitability if the change in risk and the release of the margin are determined separately. In other words they believe that the benefits of this increased transparency about the drivers of the insurer's profitability exceed the costs of the additional complexity that results from determining those items separately.

40. The boards have yet to consider in full the presentation in the statement of comprehensive income. The ED proposed that information about changes in the risk adjustment and the release of the residual margin should be presented separately in the statement of comprehensive income. The boards may consider whether that information is better presented in the notes to the financial statements, with a combined line item presented for change in risk and release of residual margin. However, without measuring a risk adjustment explicitly, that separate presentation or disclosure could not be achieved.

Adjustment to residual margin

41. In the IASB's model a net increase in expected future outflows is offset against the residual margin and a net decrease in expected future outflows is added to the residual margin[9]. Consequently, a decrease (or increase) in the contract's expected profitability arising from changes in estimates of future cash flows would not be recognised immediately[10] (except to the extent that a decrease exceeded the residual margin available for offset, i.e. if the contract became onerous). It would be recognised in subsequent periods, when the residual margin is released to profit or loss. This is commonly referred to as 'unlocking'.

42. An effect of 'unlocking' the residual margin in the manner summarised in the previous paragraph is that it 'locks' the liability as a whole (except to the extent that the contract becomes onerous). The liability is locked at an amount equal to the premiums received from the policyholder for services not yet provided. Thus,

[9] Experience adjustments that relate to past events would be recognised immediately in profit or loss.

[10] However, that change would be disclosed in roll forwards in the notes to the financial statements.

the effect of 'unlocking' the residual margin is to make the building block approach more like the model proposed in the revenue recognition project.

43. Although potentially more complex to apply than an approach that recognises all changes in estimates in profit or loss, the IASB decided unlocking the margin would provide better information for users of financial statements. The reasons for the IASB's approach are:

    (a) It would reflect 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 the cash outflows increase, the contract becomes less profitable and the residual margin decreases accordingly. If the increase relates to estimates of *future* cash flows (as opposed to experience adjustments), the increase reduces the unearned component of the residual margin. Consequently a change in the estimate of the future cash flows should be viewed as a transfer between the components of the total liability, i.e. offset against the residual margin.[11]

    (b) It would avoid outcomes that some people regard as counterintuitive. Immediate recognise 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.

    (c) 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 fulfilment 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,

[11] In contrast, in the IASB's ED the residual margin could be viewed as an estimate of the return (beyond 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 fulfilment cash flows does not reflect a reduction in the residual margin. Rather it reflects an increase in the liability and should be recognised in profit or loss.

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 fulfilment cash flows on day 1. The insurer would not recognise an immediate gain.

44. In the FASB's single margin approach, all changes in estimate, whether relating to past or future events, are immediately recognised in profit and loss[12]. The FASB plans to consider an exception to this approach, whereby the changes in estimate would release the remaining single margin if the contract is onerous (this would address the concern in paragraph 43(c)). If the remaining single margin were released when the contract is onerous, this would have the same effect as offsetting the increase in expected future cash outflows against the single margin. There would be a discontinuity because this effect would occur only if the increase in expected cash outflows was significant enough to make the contract onerous.

45. The difference between a locked and unlocked approach affects all contracts for which there are changes in cash flow estimates, e.g. from changes in mortality or lapse assumptions, i.e. the majority of life contracts. The difference would be seen for changes in estimates up to the point that both the residual and single margin would be consumed. An example of the difference between a locked and unlocked margin is shown below:

Example

46. Consider a five-year contract with premiums of CU1,500 and expected claims at inception of CU500, which arise evenly over the contract. For simplicity, we ignore the time value of money and risk adjustment. Assume the residual margin is allocated evenly over the coverage period (i.e. based on the passage of time), consistent with the manner in which the service is delivered.

[12] Some of the arguments against unlocking are a common belief that unlocking adds complexity with minimal benefit; that users won't immediately see the effect of updated assumptions in the profit or loss and increased potential for manipulating earnings. Refer to previous papers on unlocking the margin (as listed in appendix A) for more detail.

47. The statement of total comprehensive income would include the following amounts:

	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Premiums	300	300	300	300	300	1,500
Expected claims	(100)	(100)	(100)	(100)	(100)	(500)
Underwriting result	**200**	**200**	**200**	**200**	**200**	**1,000**

48. At the end of year 2 the insurer expects future claims in years 4 and 5 to increase from CU100 to CU250 per year. Therefore, the change in estimates results in an increase in expected claims and a decrease in expected contract profitability of CU300.

49. The underwriting margins for locked and unlocked approaches would differ for years 2-5 as set out in the following table.

Underwriting result	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Margin locked [13]	200	(100)[14]	200	200	200	700
Margin unlocked [15]	200	200	100[16]	100	100	700

[13] According to the approach adopted for the single margin by FASB, the release of single margin would change in the following years if change of the estimation would influence the variability of cash flows. In this example it is assumed (for simplicity) that the change of estimates does not affect the pattern of margin release.

[14] CU200 – CU300 = CU-100

[15] The IASB has not yet discussed how an insurer should allocate a residual margin in the periods after residual margin has been unlocked for changes in estimates. In this example it is assumed that the allocation pattern would stay the same after changes in estimates, i.e. the residual margin is released on the time basis.

[16] (CU1000 – (CU200 * 2) – CU300) / 3 = CU100

Difference	**0**	**(300)**	**100**	**100**	**100**	**0**

Other considerations

50. The staff thinks the following factors are relevant when the Board considers whether it should change existing tentative decisions to reduce differences between the IASB and FASB:

    (a) Development work needed for the single margin and residual margin;

    (b) Timing;

    (c) The extent to which there will be convergence on other areas of difference; and

    (d) Response to the IASB's proposals.

Development work needed for the single margin and residual margin

51. The staff notes that if the IASB were to substantially change its decisions on risk adjustment and residual margin, it would need to explore additional details about the single margin approach, including:

    (a) the mechanism through which the single margin is sped up or slowed down;

    (b) the extent to which guidance should be provided to constrain the subjectivity inherent in an approach which releases the single margin in line with variability of cash flows, determined by judgement, based on facts and circumstances;

    (c) whether an insurer would be permitted to use an explicit determination of risk to release the margin; and

    (d) the operationality of the approach, including the unit of account for determining when the insurer is released from risk.

52. However, the IASB would avoid any need to consider developing further the requirements for the residual margin, e.g.:

(a) The disclosures required to ensure that changes in estimates are transparent.

(b) Whether all changes in estimates of future cash flows should be offset against the residual margin, or whether some changes in estimates of future cash flows (e.g. those that can be attributed to events that have already occurred) should be recognised in profit or loss immediately.

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

53. In addition, there are interrelationships between the decisions on unlocking the residual margin and the use of other comprehensive income to recognise the effect of changes in discount rates and in how the insurer should treat changes in estimates of cash flows that are a consequence of changes in discount rates (discussed in agenda papers 14A, 14B and 2G-2M for this meeting).

Timing

54. In the staff's view, answering the remaining questions about a single margin approach, particularly if it results in changes in the FASB's proposals to date and/or raise issues that their model does not already consider, could add time to the project timetable.

55. The timing of the insurance project is an important consideration in determening the most appropriate path. At present, IFRSs have no credible standard that deals with the accounting for insurance contracts. IFRS 4, published in 2004, is an interim standard that permits a wide range of practices and includes a 'temporary exemption' that states explicitly that an insurer does not need to ensure that its accounting policies are relevant to the economic decision-making needs of users or are reliable. As a result, there are "substantial differences used by different companies to account for [insurance] contracts", as noted in the November 2011 SEC staff paper *An analysis of IFRS in Practice*.

56. The diversity in current application of IFRS 4 today means that until a standard on insurance contracts is finalised, IFRSs could be regarded as incomplete.

Furthermore any standard that the IASB finalises is likely to significantly improve comparability and consistency in the accounting for insurance contracts worldwide, regardless of whether that standard is fully converged with US GAAP.

57. However, in determining the importance of timing, the Board also needs to consider whether differences between a finalised IFRS and US GAAP might need to be re-examined in the near future.

Other areas of difference between the boards

58. If the Board decides to change its decisions on margins in order to reduce differences between the IASB's and FASB's models, the extent to which other areas of difference remain should be considered. While any reduction in differences between the boards would improve convergence and reduce the need for reconciliation adjustments, some may believe that the boards should amend their decisions only if they are able to eliminate all of the substantive differences between the boards' models, particularly if the time line is negatively impacted. Accordingly, the staff has provided a summary of differences between the boards in appendix B.

Response to the IASB's proposals

59. In its Invitation to Comment on the exposure draft, the Board asked for input on whether interested parties supported using a risk adjustment and a residual margin or a single composite margin. The Basis for Conclusions described the rationale for both approaches (though the single margin approach has evolved since then). Paragraphs 15-18 set out a summary of the feedback received on the Board's exposure draft. That feedback was consistent with the feedback received on the Board's 2007 Discussion Paper.

60. The staff believes that the Board should consider whether there might be any implications in changing a position that was widely supported by interested parties. Some may be concerned that the IASB might change, at a relatively late stage, a feature that has been present in the IASB's model since the beginning of

the project. If significant remaining differences remain between the boards' models, this may heighten this concern.

Questions for Board members

Question 1 – Change of existing decisions on technical merit

(a) Do you think that the IASB should change any of its previous decisions on the risk adjustment and residual margin with the objective of developing an approach that Board members believe would result in a more relevant and faithful representation than would result from the existing tentative decisions?

(b) If so, which of the following tentative decisions would you change and why:

(i) the remeasurement of the amount attributed to risk at each reporting date

(i) the allocation basis for the residual margin

(iii) the offset of changes in estimates of future cash flows in the residual margin?

Question 2 – Change of existing decisions to achieve convergence

If your answer to question 1 identified decisions that you believe the IASB should *not* change solely on technical considerations, should the IASB nevertheless consider changing any of those decisions if that would reduce differences with the FASB's model, even if some or all of the other differences between the boards, described in appendix B, remain?

If so, which decisions would you change and why?

61. Paragraphs 3-8 describes the process that the staff plan to follow in the light of the Board's answers to these questions.

Appendix A: Previous papers on risk adjustment, residual margin and single margin

Risk adjustment and single margin

February 2011

- AP 3G/Memo 58G: *Explicit risk adjustment*

1-2 March 2011

- AP 2I/Memo 59I: *Informational session on uncertainty in the measurement of insurance liabilities*

w/c 14 March 2011

- AP 3B/Memo 60B: *Cover note for risk adjustment education sessions*
- AP 3C/Memo 60C: *Education session on explicit risk adjustment*
- AP 3J/Memo 60J: *Composite margin*

w/c 21 March 2011

- AP 12A/Memo 61A: *Education session on explicit risk adjustment*
- AP 12B/Memo 61B: *Education session on explicit risk adjustment*
- AP 12D/Memo 61D: *Objective for an explicit risk adjustment*

May 2011

- AP3A/Memo 68A: *Risk adjustment: the story so far*
- AP3B/Memo 68B: *Risk adjustment: useful financial information*
- AP3C/Memo 68C: *Risk adjustment: techniques to meet the objective*
- AP3D/Memo 68D: *Risk adjustment: comparability and verifiability through disclosure*
- AP3E/Memo 68E: *Composite Margin – Overview*
- AP3F/Memo 68F: *Composite Margin – Profit Realization*
- AP3G/Memo 68G: *Composite Margin – Conceptual Analysis*
- AP3H/Memo 68H: *Risk adjustment or composite margin?*
- AP3K/Memo 68K: *Composite Margin – A Comparison to Risk Adjustment*

June 2011

- AP3D/Memo 70D: *Allocation of the residual margin*

September 2011

- Memo 72B (FASB only): *Single Margin and Liability for Incurred Claims*
- AP 3A/Memo 73A: *Report back on FASB single margin discussions*
- AP 3B/Memo 73B: *Risk adjustment: objective and confidence level disclosure*
- AP 3C/Memo 73C: *Risk adjustment: techniques and inputs*

Unlocking the margin

February 2011

- AP3L/Memo 58L: *Margins*
- AP3M/Memo 58M: *Margins – illustrative examples*

w/c 28 March 2011

- AP1A/Memo 62A: *Considerations in unlocking the margin*

June 2011

- AP 3B/Memo 70B: *Whether to unlock the residual margin*
- AP 3C/Memo 70C: *How to unlock the residual margin*

November 2011

- AP 6 (IASB only): *Residual margin series: cover note*
- AP 6A (IASB only): *Which changes in estimate adjust the residual margin?*
- AP 6B (IASB only): *Residual margin – two approaches*

Appendix B: differences between the IASB's and FASB's models, other than risk adjustment and residual margin

Topic	IASB view	FASB view
Short duration contracts - eligibility *(difference carried over from ED/DP)*	Permit premium allocation approach for contracts when it produces similar measurements to building block approach.	Require premium allocation approach for all contracts meeting specified criteria.
Acquisition costs *(new difference since ED/DP)*	Residual margin shows expected profit after deducting all costs of acquiring and fulfilling the insurance contract liability.	Margin shows expected profit after deducting all costs of acquiring and fulfilling the insurance contract liability, excluding the portion deemed to not result in the issuance of contracts.
Scope: financial guarantee contracts *(new difference since ED/DP)*	Carried forward exemption from standard for some financial guarantee contracts that are accounted for in accordance with financial instruments standards.	Yet to be determined.
Scope: investment contracts with discretionary participation features *(difference to be carried over from ED/DP)*	Investment contracts with discretionary participation features issued by insurers included within the scope of the insurance contracts standard.	Investment contracts with discretionary participation features excluded from the scope of insurance contracts standard.
Disaggregation *(**potential** new difference since ED/DP)*	Exclude from premium presented in the income statement, the present value of amounts to be paid to policyholders or their beneficiaries, regardless of whether an insured event occurs, measured consistently with measurement of overall insurance liability.	The FASB has yet to determine how to measure the amount to be excluded from the premium presented in the income statement.
Definition of a portfolio of insurance contracts *(new difference since ED/DP)*	The unit of account for releasing the residual margin should not be prescribed. The principle to be followed is that the residual margin	The unit of account for releasing the margin is specified as the portfolio. Included within a portfolio are contracts that have

	should be released to the accounting period(s) in which the service is provided.	similar durations and similar profit distribution.

In addition, IFRS 9 *Financial Instruments* and the FASB's tentative model have different requirements for classification and measurement of financial assets including those that insurers hold to back insurance contract liabilities (not part of the insurance contracts project). The IASB is currently considering limited modification to IFRS 9. One of the reasons for those possible amendments is to seek to reduce key differences between the boards' respective classification and measurement models for financial instruments. That would also reduce potential differences between the boards' respective models for insurance contracts.