AASB & NZASB staff paper **July 2015**

Project	**Insurance contracts**
Topic	Contractual Service Margin (CSM) recognition – non-participating insurance contracts

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Objective

1. This paper outlines ideas for the IASB to consider in finalising its requirements on the manner in which the CSM should be recognised in relation to non-participating insurance contracts.

2. Unless otherwise specified, paragraph references in this paper are to paragraphs in ED/2013/7[1].

3. References in the paper to the 'general model' are to the measurement model sometimes referred to as the Building Block Approach. This paper refers to the simplified approach to measurement as the Premium Allocation Approach (PAA).

AASB and NZASB concerns and recommended solution

4. Based on feedback from Australian and New Zealand stakeholders, including users of financial statements, the AASB and NZASB staff do not support the tentative decision to require CSM recognition using the passage of time and reflecting the expected number of contracts in force, principally on the basis that:

   (a) in many cases, the 'number of contracts' will not be representative of the services to be provided because, for example, larger contracts can be the last to settle or lapse (unless the level of portfolio aggregation were required to be based on having contracts of identical size, which would impose considerable operational complexity);

1 IASB Exposure Draft ED/2013/7 *Insurance Contracts*

(b) the passage of time is not reflective of services provided to policyholders under some contracts,[2] particularly when the CSM is largely associated with the cost of capital needed to back the contracts in order to provide the service to policyholders, and this is far in excess of the capital the entity would choose to retain as a business decision;

(c) having different CSM recognition criteria for the general approach and the PAA undermines the notion that the two approaches are parts of the one measurement model; and

(d) it is inconsistent with the approach taken in other IFRS, which require a pattern to be applied for recognition purposes where such a pattern reflects the economic substance.

5. The AASB and NZASB staff recommend that, in common with the IASB's tentative decision on the PAA, the CSM under the general approach be recognised in profit or loss:

(a) on the basis of the passage of time; but

(b) if the expected pattern of release of risk differs significantly from the passage of time, then on the basis of expected timing of incurred claims and benefits.

6. If the IASB has doubts about whether the above criteria would automatically lead preparers of financial statements to take into account the level of settlement or lapse of contracts, this matter could be made clear in guidance.

Background – ED/2010/8[3]

7. For the general approach, ED/2010/8 proposed that an insurer recognise the residual margin[4] for insurance contracts as income in profit or loss over the coverage period in a systematic way that best reflects the exposure from providing insurance coverage, as follows:

(a) on the basis of the passage of time, but

2 The types of contracts referred to in paragraph 20(b) above include, for example, Lenders' Mortgage Insurance in many jurisdictions.

3 IASB Exposure Draft ED/2010/8 *Insurance Contracts*

4 ED/2010/8 referred to 'residual margin' rather than CSM.

(b) on the basis of the expected timing of incurred claims and benefits, if that pattern differs significantly from the passage of time [ED/2010/8, paragraph 50].

8. In respect of the PAA, ED/2010/8 proposed that the same basis (passage of time, but on the expected timing of incurred claims and benefits, if that pattern differs significantly from the passage of time) be used for reducing the measurement of the pre-claims obligation over the coverage period [ED/2010/8, paragraph 58].

9. The IASB received mixed feedback on the proposal, including:

(a) neither the passage of time nor the expected pattern of incurred claims and benefits would reflect the exposure from insurance coverage for all insurance contracts; and

(b) if the expected timing of incurred claims and benefits were applied to long duration life insurance contracts, the CSM would be recognised primarily towards the end of the coverage period; an effect that would be magnified by the accretion of interest on the remaining CSM.

Background – ED/2013/7

10. ED/2013/7 included the following proposal:

> An entity shall recognise the remaining contractual service margin in profit or loss over the coverage period in the systematic way that best reflects the remaining transfer of services that are provided under the contract [paragraph 32]

11. Much of the feedback on the ED/2013/7 proposal received by the IASB expressed concerns that the principle would allow too much scope for inconsistent outcomes between different entities and different portfolios of contracts.

12. The AASB and NZASB submissions on ED/2013/7 were generally supportive of the proposed approach on the basis that it would facilitate recognition of the CSM (in profit) as the insurer provides future services.[5]

5 The Boards also recommended that an improvement be made to the proposals to require a change in the risk adjustment relating to future coverage to be adjusted to the CSM. The IASB tentatively concurred with this view at its 18 March 2014 meeting (subject to the condition that the CSM should not be negative).

13. In relation to the general approach, at its meeting on 21 May 2014 the IASB tentatively decided to:[6]

    (a) confirm the principle in ED/2013/7 that an entity should recognise the remaining CSM in profit or loss over the coverage period in the systematic way that best reflects the remaining transfer of the services that are provided under an insurance contract; and

    (b) clarify that, for contracts with no participating features, the service represented by the CSM is insurance coverage that:

        (i) is provided on the basis of the passage of time; and

        (ii) reflects the expected number of contracts in force.

14. Although the tentative decision on the general approach in paragraph 13(b) above was identified as a clarification, the AASB and NZASB staff would characterise that tentative decision as a significant change from the ED/2013/7 proposals because of its potentially significant impact on profit recognition when compared with the principle proposed in ED/2013/7.

15. ED/2013/7 proposed that an entity applying the PAA would determine insurance contract revenue for the period in the same manner as for the general approach, by allocating expected premium receipts in the systematic way that best reflects the transfer of services that are provided under the contract [paragraph B91].

16. In relation to the PAA, at its meeting on 23 September 2014, the IASB tentatively decided[7] to effectively return to the 2010 proposals, such that an entity applying the PAA to account for an insurance contract would recognise insurance contract revenue in profit or loss:

    (a) on the basis of the passage of time; but

    (b) if the expected pattern of release of risk differs significantly from the passage of time, then on the basis of expected timing of incurred claims and benefits.

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6 Tentative decision outlined in: http://www.ifrs.org/Current-Projects/IASB-Projects/Insurance-Contracts/Documents/2015/Effect-of-redeliberations-on-ED-January-2015.pdf

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17. The AASB and NZASB staff would characterise the tentative decision on the PAA outlined in paragraph 16 as an amplification that does not represent a significant change from the ED/2013/7 proposals.

Reasons for IASB tentative decisions

18. In respect of the IASB's tentative decision on providing more guidance on CSM recognition, agenda paper 2C for the May 2014 IASB meeting noted:

> Many respondents [to ED/2013/7] observe that the allocation pattern for the CSM will have a material impact on the profit reported by entities. In the light of this observation, some respondents were concerned that, without further guidance, the subjectivity in determining the pattern of underlying services will create significant diversity in the pattern of recognition of the CSM in profit or loss. [paragraph 4]

19. Based on agenda paper 2C for the May 2014 meeting, the IASB has tentatively decided on its guidance for recognising the CSM in profit or loss under the general approach based on the following comments:

> If more contracts terminate in a period than was expected at the beginning of the period, it may be necessary to derecognise the element of the CSM that relates to them. If fewer contracts terminate in a period than expected it may be necessary to re-estimate fulfilment cash flows, and adjust the CSM accordingly, and use the revised expectation of future service to determine the pattern of future CSM recognition. [paragraph 41]
>
> Allowing for expected contract terminations enables a more accurate calculation of the proportion of total service that is provided in the current period, and hence the proportion of CSM to be recognised in profit or loss. In Appendix A, the staff provide an example that compares CSM recognition on a time basis with and without allowing for expected contract terminations. The purpose of the example is to demonstrate the necessity of using expected contract terminations to:
>
> (a) calculate the number of expected insurance coverage hours to be provided, and hence the proportion of total service provided in a period, and
>
> (b) minimise catch up adjustments to derecognise the CSM for contracts no longer in force. [paragraph 42]
>
> The fulfilment cash flows and the carrying amount of the CSM for a portfolio of life insurance contracts reflect the expected level and timing of contract terminations at each period end. This is the best information available to estimate the contract coverage hours in a current reporting period as a proportion of total remaining coverage hours for all contracts and hence the basis for releasing the CSM to profit or loss. [paragraph 43]

20. Agenda paper 2C for the June 2015 IASB meeting[8] also notes:

> For non-participating contracts, the IASB decided that the recognition of the contractual service margin in profit or loss would need to reflect the expected number of contracts in force. This is because, for a portfolio of contracts, an entity would expect to transfer more insurance coverage service (and hence to recognise a greater proportion of the contractual service margin in profit or loss) in the early years of the coverage period for a group of contracts, if it expects a significant proportion of insurance contracts to terminate before the end of their term, whether due to death, claims or lapses. [paragraph 34]
>
> In the staff's view, this rationale applies equally to contracts with participation features. However, the staff also note that the objective of the proposed insurance contracts Standard is to provide principles for the measurement of an individual insurance contract and that, in meeting that objective, an entity would already need to ensure that the allocation pattern of the contractual service margin reflects the expected number of contracts that would be in force. Therefore, it would not be necessary to state [that] the contractual service margin should be recognised in profit or loss in a way that reflects the expected number of contracts in force. The staff note that the IASB's previous decision for the premium allocation approach already reflects this thinking. [paragraph 35]

21. The AASB and NZASB staff consider that the basis tentatively decided for the recognition of CSM in profit or loss for the PAA (the basis of the passage of time; but, if the expected pattern of release of risk differs significantly from the passage of time, then on the basis of expected timing of incurred claims and benefits), if applied in the context of the general approach, would automatically take into account the level of settlement or lapse of contracts. If that matter is in doubt, we suggest that it be made clear in guidance that one of the factors that would impact on the expected timing of incurred claims and benefits would be contract settlements or lapses. This is because the number (as well as the relative significance) of contracts in force would be a key factor:

    (a) in the first instance, in determining whether the passage of time basis is significantly different from the expected timing of incurred claims and benefits; and

    (b) in determining the expected timing of incurred claims and benefits when the expected pattern of release of risk differs significantly from the passage of time.

8 At the time of writing this paper, the IASB had not yet considered this agenda paper.

22. The AASB and NZASB staff consider that the tentatively decided approach to CSM recognition under the PAA, if applied under the general approach, would avoid the problems (identified below) of the tentatively agreed approach of relying on passage of time and the number of contracts in force as the recognition criteria.[9]

View of the tentative decisions from Australia and New Zealand

23. The AASB and NZASB staff do not support the tentative change to require CSM recognition using the passage of time and reflecting the expected number of contracts in force (paragraph 13(b) above) on the basis that:

    (a) in many cases, the 'number of contracts' will not be representative of the services to be provided because, for example, larger contracts can be the last to settle or lapse (unless portfolio aggregation were required to be based on having contracts of identical size, which would impose considerable operational complexity);

    (b) the passage of time is not reflective of services provided to policyholders under some contracts,[10] particularly when the CSM is largely associated with the cost of capital needed to back the contracts in order to provide the service to policyholders and this is far in excess of the capital the entity would choose to retain as a business decision;

    (c) having different CSM recognition criteria for the general approach and the PAA undermines the notion that the two approaches are parts of the one measurement model;

    (d) it is inconsistent with the approach taken in other IFRS, which require a pattern to be applied for recognition purposes where such a pattern reflects economic substance; and

    (e) the passage of time combined with the number of contracts remaining in force is more of a 'method' than a 'principle' and, although in the vast majority of cases we would expect the unit of account to be portfolios of contracts, as a method it is not functional for a single contract because a single contract either persists or lapses.

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9 The AASB and NZASB staff consider that most of the identified problems would also arise if the passage of time alone were used as a recognition criterion.

10 The types of contracts referred to in this sub-paragraph, for example, lenders' mortgage insurance in many jurisdictions.

24. In relation to paragraph 23(d) above, there are a number of IFRS that require a pattern to be applied for recognition purposes. For example:

    (a) IAS 16 *Property, Plant and Equipment* requires the depreciation method used to "reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity" [IAS 16, paragraph 60]; and

    (b) IAS 38 *Intangible Assets* requires the amortisation method used to "reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity" for intangible assets with finite lives [IAS 38, paragraph 97].

25. ED/2013/7 defined the 'risk adjustment' as:

    > The compensation that an entity requires for bearing the uncertainty about the amount and timing of the cash flows that arise as the entity fulfils the insurance contract." [Appendix A]

26. ED/2013/7 also includes the following application guidance:

    > The risk adjustment measures the compensation that the entity would require to make the entity indifferent between:
    >
    > (a) fulfilling an insurance contract liability that has a range of possible outcomes; and
    >
    > (b) fulfilling a liability that will generate fixed cash flows with the same expected present value as the insurance contract.
    >
    > For example, the risk adjustment would measure the compensation that the entity would require to make it indifferent between fulfilling a liability that has a 50 per cent probability of being CU90 and a 50 per cent probability of being CU110 and fulfilling a liability that is fixed at CU100. As a result, the risk adjustment conveys information to users of financial statements about the entity's perception of the effects of uncertainty about the amount and timing of cash flows that arise from an insurance contract. [paragraph B76]
    >
    > Because the measurement of the risk adjustment reflects the compensation that the entity would require for bearing the uncertainty about the amount and timing of the cash flows that arise as the entity fulfils the contract, the risk adjustment also reflects:
    >
    > (a) the degree of diversification benefit that the entity considers when determining the compensation it requires for bearing that uncertainty; and
    >
    > (b) both favourable and unfavourable outcomes in a way that reflects the entity's degree of risk aversion. [paragraph B77]

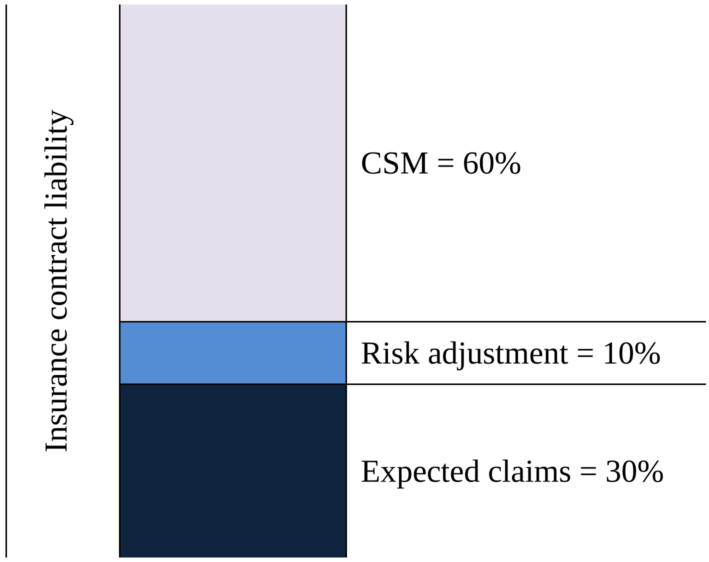
27. In some forms of insurance business, insurers' degree of risk aversion is much lower than that of the prudential regulator. This is because the prudential regulator has a much wider responsibility for economic stability across a whole economy, rather than just one entity. Accordingly, the regulator requires insurers to hold a much greater level of

capital than they would hold for business reasons. Premiums charged by an insurer need to be sufficient to compensate them for holding a level of capital determined by a prudential regulator. In respect of lenders' mortgage insurance, for example, regulators can have an extremely low tolerance for the risk of uninsured losses based on their responsibilities for managing systemic risks to banking and the economy. Accordingly, the CSM can be relatively large compared with the risk adjustment.

EXAMPLE – Lenders' Mortgage Insurance (LMI)

A portfolio of LMI contracts has an expected life of 20 years. Based on an economic assessment of the exposure to risk, the risk adjustment is a relatively small proportion of the total liability. Due to the potentially systemic impact of significant numbers of home mortgage defaults, the prudential regulator has a very low risk tolerance and imposes stringent capital requirements on LMI insurers, which leads to a proportionately large CSM. The amount of capital that the regulator requires insurers to maintain is a function of a number of factors including stress modelling for a three-year economic or property downturn. Based on these factors, in simplified terms, the entity has determined that its capital needs to be maintained in line with the following percentages of the underlying outstanding loan balances (which themselves reduce over time). The significant skew towards claims early in the contract period is due to there being higher loan-to-value ratios in the early years.

Years	1 & 2	3 & 4	5 to 7	7 to 9	10 to 15	15 to 20
%	4%	3%	2%	1%	0.5%	0.25%



There is a strong correlation between the expected loss ratio, the cost of capital deployed to support the business and the level of service being provided to the insured parties. There are usually higher claims, higher capital demands and higher levels of service in the early years compared to the later years. Accordingly, conventionally, the CSM is recognised in greater amounts in the early years and lesser amounts in later years, even though the number of contracts might remain stable over the life of the portfolio.

28. Although, in the case of lenders' mortgage insurance, the holding of capital might not be considered to be a service to a policyholder, without the capital being held, the policyholder would not receive the risk bearing service. In addition, the pattern of exposure to risk is likely to be highly correlated with the extent to which capital needs to be held. This is because the capital requirements imposed by a prudential regulator would be a multiple of the capital that the entity would choose to hold for business reasons, which is a key factor for the insurer determining the compensation it requires for bearing the uncertainty about the amount and timing of cash flows under insurance contracts.

29. The need to hold capital can be likened to a performance obligation under IFRS 15 *Revenue from Contracts with Customers*. The link can probably best be seen with life insurance business. At a business level, the insurer, in setting its risk adjustment, might be prepared to operate on the basis of being able to pay claims up to a 90% confidence level. However, the prudential regulator on behalf of policyholders requires life insurers to hold sufficient capital to ensure the ability to pay claims up to a 99% confidence level. In the case of life insurance, policyholders would be expecting to receive that higher level of certainty of their claims being paid and regard that as a service to them (and their beneficiaries).

30. Under the IASB's tentatively decided approach, those insurers with a growing business in some types of insurance such as lenders' mortgage insurance would show lower levels of profit than would be justified by the levels of service being delivered in the current period. Conversely, those insurers that have shrinking levels of business such as lenders' mortgage insurance would show higher profits than would be justified by the levels of service being delivered in the current period.

31. The AASB and NZASB staff consider that, for the reasons outlined above, requiring CSM recognition using the passage of time alone, or in conjunction with reflecting the expected number of contracts in force, would give rise to misleading information in many circumstances and, therefore, disadvantage users of financial statements. In the above example, users would expect to see greater recognition of CSM in the earlier years than the later years because most of the service is provided in the earlier years.

32. The AASB and NZASB staff are in the process of consulting with Australian and New Zealand insurance analysts on the potential impacts of the tentative decision on CSM recognition under the general approach. Those analysts with whom we have consulted so far have expressed concerns about the potential outcomes, mainly for the reasons outlined in paragraphs 23(a) and 23(b) above.

33. The AASB and NZASB staff also note that, at its meeting on 18 March 2014, the IASB tentatively decided[11] to confirm the proposal in ED/2013/7 that, after inception, differences between the current and previous estimates of the present value of cash flows that do not relate to future coverage and other future services should be recognised immediately in profit or loss. These gains and losses could include, for example, one-time claims due to factors such as policyholder deaths, which would mean those contracts are no longer in force. This would imply that the number of contracts in force would automatically be a factor in determining insurance liabilities, including the CSM, and need not be specifically identified as basis for determining CSM recognition.

AASB and NZASB staff recommendation

34. The AASB and NZASB staff recommend that, consistent with the IASB's tentative decision on the PAA, the CSM under the general approach be recognised in profit or loss:

    (a) on the basis of the passage of time; but

    (b) if the expected pattern of release of risk differs significantly from the passage of time, then on the basis of expected timing of incurred claims and benefits.

35. If the IASB has doubts about whether the above criteria would automatically lead preparers of financial statements to take into account the level of settlement or lapse of contracts, this matter could be made clear in guidance. That is, it could be explained in guidance that one of the factors that would impact on the expected pattern of release of risk and the expected timing of incurred claims and benefits would be the number and significance of contract settlements or lapses.

11 Tentative decision outlined in: http://www.ifrs.org/Current-Projects/IASB-Projects/Insurance-Contracts/Documents/2015/Effect-of-redeliberations-on-ED-January-2015.pdf

36. The AASB and NZASB staff also note that, if the level of settlement or lapse of contracts has a material impact, the expected timing of incurred claims and benefits would differ significantly from using the passage of time alone.

37. Furthermore, the AASB and NZASB staff suggest that the word ‘materially’ be used in the CSM recognition criteria for both the PAA and the general approach instead of ‘significantly’, unless the IASB is satisfied that there needs to be a distinction made between materiality and significance in this context.