Project **Insurance contracts**

Topic **Key measurement issues**

Purpose of this paper

1. Paragraph 14 of agenda paper 6C lists some of the key questions on measurement that have not been answered by the boards conclusively. Those questions (and perhaps some other) need to be answered in order to determine the measurement approach. This paper discusses some of the key measurement issues associated with those questions.

2. We cannot discuss all issues in this paper. In this paper, we focus our analysis on a number of critical issues around a measurement objective and margins – staff sees these issues as particularly important in order to make progress on the measurement approach. These issues are:

   (a) What should the measurement objective be? (paragraphs 3-9)

   (b) Should a risk margin be identified and measured separately? (paragraphs 10-13)

   (c) Should a margin for other services be identified and measured separately? (paragraphs 14-19)

   (d) What is the role of the premium in subsequent measurement? (paragraphs 20-23)

   (e) How should an insurer release residual and composite margins? (paragraphs 24-28)

What should the measurement objective be?

3. Some of the questions referred to in paragraph 14 of agenda paper 6C are connected to the measurement objective. Arguably some of these questions

would be answered by the selection of a measurement approach- some features of a measurement approach can flow more or less directly from an objective.

4. The list of candidates in paper 6A includes the following objectives[1]:

   (a) The price a market participant would require for taking over the liability.

   (b) The cost of fulfilling the obligation with the policyholder over time.

   (c) The amount the entity would rationally pay at the end of the reporting period to be relieved of the present obligation, ie to settle it or to transfer it to a third party. This is the objective from the IASB's IAS 37 project.

5. In its February 25 meeting, the FASB already decided tentatively not to explore a current exit price as the measurement approach for insurance contracts. Agenda paper 6E deals with the status of current exit price for the IASB discussions on the measurement approach for insurance. In paper 6E, staff argues that the IASB should not explore current exit price any further- we will therefore not discuss this candidate and its objective any further in this paper [in other words, we will focus on the fulfilment candidates and the updated IAS 37 model].

6. Therefore, staff recommends to consider for insurance contracts those candidates that build on:

   (a) the objective of current fulfilment value (the cost of fulfilling the obligation with the policyholder over time), or

   (b) the objective used in the IAS 37 model (the amount the entity would rationally pay at the end of the reporting period to be relieved of the present obligation).

7. On (a) cost of fulfilling the obligation, staff wants to note that this notion offers more flexibility in defining the measurement approach than the other objectives; some of the features follow directly from its definition but not all.

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[1] The list of candidates also includes an unearned premium approach. This approach is being considered only for one type of liabilities (pre-claims liabilities of short-duration contracts) and applies an allocation approach similar to the proposed model in the discussion paper *Preliminary Views on Revenue Recognition in Contracts with Customers.* We do not discuss this candidate in this paper.

8. Objective (b) the amount the entity would rationally pay arguably provides a clearer basis for filling in all the features of the measurement approach. This basis that would be consistent with the principles used for liabilities accounted for under IAS 37.

9. We would like to note that one can conclude on the measurement approach and its objective via two routes:

   (a) Some may first look at which measurement candidate includes the features they find most suitable for insurance contracts; the objective of that candidate would be the objective that they would support.

   (b) Others may start by selecting a preferred measurement objective and accept the features of the model that follow from that objective as a consequence.

Should a risk margin be identified and measured separately?

10. One margin component that could be identified and measured separately is a margin for bearing risk, ie a risk margin[2]. Views differ on risk margins; we summarise the two main views:

   (a) Some believe an explicit risk margin should be part of the measurement because it ensures that financial reporting does not represent two liabilities as the same if one liability is more risky than the other. Not including such a margin could result in financial reporting representing two liabilities as the same if one liability is more risky than the other.

   (b) Others however believe a split between a risk margin and other components of the margin is neither reliable nor useful, for both initial measurement and subsequent measurement. The risk margin would be part of one single composite margin that is implied by the premium at inception.

11. For a fulfilment notion, it is arguably not straight-forward to determine whether a risk margin is included.

   (a) if a separate risk margin is **not** identified, the risk margin will be implicitly included in a composite margin. Whether a contract that is

[2] Staff refers to agenda paper 5A, April 2009, for a more detailed discussion on whether the measurement should include a separate risk margin. [A link to the observer notes for agenda paper 5A, April 2009 is included here].

onerous or on the edge of being onerous includes a risk margin depends on the liability adequacy test [in other words, is there a liability adequacy test and, if so, does it include an explicit risk margin?].

(b) If a separate risk margin **is** identified, the only form of risk margins that flows directly form the draft definition of fulfilment value is the cost of bearing risk. However, staff so far has been unsuccessful in defining a risk margin that represents cost (expense) as defined in the IASB's Framework or the FASB Statement of Concepts. Perhaps the only way to include a separate risk margin in a fulfilment notion is to prescribe a fulfilment in such a way that it includes, in addition to the expected present value of the cash flows, a risk margin based on the compensation (ie a profit) for bearing risk.

12. The objective of the IAS 37 model is to measure the amount an insurer would rationally pay to be relieved of the obligation. This measure would also consider any possible variations in the amount or timing of the future cash flows that affect the amount that the entity would rationally pay to be relieved of a risk. If the insurer considers risk when it takes on an obligation, it seems natural to presume that an insurer also considers risk in the amount that it would rationally pay to be relieved of an obligation. This amount would therefore include a price (ie profit) for bearing risk by the insurer. Because the IAS 37 model is a current model, this risk margin is updated each reporting period.

13. Staff would like to point out the following consequences:

(a) If one selects a candidate that reflects risk only implicitly as part of the overall margin, one accepts that circumstances can exist where the measurement in effect does not include a risk margin. For example, contracts that are sold at a loss for commercial reasons or that are mispriced. [This could be prevented by requiring the insurer to perform a liability adequacy test that includes a risk margin at each reporting date- but in that case one could argue that the measurement in effect includes a separate risk margin.]

(b) If one selects an approach that includes a separate risk margin, one accepts that in some circumstances the insurer recognises in the current year an expense that will, in effect, reverse in future years.

Should a margin for other services be identified and measured separately?

14. Another margin component that could be reported separately is a margin for services other than the service of bearing risk, in other words a service margin[3].

15. Some may take the position that a measurement of an insurance contract should include a separate service margin rather than include it implicitly in a residual or composite margin. A separate service margin would ensure that the insurer includes and updates a margin it requires for services (if any) other than bearing risk each reporting period and reports the release of that margin in income in way that reflects that pattern of providing those services.

16. Others believe that it is impracticable and not useful to separate the service margin from any other implicit components in the margin, particularly when such a margin does not flow explicitly from the measurement objective.

17. We want to divide 'other services' for insurance into two categories.

    (a) In some cases the insurer could use margins required for activities that it also provides on a stand-alone basis, eg. some insurance groups provide fund management services or car repairs. An insurer would generally not commit to provide those services without compensation; in some cases that compensation is explicitly charged to the policyholder. A service margin could be estimated based on the stand-alone selling price for those services.

    (b) Other activities that the insurer performs may be considered as ancillary services, for example policy administration, claims investigation, claims administration and claims payment. The insurer would not necessarily expect an explicit return for them; the return on those activities usually is implicitly included in the overall margin the insurer earns on the contract. Estimating a required separate service margin for those activities that might be seen as ancillary services is arguably less straight-forward.

18. The definition of the fulfilment candidates does not seem to provide a clear basis for including a separate margin for other services. If one wants to include it in

[3] Staff refers to agenda paper 5A, April 2009, for a more detailed discussion on whether the measurement should include a separate service margin. [A link to the observer notes for agenda paper 5A, April 2009 is included here].

the measurement, it probably is necessary to explicitly prescribe it as a separate component of the margin.

19. The updated IAS 37 model requires an insurer to consider a required profit margin if the entity has to undertake a service to fulfil the obligation. The model regards this as a part of the price that the insurer would rationally pay to be relieved of the obligation, although a margin for other services might not be material in all cases.

What is the role of the premium for subsequent measurement?

20. In the April 2009[4], staff identified two views on the role of the premium (the customer consideration) for subsequent measurement:

    (a) View A: the premium (customer consideration) determines the measurement, in particular the overall margin, at inception, unless the contract (or, perhaps, a portfolio of contracts) is onerous. Subsequently, the premium may be relevant for presenting revenue (‘top line’) in the income statement (depending on what presentation for the income statement is selected), but not for the overall measurement of the liability. As a result, changes in estimates will be recognised in profit or loss when they occur.

    (b) View B: the objective is to measure the overall margin that the insurer expects to earn over the life of the contract, based on current expectations. If there is a change in the measurement of the expected cash flows plus specified margins (if any), the value of any residual or composite margins must change accordingly (unless those margins become negative). In other words, the remaining residual or composite margin would be reassessed at each reporting date.

21. Proponents of view A would argue that, as a result of applying a current approach, the insurer should report changes in circumstances in profit and loss promptly. Proponents of view B would argue that an insurer should not recognise income or expense in one period from changes in estimates only to reverse it in a subsequent period; in their view this is not a fair depiction of the actual margin the insurer earns over the life of the contract.

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[4] We refer to agenda paper 5B of April 2009 for more details on those tow views. [A link to the observer notes for agenda paper 5B, April 2009 is included here].

22. We note that proponents of view B generally would apply it to only changes in estimates other than (financial) market variables. Changes in (financial) market variables would be recognised immediately in profit or loss (or other comprehensive income) together with changes in the carrying amount of the assets backing the insurance liabilities- not doing so would result in an accounting mismatch if the assets are measured at fair value.

23. We also note that, in our view, only those margins that are unspecified (ie residual or composite margins) can potentially be used for adjusting changes in estimates. Any margin that is identified and measured separately should be measured at each reporting period and therefore cannot be used for reassessing the impact of changes in estimates for the overall margin.

How should an insurer release residual and composite margins?

24. All the candidates that use an explicit building block approach have either a residual margin or a composite margin. A residual margin includes the difference between (a) the premium [IASB: premium less acquisition costs] and (b) the expected cash flows plus margins that are measured separately. The composite margin is determined by calibrating to the premium [IASB: premium less acquisition costs] directly from the expected cash flows. Both residual margins and composite margins are therefore capturing any positive day one difference so that no day one difference will be recognised in profit or loss. These margins will be released to profit or loss in subsequent periods.

25. Residual and composite margins are blends. Therefore it may be difficult to determine an appropriate driver for their release at subsequent reporting dates; if no other driver is available, perhaps release from risk could be used as a default. However, other drivers like expected benefit payments or expected claims may also be considered.

26. One particular issue is over which part of the term of the liability a residual or composite margin should be released:

    (a) one approach is to apply the full term of the liability, covering both pre-claims and a claims period.

(b) another approach is to the release full residual or composite margin during the coverage (ie pre-claims) period.

27. For life contracts, the claims period typically is very short; both approaches would probably end up in an answer that is very similar.

28. The issue is relevant to non-life contracts because the claims handling period may stretch significantly beyond the end of the coverage period. A release over the full term of the liability would mean that some income is also reported after the coverage period has ended. However, it may be difficult to determine and apply an appropriate driver for the release of residual and composite margins over the claims handling period. Furthermore, candidates that include a separate risk margin would still report income during the claims handling period as a result of release of the risk margin.