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**International
Accounting Standards
Board**

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INFORMATION FOR OBSERVERS

Board Meeting: February 2009, London

Project: Insurance Contracts

Subject: Margins (Agenda paper 10B)

Purpose of this paper

1. This paper gives further information on margins, in support of agenda paper 10A.
2. The rest of this paper deals with the following subjects:
 - (a) Why include a margin? (paragraphs 3-8)
 - (b) Margins for insurance contracts (paragraphs 9-17)
 - (c) Margins and day one differences for candidates 1-4 (paragraphs 18-26)
 - (d) Issues for Current exit value (paragraphs 27-37)
 - (e) Issues for Current fulfilment value (paragraphs 38-51)
 - (f) Unearned premium (paragraph 52)
 - (g) Liability adequacy test (paragraphs 53-55)

Why include a margin?

3. Consider two assets, asset A and asset B. The assets are exactly the same, with one exception. Asset A generates future cash flows with no uncertainty. Asset B generates cash flows that are subject to uncertainty. It is expected that market participants place a higher value on asset A, because they are risk-averse or, perhaps, loss-averse. Those market participants therefore seek compensation, a risk premium, for accepting uncertainty¹.
4. Similarly, risk-averse entities require a risk premium for accepting obligations that generate uncertain cash flows.
5. The notion that accounting measurements should reflect risk is not new. For example, in US GAAP, paragraph 67 of FASB Concepts Statements No. 7, says:

The objective of including uncertainty and risk in accounting measurements is to imitate, to the extent possible, the market's behaviour towards assets and liabilities with uncertain cash flows. [.....]

6. In the discussion paper *Preliminary Views on Insurance Contracts* (DP), the IASB expressed the preliminary view that insurance liabilities should include a margin that is measured explicitly. The margin should consist of:
 - (a) A risk margin. The objective of a risk margin is to convey decision-useful information to users about the uncertainty associated with future cash flows. The risk margin is an estimate of the compensation that market participants require for bearing risk.
 - (b) A service margin, if required by a market participant. The service margin is the compensation that market participants require for providing services other than bearing risk.
7. More recently, the boards took the position in their preliminary views on revenue recognition that an entity should include a margin in measuring its performance obligation from contracts with customers. This margin reflects the return the entity charges for providing the goods and services under the contract, as well as the return it requires on originating the contract. However, the revenue recognition model proposed in

¹ FASB Concepts Statements No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, paragraph 65

the discussion paper *Preliminary Views on Revenue Recognition in Contracts with Customers* (DP on revenue) does not measure this margin explicitly.

8. There is a wide range of terms relating to margins: margin, risk margin, service margin, profit margin, compensation, risk premium, cost of risk, return, and reward. We try to limit the use of terms and apply them consistently throughout the rest of the paper.

Margins for insurance contracts

9. We start by looking at what might be included in the overall margin for an insurance liability:
 - (a) risk margin: the compensation required for bearing risk.
 - (b) service margin: the compensation required for services other than bearing risk.
 - (c) margin for past origination activities: the compensation required to recover past origination activities, including a reasonable return.
10. The overall margin included in the liability is, on average, expected to turn into ‘profit’ by making the bottom line of the income statement more positive or less negative.
11. Arguably, the **risk** margin therefore has two effects in financial reporting:
 - (a) in accounting measurements, it reflects the effect of uncertainty.
 - (b) on release, it shows the profit earned for the effort (or service) of bearing risk. Ex ante, it shows the estimated profit that will arise if the actual cash flows coincide with expected cash flows. Ex post, it shows the actual profit for bearing risk.
12. When taking over a contract, a market participant transferee wants to be compensated for any risk it takes on or future services it will have to provide. However, a market participant transferee does not typically require any elements of the insurance premium for origination activities because it did not incur any direct and indirect origination costs. A market participant transferee therefore typically requires a risk margin and a service margin, but not compensation for past origination activities².

² IASB January 2009, Agenda Paper 3E.

13. Like a market participant transferee, the insurer that originated and still holds the contract also wants to be compensated for risks and future services. In addition, the insurer also incurred expenses to originate the contract. An insurer would seek recovery for those past origination expenses and include a margin for past origination activities in the premium. Is this margin for past origination activities part of the insurance liability when looking at it from the perspective of an insurer fulfilling the obligation? We identified three views.

- (a) The premium is an appropriate depiction of an insurance liability at inception, because it reflects the fact that neither party has performed under the contract yet. This view is consistent with the preliminary view the boards took in the DP on revenue
- (b) Insurers often have to incur considerable origination costs and not recognising any revenue at contract inception would result in a day one loss that economically is not a loss. Therefore, insurers should recognise as revenue at inception that part of the premium that provides a recovery of the origination costs.
- (c) The margin for past origination activities does not relate to the remaining obligations. Therefore, the insurer should not include that margin in the measurement of its performance obligation (and may, in some cases, recognise a net contract asset at inception).

14. We believe that a difference between a market participant's margin and the margin of an entity that originated the contract is caused by two factors:

- (a) the margin of an entity that originated the contract includes a component that a market participant would not include in the margin because it does not relate to the remaining obligation.
- (b) the actual margin the entity charges to the policyholder differs from the margin a market participant requires. This may cause one or more of the margin components to differ from what a market participant would typically require, if for example the insurer is able to charge higher prices as a result of niche markets or superior distribution systems or is willing to charge lower prices to build market share.

15. Can day one differences occur? When one looks at a margin required by a market participant, a day one difference can exist as a result of both factors.

16. From the originator's perspective, a day one difference can only occur from a margin that does not relate to the remaining obligation. Whether the measurement approach would actually result in a day one difference depends on the treatment of the margin at inception:
- (a) if no day one revenue is recognised: day one loss equals the amount of the related acquisition costs at that time.
 - (b) if day one revenue is recognised equal to the amount needed to recover related acquisition costs incurred in the same period: no net day one difference.
 - (c) if day one revenue reflects the release of any part of the margin that is not associated with the remaining obligations: day one profit in some, perhaps many, cases. [We believe that a significant day one difference may still exist after taking into account acquisition costs, particular for insurers selling in retail markets, because these insurer price to recover more past origination costs than just the related acquisition cost.]
17. In addition, day one differences could also arise if some pricing elements are not included in accounting measurement or if measurement errors occur.

Margins and day one differences for candidates 1-4

18. Agenda paper 10A identifies five candidate measurement approaches. They vary in how they estimate margins and treat day one differences.

Initial measurement

19. Candidate 1 (current exit value) includes an estimate of the margin that market participants would require. This includes a risk margin, and also includes a margin for other services if market participants require such a margin. Candidate 1 may use the premium for a reasonableness check, but the premium does not override an unbiased estimate of the margin required by market participants. Candidate 1 can result in a day one difference; this difference will be recognised at inception in profit or loss [an alternative would be not to recognise these day one gains in profit or loss; we will come back to this point later in the paper].
20. Candidate 2 measures the insurance liability as the cost of fulfilling the obligation to the policyholder over time in the ordinary course of business. The cost of fulfilling the

obligations include a margin for the cost of bearing risk [later in this paper we describe how the cost of bearing risk compares to compensation for bearing risk]; any further margins included in the premium are not part of the cost to fulfil the obligations and are recognised in profit or loss at inception. Unlike current exit value, candidate 2 does not include a service margin.

21. Like candidate 2, candidate 3 also includes a risk margin based on the cost of bearing risk. However, candidate 3 would recognise the day one difference as a part of the insurance liability, separate from the risk margin, for reasons of consistency with revenue recognition. We tentatively refer to this separate margin as the 'additional margin'. This additional margin could arise from various items, such as service margins (of the kind included in current exit value), selling margins, recovery of past investment, and measurement errors. Often, perhaps all of these factors are present and proponents of candidate 3 might argue that it is impracticable to quantify their separate effects. The additional margin cannot be negative; the insurance liability comprises at least the cost of fulfilling the obligations, including the cost of bearing risk.
22. Candidate 4 sees the actual premium as the best (and perhaps only) market evidence for estimating the margin. It therefore uses the premium to determine the initial overall margin, so no 'positive' day one difference can occur. Therefore, this margin would arguably include not only a margin for risk, but also other margin components. We therefore tentatively refer to this margin as a 'composite margin'. Proponents of candidate 4 do not regard a split (as included in candidate 3) between a risk margin and other components of the margin as reliable or useful. As a consequence of calibrating to the premium directly, a liability adequacy test is required at inception since the premium may not be sufficient to cover the obligations; a 'negative' day one difference (day one loss) will be recognised in profit or loss immediately.

Subsequent measurement

23. Candidate 1 remeasures both the risk margin and service margin at each reporting date. The margins are reported in income as the insurer is released from risk and performs services respectively.

24. The risk margins for candidate 2 and 3 are based on the cost of bearing risk. The cost of bearing risk is considered to be one of the costs of fulfilling the obligation with the policy holder. It is remeasured at the end of each reporting period.
25. The additional margin for candidate 3 and the composite margin of candidate 4 are locked-in at inception (ie the margin is not remeasured subsequently):
- (a) for candidate 3, it does not seem useful to remeasure subsequently a component of the liability that is a mixture of things.
 - (b) candidate 4 builds on the rationale that no subsequent information will provide better evidence of the margin. As a result, the margin will not be remeasured for subsequent changes; no subsequent liability adequacy test is needed because all other building block elements are remeasured.
26. The additional margin of candidate 3 and the composite margin of candidate 4 will be released to the income statement over time. Because these margins are blends, it may be difficult to determine an appropriate driver for the release of these margins; if no other driver is available, perhaps release from risk could be used as a default. Some believe that these margins should be ‘recalibrated’ (ie adjusting the remaining margin for subsequent changes in estimates rather than recognising those changes in profit or loss) in some cases; we will discuss this at a future meeting.

Issues for current exit value

27. Insurance contracts are typically originated in the retail market (individual contracts) and transferred (if transferred at all, which is not a common event) in the wholesale market. If insurance liabilities are measured at current exit value, significant day one differences may arise in some, perhaps many, cases, for the following reasons:
- (a) the only true exit market for the insurer is the secondary (wholesale) market with other insurers, not the primary (retail) market with policyholders.
 - (b) the exit price for the insurer provider reflects the perspective of the insurer, not the perspective of the policyholder.

(c) on initial recognition, the exit price for the insurer is likely to differ from the premium because the insurer will typically price the transaction to recover its direct and indirect origination costs (acquisition costs) and to provide a reasonable return on the originating activity. In contrast, a transferee would not require payment for the origination activity performed by the original insurer³.

28. This means that at inception the transaction price of an insurance contract **conceptually** does not reflect the price an insurer could transfer that liability for to another insurer. The overall margin that should be included in the current exit value of an insurance liability therefore consists of:

- (a) a risk margin as required by market participants
- (b) a service margin as required by market participants

Estimating the margins

29. Some argue that conceptually the margin for current exit value, a market participant margin, is easy to define. We believe that is true. An exit notion provides a clear principle for the margin; that is what a market participant requires for both initial and subsequent measurement. However, the fact that this margin is conceptually easy to define, does not necessarily mean that it will be easy to estimate where no active market exists. Consider the following example.

On 31 December 2007, Insurance Company A enters into a one-year term non-life contract. The premium for the contract is CU1,000 and is received at inception. At contract inception, the expected present value of the future cash outflows associated with the contract is CU700. The relevant acquisition costs are CU50 and are paid at inception. The overall margin implied by the transaction price is CU300 (premium of CU1,000 less expected present value of the future cash flows of CU 700); we refer to this margin as a 'gross day one difference'.

Under current exit value insurer A estimates the margin required by a market participant. To take over the liabilities, a market participant would require an amount that is more than the expected value of the future cash flows, but would not require the portion of the premium related to acquisition costs. This implies that, at inception, that the margin a market participant requires would typically be somewhere in the range from CU1 to CU250 (most likely nearer CU250).

³ January 2008 IASB meeting, agenda paper 3E. Paragraph 17 of SFAS 157 *Fair Value Measurements* is likely to provide a similar answer under US GAAP.

30. By looking at the concepts of current exit value, we arrive at the range for the margin quite easily. But knowing the range is not enough; we must pinpoint where the market participant is in the range. So, how much is it? CU2 (lower range), CU 125 (somewhere in the middle), CU248 (upper range)? How is the split between risk margin and service margin? Where an active market exists, the market is likely to come up with the answer to the previous question. But for insurance contracts, no active secondary market is in place. This means that the margins need to be estimated.
31. For estimating the risk margin an insurer would typically use an actuarial technique. For estimating the service margin, an insurer would look at the margin a market participant would typically require for the stand-alone service.
32. These estimates for the risk margin and the service margin are estimates made by the insurer; it would be the insurer that pinpoints a market participant's margin within the range of possibilities with generally no or little observable market information available. Respondents to the DP particularly expressed concerns about estimating a service margin. Even though current exit value offers a clear concept for the margin, establishing the margin in practice may be a challenge. Some would describe this as an arbitrary process.

Day one differences

33. The DP took the position that day one differences would not be common and significant. However, the analysis in paragraph 27 provides a clear rationale why the transaction price would not be the best evidence for fair value (current exit value) at initial recognition in the case of insurance contracts. A day one difference is therefore a natural outcome of current exit value and may be significant in some, perhaps many, cases. In addition, any differences between the actual pricing by the insurer and the estimates of a market participant for the risk margin and the service margin could also contribute to day one differences. The measurement approach in the list of candidates that is based on current exit value (candidate 1) recognises this day one gain in profit or loss.
34. A current exit value of insurance liabilities is likely to involve a significant number of level 3 inputs. As a consequence some may not feel comfortable with recognising day one differences in profit or loss in the case of insurance liabilities for reasons of complexity and risk of error. However, we concluded that day one differences are a natural outcome of current exit value. Arguably, prohibiting recognition of day one profits in profit or loss

can therefore only be achieved by deferring the day one difference as a separate explicit adjustment to the insurance liability after current exit value is determined; this deferred item would not be part of current exit value. But the difference could be seen as part of the insurance liability as it flows from the insurance contract. The deferred day one difference would be something similar to the additional margin of candidate 3 (see paragraph 21), although it would not include a service margin because current exit value already includes a service margin.

35. However, there are some issues involved with the approach mentioned in the previous paragraph:
- (a) one needs to specify whether to use (i) the premium or (ii) the premium less relevant acquisition costs (and if (ii), to define which acquisition costs are relevant). The DP proposed that an insurer recognises its acquisition costs as an expense when incurred. If the initial measurement uses the premium in that case, a day one loss equal to the related acquisition costs is likely to occur.
 - (b) one needs to decide whether the restriction on recognising day one differences in profit or loss should be in all cases or involve a reliability threshold [we have not developed such a threshold yet; setting this threshold may be somewhat arbitrary].
 - (c) a principle needs to be developed for releasing the deferred item to profit or loss.
 - (d) this measurement approach is, arguably, not an attribute of the insurance liability; it is a hybrid of a current attribute (the exit value) and the remaining portion of another element, determined at inception.
36. Another possibility to limit recognition of day one differences in the income statement is using a presumption that the actual premium represents the best evidence for the margin required by a market participant; the DP explored this as Implementation A. However, this presumption seems difficult to make when day one differences are a natural outcome of current exit value and may be significant in some, perhaps many, cases.
37. Some believe that, when applying current exit value to insurance contracts, any attempt to avoid day one differences will be unsatisfactory. They believe that the only way to avoid day one profits under current exit value in a satisfactory way is **not** to select current exit

value as the measurement approach for insurance contracts; instead a measurement approach should be selected that precludes day one differences in principle. The boards applied a similar approach in their project on revenue recognition; some of the arguments for rejecting exit price as the designated revenue recognition model arise from objections to recognising day one differences in the income statement.

Issues for current fulfilment value

38. The margins for the fulfilment candidates also come with some issues. First of all, the risk margins for candidates 2 and 3 need to be estimated by using an actuarial technique. This arguably involves arbitrary aspects on estimating the risk margin in practice similar to those mentioned in paragraph 31 for current exit value. But there are other issues specific to margins for fulfilment value as well.

What is the basis for the margin?

39. We tentatively described current fulfilment value as:

the expected present value of the cost of fulfilling the obligation to the policyholder over time.

40. For candidate 2, this definition provides a principle for what the risk margin should represent. Candidate 2 sees the cost of bearing risk as a component of the total cost to meet the obligations to the policyholder over time in the ordinary course of business. The cost of bearing risk is a form of risk margin. Thus for candidate 2 fulfilment value includes a form of risk margin (the cost of bearing risk) that flows fairly naturally from the proposed definition.

41. However, the additional margin of candidate 3 and the composite margin of candidate 4 do not seem to flow directly from the definition of fulfilment value. We believe that, when applying the definition in paragraph 39, candidates 3 and 4 are hybrid approaches and not attributes of the liability.

42. A reason why some prefer candidate 3 or 4 is the fact that is more consistent with revenue recognition for initial recognition (no day one net profit). The proposed revenue recognition model defines a performance obligation as an entity's obligation at each financial statement date arising from its promise to transfer goods and services to customers. This obligation includes a margin required by the entity for providing goods

and services as implied by the actual transaction price; the revenue recognition model works on the presumption that at inception of the contract neither party has performed under the contract yet. Reference to this revenue recognition principle may arguably result in a basis for the margin of candidate 3 and 4. This may be established by:

- (a) a hybrid model that uses the cost of fulfilment together with the principles from revenue recognition for (a part of) the margin.
- (b) using a definition for fulfilment value that refers to the principle that an insurer satisfies its performance obligations under the insurance contract [we have not yet developed such a definition yet].

Is the additional margin of candidate 3 part of the insurance liability?

43. Some proposed a model that would estimate the expected cash flows and a risk margin similar to candidate 2, but would recognise the day one difference as a liability, separate from the insurance liability. Proponents of this view believe that the additional margin component is not part of the fulfilment cost. Rather, this margin reflects profit that is generated over the lifetime, akin to deferred income; some refer to this margin as an ‘initial profit margin’. This separate liability would be recognised in income over time in line with the release from risk. Issues with this approach are:

- (a) it may be difficult, if not impossible, to describe this deferred item outside the insurance liability in such a way that it meets the definition of a liability.
- (b) we considered the option of treating the separated liability as a service component in line with IAS 18 *Revenue*. However, paragraph 7 of IAS 18 defines revenue as the gross inflow of economic benefits. The initial profit margin is a blend that can include service margins, margins for past origination activities and measurement errors. We find it difficult to reconcile such a blend to an approach that deals with **gross** inflows associated with servicing activities. Furthermore, applying the onerous test required by IAS 18 to the separated liability may be problematic.
- (c) the boards’ preliminary views on revenue recognition do not seem to provide a basis to present two performance obligations from the same contract as separate items.

44. We therefore believe that the additional margin should be part of the insurance obligation, unless a service component is accounted for separately from the insurance contract [this principle is known as ‘unbundling’; respondents to the DP generally opposed unbundling]. We therefore believe that the difference should be part of the insurance liability. This approach is included in candidate 3.
45. Should the additional margin be disclosed separately from the risk margin (in the notes)? The answer to this question will become relevant when choosing between candidate 3 and 4 [though this choice would also involve some measurement issues]. We will address this topic at a future meeting (if relevant).

Cost of bearing risk: cost or compensation?

46. Some of those who prefer a fulfilment approach believe the insurance liability should only include a risk margin that reflects only the **cost** of bearing risk and that risk margin should not include any further **compensation** that the insurer, or another insurer, would require for bearing that risk. As mentioned earlier, candidates 2 and 3 see this cost of bearing risk as a component of the total cost to meet the obligations to the policyholder over time in the ordinary course of business. Is the cost for bearing risk something other than compensation or profit?
47. An insurer’s ability to sell new business to policyholders depends on the expectation that the insurer will have sufficient assets to pay all valid claims and other policyholder benefits. It can do this only if it holds sufficient capital to enable it to cope with adverse events, for example because the regulator demands and/or the policyholder has firm expectations that the insurer will ultimately be able to meet the obligations coming from the contract [otherwise the policyholder would probably not have bought the insurance contract from the insurer]. Part of this capital relates to risks associated with the insurance liability, e.g. mortality risk, operational risk, risk involving policyholder behaviour and risk involving very long term financial instruments.
48. Some see the cost of holding capital related to those risks as one way to express (or estimate) the market price of the risk associated with the uncertainty of future cash flows. Others see it as the cost of providing a high level of certainty to the policyholder. Both views are likely to be two sides of the same coin. In economic terms, setting up and maintaining the capital is necessary for an insurer to be in business. Capital is not free; it

comes at an economic cost. That cost would typically be the compensation (return) required by capital providers. This cost will however not reflect the full required return on all of the capital provided, but will be based on:

- (a) the capital covering risks associated with the insurance liability (it will therefore not include the capital covering eg. asset risks).
- (b) the part of the return that represents the compensation for bearing the uncertainty in the cash flows that come from those risks (it will therefore not include the return for eg. past origination activities).

49. Is there a difference between the cost of bearing risk and the required compensation for bearing that risk? As the margin is recognised over time in the income statement, it is expected to make the bottom line in the income statement more positive or less negative. So, on average, it is expected to turn into a profit. Therefore some may argue that, conceptually, the cost of bearing risk is a form of compensation for bearing risk.

50. Are the cost of bearing risk for a fulfilment perspective and compensation for bearing risk from a market participant perspective different? We believe this is not the case. In order to be able to take over a block of insurance contracts, a market participant also needs to have an appropriate level of capital. And that market participant needs to maintain that capital when subsequently fulfilling the contract with the policyholder over time. One way (but perhaps not the only way) a market participant could determine its required margin for taking on the risk is to look at the return its capital providers require. This technique would not be different from the cost of bearing risk approach in candidate 2.

51. Can the amount of margin required by market participants differ from the amount of an insurer's cost of holding the necessary capital? We think it can differ in practice, though arguably not conceptually. Differences might arise if market participants:

- (a) quantify the required return using a technique other than cost of capital;
- (b) estimate the required capital at a different amount than the amount estimated by the insurer itself; or

- (c) estimate the (percentage) required return on capital at a different amount than the (percentage) cost estimated by the insurer itself.

Unearned premium

52. The margin for the unearned premium approach (candidate 5) is straight-forward. The obligation reflects the part of the premium that has not been earned because the insurer has not performed under the contract. Like the allocated transaction price approach proposed in the revenue recognition project, the unearned premium includes an implicit margin that follows from the actual transaction price. This implicit margin will be recognised in the income statement over time as the insurer satisfies its performance obligations by providing the promised service of standing ready to bear risk. We will ask the boards to consider at a future meeting whether to require (or perhaps permit) the unearned premium approach for such contracts, either as the designated measurement approach for these contracts or as a reasonable approximation for an explicit measurement.

Liability adequacy test

53. Candidates 4 and 5 require a liability adequacy test because they calibrate to the premium directly without considering whether the premium is sufficient to pay for the expected cash flows (and, perhaps, provide an acceptable margin). Candidate 4 needs a liability adequacy test only at inception. Candidate 4 remeasures at each reporting date the **cash flows** and **time value of money**, but locks in the **margin** at inception. Candidate 5 requires a test at each reporting date because it remeasures neither the cash flows, nor the time value of money nor the margin.
54. This paper does not discuss the basis of comparison for liability adequacy test for those candidates. Natural choices might be current exit value, current fulfilment value (the candidate 2 version) or the amount that would be determined using the current or future version of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. We will discuss this issue at a future meeting. One aspect of this discussion will be whether candidate 4 and 5 require the same liability adequacy test, particularly as to whether the test should include a margin.

55. Candidates 1 and 2 do not require a liability adequacy test because initially and at each reporting date they explicitly measure all components (cash flows, time value of money, margin). Similarly candidate 3 does not need a liability adequacy test because candidate 3 is simply candidate 2 plus an additional margin.