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Project **Insurance Contracts**

Topic **Residual margins**

Purpose

1. In agenda paper 6A (FASB Memorandum 35A) the four building blocks selected tentatively by the boards for insurance contracts include an amount to eliminate any positive day one difference (a residual margin). This paper discusses the subsequent accounting for that residual margin.

2. As part of that discussion, this paper also deals with the recognition of negative day one differences (day one losses).

Summary of the staff's recommendations

3. If the initial measurement of an insurance contract results in a negative day-one difference, an entity should recognise that difference immediately in profit or loss.

4. Some staff members recommend that the **basis** for recognising a residual margin in profit or loss over time should reflect the characteristics of that margin. Those staff members also recommend that the exposure draft should not prescribe particular drivers; rather, the insurer should select the driver or drivers that result in recognising that margin in income in a systematic way that best depicts the insurer's performance under the contract (tentatively agreed to by the IASB at its September 2009 meeting). Other staff members believe that, in all cases, the driver should be the release from risk, to provide some rigor for the release.

5. The residual margin should be released to income over a period that follows from the driver(s) for releasing that margin.

6. The arguments for and against adjusting the residual margin for changes in the expected net cash flows can be summarized in the following two positions:

   (a) If the boards conclude that the current measure is integral to understanding and reporting insurance contracts and therefore needs the most emphasis, they should select an approach that reports all changes in estimates in profit or loss (Approach A).

   (b) If the boards conclude that the guidance in revenue recognition is integral to all components of the insurance liability and therefore the allocation part needs the most emphasis, then they should select an approach that recognises changes in estimates of financial market variables in profit or loss, but adjust the remaining residual margin for all other changes in estimates, provided that this margin does not become negative (Approach B).

Structure of the paper

7. The rest of this paper is divided into the following sections:

   (a) The purpose of a residual margin (paragraphs 9-16)

   (b) Subsequent release of the residual margin to the income statement (paragraphs 17-30)

   (c) Changes in expected present value of cash flows (paragraphs 31-37)

8. This paper does not address the following issues, which we will consider separately:

   (a) Detailed guidance on the treatment of a residual margin. If necessary, we intend to bring this as a follow-up item in a future meeting.

   (b) Implicit release of margins under an unearned premium approach. The IASB has tentatively decided to require such an approach for the pre-claims period of some contracts, as an approximation to the approach proposed for all (other) insurance contracts. The FASB has not yet discussed this topic.

The purpose of a residual margin

9. The boards have decided tentatively that the measurement of an insurance contract should not result in the recognition of an accounting profit at inception. As a result, the positive difference between (a) the premiums and (b) the cash out flows plus the risk adjustment, the residual margin, should be included in the measurement at inception and reported in income over an appropriate period.

10. The purpose of the residual margin therefore is to eliminate any positive day one difference and report the release of that residual profit to the income statement over an appropriate period.

Recognition of negative day one differences

11. The previous two paragraphs deal with a positive day one difference. However, in some case that difference may also be negative.

12. A negative day-one difference arises when a contract is onerous at inception; that is, the contract obligation exceeds the premium. This situation can occur in instances where a product is designed to be a loss leader as part of an entity's broader strategy to increase market share. Both recent discussions in the revenue recognition project (the onerous test) and existing accounting for insurance contracts (premium deficiency and liability adequacy tests) support recognizing an expense when the obligation exceeds the consideration.

13. Because the proposed building block measurement for insurance contracts is a direct measure of the liability, no separate onerous contract test is required. As a consequence of that direct measurement, the liability includes not only the expected present value of the net cash flows, but also a risk adjustment. [An onerous test would be needed if the boards decided to use an unearned premium approach for some liabilities because that measurement does not result in a

direct liability measurement. We will discuss this issue when we deal with the unearned premium approach at a future meeting.]

14. The staff recommends that an entity should recognize a negative day-one difference in profit or loss. The staff believes that the recognition of a negative day-one difference is not only consistent with existing practice but is also consistent with current discussions in other relevant projects. As a consequence, the residual margin cannot be negative at inception.

15. Therefore, initial measurement of the residual margin could be summarised as:

    (a) Set so the overall insurance measurement at inception does not result in recognizing positive day one differences in profit or loss. In other words, it is the difference at inception between:

        (i) the expected present value of premiums; and

        (ii) the expected present value of the cash outflows plus a risk adjustment.

    (b) Cannot be negative, which means a day one loss can occur.

16. The proposed onerous test in the project on revenue recognition considers expected cash flows, but includes no risk adjustment. This causes two differences between the revenue recognition model and the insurance contracts model:

    (a) A day one loss would arise for some insurance contracts that the revenue recognition model would not identify as onerous. This would occur if the expected present value of the cash flows plus the risk adjustment exceeds the premium.

    (b) A day one loss for an insurance contract includes the effect of the risk adjustment and so would be larger than the day one loss identified by the revenue recognition model (no risk adjustment).

Question for the boards
Do the boards agree with (reaffirm in the case of the IASB) the staff recommendation in paragraph 14 that, if the initial measurement of an insurance contract results in a negative day-one difference, an entity should recognise that difference in profit or loss?

Subsequent release of the residual margin to the income statement

Basis for release

17. Since any replication of the calculation of a residual margin after day one would have no intrinsic meaning, any remeasurement would lack substance and therefore the staff considers that it would not provide relevant information to users (other than perhaps an adjustment for some changes in estimates, see paragraphs 30-36).

18. The subsequent release of residual margins is therefore an allocation. It seems natural to look for a release (allocation) that best reflects the dominant characteristics of the margin. Such a basis would also seem to coincide with recognising a residual margin based on a pattern that resembles how an entity

transfers a good or a service to the customer (that is, performance under the contract, as applied by the boards' proposed approach to revenue recognition).

19. Possible drivers for releasing the margin in a pattern that appropriately depicts performance under the contract include, but are not necessarily limited to, the following:

    (a) Release from risk

    (b) Expected benefit and claim payments

    (c) Premium receipts

    (d) Passage of time

    (e) Funds under management

    (f) A mix of two or more drivers

20. In relation to paragraph 18, we comment as follows:

    (a) Item (a) might refer to two different notions. One is the traditional notion of bearing the risk of insured events that occur during the coverage period. The other is the notion that the insurer is exposed to the risk that the ultimate outcome may differ from the expected outcome throughout both the coverage period and the claims handling (settlement) period.

    (b) Basing the release of the margin on item (d) (passage of time) could provide an observable and cost-beneficial approximation for release from risk in at least some cases. However, releasing the margin on the basis of the release from risk may produce skewed results if risk is not the predominant driver. Also, basing the release of the margin on the passage of time will not reflect uneven insurance risks, nor will it reflect changes over time in the probability that options and guarantees may come into the money (many insurance contracts contain significant options and guarantees).

(c) An approach based on item (e) (funds under management) may be an appropriate driver if the insurance contract contains a significant investment component.

21. However, a residual margin is a blend and differs from case to case. Identifying a driver related to one dominant component may be challenging. In the case of a residual margin, a risk component is not relevant because that component is already included as a separate risk adjustment. Consequently, release from risk may not be an appropriate driver for a residual margin. Other drivers like funds under management, expected premium receipts or claim payments could provide a better basis (but if no other driver is available, perhaps release from risk could be used for convenience).

22. As a way forward, the boards could select:

(a) An approach that gives detailed guidance, perhaps even prescribes, a particular driver for releasing the margin. This driver could depend on other features of the measurement approach. For example, a measurement approach that includes a separate risk adjustment will already include a factor based on the release from risk. Consequently, other drivers like funds under management or claim payments should be used.

(b) A more principles-based approach in which the insurer must determine what the driver or drivers are for the particular insurance contract. If the contract involves a significant service element, the pattern of provision of those services is likely to be a main driver. For some contracts, the main driver may be protection (generally short-duration contracts). For more investment-oriented contracts, the liability carrying amount may be a more significant driver (similar to funds under management). For other insurance contracts, a blend of drivers may be appropriate.

23. Providing detailed guidance reduces the ambiguity surrounding the intent of the boards and provides a degree of comparability among reporting entities. But such accounting guidance can limit judgment. Using a principles-based

approach allows for judgment but may lead to the need for implementation guidance in the future if the intent of the boards is not appropriately applied.

24. Some staff members recommend that the basis for releasing a residual margin should reflect the characteristics of that margin. Those staff members also recommend that the exposure draft should not prescribe particular drivers; rather, the insurer should select the driver or drivers that result in recognising that margin in income in a systematic way that best depicts the insurer's performance under the contract (tentatively agreed to by the IASB at its September 2009 meeting). Other staff members believe that, in all cases, the driver should be the release from risk to provide some rigor in the release of the residual margin.

Question for the boards
Should the release of the residual margin to income be based on the characteristics of that margin by selecting a driver for release that best depicts performance under the contract? If not, should that release to income always be based on release from risk?

Period for release

25. Staff identified three possible views regarding the period over which the residual margin exist (that is, the insurer performs):

(a) limited to the coverage period. The coverage period is the period during which the contract is in force (the period during which protection is provided). For example, the coverage period for an annual contract is one year. In most cases, the coverage period provides an easily observable time period over which to release the margin because most insurance contracts stipulate the coverage period.

(b) the claims handling period. The claims handling period is the period from when the first claim arises to when the last claim is paid (the claims handling period often includes most if not all of the coverage period). In some instances, the coverage period and the claims handling period are not significantly different (such as for traditional life insurance). In other instances, particularly for some non-life contracts, the coverage period may be 1 year but the claims handling period can be 10 or more years.

(c) some variation based on the coverage and claims handling periods.

26. Previously[1], staff argued that, if the measurement of insurance contracts includes a separate risk adjustment and a residual margin, that residual margin should be released over the coverage period (tentatively agreed to by the IASB at its September 2009 meeting).

27. However, in the previous section (paragraphs 17-24) some staff members argued that the insurer should release the residual margin to income based on the characteristics of that margin by selecting a driver for release that best depicts performance under the contract. Those staff members also argued that, if the contract involves a significant service element, the pattern of provision of those services is likely to be a main driver.

28. In some, perhaps many cases, the insurer would not be able to identify a significant service element or the service element mainly would be provided over the coverage period. In that case, the staff members referred to in the previous paragraph recommend that the residual margin should be fully released over the coverage period. In other cases, the insurer might identify significant services during the claims handling period and therefore would release some of the residual margin during that period.

29. Other staff members argued that release from risk should be used as a driver for reporting the residual margin to income. In that case, the period for releasing the residual margin will be the period over which the insurer is released from risk.

30. Therefore, the staff recommends releasing the residual margin over a period that follows from the driver(s) used for releasing that margin.

Question for he boards
Should the residual margin be released to income over a period that follows from the driver(s) for releasing that margin?

[1] See September 2009, agenda paper 17C (FASB Memorandum 27C).

Changes in expected present value of cash flows

31. The relationship between the residual margin and subsequent changes in the estimated expected present value of cash flows is a question about whether the margin should be impacted by changes in expected present value of the cash flows. Consider the following simplified example:

Insurer A enters into an insurance contract on January 1, 2010. For simplicity, we ignore risk adjustment. The premium is CU100 and is received at inception. The initial expected present value of the claims is CU80. As a result, the residual margin at inception is CU20. Suppose that on January 2, 2010, the insurer's expected cash outflows increase from CU80 to CU 90. For simplicity, we ignore any amounts the insurer would release to the income statement from January 1 and 2.

32. From this example, the staff believes that there are three potential approaches to address the subsequent changes in the residual and composite margins:

    (a) **Approach A:** The margin remains locked-in at the amount determined at inception and is released over the remaining period of the contract. This means that the liability at January 2 is CU110, consisting of expected cash flows of CU90 plus a margin of CU20. The changes in cash flows of CU10 are recorded as an expense in the income statement. Variability in cash flows is a significant inherent characteristic of the contract. At each subsequent measurement date, the performance statement reports changes in estimates promptly and transparently. Those changes are not absorbed by the remaining residual margin and subsequent changes in estimates are reported in profit or loss as they occur.

    (b) **Approach B:** The residual margin is adjusted for the changes in cash flows. The liability at January 2 is CU100, with expected cash flows of CU90 and a margin of CU10. Consequently, no expense is recognised in the income statement. The measurement of an insurance contract includes the residual margin. The objective is to measure the overall margin that the insurer expects to earn based on current expectations. If the expected present value of the cash flows changes, any residual margins must change accordingly, unless those margins would become negative (onerous). As a result, the residual margin should be adjusted for changes in estimates at each subsequent reporting date; that is, by adjusting the remaining margin for subsequent changes in estimates rather than recognising those changes in profit or loss. Changes in estimates therefore will be reflected in the release of smaller margins in future reporting periods, not in the current year's profit or loss (unless a residual margin would become negative). Similarly, if changes in estimates result in a decrease in the expected cash flows, the margins would be increased with no impact to profit or loss.

(c) **Approach C:** The residual margin is updated subsequently as a fixed proportion of the expected cash flows, determined at inception. This results in a liability on January 2 of CU112.5, consisting of cash flows of CU90 and a margin of CU 22.5 (CU90* CU20/CU80). The income statement shows an expense of CU12.5. This approach in effect remeasures the residual or composite margin in proportion to the premium. However, the staff believe it is not useful to remeasure a margin that is an aggregation of components. Furthermore, under this approach, the total residual and composite margins on January 2 end up at an amount that is higher than implied by the actual premium at inception. The staff finds it difficult to understand why a margin that aims at eliminating day-one profit and is allocated over the life of the contract should be updated subsequently in such a way. Accordingly, no further analysis is provided for Approach C.

33. Approach A has the benefit of reflecting changes in the estimates of the underlying cash flows immediately in profit and loss. The immediate recognition of these changes provides information to users about changes in those estimates. Proponents of Approach A believe that it is more consistent with a current measurement approach. These proponents also point out that usefulness of that information could be enhanced by presenting changes in estimates as separate items in profit or loss. Proponents of Approach B note that Approach A may result in an insurer recognizing income or expense in one

period only to reverse it in a subsequent period; in their view, this is not a faithful depiction of the margin the insurer earns over the life of the contract.

34. Some point out that Approach B is more consistent with the allocated transaction price approach proposed for revenue recognition. Proponents of Approach B also point out that reporting changes in estimates and the impact those changes have on margins could be achieved by disclosing period-to-period changes in the margin. However, some opponents of Approach B note that the margin in effect absorbs negative changes in the expected cash outflows and therefore could conceal an insurance contract or a portfolio of insurance contracts that could become onerous in the near future. Accordingly, these opponents believe that current information is lost if negative changes are absorbed and that disclosure about the changes in estimates is not an adequate substitute for reporting those changes in profit or loss.

35. Most respondents to the discussion paper on insurance contracts, including those who support Approach B, agreed that changes in financial market variables should be reported in profit or loss or, in some cases, in other comprehensive income. When changes in financial market variables affect insurance liabilities, not recognising those changes would result in an accounting mismatch if the assets are measured at fair value.

36. Approach B would therefore only adjust the residual margins for subsequent changes in estimates of other than financial market variables. This typically would relate to changes in non-market variables like mortality, lapses, expenses, frequency, severity, and the risk adjustment. (Approach A by definition reports all changes in estimates in profit or loss).

Staff recommendation

37. The arguments for and against the approaches A and B described in paragraphs 32-36 can be summarized into the following two positions, both from the perspective that the insurance model is a hybrid of an current measure model (first three building blocks) and an allocation model (residual margin):

    (a) If the boards conclude that the current measure is integral to understanding and reporting insurance contracts and therefore needs the most emphasis, they should select an approach that reports all changes in estimates in profit or loss (Approach A).

(b) If the boards conclude that the guidance in revenue recognition is integral to all components of the insurance liability and therefore the allocation part needs the most emphasis, then they should select an approach that recognises changes in estimates of financial market variables in profit or loss but adjusts the remaining residual margin for all other changes in estimates, provided that this margin does not become negative (Approach B).

Question for the boards
a) Should changes in the expected present value of cash flows be recognized in income immediately (View A), or b) should the residual margin be adjusted for changes in estimates other than financial market variables (View B)? The result of View B is to recognise in income the change in estimate of a variable that is not a financial market variable only when the contract becomes onerous.