

Insurance Accounting Newsletter

Margins for risk, new business revenue and calibration



The IASB has made another step towards the new IFRS for insurance after it reached a new set of insurance accounting tentative decisions at its latest meeting on 22 April.

Although the American FASB discussed the same issues on the 6 May, the session was educational as opposed to decision making. FASB will attempt to decide on these topics at its next meeting on insurance which is scheduled for 18 May.

The key tentative decisions taken by the IASB in April are that the new accounting standard will:

- require insurers to recognise revenue when they generate new business; and
- the new business revenue, together with the acquisition expenses incurred to secure it, will provide the elements for the initial calibration of the residual margin or the recognition of a day one loss.

Margins for Risk

Having decided to defer its final choice between Current Exit Price (CEP) and Current Fulfilment Value (CFV) measurement attributes to a later stage of the process, the IASB has continued its work to narrow down the characteristics of the new accounting standard using the alternative models presented by the IASB Staff in February 2009 (see Insurance Accounting Newsletter – Issue 1).

The tentative decision from previous meetings that the new IFRS would prohibit an accounting profit at initial recognition of an insurance contract, had the consequence of narrowing down the choice of models removing those where the CEP and the CFV required the insurer to calculate the initial value of the contract independently of the transaction price, negotiated with the customer, and the acquisition costs incurred to secure the contract.

The IASB confirmed this position and considered the three remaining models:

- a) A CEP with a Margin for Risk (MfR) and a Service margin (SM) calculated on a market consistent basis and a Residual Margin (RM) calibrated to the transaction price with the policyholder (candidate 1 in the IASB Staff papers);

- b) A first CFV model with an explicit MfR based on the entity cost of bearing risk and a RM calibrated to the transaction price (candidate 3 in the IASB Staff papers); and
- c) A second CFV model with a composite margin calculated comparing the discounted probability weighted expected value of the contract (i.e. blocks 1 and 2 of the “three-building-blocks” model) with the transaction price (candidate 4 in the IASB Staff papers).

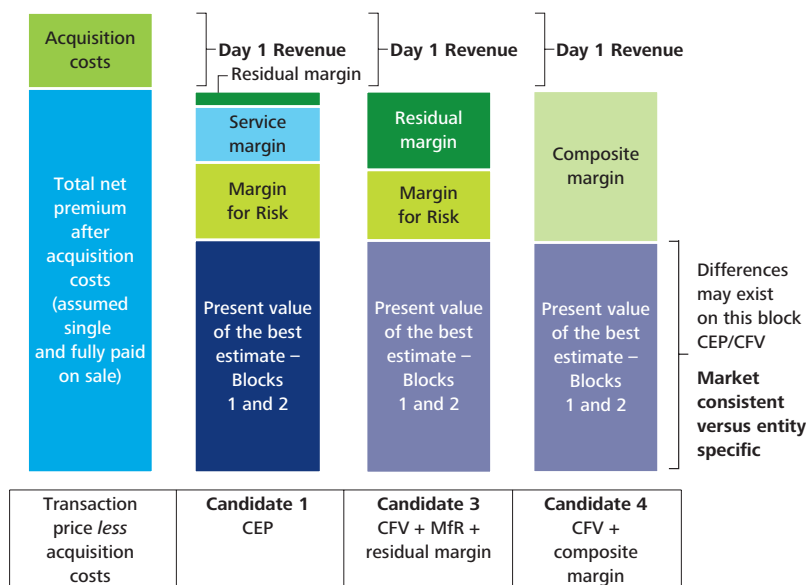
Opposite is the illustrative graph from our previous newsletter modified to represent the remaining measurement candidates still being considered, using a single premium policy as per the observer notes provided for the April meeting (IASB 22 April meeting observer notes).

The IASB Staff recommended that the new IFRS should always require the calculation of an explicit MfR, thus suggesting that the IASB abandon the third option, i.e. “Candidate 4: CFV with a composite margin” as presented in the IASB Staff paper. At the meeting, the Board members agreed with the Staff, thanks to the casting vote of the chairman. However, the official record of their tentative decisions published subsequently indicates that this issue will need further discussion before it is confirmed.

The IASB Members who voted against the staff recommendation on margins at the April meeting, appeared to have done so mainly on the grounds of needing more information on the nature of the MfR before they can accept it in the new IFRS, and not because they believe that a MfR is not a necessary component of the new accounting standard.

The discussion highlighted that the majority of the IASB Members accepts the need for a margin to represent the underlying estimation uncertainty. If we look at the example of an insurance contract for which the payout can either be 100 or nil with equal probabilities, it is clear that this contract should have a larger liability than one where the two equally probable payouts are 51 and 49. Both contracts have the same carrying amount for blocks 1 and 2 (i.e. the probability weighted present value of all future cash flows scenarios is the present value of 50 in both cases).

Figure 1. Measurement candidates considered



However, to faithfully represent the level of uncertainty of these two contracts, the MfR would seem a necessary additional element in the accounting for the liability. This is particularly important when the remeasurement of the contract occurs several months/years after its sale, at which time the usefulness of the initial price for financial reporting purposes is significantly reduced.

The IASB Members who voted in favour of the Staff recommendation on margins noted that the MfR approach is consistent with the direction taken by the IASB on other projects, such as the onerous contract liability and the fair value measurement of contracts when there is no active market.

The IASB Staff also asked the Board members to give their views on the issue of accounting for a separate service margin (an element of the CEP model only) and its remeasurement. Many Board members asked that the new IFRS makes clear that, even if a service margin is not reported / calculated on a separate explicit basis, it would still be included implicitly in the Residual Margin of the CFV “candidate 3” approach (or the composite margin of “candidate 4”). No decision was reached on accounting for a separate service margin.

Finally, the IASB has not yet decided whether the MfR and RM should be part of the insurance liability or shown separately. IASB Members who view the margin purely as the insurer's future profit from the insurance contract argued that keeping the margins separate from the insurance liability would be a more faithful representation of their nature. Those who believe the MfR is needed to reflect the uncertainty in estimating the insurance contract would instead see that margin, and also the RM, as components of the insurance liability.

New business revenue and calibration

The IASB discussed what should the calculated amount (i.e. the three building blocks) be calibrated to at inception. The IASB took the very important tentative decision to calibrate to the transaction price less acquisition costs (AC).

The IASB Update, issued following the meeting, notes that "the Board decided tentatively that for this purpose, acquisition costs should be limited to the incremental costs of issuing (i.e. selling, underwriting and initiating) an insurance contract and should not include other direct costs. Incremental costs are those costs that the insurer would not have incurred if it had not issued those contracts".

This tentative decision, which has still to be considered by FASB, aligns the definition of acquisition costs for insurance contracts with the IAS 39 definition of transaction costs.

The IASB believes that the new IFRS must produce the same liability for two contracts which transfer the same insurance risk but are sold via different distribution channels. The IASB Staff paper illustrated this with an example. Consider two contracts with identical risks: one sold through an agent for 100 with AC of 4 and another sold via the internet with a lower price of 97 and lower AC of 1. Although the risk for each contract remains the same (in the example they both have an expected present value of 90), the AC associated with selling the contract are different. The IASB decided that the insurance liability for both contracts should be 96 and concluded that the IFRS should result in the same accounting liability for insurance contracts where the only difference is the amount the policyholder pays to cover the insurer's AC.

As a further illustration, we have considered a different case to the single premium contract type used previously, and we have attempted below to put these tentative decisions into the context of a regular premium term assurance contract, where the AC are typically several times the amount of the first instalment paid by the policyholder.

For the purpose of our example, we define the following:

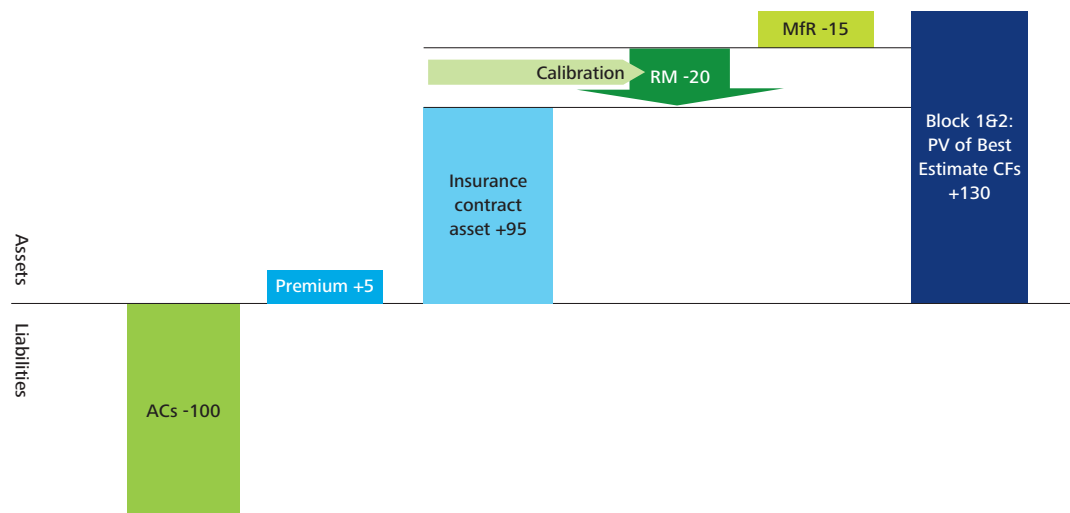
AC	Acquisition Cost	100
RP	First regular premium	5
MfR	Margin for Risk	15
Block 1&2	Probability weighted present value of future cash flows (in our example, resulting in a net inflow as discounted future premiums exceed discounted future claims and expenses)	130
CFs	Cash Flows	
PV	Present Value	
RM	Residual Margin	

This example, represented graphically below, ignores the issue of limiting the consideration of certain future premiums within the present value of future cash flows that the Boards will be discussing this month.

For a typical regular premium term assurance contract, at the point of sale, the probability weighted present value of future premiums is higher than claims and expenses. In our example, this present value calculation results in an asset of 130. This asset is then reduced by the MfR of 15 reflecting the underlying estimation uncertainty. If we ignore the issue of calculating a separate service margin, the calibration process produces a further reduction of the insurance contract asset by recognising a residual margin of 20 arising from the calibration of the three building blocks to the net transaction price (premium of 5 less AC of 100).

In our example the insurer recognises new business revenue of 100 and incurs AC for the same amount with no profit or loss. The balance sheet will have an insurance contract asset of 95, cash at bank of 5 and financial liabilities of 100 being the amount payable to the agent.

Figure 2. Regular premium term assurance



Contract boundary and next steps

The IASB and the FASB have both held an educational session (respectively on 24 April and 6 May) on the subject of policyholder behaviour and contract boundaries. The paper presented an idea that is being developed out of research carried out by industry groups, which suggests an alternative to the guaranteed insurability principle presented in the IASB Discussion Paper (DP, May 2007).

This new approach defines the contract boundary based on the right an insurer may have to individually re-underwrite that contract. The emergence of that particular right would represent the boundary of an existing contract and the beginning of a new contract. Any cash flow that arises from an existing contract as defined would be counted in the measurement of that contract.

This approach is one of “substance over form” and cash flows arising after the date that represents the contract boundary would be excluded from the accounting measurement even if they arise from the same legal contract.

This approach is different from the “guaranteed insurability” rule that was presented in the DP and which considered the issue from a policyholder’s perspective. The proposed criteria focus on the insurer’s rights and obligations rather than the policyholder’s. This will be discussed for a decision to be reached at the IASB and FASB May meetings.

Next steps

The next steps are for the IASB to meet on 21 May. At this meeting, the Board will discuss policyholder behaviour and the related issue of contract boundaries. Discussions on measurement will continue in June when the Staff is expected to produce a revised timetable.

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