

Preliminary views on Insurance Contracts
Frequently asked questions: service margins
October 2007

In May 2007, the International Accounting Standards Board (IASB) published a Discussion Paper *Preliminary views on Insurance Contracts*. Paragraphs 87-89 of the Discussion Paper discuss service margins. The IASB staff has received many questions about those paragraphs and has prepared this document to answer them. The Board has not reviewed or approved this document.

What is the service margin?

1. The service margin is the profit that market participants require for providing services, other than the service of bearing risk.

What is the rationale for the service margin?

2. The current exit value of an insurance liability includes an unbiased estimate of the margin that market participants would require to take over that liability. That margin reflects all factors that market participants would consider when they determine whether the margin is acceptable.
3. The most obvious factor that market participants would consider is risk, but they may sometimes consider other factors. For example, if the contract requires the insurer to provide other services, not just to bear risk, market participants may sometimes require a reward for providing those services, especially if those services are a significant part of the contract.
4. To highlight the need to consider all other factors that market participants would consider, the Discussion Paper uses two separate labels for different parts of the margin:
 - (a) The **risk margin** is the reward that market participants require for accepting risk.
 - (b) The **service margin** is the reward, if any, that market participants require for providing other services.

Must an entity estimate the service margin separately from the risk margin?

5. The Discussion Paper labels the service margin separately from the risk margin. This emphasises that risk may not always be the only driver of margins and that the margin should reflect all factors that market participants would consider. The Board has not yet discussed:
 - (a) whether an insurer could determine a single margin reflecting all those factors, without splitting the total into a separate service margin and a separate risk margin.
 - (b) whether an insurer should disclose the risk margin and service margin separately.

Is the service margin intended to reflect the risks associated with providing services?

6. The service margin represents the reward required for providing services. It is not a reward for bearing risk.
7. The provision of services exposes the provider to risks, such as risks of cost overruns and lapse. The overall margin (risk margin plus service margin) would need to reflect those risks. As long as the overall margin includes those risks and does not count them twice, where they are included (in the risk margin or in the service margin) is less important.

How does the service margin approach differ from the IAS 18 approach?

8. The following table compares the proposed approach to the service margin and the treatment of revenue under IAS 18. For brevity, the table uses the following two informal terms:

(a) **market margin** is the estimated margin that market participants require

(b) **contractual margin** is the margin implied by the contract (ie the margin that produces no profit or loss at inception).

	<i>Service margin</i>	<i>IAS 18</i>
Initial measurement		
Does the initial carrying amount of the liability include a service margin?	Yes	Yes
How is the service margin measured initially?	Market margin	Contractual margin
Can a profit arise at inception?	Yes, if the contractual margin exceeds the market margin	No
Can a loss arise at inception?	Yes, if the market margin exceeds the contractual margin	Yes, if the contract is onerous ¹
How are acquisition costs treated?	Acquisition costs are recognised as an expense.	Incremental origination costs are deferred (ie recognised as an asset), if recoverable.
How does the issuer treat the part of the revenue from which acquisition costs are recovered?	The issuer recognises it as income at inception	The issuer defers it (ie recognises it as a liability) until the service is provided.

¹ Under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, a contract is onerous if the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.

	<i>Service margin</i>	<i>IAS 18</i>
Does a profit or loss arise at inception if actual acquisition costs differ from those incurred by market participants?	Yes (because the contractual margin reflects the issuer's actual acquisition costs but the market margin reflects the acquisition costs incurred by market participants)	No
Subsequent measurement		
What margin does the carrying amount of the liability include?	The estimated (current) market margin for services still to be provided	The part of the (original) contractual margin attributed to services still to be provided
If there is a change in the estimated market margin for services still to be provided, does the carrying amount of the liability change?	Yes	No
Does the insurer recognise revenue as it provides services?	Yes	Yes
How does the insurer measure that revenue?	The estimated (current) market margin for services provided during the period	The part of the (original) contractual margin attributed to services provided during the period

Could IAS 18 be used for the service element?

9. If an insurance contract contains a significant service component (eg a significant investment management component), one conceivable approach would unbundle the contract into:
 - (a) an insurance component, measured as a stand-alone insurance contract, and
 - (b) a service component. IAS 18 *Revenue* would apply to the service component.
10. Unbundling would create consistency between a service component of an insurance contract and an identical stand-alone contract. However, it may be more complex than measuring the entire contract at current exit value. Also, the result could be arbitrary if the components are interdependent.

Why should the carrying amount of a liability include future profit?

11. If an entity contracts to bear risk or provide other services, it will typically require a payment of more than the expected present value of the cash cost of bearing the risk or providing the services. In other words, that contract is more onerous than a contract that just requires the entity to pay the expected cash cost. The current exit value of the liability represents that fact by including the additional payment that market participants would require to induce them to take on the contract (ie the margin). Once the entity is released from the risk or provided the related service, the margin is released and included in profit.
12. For example, suppose a contract requires an entity to provide services at a future date and the expected cash outflows are CU5. That contract is more onerous than a contract that does not require the entity to provide the service, but merely requires the entity to pay CU5 at the same future date. Therefore, the current exit value of the entity's contractual service obligation is more than CU5 (before considering the time value of money).

Is the service margin intended as a 'plug' to eliminate profits at inception?

13. The purpose of the service margin is to ensure that the current exit value of the insurance liability reflects all factors that market participants would consider. Its purpose is not to prevent an insurer from recognising a profit at the inception of an insurance contract.
14. If the contract provides a margin (contractual margin) that exactly equals the margin required by market participants (market margin), no profit will arise at inception. However, a profit will arise at inception if the contractual margin exceeds the market margin.²

Would the carrying amount of all insurance liabilities include a service margin?

15. The carrying amount would include a service margin if the insurer estimates that market participants would require a service margin to induce them take over the contract. Whether market participants would require a service margin depends on the circumstances. Here are two examples:
 - (a) At one extreme, some insurance contracts have a significant savings element and require the insurer to provide significant investment management services. This is the case for many unit-linked, universal life and participating contracts. An investment manager would not willingly provide those services in a separate investment management contract without adequate compensation. It seems unlikely that an insurer would provide the same services within an insurance contract without adequate compensation. In these cases, it is natural to assume that market participants would require some payment for providing those services within an insurance contract (ie a service margin).
 - (b) At the other extreme, consider the routine administration of a traditional life insurance contract. An outside entity would require compensation if the insurer outsourced the administration to it. Nevertheless, if market participants were taking on all the rights

² Because of the way this paper defines the contractual margin and service margin, a profit will also arise at inception if the actual acquisition costs are less than the acquisition costs incurred by market participants.

and obligations associated with the entire contract (as opposed to just the administration), it seems unlikely that any service margin for the administration would be material in practice. Similarly, it seems unlikely that the current exit value of a non-life insurance contract would include a significant service margin for loss adjustment activities.

Why not use the cash flows that would be incurred to outsource the servicing?

16. Some have suggested an alternative to the inclusion of a service margin:

- (a) The cash flows used in measuring the liability should be the cash flows that a market participant would expect if it outsourced the service component of the contract.
- (b) Those cash flows would replace both (i) the cash flows that a market participant would expect and (ii) the service margin, if any.

17. The resulting measurement might differ from current exit value, unless market participants could be expected to outsource all service components. That is because market participants would not necessarily require the same margin for a bundle of components as they would require for each component separately.

Do IFRSs contain any precedents for including a service margin?

18. If an entity derecognises a financial asset but retains the right to service that asset for a fee, IAS 39 *Financial Instruments: Recognition and Measurement* requires the entity to recognise:

- (a) a servicing liability, if the fee to be received is not expected to compensate the entity adequately for performing the servicing.
- (b) a servicing asset, if the fee is expected to be more than adequate compensation for the servicing.³

Does embedded value include a service margin?

19. Unlike the approach proposed in the Discussion Paper, embedded value approaches do not include an explicit service margin. If the initial carrying amount of an insurance liability does not include a service margin, the insurer will recognise the present value of the service margin at inception as income.

Does Solvency 2 include a service margin?

20. The European Commission's current proposal for Solvency 2⁴ does not refer explicitly to service margins. However, it states that:

- (a) the risk margin shall be such as to ensure that the value of the technical provisions is equivalent to the amount insurance and reinsurance undertakings would be expected

³ IAS 39, paragraph 24

⁴ Proposal for a Directive of the European Parliament and of the Council *on the taking-up and pursuit of the business of Insurance and Reinsurance SOLVENCY II*
http://eur-lex.europa.eu/LexUriServ/site/en/com/2007/com2007_0361en01.pdf

to require in order to take over and meet the insurance and reinsurance obligations.
(Article 75.3)

(b) the risk margin shall be calculated by determining the cost of providing an amount of eligible own funds equal to the Solvency Capital Requirement necessary to support the insurance and reinsurance obligations over the lifetime thereof. (Article 75.5)

21. It would be consistent with the requirement in (a) to include a service margin if market participants would require it. On the other hand, the more detailed requirement in (b) does not allow explicitly for a service margin.

Where is the service margin shown in Example 4 of the discussion paper?

22. The appendix to this paper contains an updated version of example 4, showing more explicitly how the service margin is derived.

Appendix

Example 4 Service margin (updated version, with changes marked up)

Background

Investment manager D enters into a non-cancellable contract to manage a unitised pool of investments from 1 January 20X1 to 31 December 20X1 on the following terms:

- Investment manager D expects to collect a fee of CU15 on 31 December 20X1 and incur costs of CU5 at that date.
- Investment manager D estimates that other investment managers would require the same fee of CU15 and incur the same costs of CU5.
- Investment managers would typically expect to incur costs of CU2 to originate a similar contract.
- For simplicity, the example ignores the time value of money, risk margins and lapse.

How would market participants value the contractual rights and obligations?

In this example, market participants require an expected investment fee of CU15. Of this, CU5 is needed to pay the expected running costs and CU2 is needed to pay the acquisition costs. Therefore, market participants require an expected net return of CU8 for providing investment management services. **That expected net return is the service margin.** After the acquisition costs are paid, the expected future cash flows from the contract are CU10.* Therefore, market participants could be expected to value those cash flows at CU2.†

Put differently, if an investment manager charges the same fee as other investment managers and incurs the same costs, the value of the contract at inception equals the acquisition costs that market participants would typically incur in originating similar contracts. Furthermore, the value of the contract at inception equals the investment manager's own acquisition costs, unless they are out of line with the acquisition costs that other investment managers would incur.

Contractual fees that exceed market requirements

Extending the example, suppose the contract entitles investment manager D to charge CU16 per contract each year, but other investment managers still only require CU15 (and all other facts remain unchanged). After the acquisition costs are paid, the expected future net cash flows are CU11, but market participants still only require **a service margin of CU8**. Therefore, the contract value is approximately CU3.

Contractual fees that do not meet market requirements

Conversely, suppose the contract entitles investment manager D to charge CU12 per contract, but other investment managers still require CU15 (and all other facts remain unchanged). After the acquisition costs are paid, the expected future net cash flows are CU7, but market participants still require **a service margin of CU8**. Therefore, the contract value is now a negative amount (a liability) of CU1.

* CU15 – CU5

† Net cash inflows of CU10 less service margin of CU8

Summary of this example

The following table shows explicitly how the service margin is derived in this example.

Fee required by market participants	15
Expenses incurred by market participants	-5
Acquisition costs incurred by market participants	<u>-2</u>
Service margin required by market participants	<u><u>8</u></u>

The following table shows explicitly how that service margin affects the current exit value.

	<i>Case 1</i>	<i>Case 2</i>	<i>Case 3</i>
Expected fee for Investment manager D's contract	15	16	12
Expected expenses (for market participants, excluding entity-specific cash flows)	-5	-5	-5
Net cash flows	<u>10</u>	<u>11</u>	<u>7</u>
Time value of money (zero in this example)	0	0	0
Risk margin (zero in this example)	0	0	0
Service margin (as required by market participants)	-8	-8	-8
Current exit value	<u><u>2</u></u>	<u><u>3</u></u>	<u><u>-1</u></u>

Balance sheet at 1 January 20X1

	<i>Case 1</i>	<i>Case 2</i>	<i>Case 3</i>
Cash	-2	-2	-2
Insurance contracts: asset / (liability)	2	3	-1
Equity	<u>-</u>	<u>1</u>	<u>-3</u>

Income statement at inception (1 January 20X1)

	<i>Case 1</i>	<i>Case 2</i>	<i>Case 3</i>
Profit (loss) at inception before acquisition costs	2	3	-1
Acquisition costs	-2	-2	-2
Profit (loss)	<u>-</u>	<u>1</u>	<u>-3</u>

Balance sheet at 31 December 20X1

	<i>Case 1</i>	<i>Case 2</i>	<i>Case 3</i>
Cash	8	9	5
Insurance contracts: asset / (liability)	-	-	-
Equity	<u>8</u>	<u>9</u>	<u>5</u>

Income statement 2 January 20X1 to 31 December 20X1

	<i>Case 1</i>	<i>Case 2</i>	<i>Case 3</i>
Release of margin	8	8	8
Profit (loss)	<u>8</u>	<u>8</u>	<u>8</u>