Project **Insurance Contracts**

Topic **Follow-up on risk adjustments**

Purpose of this paper

1. At their joint meeting in December, the boards decided tentatively that the measurement approach should portray a current assessment of an insurance contract, using the following building blocks:

   (a) The unbiased, probability-weighted average of future cash flows expected to arise as the insurer fulfills the contract.

   (b) The time value of money.

   (c) A risk adjustment for the effects of uncertainty about the amount and timing of future cash flows.

   (d) An amount that eliminates any gain at inception of the contract (residual margin).

2. This paper discusses at a high level possible ways forward for (c) the risk adjustment. Because the nature and amount of (d) residual margin depends partly on the nature and amount of the separate risk adjustment, this paper also explains how the building blocks would change if no separate risk adjustment were to be included.

3. This paper does not address the boards' tentative decisions on (a) cash flows and (b) time value of money. The boards' main concerns have been on the risk adjustment and staff believe that, for the purpose of this paper, the risk

adjustment can be addressed without (re)considering cash flows and time value of money.

Background

4. At their March 17 meeting, the boards held an educational session on (c) the risk adjustment included in the proposed measurement for insurance contracts. The discussion in that session focused on:

   (a) the objective for a risk adjustment under the proposed measurement.

   (b) the numerous methods that could be used to calculate a risk adjustment.

   (c) the connection between (a) and (b); that is, the degree to which available methods could or should be narrowed down as a result of the objective for the risk adjustment.

5. The staff propose in agenda paper 6D (FASB Memorandum 41D) not to require a particular method for determining a risk adjustment. To provide transparency about the risk adjustment calculation, disclosures should be required similar to those in Statement 157 for fair value measurement with unobservable inputs. Agenda paper 6D (FASB Memorandum 41D) also asks that the boards reaffirm that the objective of the risk adjustment is the amount the insurer requires for bearing the uncertainty that arises from having to fulfil the net obligation arising from an insurance contract. [The analysis supporting that recommendation is not repeated here.]

6. However, several board members expressed concerns that that objective is not sufficiently robust to promote rigorous application of the available methods for calculating a risk adjustment. That is, the objective would in their view not specify necessary characteristics for a risk adjustment that would eliminate unsuitable methods (ie methods that do not meet specified characteristics) and not provide discipline for the application of the remaining methods. This would in their view result in wide divergence in practice.

7. But those board members that expressed concerns differed in how they would move forward. Staff identified the following three options for moving forward:

(a) evaluating the identified methods in detail and, through this selection process, limiting the methods available for estimating the risk adjustment.

(b) refining the objective for the risk margin.

(c) rejecting a separate risk adjustment for insurance contracts and pursuing one single composite margin.

8. Below staff briefly describes these three approaches. The purpose of this paper is not to discuss the approaches in detail. Once the boards decide how they want to move forward, further discussion of the selected approach is required in a follow-up meeting.

Evaluating and limiting the available methods

9. This approach evaluates all of the available methods with the aim of limiting the list significantly to no more than two or three methods. The evaluation of each method would consider:

(a) whether it reflects the remaining uncertainty associated with the cash flows that arise from fulfilling the obligation

(b) assessing the pros and cons of the method,

(c) the potential reach of the method (how widely would a method apply across different types of contracts?).

10. Limiting the available methods would reduce the possibility of divergence in practice by forcing a degree of consistency. This has the advantage of better comparability and clarity for users. But it would also limit the application of judgment in dealing with a wide range of insurance contracts. Furthermore, it would not be consistent with the objective of a principles-based standard; developments in practice and the continued advances in techniques could make selected methods obsolete.

11. In agenda paper 6D (FASB Memorandum 41D), staff noted that we were not able to identify a method that was superior to all others in all cases. We also observed that experts in this field cannot provide a consensus view on a single

method appropriate for all circumstances. Therefore, selecting a limited number of methods would be difficult and perhaps involve arbitrariness focused on achieving one or two narrow goals.

Refining the objective

12. This approach builds on the notion that a separate risk adjustment is necessary to give a representationally faithful measurement of an insurance contract. But rigor should be provided around the risk adjustment by refining the objective for the risk adjustment. Possibilities for a refined objective are:

    (a) the amount a market participant requires for bearing risk when taking over the insurance obligation [exit notion]

    (b) the amount the insurer would require today for assuming the (remaining) risk from the policyholder or another party [entry notion]

    (c) the amount the insurer would rationally pay to be relieved of the risk [the objective for the risk adjustment used in the IASB's recent exposure draft *Measurement of Liabilities in IAS 37*]

13. Those objectives could be seen as relating to a transfer or a possible transfer; the objective under (a) considers the market participant's perspective of a transfer and the objectives under (b) and (c) consider the entity's perspective. Those who support refining the objective see such an objective as clearer and more robust than the one proposed in agenda paper 6D (the amount the insurer requires for bearing the uncertainty that arises from fulfilling the obligation). A clearer objective enables, in their view, development of a set of characteristics for a risk adjustment that would eliminate certain methods (ie methods that do not meet the characteristics) in a natural way. Furthermore, it provides better discipline around the inputs to and application of methods. This would be consistent with a principles-based approach.

14. However, some may struggle with using a refined objective for the risk adjustment because:

(a) This results in two objectives within one measurement, namely a pure fulfillment objective for cash flows and a more market-based objective for the risk adjustment. In its most extreme form, it would combine an entity-specific view of the cash flows and a market participant view of the risk adjustment[1]. This might create confusion for preparers and users.

(b) There are no active secondary markets for insurance contracts, thus generally little market information on the price for risk will be available. This issue was also raised by many respondents to the IASB's discussion paper *Preliminary Views on Insurance Contracts*, albeit in the context of an exit notion applied to all building blocks.

(c) Even a refined objective might not narrow down the methods sufficiently and could therefore still result in divergence in practice.

Adopting a composite margin

15. This approach is based on the view that the objective of a fulfillment value does not include the notion of a separate risk adjustment because a transfer between market parties is not relevant. Instead, this approach uses a single composite margin. For this purpose, the four building blocks would be reduced from four to three, with the third (risk adjustment) and fourth (residual margin) combined into one single margin, a composite margin. A future decision would be needed to determine how this composite margin would be released over time.

16. Proponents of this approach argue that a market-based risk adjustment would, in most cases, imply a purely hypothetical transfer notion. This would make any attempt to estimate a separate risk adjustment inherently subjective and arbitrary and not decision-useful. Furthermore, a model with a separate risk margin would arguably be more complex than an insurance model with a composite margin.

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[1] This would be similar to the IASB's notion of Value in use in IAS 36 *Impairment of assets*. Under IAS 36, an entity applies a current market assessment of time value of money and risk to cash flows of amount, timing and risk profile equivalent to those it expects to derive from the asset.

17. However, under this approach, the composite margin would be calibrated at inception to the premium (IASB: premium less incremental acquisition costs). Some see this as an approach that could result in understating the insurer's liability because the composite margin could be nil at inception or become come nil over time, while that liability still includes risk (uncertainty associated with future cash flows).[2] The boards could deal with this by applying a 'floor' (adequacy test) that includes a risk adjustment. But it seems odd to apply an adequacy test with a risk adjustment if the rationale behind a composite margin approach is that a risk adjustment cannot be done in the first place.

18. Furthermore, the release of the composite margin may result in some complexity. Because risk is no longer dealt with separately, it is implicit in the composite margin. Risk should therefore be an important factor in determining the release of the composite margin. Release from risk involves (a) estimating the amount of risk at inception and (b) determining the decline of the amount of risk over time. Release from risk would be relevant for both the coverage period and the claims handling period. Moreover, some model(s) would be needed to quantify how risk declines over time. The boards would need either to specify one or more models, or to specify the characteristics of acceptable models. Developing such models is likely to involve some of the same complexities as developing models for separate risk margins.

[2] The boards decided that a loss at inception should be recognised. Applying that principle to a model with a composite margin means that this margin cannot be negative at inception. Our analysis is based on the working presumption that the boards would also recognise losses at inception in profit or loss for a model with a composite margin, but we will ask the boards to confirm this if necessary.

Question for the boards

How would do you like to proceed?

(1) Following the staff recommendation as included in agenda paper 6D (FASB Memorandum 41D).

(2) Limiting the available methods.

(3) Refining the objective for the risk margin.

(4) Adopting a composite margin.