Project **Insurance Contracts**

Topic **Risk adjustment – Cover note**

Purpose of this paper

1. This paper provides background for the discussion on the existence, objective and quantification of an explicit risk adjustment as part of the proposed measurement model for insurance contracts. It does not include any questions for Working Group participants. Questions for participants are set out in agenda papers 4A-4C.

The proposals in the Exposure Draft

2. The Exposure Draft (ED) *Insurance Contracts* proposes that an insurer determines an explicit risk adjustment as part of the measurement of the present value of the fulfilment cash flows for its insurance liabilities. The risk adjustment is intended to depict "the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected" (paragraph 35).

3. The IASB considered that an explicit risk adjustment would (extract from BC109):

   (a) convey useful information to users about the amount of risk associated with the insurer's insurance contracts because the management of risk is integral to the insurance business model.

   (b) reflect the insurer's view of the economic burden imposed on it by the presence of that risk.

   (c) be broadly consistent with existing requirements in IAS 37, and with the refinements of, and extensions to, those requirements proposed in the exposure draft *Measurement of Liabilities in IAS 37*.

(d) reduce the amount of the residual margin for which a release pattern is somewhat arbitrary.

4. Although the IASB and FASB discussed the Insurance Contracts project jointly from October 2008, the FASB decided not to include an explicit risk adjustment in the measurement of an insurance liability. In the FASB's Discussion Paper, *Preliminary Views on Insurance Contracts*, the FASB Board preliminarily decided that risk and uncertainty would be reflected implicitly through a single composite margin rather than explicitly through a separate risk adjustment.

Some open issues

5. In this session, the staff would like to discuss:

   (a) whether there should be an explicit risk adjustment. Agenda paper 4A discusses the use of a risk adjustment plus residual margin approach versus a composite margin approach.

   (b) how the risk adjustment would be determined. Agenda paper 4B discusses some issues related to the estimation of the risk adjustment.

   (c) how the composite margin would be recognised in earnings (profit or loss) after initial recognition. This is addressed in agenda paper 4C.