Project: **Insurance Contracts**

Topic: **Explicit risk adjustment**

Purpose of this paper

1. The Invitation to Comment on the Exposure Draft (ED) *Insurance Contracts* requested input on the risk adjustment plus residual margin approach versus a composite margin approach. This paper considers:

   (a) benefits and concerns associated with an explicit risk adjustment; and

   (b) a comparison with a composite margin approach.

2. This paper does not address:

   (a) the release pattern of the composite margin. This is considered in agenda paper 4C.

   (b) whether the residual / composite margin should be re-measured or locked-in. This is considered in agenda paper 3C.

Benefits and concerns associated with an explicit risk adjustment

3. Paragraph BC112 of the Basis for Conclusions on the ED describes the benefits of an explicit risk adjustment as follows:

   (a) It provides a clearer insight into the core activity of an insurer.

   (b) It reduces the amount that needs to be released to income using the inherently somewhat arbitrary mechanisms used to release the composite or residual margin.

   (c) It is conceptually consistent with market valuations of financial instruments and their pricing, which indisputably reflect the degree of risk associated with the instrument.

This paper has been prepared by the technical staff of the IASB and the FASB for the purposes of discussion at a public meeting of the IASB working group identified in the header of this paper.

The views expressed in this paper are those of the staff preparing the paper and do not purport to represent the views of any individual members of the Boards, the IASB or the FASB.

The meeting at which this paper is discussed is a public meeting but it is not a decision-making meeting of the Boards.

Official pronouncements of the IASB and FASB are published only after the Boards have completed their full due processes, including appropriate public consultation and formal voting procedures.

(d) It distinguishes risk-generating liabilities from risk-free liabilities.

4. However, the Basis also noted the views of those who oppose the inclusion of a risk adjustment, as follows:

   (a) Although practitioners may, in time, develop intuitions that help them assess whether the amount of a risk adjustment is appropriate for a given fact pattern, it is not possible to perform direct back-tests to assess retrospectively whether a particular adjustment was reasonable. Over time, an insurer may be able to assess whether subsequent outcomes are in line with its previous estimates of probability distributions. However, it would be difficult, and perhaps impossible, to assess whether, for example, a decision to set a confidence level at a particular percentile was appropriate.

   (b) Developing systems to determine risk adjustments will involve cost, and some doubt whether the benefits will be sufficient to justify the cost.

   (c) The inclusion of an explicitly measured risk adjustment is inconsistent with the Board's proposals on revenue recognition, whereas the use of a single composite margin is more consistent with those proposals.

   (d) If the remeasurement of the risk adjustment for an existing portfolio of contracts results in a loss, that loss will reverse in later periods as the insurer is released from that risk. Reporting a loss followed by an inevitable reversal of that loss may confuse some users.

5. Furthermore, the Basis noted concerns about how a risk adjustment is determined, as follows:

   (a) No single technique for developing risk adjustments is universally used and accepted. The co-existence of a range of methods would limit comparability across insurers.

   (b) Some techniques are difficult to explain to users and, for some techniques, it may be difficult to provide clear disclosures that would give users an insight into the inner workings of the technique.

   These concerns are discussed in agenda paper 4B.

A comparison with a composite margin approach

6. The FASB Discussion Paper (DP) *Preliminary Views on Insurance Contracts* proposes a composite margin approach in which the measure of an insurer's exposure to risk is implicitly embedded in a composite margin. This margin "would be recognized in earnings over the coverage and claims-handling periods to reflect the insurer's exposure to uncertainties related to the amount and timing of net cash flows" [paragraph 82].

7. In the risk adjustment plus residual margin approach proposed by the IASB, the risk component of an insurance liability would be recognised over the coverage plus claims handling period (while the residual margin would be released over the coverage period only). However, there are two key differences compared to a composite margin approach, ie the risk adjustment plus residual margin approach:

   (a) identifies explicitly the risk component; and

   (b) requires reassessment of the exposure to risk at each reporting period based on new information available.

8. In contrast, the composite margin is an allocation of an amount determined at inception of the contract. A further difference is that a risk adjustment approach is more likely to generate a loss at initial recognition of an insurance contract, as opposed to a composite margin approach.

9. Some may argue that a composite margin approach provides a response to some of the concerns presented in paragraphs 4 and 5. For example, a composite margin approach would:

   (a) be more consistent with the revenue recognition approach as it would be released in profit or loss over time, based on the performance by the insurer; and

   (b) reduce the subjectivity inherent in the determination of an explicit risk adjustment.

10. However, a composite margin approach:

(a) reflects the insurer's expected profit and may not correspond to the degree of risk present in the liability both at inception and throughout the contract term;

(b) does not entirely eliminate the subjectivity involved in measuring the risk adjustment because an insurer will still need to determine the release pattern of this margin based on the release from risk.

Question for participants
Do you believe that there should be an explicit risk adjustment? Why or why not?