

Project

Insurance Contracts

Topic

Estimation of the risk adjustment

Purpose of this paper

1. This paper discusses:
 - (a) the proposal to permit only three techniques for determining a risk adjustment.
 - (b) the proposed requirement to translate the risk adjustment into a confidence level for disclosure purposes.
 - (c) the determination of the level of aggregation to calculate the risk adjustment.

A principle-based objective

2. The purpose of the risk adjustment is to measure the effect of uncertainty in the cash flows arising from the insurance contract. The ED proposes that the risk adjustment shall depict the risk and uncertainty inherent in insurance contracts by indicating “the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected”.
3. The ED (paragraph 72) also provided a list of characteristics for risk adjustments, intended to help preparers interpret the objective, as follows:
 - (a) risks with low frequency and high severity will result in higher risk adjustments than risks with high frequency and low severity.
 - (b) for similar risks, contracts with a longer duration will result in higher risk adjustments than those of a shorter duration.
 - (c) risks with a wide probability distribution will result in higher risk adjustments than those risks with a narrower distribution.

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.

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- (d) the less that is known about the current estimate and its trend, the higher the risk adjustment shall be.
 - (e) to the extent that emerging experience reduces uncertainty, risk adjustments will decrease and vice versa.
4. Many are concerned about how a risk adjustment is determined, for the following reasons:
- (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.
5. The boards concluded that permitting a wide range of techniques to determine the risk adjustment could lead to diversity in practice, which might reduce the relevance of the resulting measurement and make it difficult for users to compare risk adjustments made by different insurers.
6. As a result, the ED proposed to permit only three techniques for the calculation of the risk adjustment:
- (a) Confidence level;
 - (b) Conditional tail expectation; and
 - (c) Cost of capital.
7. In the IASB's view, these three techniques are reasonably widely understood, applied in practice and capable of providing relevant information consistent with the objective 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.
8. The proposal to permit only three techniques raised the following concerns, discussed in paragraph BC116 of the Basis for Conclusions:
- (a) limiting the number of techniques would conflict with the IASB's wish to set principle-based standards.

- (b) in particular situations, some techniques may be more applicable, or may be easier to implement. It may not be practicable for an IFRS to specify in detail every situation in which particular techniques would be appropriate.
 - (c) techniques may evolve over time. Specifying particular techniques might prevent the use of new techniques that are more suitable.
9. Feedback from outreach also indicates that new techniques may emerge and therefore a more flexible approach should be allowed in order to make sure that entities are able to select the technique which is most appropriate and representative of their risk profile.

Questions

1. Do you think that the principle-based objective proposed in the ED to determine the risk adjustment is sufficiently understandable? Do you think that the proposed techniques meet that objective? If not, how would you modify the proposals in the ED?
2. Do you believe the standard should state only a principle for determining the risk adjustment and some related guidance, without further limiting the range of permitted techniques? If so, do you think the principle proposed in the ED, together with the proposed application guidance, provide sufficient guidance? If not, how would you modify the proposals in the ED and why?
3. If you do not believe it is sufficient to state only a principle for determining the risk adjustment, do you believe that the number of available techniques should be limited? If not, what do you suggest to reduce the risk of diversity in practice?
4. If you think the number of available techniques should be limited, do you also believe that an insurer should be permitted to use a technique that meets the principle for determining risk adjustments, even if it is not explicitly specified?

Translation of the risk adjustment into a confidence level for disclosure

10. The ED proposes that, if an insurer uses a conditional tail expectation technique or a cost of capital technique, it should disclose the confidence level that corresponds to the risk adjustment estimated under those methods. For example, if an insurer uses a cost of capital technique to determine that the risk margin is CU100, it would disclose the (estimated) probability that the actual outcome is more than CU100 above the expected value.

11. This proposal allows for some degree of comparability among entities using different techniques to determine the risk adjustment.
12. The Basis for Conclusions does not explain why the common benchmark for disclosure should be the confidence level, rather than the conditional tail expectation (CTE) or the cost of capital. However, the staff believes that it is probably less onerous to translate the results of other techniques into the confidence level than to translate the results of other techniques into a CTE or into an implied cost of capital.

Questions

5. Do you agree that insurers that use a conditional tail expectation technique or a cost of capital technique should disclose the confidence level that corresponds to the amount of the risk adjustment? Why or why not?
6. If not, how would you ensure that entities provide comparable information about risk adjustments?

Level of aggregation

13. The ED proposes that an insurer measures the risk adjustment at the portfolio level of aggregation. The Board concluded that this is the most practical solution and the most likely to produce relevant information for users at reasonable cost. Because the portfolio contains reasonably homogeneous contracts, it is the most natural level at which to estimate the probability distribution of the cash flows. Furthermore, although an insurer might expect to derive some diversification benefits by grouping together various portfolios, determining the extent of those benefits is difficult because of the lack of full fungibility between portfolios. The boards also considered the following levels of aggregation (extracts from paragraph BC 119):
 - (a) Determining risk adjustments at the level of individual contracts. However, this approach would contradict the rationale of insurance, which is to pool risks by grouping similar contracts into a portfolio.
 - (b) Determining risk adjustments directly for a legal entity or for the entire reporting entity. However, this approach would require the insurer to undertake one of the following:

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- (i) to assume that all portfolios within that entity are fungible, ie that a surplus in one portfolio is available in full to cover a deficit in another portfolio. In the Board's view, this would be inappropriate because complete fungibility is rare in practice, for legal and regulatory reasons.
- (ii) to consider the degree of fungibility in estimating the probability distribution. In the Board's view, this would be a difficult and burdensome exercise and would be so reliant on difficult judgements that it would not produce information that is relevant or represents faithfully the degree of fungibility that exists.

Question

7. Do you agree that the risk adjustment should be determined at the portfolio level of aggregation? If not, what level of aggregation would you suggest for measuring the liability arising from an insurance contract, and why?