

STAFF PAPER

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Project	Insurance contracts		
Paper topic#	Unit of account – risk adjustment		
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What is this paper about?

1. The purpose of this paper is to discuss the unit of account that should be used in the forthcoming insurance contracts standard when calculating the risk adjustment.
2. This paper should be read in conjunction with the “Definition of a portfolio of insurance contracts” paper (agenda paper 7A/77A).
3. Agenda paper 7B/77B discusses the unit of account that should be used when (i) determining and allocating the residual/single margin and (ii) performing the onerous contract test.
4. This paper will be discussed at the joint board meeting. However, the question in the paper is relevant to the IASB only.

Staff recommendations

5. The staff recommends that the unit of account to be used when calculating the risk adjustment should *not* be prescribed as long as the manner in which the risk adjustment is calculated achieves the overall objective of the risk adjustment.

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However, should the IASB decides to prescribe the unit of account to be applied in calculating the risk adjustment, the staff also provide alternative recommendations (Appendix A).

Background

6. In some areas unit of account does not matter for measurement purposes (ie measuring groups of contracts does not give a different answer to measuring contracts individually). The same measurement results will be obtained irrespective of whether the unit of account is the individual contract or a grouping of contracts. An example is the measurement of cash flows (including acquisition costs) because expected value is additive (ie the expected value from a portfolio of contracts equals the sum of the expected values of the individual contracts).
7. However, in some areas the unit of account does matter since the interrelationship between contracts and the manner in which contracts are grouped will impact on measurement. Different measurement results will be obtained depending on the manner in which the unit of account is applied. This is the case when measuring the risk adjustment.

Calculating the risk adjustment

8. Insurance is based on the concept of pooling and mitigating risks. Risks can be pooled and mitigated in a number of ways including:
 - (a) the aggregation of *similar* risks. Agenda paper 7A/77A (“Definition of a portfolio of insurance contracts”) discusses what the staff mean by similar risks. Through the application of the “law of large numbers” similar risk is mitigated by spreading exposure to a particular risk amongst many different policyholders. This will result in a narrower distribution, ie higher certainty in outcome.

- (b) the aggregation of *dissimilar risks*, ie risks that are uncorrelated; partially correlated or negative correlated. Uncorrelated risks refer to risks where the correlation is zero. Negatively correlated risks (also known as offsetting risks) refer to risks where a particular event will impact favourably on one type of risk protection and unfavourably on another type of risk protection. A typical example is that the effect of policyholders living longer will tend to have offsetting effects on life and annuity businesses.
9. Risks are therefore pooled and mitigated in a number of different ways. The pooling and mitigation of risks in the context of this paper and the exposure draft is referred to as “diversification”, which consists of two components, namely:
- (a) the aggregation of high volumes of *similar* risks; and
- (b) the aggregation of *dissimilar* risks.
10. Diversification is fundamental to the business of insurance as it mitigates risk. It is important for entity-wide risk management and capital management.
11. Diversification benefits are, under the exposure draft proposal, incorporated in the risk adjustment included in the measurement of insurance contract liabilities. However, paragraph 36 of the exposure draft *Insurance Contracts* restricts the measurement of the risk adjustment to reflect only risk diversification within a portfolio (ie the portfolio is the unit of account for determining the risk adjustment) and not the risk diversification between portfolios or between higher levels (for instance diversification benefits arising between entities within a consolidated group of companies):

An insurer shall estimate the risk adjustment at the level of a portfolio of insurance contracts. Therefore, the risk adjustment shall reflect the effects of diversification that arise within a portfolio of insurance contracts, but not the effect of diversification between the portfolio and other portfolios of insurance contracts.

12. A portfolio was defined in the exposure draft as insurance contracts that are subject to broadly similar risks and managed together as a single pool. Consequently, under the proposals in the exposure draft, only diversification benefits that arise from mitigating similar risks are considered when measuring the risk adjustment.
13. The IASB noted prior to the issuance of the exposure draft that there are no conceptual grounds for restricting the recognition of diversification benefits to the portfolio level. Only practicality and subjectivity arguments were put forward against considering diversification benefits at a higher level than a portfolio.
14. Furthermore, the IASB considered whether the surpluses arising on different portfolios within a legal or reporting entity are fungible (ie the surplus in one portfolio is fully available to cover a deficit in another portfolio). In the IASB's view complete fungibility is rare in practice, for legal and regulatory reasons. Furthermore, the IASB believed it is a difficult and burdensome exercise to calculate the risk adjustment at the legal or reporting entity level. Consequently, the IASB proposed to preclude the recognition of diversification benefits at a reporting or legal entity level for the reasons described in paragraph BC119 of the Basis for Conclusions, as follows:

BC119 The Board considered the following levels of aggregation:

- (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:
 - (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.

- (c) Determining risk adjustments at the level of individual portfolios. 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.

Input from comment letters

How much diversification benefit to include

15. Almost all respondents believe the recognition of diversification benefits should not be restricted to the portfolio level. They believe that recognising diversification benefits between portfolios would reflect the economic reality of how the business is operated, as evidenced in pricing decisions. They indicated that the current proposals in the exposure draft would potentially result in:
- (a) overstated risk adjustments;
 - (b) losses at issuance for portfolios that are expected to be profitable; and
 - (c) depriving users of decision-useful information about the effective risk mitigation policy of the insurer.
16. Furthermore, it is some insurers' business model to generate diversification benefits from risks being negatively or partially correlated, for instance, the correlation between term assurance and annuity books. Both term assurance and annuity contracts are affected by mortality rates. However, the effect of changes in mortality rates is in opposite directions. As mortality rates increase expected cash outflows on term assurance contracts increase but expected cash outflows on annuity contracts decrease. As a consequence, an insurer that underwrites both life insurance and life annuities will have *less* uncertainty and experience *less* volatility in its overall results than an insurer that issues only one of these types of insurance products.

17. Therefore, some believe that risk adjustments should be lower for an insurer that provides a wide range of insurance contracts that are dissimilar compared to an insurer writing only a single line of insurance as uncertainty is reduced. They indicated that diversification of risk is an essential part of the insurance business model for managing risk.
18. Respondents also stated that there are widespread actuarial techniques that are used by the insurance industry to reflect diversification effects in their capital management models.
19. Moving on to the unit of account to be applied in setting the risk adjustment. Some respondents suggested that the risk adjustment should be measured at the legal entity level, depending on how the risk is managed by the entity so that diversification effects between portfolios would be permitted to the extent that insurers make use of diversification between portfolios in each legal entity. It is also believed by some respondents to be consistent with emerging practices regarding risk and capital management.
20. In addition, other respondents believe the impact of diversification across legal entities (ie at group or subgroup level) should also be reflected in the financial statements because the degree of diversification is established at the highest level at which an entity is consolidated and that the risk diversification of the group should be reflected in the measurement of the risk adjustment at the individual entity level(s). Consequently, all entities forming part of the ultimate group of companies would therefore share in the ultimate diversification benefit.
21. However, some believe diversification benefit across portfolios should *not* be recognised, for the following reasons:
 - (a) The determination of diversification benefits is subjective and this could create lack of comparability between preparers.

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- (b) Practical challenges may exist in estimating diversification benefits beyond the portfolio level. Relevant information at a reasonable cost will be produced by limiting diversification benefits.
- (c) The main unit of account in the exposure draft is the portfolio level and there should be consistent application of this notion.
- (d) There is limited evidence that insurers allow for diversification across portfolios and lines of business when pricing their contracts.

Restrictions on diversification benefit available

- 22. Some believe that diversification benefits between group entities should be reflected in financial statements only *if enforceable intercompany agreements exist* that would allow access to those. An insurer should for instance not reflect the benefits of diversification from contracts held by a fellow subsidiary, unless enforceable intercompany agreements exist that would allow access to those diversification benefits.
- 23. The ED proposed that restrictions on the fungibility of surplus between portfolios or legal entities would restrict the amount of diversification benefit available. Some disagreed with the IASB that fungibility is relevant in assessing whether the risk adjustment should reflect diversification benefits across portfolios or legal entities. They indicated that fungibility is a capital management and regulatory issue that in their view does not belong to financial reporting, ie it is linked to the ability to use available capital across portfolios or legal entities within a reporting entity and the extent of fungibility should not affect the measurement of liabilities.

Staff analysis

- 24. Respondents overwhelmingly opposed the exposure draft’s proposal to exclude diversification benefits between portfolios in the measurement of the insurance contract liability.

25. The staff agree with respondents that diversification benefits between portfolios have value. In the staff's view, the extent to which an entity should include this value in the measurement of the risk adjustment should consider the objective of the risk adjustment.
26. The IASB has tentatively decided that the objective of the risk adjustment is to measure the compensation a *particular* insurer requires for bearing the risk that the ultimate cash flows will exceed those expected. The amount of that compensation could therefore differ from insurer to insurer as the objective of the risk adjustment relies on the *entity specific* viewpoint.
27. Since the entity specific viewpoint should be reflected in the measurement of the risk adjustment, the staff believe an insurer should reflect all factors (including diversification) that management would consider in determining the compensation for bearing the risk that the ultimate cash flows will exceed those expected. For example, if a single-line insurer requires more compensation for bearing risk than an insurer that issues similar contracts as part of a wider package of products, the risk adjustments of the two insurers should reflect that difference.
28. The staff also note that the IASB does not intend to describe a particular methodology or particular inputs (such as a particular confidence level) for the determination of the risk adjustment. This means that if the IASB decide to restrict the diversification benefits that can be considered in determining the risk adjustment, an entity would be likely to compensate for this by (for example) using a lower confidence level. For this reason the staff believe the calculation of a *component* (ie the effect of diversification) of the adjustment for risk should not be prescribed.
29. Similar arguments apply to the unit of account used to determine the amount and type of diversification benefits that are included in the determination of the risk adjustment. The staff believe, consistent with the discussions in paragraphs 25 -28, that prescribing the unit of account to be applied in measuring the risk adjustment could contradict the objective of determining the amount the insurer would require

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as compensation for bearing risk. The staff therefore believe the unit of account in measuring the risk adjustment should *not* be prescribed.

30. Thus, the staff believe that it is sufficient to state the overall objective of the risk adjustment is the compensation the insurer requires for bearing risk. Additional guidance on the level at which the risk is measured is unnecessary.

Question 1 - Whether to prescribe the unit of account to be used when calculating the risk adjustment?

Does the IASB agree that the unit of account to be used when calculating the risk adjustment should *not* be prescribed as long as the manner in which the risk adjustment is calculated achieves the overall objective of the risk adjustment (ie to measure the compensation the insurer requires for bearing the uncertainty inherent in the cash flows that arise as the insurer fulfils the insurance contract)?

31. If the IASB does not agree with the staff recommendation, we have provided an alternative analysis and recommendation in Appendix A.

Appendix A: Alternative staff recommendation if the IASB disagrees with the recommendation

This appendix is relevant only if the IASB does not agree with the staff recommendation in question 1 above.

Prescribing the unit of account

- A1. Insurance is about providing risk protection. Different techniques are applied by management in mitigating risk. One is through increasing the *number* of contracts to spread the risk (ie through the aggregation of similar risks); another is by widening the range of the *types* of risks (ie through the aggregation of dissimilar risks).
- A2. These techniques can result in diversification benefits being created, for instance when different *types* of risk react differently to the occurrence of a particular event.
- A3. The staff believe that, should the IASB decide to prescribe the unit of account that should be used in calculating the risk adjustment, the two components of diversification (ie the aggregation of *similar* risks and the aggregation of *dissimilar* risks) need to be considered separately to assess whether or not they should be included in the risk adjustment.
- A4. The staff believe the aggregation of similar risks forms the essence of insurers' activities and should be reflected in the measurement of insurance contract liabilities.
- A5. The staff also think that the benefit arising from aggregating dissimilar risks needs to be considered in the measurement of insurance contract liabilities for the same reasons as for including the effect of aggregating similar risks in the measurement of insurance contract liabilities. Both originate from the manner in which insurance contracts and risks within the contracts interrelate with each other.

Therefore, any benefits arising from techniques used by management in mitigating risk and potentially limiting overall cash outflows in fulfilling contracts need to be reflected in the measurement of insurance contract liabilities.

A6. Furthermore, the IASB considered the notion that the risk adjustment reflects the point at which the insurer is indifferent between holding the insurance liability and a similar liability that is not subject to uncertainty. To determine the point of economic indifference between these two hypothetical liabilities, it is necessary to contemplate management's techniques in mitigating risks related to the insurance liability. Otherwise, it cannot be fairly compared to the same liability without uncertainty.

A7. The staff also believe it can potentially be very difficult to differentiate between similar and dissimilar risks. For instance, judgement needs to be applied in identifying and grouping similar risks, as discussed in agenda paper 7A/77A "Definition of a portfolio of insurance contracts". The staff also believe additional complexities will be introduced if insurers have to differentiate between these two types of risks for measurement purposes.

In support of only similar risks

A8. Some argue that insurers should not be permitted to recognise benefits arising from assembling different products in measuring insurance liabilities as such a treatment will not be in line with the principles identified in other IFRSs and will result in the insurance industry being treated differently from other industries. Their reasons are as follows:

- (a) Entities, whether they are insurers or not, can limit (effectively hedge) their exposure to a particular event by having different product offerings that will react differently to the occurrence of the particular event. For example, an entity that produces sunhats and umbrellas has sales volumes that are dependent on an uncertain event, namely the weather conditions. The same is true for any product that has a correlation between -1 and 0.

Those entities would not be permitted to recognise the benefits of these different product offerings. Their situation is similar to an insurer issuing life and annuity type of contracts which react differently to life expectancy changes of policyholders.

- (b) Benefits arising from assembling different product offerings are in effect a form of internally generated goodwill (ie a form of intangible asset). Such benefits are considered when valuing an entity but are normally not recognised in the financial statements of non-insurers. Including the value of these benefits in measuring insurance contract liabilities will go beyond the objective of preparing financial statements as the purpose of financial statements is not to put a value on an entity, but to measure the entity's assets and liabilities as a means of providing useful information to users.
- (c) The mitigation of dissimilar risks has value to an insurance entity but is not essential to how the insurer operates (ie it is possible to have an insurer who only writes business that covers similar risks but it would be highly unusual to have an insurer that only writes one single insurance contract). It should for this reason not be included in the measurement of an entity's assets and liabilities.
- (d) The fact that an insurer is diversified does mean increased security for the policyholders. However, some believe it should not translate in to lower liabilities (and higher equity) as diversification is a risk management technique that should not be reflected for financial reporting purposes.
- (e) Decision useful information will be obscured if the effect of dissimilar contracts is reflected in the measurement of insurance contract liabilities. Users of financial statements may, for instance, find it difficult to compare the performance of *individual* types of contracts.

A9. The staff recommend, for the reasons discussed in paragraphs A5 to A7, that insurers should consider diversification benefits arising from the aggregation of *similar* and *dissimilar* risks in calculating the risk adjustment.

Question A1 – include similar and dissimilar risks

Does the IASB agree that insurers should include diversification benefits arising from the aggregation of similar and dissimilar risks in the determination of the risk adjustment?

Unit of account

A10. If the IASB does not agree with the staff recommendation in question 1, the IASB would also need to specify the unit of account that should be used when measuring the risk adjustment. The amount and type of diversification benefits that are considered when measuring the risk adjustment will be determined by the unit of account.

A11. The axioms and assumptions that the boards tentatively confirmed in their meeting of 2 February 2011 state that in general, the final standard will measure insurance contracts at the portfolio level.

A12. Some argue against measuring diversification benefits using a unit of account higher than the portfolio level, on the grounds that this would be too far removed from the initial objective of the project, ie the measurement of insurance contracts.

A13. However, the staff note that if the IASB decide to measure the risk adjustment at the portfolio level:

- (a) diversification benefits arising when *similar* risks are grouped in *different portfolios* will not be reflected in the measurement of the risk adjustment. This would be the case when contracts with similar risks are not managed together (for example, similar risks exist in different geographical locations or in separate legal entities).

- (b) the number of portfolios an insurer holds will impact the calculation of diversification benefits. A smaller number of portfolios will result in a higher utilisation of diversification benefits and *vice versa*. The manner in which portfolios are defined and structured will therefore affect the measurement of the risk adjustment; or *vice versa*; the diversification benefits an insurer wants could affect their determination of portfolios.
- (c) the effect of aggregating dissimilar risks will not be reflected at all as the proposed definition of a portfolio (refer to agenda paper 7A/77A “Definition of a portfolio of insurance contracts”) requires all *similar* risks to be grouped together. It follows that dissimilar risks will not be included in the same portfolio.

A14. Thus, if the IASB wishes to include the diversification effect of *similar* risks that are in *different* portfolios and the effect of *all* dissimilar risks in the measurement of the risk adjustment then the risk adjustment should be measured at a level higher than portfolio.

A15. The staff believe that an entity’s overall exposure to risk should be reflected in the measurement of insurance contract liabilities. Consequently, the staff believe that the measurement of the risk adjustment should not be restricted to the portfolio level.

A16. However, the staff believe a maximum level should be determined at which diversification benefits are to be calculated to reflect the *insurer’s* overall exposure to risk. Said differently, the staff believe an insurer should reflect in the measurement of the risk adjustment diversification benefits arising from risks underwritten by the particular *insurer*. Benefits arising from the interrelationship between contracts under the reporting entity’s control and contracts *not* under the control of the reporting entity (for instance under the control of a fellow subsidiary or parent company) should *not* be reflected in the measurement of the insurance contract liability in the financial statements of that entity. Accounting

for more benefits than are under the insurer's control will not reflect the economic reality and make results incomparable.

A17. Consequently, the staff believe the following should apply in calculating the risk adjustment (ie in determining the unit of account), in both individual entity and group financial statements:

- (a) benefits should be included only to the extent that they are fungible. The staff believe unless diversification benefits are at least partially fungible, there is no real economic value of those benefits to the insurer because it will not be able to access those benefits; and
- (b) diversification benefits should only be included in the measurement of insurance contract liabilities to the extent that diversification benefits are derived from risks for which the insurer provides insurance coverage. Risks to which an insurer is not exposed to should *not* be included in the measurement of the insurance contract liability.

A18. Allowing insurers to reflect the impact of diversification to the extent utilisable by the insurer has the following advantages:

- (a) the artificial distinction in treatment of the diversification benefits between insurance contracts within the same portfolio versus contracts in different portfolios will be removed;
- (b) it acknowledges the value that insurers create by building their business in a way which increases diversification;
- (c) it will significantly reduce the ability of an insurer to influence its own profit by redefining the way that its contracts are allocated to portfolios; and
- (d) it will put less pressure on the definition of portfolio.

Question A2 – Which unit of account for calculation of the risk adjustment?

Does the IASB agree that diversification benefits should be included in the measurement of the risk adjustment only if they are utilisable (ie if they arise from the interrelationship of contracts under the reporting entity's control and are fungible)?