IASB/FASB Meeting
Week commencing 21 March 2011

IASB Agenda reference	**12D**
FASB Agenda reference	**61D**

Staff Paper

Project	**Insurance contracts**
Topic	**Objective for an explicit risk adjustment**

What this paper is about?

1. This paper discusses draft wording for an objective for a risk adjustment. In the staff's view, the objective for a risk adjustment needs to be defined regardless of whether the boards later decide that a risk adjustment should be implicit (as in a composite margin approach) or explicit (as in a risk adjustment plus residual margin approach).

2. This paper does not discuss:

    (a) The practical implementation of an explicit risk adjustment which, as outlined in agenda paper 3B/60B, is considered in agenda papers 3C/60C, 12A/61A and 12B/61B for the March education sessions.

    (b) Whether a risk adjustment is compatible with a fulfilment notion. The boards indicated at their main February meeting that a risk adjustment is compatible with a fulfilment model (see agenda paper 3G for that meeting).

    (c) Whether in practice an explicit risk adjustment can be determined in a way that provides comparable and verifiable information that passes a cost-benefit test. This will be discussed at a future meeting.

    (d) How a risk adjustment could be included in a single risk-adjusted margin approach (such as a composite margin approach). This will be discussed at a future meeting.

This paper has been prepared by the technical staff of the IFRS Foundation and the FASB for discussion at a public meeting of the FASB or the IASB.

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

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The tentative decisions made by the FASB or the IASB at public meetings are reported in FASB *Action Alert* or in IASB *Update*. Official pronouncements of the FASB or the IASB are published only after each board has completed its full due process, including appropriate public consultation and formal voting procedures.

(e) Whether risk adjustments should be determined at the portfolio level or at some higher level. This will be discussed at a future meeting.

(f) The application guidance accompanying any requirements to include, either implicitly or explicitly, a risk adjustment in the measurement of insurance liabilities.

Staff recommendation

3. Staff recommend that the boards amend the objective of the risk adjustment proposed in paragraph 35 the ED to explicitly include a point-of-indifference notion. Accordingly, the objective would no longer refer to:

   (a) 'the risk that the actual cash flows exceed those expected';

   (b) 'the amount the insurer would rationally pay to be relieved of the risk';

   (c) a 'maximum amount'.

4. Accordingly, the staff propose that the objective of the risk adjustment would be:

   The risk adjustment shall be the amount that makes the insurer indifferent between:

   (a) undertaking or retaining the obligation to fulfil the insurance contract; and

   (b) undertaking or retaining an obligation to pay an amount equal to the expected present value of the cash flows that will arise as the insurer fulfils the liability.

Structure of the paper

5. The rest of the paper is structured as follows:

   (a) Background about an explicit risk adjustment (paragraphs 6–19).

   (b) The staff analysis and recommendation:

(i) Uncertainty arising from insurance contracts and the objective of a risk adjustment (paragraphs 19–21).

(ii) Reflecting a fulfilment notion in the objective for a risk adjustment (paragraphs 22–34).

(iii) Double counting of risk and uncertainty (paragraphs 35–39).

(iv) The use of the term 'maximum amount' (paragraphs 40–43).

Background

Refresher of the boards discussions on risk and uncertainty

6. At their main February meeting[1], the boards concluded that, in concept, an explicit risk adjustment that provides information about the uncertainty arising from insurance contracts has the potential to provide relevant information to users of financial statements. At that meeting, the boards also considered the following:

   (a) the need for a risk adjustment to account for the degree of risk aversion in an expected value measurement model; and

   (b) the consistency of a risk adjustment with the fulfilment notion. The boards indicated that a risk adjustment is compatible with a fulfilment model.

7. At their meeting on 1-2 March the boards discussed, in an informational session[2], where the proposed building block approach seeks to capture the elements of risk and uncertainty. No decisions were made.

Summary of the IASB's proposals and the FASB's preliminary views

8. Paragraph 35 of the ED states that:

[1] Agenda paper 3G/58G – Explicit risk adjustment.
[2] Agenda paper 2I/59I – Informational session on uncertainty in the measurement of insurance liabilities.

> **The risk adjustment shall be the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected.**

9. Appendix A of the ED defines a risk adjustment as:

> **An adjustment to the expected present value of future cash flows, to capture the effect of uncertainty about the amount and timing of those cash flows.**

10. Paragraph B72 lists the characteristics that a risk adjustment needs to include to meet the objective in paragraph B68:

> **(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.**
>
> **(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.**

11. The IASB concluded that providing information about the effects of uncertainty about amount and timing of the cash flows arising from insurance contracts would provide relevant information to users because, as stated in BC44(c):

> **Accepting and managing risk is the essence of insurance.**

Relevant questions in the exposure draft / discussion paper

12. Question 5(a) of the ED asked respondents the following:

> Do you agree that the risk adjustment should depict the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected? Why or why not? If not, what alternatives do you suggest and why?

13. Question 9 of the DP asked respondents the following:

> Is the objective of the risk adjustment margin understandable? If so, do you think that the techniques for estimating the risk adjustment margin (see paragraph 52(b)) faithfully represent the maximum amount that the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected?

Overview of comments on the ED / DP

14. Most respondents to the ED agreed with the proposed objective for a risk adjustment, although they made suggestions for improving the way it was expressed in the ED. In contrast, most of those who commented on the DP stated that the objective proposed was not understandable.

15. In general, positions of disagreement or agreement with respect to the objective for the risk adjustment should be read in the context of each respondent's overall position on an explicit measurement of a risk adjustment. Most who favoured an explicit risk adjustment also broadly agreed with the proposed objective. The opposite is true for those who preferred a composite margin approach, who considered the proposed objective to be either unclear or inappropriate.

16. Respondents to the ED and the DP considered that the following aspects of the proposed notion of a risk adjustment as described in the ED needed revision:

    (a) The reference to the 'maximum amount' could suggest the application of conservatism or prudence in estimating the risk adjustment. Under this reading of the proposed objective, the insurer would need to select the highest point of a range of values is identified when estimating the risk adjustment.

(b) The description of the risk adjustment as the amount an insurer would 'pay to be relieved of the risk' could, arguably, imply an exit notion rather than a fulfilment notion.

(c) The ED refers only to the risk that the ultimate fulfilment cash flows 'exceed those expected'. Some respondents felt that this definition could exclude scenarios where premiums are higher than expected or claims are lower than expected. Therefore some respondents felt that a two-sided notion of risk (favourable and unfavourable events) should be included in the objective for the risk adjustment instead of reflecting the unfavourable events only.

(d) Conversely, some respondent felt that the ED's formal definition of the risk adjustment as an adjustment for 'the effects of uncertainty about the amount and timing' of future cash flows could be regarded as inconsistent with the notion that the risk adjustment should only capture the risk that the ultimate cash flows exceed those expected.

(e) The requirement to use entity-specific inputs was regarded by some respondents as implying the exclusion of market-consistent inputs. These respondents suggested that the objective for a risk adjustment should make it clear that: (i) this estimate should reflect market-consistent inputs; and (ii) if, and only if, these inputs are not available, entity-specific inputs should be used. However, some feared that the use of entity-specific inputs would lead to excessive arbitrariness and judgement in the estimate.

Staff analysis and recommendation

17. In this section we analyse the risk adjustment objective as proposed in the ED, consider what notions for the objective for a risk adjustment the boards intended to convey and for each of these notions consider whether they should be retained; and how they might be drafted.

18. For the reader's convenience we recall that paragraph 35 of the ED states that:

> **The risk adjustment shall the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected.**

Uncertainty arising from insurance contracts and the objective of a risk adjustment

19. Paragraph B68 of the draft application guidance in the ED provides the context in which the definition in paragraph 18 is to be read; as follows:

> **The risk adjustment conveys information to users of financial statements about the effects of uncertainty about the amount and timing of the cash flows arising from an insurance contract. To achieve this, paragraph 35 requires that the risk adjustment shall be the maximum amount that the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected.**

Therefore, the boards intended to assign to the risk adjustment the objective of reflecting the effects of uncertainty – ie the risk – about amount and timing of the cash flows arising from insurance contracts.

20. However, some respondents felt that this objective conflicted with the use of the words 'the risk that the ultimate fulfilment cash flows exceed those expected' in paragraph 35, because they thought that the notion of uncertainty would imply the consideration of both favourable and unfavourable events that might affect the amount and timing of fulfilment cash flows. In contrast, they believed, the reference only to the risk that 'cash flows exceed those expected' would have limited the measurement of the uncertainty to the unfavourable changes.

21. Staff note that:

    (a) generally respondents accepted the notion that if a risk adjustment were included in the measurement, it should reflect the effects of uncertainty about the amount and timing of the cash flows; and

(b) defining the objective of an explicit risk adjustment by reference to uncertainty about the amount and timing of the cash flows is consistent with the objective of providing relevant information to users of financial statements (as discussed in agenda paper 3G for the February Joint meeting).

Reflecting a fulfilment notion in the objective for a risk adjustment

22. Although most respondents agreed with the boards' intention that an exit value or a fair value notion should not be reflected in the measurement of a risk adjustment, they were concerned that paragraph 35 of the ED conveyed an exit notion because it referred to the 'amount the insurer would rationally pay to be relieved of the risk'.

23. However, the boards intended the objective for a risk adjustment to be consistent with the fulfilment notion and rejected an 'exit notion' as explained in BC50 of the ED (emphasis added):

> **In the light of comments made by respondents to the discussion paper and subsequent discussions, the Board amended the proposed measurement model as follows:**
>
> **(a) The model focuses on the fact that insurers generally fulfil their contracts directly over time by paying benefits and claims to policyholders, <u>rather than by transferring the contracts to a third party</u>. […]**

24. BC110 states that (emphasis added):

> **The Board thinks that a risk adjustment <u>should not</u> represent:**
>
> **(a) the compensation a market participant would require for bearing the risk associated with the contract. As noted in paragraphs BC49 and BC50, <u>the objective of the measurement model is not current exit value or fair value and therefore does not reflect transfer to a market participant</u>. […]**

25. Staff believe that, by excluding an exit notion and a fair value notion, the boards intended to assign to the risk adjustment the objective of measuring the effects of the uncertainty inherent in *fulfilling* the insurance contracts that the insurer issues. The insurer would measure this uncertainty by reference to the economic burden it suffers for bearing the risk that arises from the need to fulfil its insurance contracts.

26. As staff noted in paragraphs 32 and 33 of agenda paper 3G for the main February joint meeting, the risk adjustment intends to measure the additional amount that a risk adverse insurer would require to persuade it to undertake to fulfil a liability with uncertain cash flows, as opposed to a liability with cash flows which are not subject to uncertainty.

27. Assigning a value to reflect this additional amount is relevant under a fulfilment notion because the measurement of the liability would then reflect the *point at which an insurer is indifferent* between fulfilling the liability and paying to be relieved of the liability.

28. Intuitively, the insurer could get to this amount (or point) of indifference also by considering an entry notion. The total price charged by the insurer to the policyholder to persuade it to undertake an obligation would typically include amounts intended to cover:

    (a) the (expected present value of) the cash flows that will arise as the insurer fulfils the contract.

    (b) the amount the insurer requires for bearing risk

    (c) the acquisition costs.

29. The amount an insurer would be willing to pay so as not to retain (and fulfil) the same obligation would cover only (a) and (b) above. In respect of (a) and (b), the staff have identified no reason to think that the amount required by an insurer to persuade it to undertake an obligation would differ from the amount it would be willing to pay so as not to retain (and fulfil) that obligation.

30. The obligation to fulfil an insurance contract can then be described as the combination of:

    (a) a fixed amount of cash equal to the expected present value of the net cash flows that will arise as the insurer fulfils contract; and

    (b) an additional amount because those cash flows are uncertain. This additional amount would be the explicit risk adjustment. It is the amount that would induce the insurer to undertake the obligation or that the insurer would be willing to pay so as not to retain (and fulfil) the obligation.

31. The reference to 'require or pay' should not be read as a conceptual exercise where the insurer is asked to identify the value of a hypothetical transaction to either transfer or enter into the insurance liability which it has, in fact, already committed to fulfil.

32. Instead, by referring to require or pay, we aim to identify the amount that compensates the insurer for bearing the risk that arises as it fulfils the contract. For any lower amount, the insurer would not retain the liability (if it could dispose of it) and, for any higher amount, it would be willing to assume an identical obligation.

33. Staff think that this point-of-indifference notion is in the spirit of the objective for a risk adjustment as proposed in the ED where it refers to the 'the amount an insurer would rationally pay to be relieved of the risk'. This notion was also suggested by some respondents to the ED and the DP. For example, the American Academy of Actuaries (ED comment letter no. 142, DP comment letter no. 23, suggested that the point-of-indifference notion could be described along the lines of:

    An equivalent amount where the insurer is indifferent between paying a certain amount (to eliminate the uncertainty) and keeping the uncertain cash flows.

34. Therefore staff believe that the point-of-indifference notion is consistent with the overall measurement objective of fulfilment value and it would help eliminate the confusion generated by the reference in the ED to 'the amount an insurer would rationally pay to be relieved of the risk'.

Double counting of risks and uncertainty

35. The boards considered at their 1st March meeting[3] that, under the proposed model, the risks captured in the risk adjustment would not be captured in the expected cash flows or in the discount rate.

36. Paragraph B69 in the draft application guidance in the ED clarifies that:

> **Because the purpose of the risk adjustment is to measure the effect of uncertainty in the cash flows arising from the insurance contract only, the risk adjustment shall reflect all risks associated with that contract. It shall not reflect risks that do not arise from the insurance contract, such as investment risk (except when investment risk affects the amount of payments to policyholders), asset-liability mismatch risk or general operational risk relating to future transactions.**

37. Paragraph 23(a) in the ED refers to estimates of cash flows and states that these:

> **shall be explicit (ie <u>separate from</u> estimates of discount rates that adjust those cash flows for the time value of money and the risk adjustment that adjusts those cash flows for the effects of uncertainty about the amount and timing of those future cash flows).**

38. As shown in paragraphs 36 and 37 above, the ED:

    (a) explains what types of risks are intended to be captured with a risk adjustment; and

[3]Agenda paper 2I/59I – Informational session on uncertainty in the measurement of insurance liabilities.

(b) requires that cash flow estimates, discount rates and the risk adjustment are to be captured in separate items in the model (ie in separate building blocks).

39. Staff believe that the objective for the risk adjustment should not contain an explicit reference that the risk adjustment captures all those risks which are not already captured in other building blocks. The staff will consider whether to include such a reference in drafting the application guidance.

The 'maximum amount'

40. From the feedback received, it appears that one of the major sources of confusion on the objective for the risk adjustment as stated in the ED is the reference to the 'maximum amount' the insurer would rationally pay.

41. Most respondents believed that referring to the risk adjustment as the 'maximum amount', would be inconsistent with the objective of depicting the uncertainty arising from insurance contracts. They thought that this reference would imply that an insurer should select a range of techniques and inputs to those techniques and select the technique and input that produce the largest risk adjustment.

42. Paragraph BC110 of the basis for conclusions on the ED clarifies that the boards' intention was not to convey a prudential-type of measurement with the risk adjustment as follows (emphasis added):

> **The Board thinks that a risk adjustment should not represent:**
>
> **[…]**
>
> **(b) an amount that would <u>provide a high degree of certainty that the insurer would be able to fulfil the contract.</u> Although such an amount might be appropriate for regulatory purposes, it is not compatible with the Board's objective of providing information that will help users of financial statements make economic decisions.**

43. Staff recall that the reference to the 'maximum amount' was included to counter the concerns of one board member about previous drafting that referred to the amount the insurer 'would rationally pay'. That board member believed that an insurer would rationally (in fact, willingly) pay nil. Thus, that board member believed that the previous drafting could lead to a risk adjustment measured at nil. The reference to the 'maximum amount' was inserted to avoid that possible misunderstanding. Staff believe that including the point-of-indifference notion in the objective of a risk adjustment would make the word 'maximum' unnecessary.

Staff recommendation

Questions for the boards
(a) Do the boards agree to amend the objective of the risk adjustment proposed in paragraph 35 the ED to explicitly include a point-of-indifference notion? Accordingly, the objective would no longer refer to: (i) 'the risk that the actual cash flows exceed those expected'; (ii) 'the amount the insurer would rationally pay to be relieved of the risk'; (iii) a 'maximum amount'. (b) Do the boards agree that the objective of the risk adjustment should be: **The risk adjustment shall be the amount that makes the insurer indifferent between:** **(a) undertaking or retaining the obligation to fulfil the insurance contract; and** **(b) undertaking or retaining an obligation to pay an amount equal to the expected present value of the cash flows that will arise as the insurer fulfils the liability.**