Project **Insurance Contracts**

Topic **Risk adjustment: useful financial information**

Purpose of this paper

1. This paper considers whether the inclusion of an explicit risk adjustment in the measure of an insurance contract provides users of financial statements with useful information.

How this paper applies the qualitative characteristics

2. In determining the usefulness of an explicit risk adjustment that is independently measured and remeasured at each reporting period, we considered the boards' *Conceptual Framework for Financial Reporting* (the *Framework*) which states in QC4:

> If financial information is to be useful, it must be relevant and faithfully represent what it purports to represent. The usefulness of financial information is enhanced if it is comparable, verifiable, timely and understandable.

3. The *Framework* also lists the four enhancing qualitative characteristics of useful information: comparability, verifiability, timeliness and understandability. QC33 states:

> Enhancing qualitative characteristics should be maximised to the extent possible. However, the enhancing qualitative characteristics, either individually or as a group, cannot make information useful if that information is irrelevant or not faithfully represented.

4. QC18 of the *Framework* goes on to state that:

> The most efficient and effective process for applying the fundamental qualitative characteristics would usually be as follows (subject to the enhancing qualitative characteristics and the cost constraint, which are not considered in this example). First, identify an economic phenomenon that has the potential to be useful to users of the reporting entity's financial information. Second, identify the type of information about that phenomenon that would be most relevant if it is available and can be faithfully represented. Third, determine whether that information is available and can be faithfully represented.

5. Accordingly, this paper considers the qualitative characteristics in the following order:

   (a) whether a measure that includes a risk adjustment and residual margin is a more relevant measure of an insurance contract than a measure that includes a composite margin – paragraphs 9-14.

   (b) whether the risk adjustment can provide a faithful representation of risk – paragraphs 15-25.

   (c) whether measures that include risk adjustments are comparable, verifiable, timely and understandable – paragraphs 27-38.

6. We will consider the cost constraint for both the explicit risk adjustment and the composite margin approach in agenda paper 3H/68H *Risk adjustment or composite margin?*

Fundamental qualitative characteristics

7. Paragraph QC5 of the Framework states that "The fundamental qualitative characteristics are relevance and faithful representation."

8. QC17 further states "Information must be both relevant and faithfully represented if it is to be useful. Neither a faithful representation of an irrelevant phenomenon nor an unfaithful representation of a relevant phenomenon helps users make good decisions."

The relevance of an explicit risk adjustment

9. In February 2011, the boards concluded that "If there are techniques that could faithfully represent the risk inherent in insurance liabilities, the inclusion of an explicit risk adjustment in the measurement of those liabilities would provide relevant information to users."

10. We demonstrate the availability of techniques in agenda paper 3C *Risk adjustment: techniques to meet the objective*. In this section, we consider whether a risk adjustment approach provides relevant information, assuming that the boards accept the conclusion in agenda paper 3C that suitable techniques exist.

11. Financial information is relevant if it has predictive value, confirmatory value or both. We do not believe that a risk adjustment would add *confirmatory value* to the measurement of insurance contracts. However, as discussed in paragraphs 12 - 14, an explicit adjustment for risk that provides information about the effect of uncertainty in the amount and timing of the estimated projected future cash flows would add *predictive value* to the measurement of insurance liabilities.

12. QC8 of the *Framework* state that:

> QC8 Financial information has predictive value if it can be used as an input to processes employed by users to predict future outcomes. Financial information need not be a prediction or forecast to have predictive value. Financial information with predictive value is employed by users in making their own predictions.

13. Furthermore, when describing the objective, usefulness and limitations of general purpose financial reporting, the *Framework* states:

> OB3 Investors', lenders' and other creditors' expectations about returns depend on their assessment of the amount, timing and **uncertainty** of (the prospects for) future net cash inflows to the entity. Consequently, existing and potential investors, lenders and other creditors need information to help them assess the prospects for future net cash inflows to an entity. (emphasis added)

14. Information about the uncertainty arising from insurance contracts cash flows and the insurer's assessment of the related risk should be a critical input to the processes employed by users to predict future outcomes because of the importance to an insurer

of managing risk. However, information about risk is not available from the expected present value of cash flows. In a risk adjustment approach, that information would be provided explicitly through the risk adjustment. The adjustment would be remeasured each period and changes in the risk would be presented in profit or loss. Therefore, in the staff's view, an explicit adjustment for risk would make information about risk more visible and more transparent and so would enhance a user's ability to obtain up to date information about uncertainty in the future cash flows. In other words, a measure that includes a risk adjustment is more relevant than a measure that excludes the adjustment.

Risk adjustment and faithful representation of risk

15. Financial information should faithfully represent the phenomena that it purports to represent. We discuss in agenda paper 3A *Risk adjustment: the story so far* the economic phenomenon that the risk adjustment attempts to depict, ie the risk in the insurance contract. This phenomenon is reflected in the objective of the risk adjustment, ie that the risk adjustment shall be the compensation the insurer requires to bear the risk that the ultimate cash flows could exceed those expected. In other words, the measurement of an insurance contract liability reflects an amount for the risk in the contract and the risk adjustment is intended to depict that risk.[1]

16. In QC12 the *Framework* stated that:

> QC12 …To be useful, financial information must not only represent relevant phenomena, but it must also faithfully represent the phenomena that it purports to represent. To be a perfectly faithful representation, a depiction would have three characteristics. It would be *complete, neutral* and *free from error.*

[1] In their meeting in the week of 22 March, the boards noted they would consider how to capture in the application guidance 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.

Completeness

17. A complete depiction includes all information necessary for a user to understand the phenomenon being depicted, including all necessary descriptions and explanations. For an insurance contract liability, an inherent characteristic is risk, and we therefore believe that a user needs to understand the amount of risk in the contract and how that risk changes. For example, we think that omitting a representation of risk from the measurement of the insurance contract liability would result in an incomplete representation because it would not show any difference between two insurers with similar discounted cash flows estimates (building blocks 1 and 2) but significantly different underlying risk positions. Similarly, we think that omitting information about changes in risk would not provide a complete depiction of the effect of any changes in those underlying risk positions. Although determining that representation would be complex, that fact is not sufficient reason to exclude it, for the reasons articulated in QC31:

> QC31 Some phenomena are inherently complex and cannot be made easy to understand. Excluding information about those phenomena from financial reports might make the information in those financial reports easier to understand. However, those reports would be incomplete and therefore potentially misleading.

18. QC13 also notes that "For some items, a complete depiction may also entail explanations of significant facts about the quality and nature of items, factors and circumstances that might affect their quality and nature, and the process used to determine the numerical depiction." We discuss agenda paper 3D *Risk adjustment: comparability and verifiability through disclosures* how disclosures relating to risk adjustments can promote comparability and verifiability.

Neutrality

19. Some question whether a measure is neutral if it includes a risk adjustment. Such a measure would not be neutral if the purpose of the risk adjustment was to import a degree of prudence or conservatism. As explained in paragraph BC3.27 of the Basis for Conclusions on the *Framework*, the *Framework* does not include prudence or

conservatism as an aspect of faithful representation because including either would be inconsistent with neutrality.

20. However, the purpose of the risk adjustment proposed in the IASB's exposure draft was not to import prudence or conservatism but to depict the risk arising from the insurance contracts liability. As paragraph QC14 explains, that depiction would be neutral if it is 'not slanted, weighted, emphasised, de-emphasised or otherwise manipulated to increase the probability that financial information will be received favourably or unfavourably by users'.

21. The staff have identified no reason why a risk adjustment should inherently lack neutrality. It is conceivable that insurers could determine a risk adjustment in a biased or incorrect manner. However, that possibility is not unique to the risk adjustment and applies to *any* item in the financial statements.

Freedom from errors

22. Some question whether a risk adjustment can be 'free from error' because of the uncertainty in estimating it. However, the *Framework* explains that 'free from error' means something other than 'precisely accurate':

> QC15 Faithful representation does not mean accurate in all respects. Free from error means that there are no errors or omissions in the description of the phenomenon, and the process used to produce the reported information has been selected and applied with no errors in the process. In this context, free from error does not mean perfectly accurate in all respects. However, a representation of that estimate can be faithful if the amount is described clearly and accurately as being an estimate, the nature and limitations of the estimating process are explained, and no errors have been made in selecting and applying an appropriate process for developing the estimate.

23. In other words, a risk adjustment can be free from error if it is accurately described and the technique used for measuring the adjustment is applied without error As discussed in agenda paper 3C *Risk adjustment: techniques to meet the objective*, a variety of techniques for determining a risk adjustment exist and these techniques could faithfully represent the risk inherent in insurance liabilities. Thus, information

about the risk arising from a contract and the insurer's assessment of the risk is capable of being 'free from error'.

Impact of estimation uncertainty

24. Whilst emphasising that an estimate can be a faithful representation if the reporting entity has properly applied an appropriate process, properly described the estimate and explained any uncertainties, the *Framework* adds a note of caution:

> However, if the level of uncertainty in such an estimate is sufficiently large, that estimate will not be particularly useful. In other words, the relevance of the asset being faithfully represented is questionable. If there is no alternative representation that is more faithful, that estimate may provide the best available information.

25. Some respondents expressed concerns about the level of uncertainty in measuring the risk adjustment (because of both the range of techniques and the subjectivity inherent in applying those techniques). These concerns raise questions over the relevance of the item being represented. Some suggest that the level of uncertainty implies that a risk adjustment approach cannot provide a faithful representation of the obligation created by an insurance contract. However, in paragraphs 9-14, we show that a risk adjustment approach can provide relevant information about risk in an insurance contract liability, and in agenda paper 3C/68C *Risk adjustment: techniques to meet the objective*, we show that there are techniques that can faithfully represent that risk. Furthermore, in paragraph 17 we conclude that failing to include a current measure of risk would result in an incomplete representation of an insurance liability.

26. Accordingly, we think that a risk adjustment approach, while imperfect and subject to inherent limitations, possesses the fundamental qualitative characteristics of useful information.

Enhancing qualitative characteristics

27. QC19 of the Framework states that: "Comparability, verifiability, timeliness and understandability are qualitative characteristics that enhance the usefulness of

information that is relevant and faithfully represented. The enhancing qualitative characteristics may also help determine which of two ways should be used to depict a phenomenon if both are considered equally relevant and faithfully represented."

Comparability

28. Paragraph QC21 of the *Framework* states that:

> Comparability is the qualitative characteristic that enables users to identify and understand similarities in, and differences among, items.

29. QC23 further states:

> Comparability is not uniformity. For information to be comparable, like things must look alike and different things must look different. Comparability of financial information is not enhanced by making unlike things look alike any more than it is enhanced by making like things look different.

30. Risk adjustments can enhance comparability because they expose differences between contracts with similar expected cash flows but very different risk profiles.

31. Risk adjustments would impair comparability only if the techniques used by entities did not meet the objectives of the risk adjustment. We discuss techniques in agenda paper 3C *Risk adjustment: techniques to meet the objective* and related disclosure in agenda paper 3D *Risk adjustment: comparability and verifiability through disclosures*.

Verifiability

32. Paragraphs QC26 – QC28 of the *Framework* state:

> QC26 […] Verifiability means that different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation. Quantified information need not be a single point estimate to be verifiable. A range of possible amounts and the related probabilities can also be verified.
>
> QC27 Verification can be direct or indirect. [...]Indirect verification means checking the inputs to a model, formula or other technique and recalculating the outputs using the same

> methodology. An example is verifying the carrying amount of inventory by checking the inputs (quantities and costs) and recalculating the ending inventory using the same cost flow assumption (for example, using the first-in, first-out method).
>
> QC28 It may not be possible to verify some explanations and forward-looking financial information until a future period, if at all. To help users decide whether they want to use that information, it would normally be necessary to disclose the underlying assumptions, the methods of compiling the information and other factors and circumstances that support the information.

33. The question on verifiability is particularly relevant in order to address the concerns raised by respondents to the ED and DP and by some board members about the perceived subjectivity involved in measuring the risk adjustment. In agenda paper 3D *Risk adjustment: comparability and verifiability through disclosures*, we discuss how disclosure helps add verifiability to the measurement of the risk adjustment by providing users with the inputs and assumptions used in the application of the technique. These conclusions are consistent with those of the boards on the forthcoming fair value measurement IFRS which states that:

> The boards noted that the objective of the disclosure is not to enable users of financial statements to replicate the entity's pricing models, but to provide enough information for users to assess whether the entity's views about individual inputs differed from their own and, if so, to decide how to incorporate the entity's fair value measurement in their decisions.

Timeliness

34. Measures that include risk adjustments are not inherently less timely than measures that exclude risk adjustments – they do not rely on information that is available only at a later date. Moreover, they may provide more timely information about changes in risk.

Understandability

35. The FASB's DP argued that a composite margin would provide a simpler and more understandable approach to account for the difference between the expected cash inflows and outflows. It also states that its proposals for subsequent recognition of the composite margin in profit or loss would be simpler to calculate and more transparent than the IASB's proposed techniques for subsequent recognition of changes in the risk adjustment margin. Concerns about complexity and understandability were also raised in the comment letters to both the ED and the DP.

36. We note that there is a difference between understanding how to perform a calculation and understanding the result of that calculation. We acknowledge that the determination of the risk adjustment may require complicated statistical techniques. However, the output of those techniques should be understandable – ie the risk adjustment should be higher when more risk is present and lower when less risk is present. We think that understandability of the output is more important for useful financial information. One does not need to understand the workings of an internal combustion engine to drive a car. Similarly, it is not necessary to understand in full detail all the inner workings of a model to be able to use the output of that model as part of the information needed to support economic decisions. As noted in QC30 "classifying, characterising and presenting information clearly and concisely makes it understandable" and a separate and explicit measure of risk would be a necessary first step in classifying and characterising that information.

37. Furthermore, if the boards did not make the adjustment for risk explicit, that would exclude information about risk and changes in risk. We believe that the disadvantages of an implicit, rather than explicit risk adjustment are well articulated in QC31 and QC32:

> QC31 Some phenomena are inherently complex and cannot be made easy to understand. Excluding information about those phenomena from financial reports might make the information in those financial reports easier to understand. However, those reports would be incomplete and therefore potentially misleading.
>
> QC32 Financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyse the information diligently. At

> times, even well-information and diligent users may need to seek the aid of an adviser to understand information about complex economic phenomena.

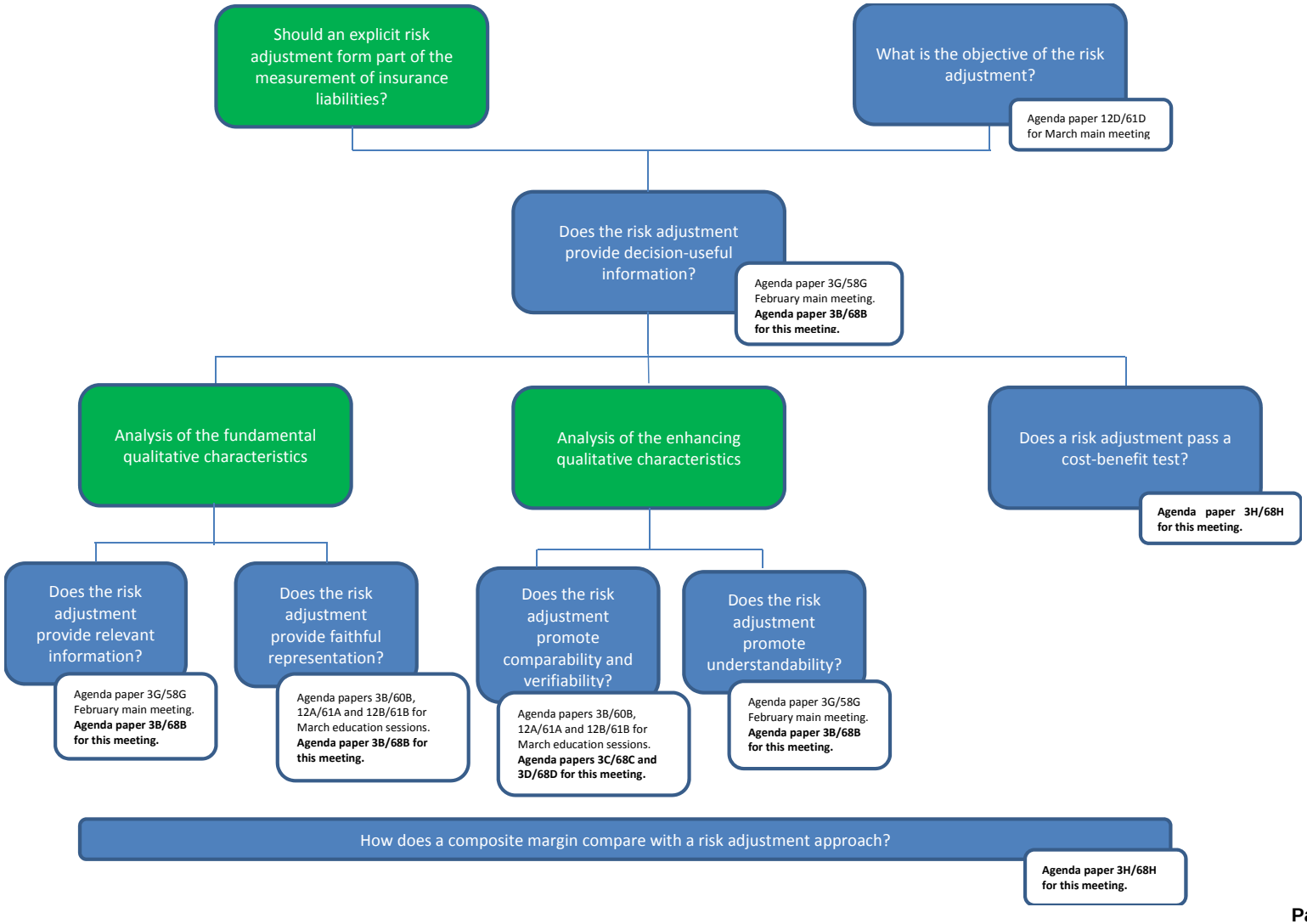
38. In the staff's view, the boards need to balance the need for information that is simple against the need for information that provides insight into a defining, although inherently complex, characteristic of an insurance contract, ie insurance risk. Any complexity added by an explicit risk adjustment does not preclude that information from being understandable and some might argue that this complexity is more informative than simplicity that does not really exist.

Staff conclusions

39. On the basis of the analysis in paragraphs 7-38, the staff conclude that a risk adjustment approach provides useful financial information for users of financial statements. Figure 1 below shows how we have structured this analysis.

Question for boards
Do you agree that the inclusion of a risk adjustment in the measure of an insurance contract liability provides users of financial statements with useful financial information?

40. In agenda paper 3H *Risk adjustment or composite margin?* we discuss whether the qualitative characteristics of useful financial information are present to a greater degree in the information generated by a risk adjustment approach or in the information generated by a composite margin approach.


Should an explicit risk adjustment form part of the measurement of insurance liabilities?
What is the objective of the risk adjustment?
Agenda paper 12D/61D for March main meeting
Does the risk adjustment provide decision-useful information?
Agenda paper 3G/58G February main meeting. **Agenda paper 3B/68B for this meeting.**
Analysis of the fundamental qualitative characteristics
Analysis of the enhancing qualitative characteristics
Does a risk adjustment pass a cost-benefit test?
Agenda paper 3H/68H for this meeting.
Does the risk adjustment provide relevant information?
Agenda paper 3G/58G February main meeting. **Agenda paper 3B/68B for this meeting.**
Does the risk adjustment provide faithful representation?
Agenda papers 3B/60B, 12A/61A and 12B/61B for March education sessions. **Agenda paper 3B/68B for this meeting.**
Does the risk adjustment promote comparability and verifiability?
Agenda papers 3B/60B, 12A/61A and 12B/61B for March education sessions. **Agenda papers 3C/68C and 3D/68D for this meeting.**
Does the risk adjustment promote understandability?
Agenda paper 3G/58G February main meeting. **Agenda paper 3B/68B for this meeting.**
How does a composite margin compare with a risk adjustment approach?
Agenda paper 3H/68H for this meeting.