IASB/FASB Meeting
Week commencing 16 May 2011

IASB Agenda reference	**3H**
FASB Agenda reference	**68H**

Staff Paper

Project	**Insurance Contracts**
Topic	**Risk adjustment or composite margin?**

Purpose of this paper

1. This paper compares a risk adjustment approach with a single margin approach and asks the boards to decide whether the proposed model to account for insurance contracts should include an explicit risk adjustment or use a single margin.

What is this paper about?

2. This is the last paper of a set that aims to help the boards decide whether to include an explicit risk adjustment in the measurement of insurance contracts, ie whether to adopt a 'risk adjustment' approach or a 'single margin' approach.

Difference between the two approaches

3. Paragraphs 7-53 set out the IASB staff's analysis and recommendation. Paragraphs 54-79 set out the FASB staff's analysis and recommendation. We note that the two approaches reflect different economic phenomena:

    (a) In the IASB staff's analysis, the economic phenomenon is the risk inherent in the insurance contract.

    (b) In the FASB staff's analysis, the economic phenomenon is potential profit at risk.

4. This paper compares the two approaches and considers:

    (a) which approach better satisfies the fundamental qualitative characteristics of useful information of relevance and faithful representation (paragraphs 11-24 and 57-66)

(b) which approach better satisfies the enhancing qualitative characteristics of useful information, ie comparability, verifiability, timeliness and understandability (paragraphs 25-42 and 67-75).

(c) how the cost constraint applies to the two approaches (paragraphs 43-46 and 76).

Staff recommendations

5. The IASB staff recommend the risk adjustment approach, ie that the measurement of an insurance contract should include an explicit risk adjustment.

6. The FASB staff recommend use a single margin approach.

IASB staff view

7. Paragraphs 7-53 should be read in conjunction with Agenda 3B/68B *Risk adjustment: useful financial information,* which provides a discussion of whether a risk adjustment approach provides useful financial information.

8. Risk is an inherent characteristic of an insurance contract. Both the IASB exposure draft (the ED) and the FASB discussion paper (the DP) acknowledged that the premium charged by the insurer includes the compensation that the insurer requires for bearing risk. However:

    (a) the ED proposed that the compensation the insurer requires for bearing risk should be reflected through an explicit risk adjustment, which is independently measured and remeasured.

    (b) the FASB DP proposed that the compensation the insurer requires for bearing risk is combined with the amount charged for other services associated with the contract in a composite margin that is calibrated to the premium.

9. The difference between a risk adjustment and a composite (‘single’) margin approach is sometimes characterized as the difference between an explicit and an implicit

measure of risk. However, there are other important differences. These differences are summarized in the table below:

	Risk adjustment approach	Composite margin approach
What it tries to measure	The risk inherent in an insurance contract	Potential profit at risk
How it is determined (day 1)	Independently measured, no cap or floor	Calibrated to the premium (ie based on pricing assumptions)
Whether it is remeasured (after day 1)	Remeasured each period, No cap or floor	Locked-in and allocated to profit and loss over the coverage and claims handling periods (discussed in Agenda paper 3F/68F), Capped at premium received

10. We will consider the effect of these differences on our assessment of which of the two approaches provides more useful financial information.

Fundamental qualitative characteristics

11. In agenda paper 3C/68C *Risk adjustment: techniques to achieve the objective* and agenda paper 3F/68F *Composite margin – profit realisation*, the staff conclude that both the risk adjustment approach and the composite margin approach provide financial information that is both relevant and capable of faithful representation. This section considers whether the information provided by one or other of the two approaches is ***more*** relevant and/or a ***more*** faithful representation of the insurance contract.

Relevance

12. 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." We demonstrate the availability of techniques in

agenda paper 3C/68C *Risk adjustment: techniques to meet the objective*. In this section, we consider whether a risk adjustment approach provides more relevant information than a composite margin approach, assuming that the boards accept the conclusion in agenda paper 3C/68C that suitable techniques exist.

13. QC6 states that relevant financial information is capable of making a difference in the decisions made by users and QC7 notes that financial information is relevant if it has predictive value, confirmatory value or both. We do not believe that either a risk adjustment or a composite margin would add confirmatory value to the measurement of insurance contracts and so discuss only predictive value.

14. 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.

15. Information about the risk in an insurance contract 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.

16. In a risk adjustment approach, that information would be provided explicitly through the risk adjustment. The liability for the insurance contract would directly reflect the economic burden imposed on the insurer by risk. That amount would be measured directly and remeasured each period. Thus changes in the risk would be presented in profit or loss. In a composite margin approach, information about risk would be more implicit. The amount of risk would be imputed from the premium, and changes in risk may not be explicitly identified and reported. Therefore, in the IASB staff's view, an explicit adjustment for risk would enhance a user's ability to obtain information with predictive value by increasing the visibility and transparency of this information, compared to a composite margin approach.

Faithful representation

17. In the IASB staff's view, the economic phenomenon that needs to be reflected in the measurement of an insurance contract liability is risk. The *Framework* states:

> 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.*

Completeness

18. A complete depiction includes all information necessary for a user to understand the phenomenon being depicted, including all necessary descriptions and explanations. One of the most important characteristics of an insurance contract liability is risk. We therefore believe that an approach which measures risk directly, and remeasures it each period, provides a more complete depiction of the risk than an approach which estimates the risk based on the premium and reflects the release from risk by an approximate allocation. Furthermore we believe that an approach which includes risk in the measurement of the liability provides a more complete depiction of the insurer's financial position than one that does not. The latter approach would not necessarily show any difference between two insurance liabilities that generate cash flows with similar expected present values (building blocks 1 and 2) but with significantly different risk profiles.

19. In particular, we believe failing to re-measure risk independently and directly would exclude information about changes in risk from the measurement of the liability and would therefore not provide complete information. Although we acknowledge that doing so may be complex, we note that the disadvantage of an implicit, rather than explicit risk adjustment is well 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.

20. We therefore believe that a risk adjustment approach provides a more complete depiction of the risk in an insurance contract than a composite margin approach

Neutrality and freedom from errors

21. As noted in agenda paper 3B/68B *Risk adjustment: useful financial information*, we have identified no reason why a risk adjustment should inherently lack neutrality or freedom from error. Accordingly do not think that the qualities of neutrality and freedom from errors are likely to distinguish a risk adjustment approach from a composite margin approach sufficiently to help the boards assess which of those two approaches they should use.

Impact of estimation uncertainty

22. 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.

23. 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 more relevant information about the obligation created by an insurance contracts. However, in paragraphs 12-16, we show that a risk adjustment approach provides more relevant information about risk in an insurance contract liability, and in agenda paper 3B/68B *Risk adjustment: techniques to meet the objective*, we show that there are techniques that can faithfully represent that risk. Furthermore, in paragraphs 18-20, conclude that a risk adjustment provides a more complete representation of the insurance liability. Accordingly, we think that a composite margin approach does not provide the best available information, even when we bear in mind the limitations of the risk adjustment approach that result from the need to estimate a risk adjustment using subjective estimates of unobservable inputs.

Conclusions regarding the fundamental qualitative characteristics

24. Because we think that a risk adjustment provides a more complete depiction of risk in an insurance contract, we believe that a risk adjustment approach contributes to a more relevant and faithful representation of an insurance contract liability than a composite margin approach does. Therefore we believe that including a risk adjustment in the measurement of the insurance contract liability better satisfies the fundamental qualitative characteristics.

Risk adjustment and enhancing qualitative characteristics

25. Paragraph QC19 of the *Framework* states:

> QC19 *Comparability, verifiability, timeliness* and *understandability* are qualitative characteristics that enhance the usefulness of information that is relevant and faithfully represented.

26. Paragraph QC33 also describes how these are to be considered, as follows:

> 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.

Comparability

27. In this section we consider whether the information from a risk adjustment approach or a composite margin approach is more comparable.

28. A risk adjustment is an estimate of risk in an insurance contract. That risk reflects both the probability distribution of outcomes, and the degree of risk aversion of the insurer. In determining a risk adjustment, an insurer is therefore required to use one of a number of techniques that require unobservable inputs. These two aspects (use of unobservable inputs and the existence of a range of techniques) raise the question of whether the risk adjustment can be comparable.

29. We discuss in agenda papers 3C/68C *Risk adjustment: techniques to meet the objective* and 3D/68D *Risk adjustment: comparability and verifiability through disclosures* why we think that a risk adjustment is capable of providing comparable information.

30. As discussed in agenda paper 3F/68F *Composite margin – profit realisation*, the run-off pattern for the composite margin, as proposed in the DP, was criticised by commentators because it would not result in meaningful information for all contracts. Agenda paper 3F/68F considers ways to modify the run-off pattern, and proposes that an insurer should allocate the composite margin in a way that reflects risk. Agenda paper 3G/68G *Composite margin – conceptual analysis* sets out the view that a composite margin approach is capable of providing comparable information.

31. In determining whether a risk adjustment approach or a composite margin approach provides more comparable information, the following paragraphs of the *Framework* are relevant:

    (a) QC21 states that comparability is the qualitative characteristics that enables users to identify and understand similarities in, and differences among, items.

    (b) QC22 states that consistency, although related to comparability, is not the same. Consistency refers to the use of the same methods for the same items, either from period to period within a reporting entity or in a single period across entities. Comparability is the goal; consistency helps to achieve that goal.

32. Because of the range of techniques to determine a risk adjustment, and because the inputs to those techniques are entity-specific and unobservable, it is clear that a composite margin approach would result in higher consistency than a risk adjustment approach. This leads some to argue that a composite margin approach would result in more comparable information than a risk adjustment approach.

33. However, although a composite margin is more *readily* comparable than a risk adjustment, such consistency may not contribute to showing similarities and differences between items. Because a composite margin is not, at inception and subsequently, based on solely on the amount of risk, the relative amount of risk in two equal composite margins would not be apparent.

Verifiability

34. Verifiability means that different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation.

35. Agenda papers 3B/68B *Risk adjustment: useful financial information* and 3D/68D *Risk adjustment: comparability and verifiability through disclosures* discuss verifiability as it relates to the risk adjustment approach. Agenda paper 3G/68G *Composite margin – conceptual analysis* discusses verifiability for the composite margin approach.

36. To the extent that the run-off of the composite margin remains straightforward, the composite margin approach is likely to be more easily verified than a risk adjustment approach. This is because of the relative complexity of measuring and remeasuring a risk adjustment, compared to applying a formula to an observable premium on day 1.

37. However, if the allocation of the composite margin is to reflect estimates of changes in risk, that may reduce the verifiability of the composite margin.

Timeliness

38. 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

39. The FASB's DP stated 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. Concerns about complexity and understandability were also raised in the comment letters to both the ED and the DP.

40. As described in agenda paper 3B/68B *Risk adjustment: useful financial information,* there is a difference between understanding how to perform a calculation and

understanding the result of that calculation. We think that understandability of the result is more important for useful financial information and that 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 we think that this would be better served by independently measuring the risk and remeasuring it in each period. We think it is less understandable for the risk in periods after initial recognition to be determined by reference to an initial premium.

41. Furthermore, we note that complexity itself does not result in lack of understandability, as articulated in QC32:

> 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.

42. In the IASB 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 reporting this complexity is more informative than reporting simplicity that does not really exist.

The cost constraint on useful financial reporting

43. According to QC38 in the Framework:

> In applying the cost constraint, the Board assesses whether the benefits of reporting particular information are likely to justify the costs incurred to provide and use that information. […]

44. An endemic problem in assessing the costs and benefits of new proposals is that the costs are relatively easy to list and quantify, whereas the benefits are more nebulous. For the risk adjustment:

    (a) The costs that need to be incurred to provide the risk adjustment calculation and the related disclosures can be identified in at least the following:

(i) training costs (initial and ongoing);

(ii) costs to set up and maintain information systems;

(iii) costs associated with external consultants hired to assist the insurer; and

(iv) costs to educate users about risk adjustment estimates.

(b) The benefits are the increase in transparency which should result from a more faithful representation of risk. This should contribute to the lower cost of capital that many hope to be a benefit of the boards' project.

45. In assessing whether a risk adjustment approach or a composite margin approach achieves a better cost-benefit balance, the following considerations apply:

(a) There are likely to be lower costs of compliance for a composite margin approach, unless the proposal to allocate the composite margin according to the risk in effect result in the same calculations that would be applied in a risk adjustment approach.

(b) A risk adjustment approach would report transparently information about risk, including changes in risk, and provides benefits in terms of greater understandability.

46. We summarise the assessment of how the cost constraint applies to the two approaches in the words of one comment letter (from a global actuarial consultancy):

> *"We concede that the cost associated with determining the separate risk adjustment would likely be higher than the composite margin approach, but we believe the information benefits to users exceed the cost."*

Summary

47. The table below summarises our assessment of how well a risk adjustment approach depicts risk compared to the composite margin approach (as described in the FASB's DP). We note that the FASB staff proposals have been modified from the DP, but nonetheless the comparison illustrates why we think that risk inherent in an insurance contracts should be independently measured and remeasured.

	Composite margin (as in DP)	**Risk adjustment approach**
Relevance	✘ Provides only indirect information about risk and changes in risk	☑ Provides information directly about risk and changes in risk
Faithful representation	✘ Depiction of risk is indirect ✘ Does not provide direct information about changes in the level of risk	☑ Provides a more complete depiction of the risk inherent in the insurance contract liability ☑ Provides more direct information about changes in risk ✘ Level of uncertainty in the estimate may call into question relevance
Comparability	☑ More readily comparable ✘ Might provide the impression that similar composite margins signal similar degree of riskiness	✘ Less readily comparable ☑ Comparability can be promoted through disclosures
Verifiability	☑ More easily verified	✘ Inputs might not be fully verifiable. ☑ Verifiability can be promoted through disclosures
Timeliness	✘ May not provide timely information about changes in risk	☑ Provides timely information about changes in risk
Understandability	✘ Does not readily provide information about the risk inherent in the contract ☑ Simpler to calculate	☑ Provides information about risk, which is the essence of an insurance contract ☑ Reduces the amount of the 'inexplicable' (residual) margin and therefore gives rise to a clearer picture of the insurer's performance.
Cost constraint	☑ Likely to be lower cost than	✘ Likely to be higher cost than composite

	risk adjustment approach	margin approach

48. In paragraphs 12-24 we concluded that a risk adjustment approach would contribute better than a composite margin approach to satisfying the fundamental characteristics of useful information: relevance and faithful representation.

49. In paragraphs 25-42, we showed that, on balance, a composite margin approach could better contribute to achieving the enhancing characteristics of comparability, verifiability, timeliness and understandability. This is true of the composite margin approach as proposed in the DP (which we believe does not satisfy the fundamental qualitative characteristics to the same extent as a risk adjustment approach).

50. However we note that agenda paper 3F/68F *Composite margin: profit realisation* proposes modifying that approach so that the allocation of the composite margin would implicitly reflect the potential profit at risk in the insurance contract. In our view, this would introduce much of the complexity in determining a risk adjustment, without providing the benefit of the transparency that results from making that information explicit. As a consequence, we believe that the single margin approach described in agenda paper 3F/68F might possess the enhancing qualitative characteristics to a somewhat greater degree than a risk adjustment approach, but we believe this difference to be marginal.

51. Similarly, we believe that the modifications proposed in agenda paper 3F/68F *Composite margin: profit realisation* would make the composite margin approach more costly than the composite margin approach as proposed in the DP, but it would still be less costly than the risk adjustment approach (see paragraphs 43-46).

52. Furthermore, we note that QC19 of the *Framework* states that the enhancing qualitative characteristics may help determine which of two ways should be used to depict a phenomenon **if both are considered equally relevant and faithfully represented** (emphasis added).

53. In the IASB staff's view, this does not apply to the risk adjustment and composite margin approaches. As described in paragraphs 12-24 above, we think that a risk adjustment approach provides more relevant information about the risk inherent in an insurance contract liability and results in a more faithful representation of that risk.

Therefore, we conclude that a risk adjustment approach provides more decision-useful information, even after considering the enhancing qualitative characteristics and the cost constraint. As a result, we recommend that the measurement of the insurance liability should include an explicit risk adjustment.

FASB staff view

54. This analysis focuses on the differences in viewpoint with the analysis in paragraphs 7-53 to avoid repetition.

55. The boards should read this section of the paper in concert with the conceptual analysis performed on the single margin at agenda paper 3G/68G *Composite margin: residual margin*.

56. While the FASB staff would agree that one of the key differences between the risk adjustment and single margin approach is the fact that the risk adjustment is included in the measurement of the liability, the other key difference is the characterization of the margin for the separate views. Many discussions have framed the argument as an explicit measure of risk versus an implicit measure of risk. The FASB staff believe that this is not a completely accurate depiction as they believe the margin represents the potential profit of the insurance contract that is at risk. The difference is that the exposure to remaining risk determines the recognition of profit over time as opposed to strictly a component of the liability. These staff also believe that a split between what is attributable to risk versus that which is attributable to residual is somewhat arbitrary. This latter difference will frame most of the discussion in this analysis. Said in a different way, we believe the economic phenomenon represented is potential profit at risk.

Relevance

57. The FASB staff would first point out that the discussion of relevance for a single margin approach is not predicated on the boards agreeing to or determining that suitable techniques for calculating an amount exist to fulfil the objective. In the case of a single margin approach, the boards would need to determine if the judgment of an insurer is a suitable means for determining the variability in cash outflows as

described in agenda paper 3F/68F. We believe this determination is a fundamentally easier choice given that many of the techniques for calculating a risk adjustment are still under development.

58. Further, we would disagree with the assertion that a single margin approach does not provide confirmatory value. QC9 of the framework states:

    (a) Financial information has confirmatory value if it provides feedback (confirms or changes) about previous evaluations.

59. The calculation of profit recognition in a single margin approach using an adjusted baseline ratio (as described in agenda paper 3F/68F) includes current estimation of cash outflows, these estimates can be used to confirm or change a users' expectations of potential realization and by extension the potential profit that is still subject to risk. We believe this is an important distinction because we believe that the pricing of the contract is indicative of the risk in that contract providing a benchmark for profit at risk and any changes in the recognition of that profit could confirm or change a user's estimates.

60. In terms of predictive value, the FASB staff believe the single margin approach provides a benchmark for potential profit at initial recognition while providing an ongoing assessment of the amount of potential profit still subject to uncertainty. Furthermore, the recognition of profit can be used as an input to predictive processes to estimate profits in future periods.

61. In addition to profit recognition, the FASB staff performed an analysis at paragraph 69 through 79 of agenda paper 3F/68F to determine if the remaining profit at risk would provide an equivalent answer to a risk adjustment meeting the specific characteristics as provided for in the IASB's ED. We determined through that analysis that a single margin approach would meet those characteristics.

62. For these reasons, the FASB staff believe that a single margin approach provides predictive and confirmatory value and is therefore relevant because it provides information that "is capable of making a difference in decisions". Further, we believe that the degree of relevance should be judged by the users of financial statements. The outreach we have performed would suggest that:

(a) Users are concerned they could possibly encounter difficulties in attempting to perform benchmarking analysis across the sector.

(b) A risk adjustment could make it more difficult for a broader population of investors to understand insurance company financial statements, thus increasing the cost of capital for these entities.

(c) Some users believe the boards are mixing "reserve" concepts with "capital" concepts thus confusing the issue of what the risk adjustment is supposed to represent. For example, does the risk adjustment represent the fact that the insurer is conservative in their estimating process or is the insurer simply not particularly adept at making an estimation.

Faithful representation

Completeness

63. We would disagree with the assertion that a single margin approach provides less complete information. We do not believe it is necessary to measure risk explicitly in order for the information to be complete. The single margin approach incorporates a methodology that considers an insurer's exposure to remaining risk through an assessment of the variability remaining in the cash flows. If there is significant variability remaining in the cash outflows, an insurer would not recognize profit. Furthermore, we do not believe this assessment (or allocation as referred to above) is any more approximate than the approximate estimation of an entity specific measure of risk.

64. We do not agree with the assertion that a single margin approach "would not necessarily show any difference between two insurance liabilities that generate different cash flows with similar expected present values". If two contracts had different risk profiles, it is reasonable to assume that the variability in the cash flow would be different and therefore the recognition pattern of the profit would be different. By extension, the profit remaining at risk would also be different.

Neutrality and freedom from errors

65. We do not disagree with the assessment provided for these characteristics. However, the boards can examine the analysis performed for these characteristics with respect to the single margin approach at agenda paper 3G/68G.

Conclusions on faithful representation

66. For the reasons discussed above, we believe the single margin approach provides complete information that is comparable to the risk adjustment approach and disagree with the assertion that a risk adjustment provides more relevant and faithful representation of an insurance contract liability.

Enhancing characteristics

Comparability

67. The FASB staff believe that comparability may be one of the strongest attributes for utilizing a single margin approach. Because a single margin represents the potential profit that could be earned over the life cycle of the insurance contract, it provides a benchmark for users of financial statements to compare performance over the long run. The FASB staff believe the concept of expected profit realization through the release from risk as depicted by the single margin approach is easily understood and can be compared across entities and within the entity to provide valuable input into a predictive process to enhance understanding of the entity. Specifically, users of financial statements can compare the pattern of realization of profit from one entity to another. This comparison, for example, could provide the potential to question differences in realization between entities when the nature and life cycle of the contracts appear to be the same.

68. The FASB staff would disagree with the assertion that:

    (a) "Because a composite margin is not, at inception and subsequently, based on solely on the amount of risk, the relative amount of risk in two equal composite margins would not be apparent."

69. On day one of the contract, the FASB staff believe that the pricing of the contract includes compensation the insurer requires for bearing the risk and therefore

contemplates differences in the variability of the cash flows that are a function of the uncertainty. Therefore, if the single margins are the same we would not expect the risk profiles of the contract to be significantly different. Subsequently, if the risk profiles proved to be different through the development of claims and the variability in the cash flows increases, the single margin approach would reflect this change through different profit recognition patterns as the insurer would be released from risk differently.

70. Finally, the FASB staff believe that currently, in jurisdictions that use a risk adjustment, these calculations are prescribed, calculated for solvency purposes, or are simply different across jurisdictions. Further, respondents that use a risk adjustment today have indicated they will continue to use their methodology. We find it difficult to understand how comparability would be improved if a risk adjustment was required in all jurisdictions and the techniques used are not limited to some extent.

Verifiability and timeliness

71. We would not disagree with the assessment of these characteristics. We do not believe the changes recommended to the profit realization of the single margin approach as part of agenda paper 3F/68F would significantly affect either of these characteristics.

Understandability

72. The FASB staff believe the single margin approach will reduce complexity in the overall model. Although we can appreciate the assertion that:

    (a) "[...] 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."

    The feedback received from field testers suggested that one of the difficulties with the calculation of the risk adjustment expressed was the determination of diversification. Some field participants expressed concern in determining the application of such diversification. The single margin approach eliminates this issue.

73. In terms of the users, some expressed:

(a) Difficulties encountered with the risk adjustment could make it more difficult for a broader population of investors to understand insurance company financial statements, thus increasing the cost of capital for these entities.

74. The users spoken to during the FASB's recent outreach additionally expressed to us that one of the critical pieces of data used is the development of the loss reserves over time. This data is obtained through footnote disclosures of changes in reserves for prior periods or with a ten-year loss development table. The information provides users with a picture of management's re-estimation of reserves throughout time and we believe is used by both preparers (to manage the business) and users (to understand the business) on a global level.

75. The FASB staff believe the baseline ratio coupled with the facts and circumstances regarding remaining variability based upon where the contract is in the life cycle captured in this single margin approach will provide users with more useful information because it incorporates all of the elements users find useful and understand.

The cost constraint on useful financial reporting

76. The FASB staff do not believe that the changes made to the single margin approach as recommended in agenda paper 3F/68F will add significant costs nor do we believe implementation of a single margin approach will add a significant amount of costs above and beyond what will already be required to implement an entirely new model.

Summary

77. We do not believe that a risk adjustment contributes better than a single margin approach to satisfying the characteristics of useful information: relevance and faithful information. We believe the degree of relevance is relative to the users of the financial statements and some users have expressed concerns about an explicit risk adjustment.

78. We believe that because changes have been made to the single margin approach so that the approach now provides comparable information to that of an explicit risk

adjustment, that enhancing characteristics should be considered as set out in QC19 and discussed above.

79. On balance, for all the reasons provided in this analysis and those included in agenda papers 3/68E, F, and G, the FASB staff believe the costs of implementing an explicit risk adjustment outweigh the benefits gained. Further, we believe a single margin approach provides information that is understandable to the users of financial statements, relevant and faithfully represents the economic phenomena (potential profit at risk) it purports to represent.

Question: the inclusion of an explicit risk adjustment
Should the measurement of the insurance liability include an explicit risk adjustment or use a single margin approach?