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Project	**Insurance Contracts**
Topic	**Risk adjustment: objective and confidence level disclosure**

Purpose of this paper and summary of recommendations

1. This paper discusses: (a) wording refinements to the objective of the risk adjustment; and (b) an alternative disclosure requirement to the confidence level equivalent disclosure proposed in the 2010 Exposure Draft *Insurance Contracts* (the ED). In doing so, it draws parallels with the treatment of the risk adjustment in IFRS 13/ASC Topic 820 *Fair Value Measurement*.

2. We recommend that:

   (a) the risk adjustment should be the 'compensation the insurer requires for bearing the uncertainty inherent in the cash flows that arise as the insurer fulfils the insurance contract'. This is largely consistent with the objective of the risk premium in IFRS 13 and ASC 820, except that IFRS 13 and ASC 820 determine the risk adjustment using the risk aversion of a market participant whereas the insurance contracts standard would determine it using the risk aversion of the insurer; and

(b) the application guidance should clarify that:

(i) the risk adjustment measures the compensation the insurer would require to make it indifferent between fulfilling the insurance contract liability and fulfilling an obligation to pay an amount equal to the expected present value of cash flows that would arise from the insurance contract;

(ii) in estimating the risk adjustment, the insurer should consider both favourable and unfavourable outcomes in a way that reflects its degree of risk aversion;

(iii) a risk averse insurer would place more weight on unfavourable outcomes than on favourable ones.

(c) the confidence level equivalent disclosure proposed in the IASB's exposure draft is replaced with a requirement that, for the key inputs the insurer used to determine the risk adjustment, the insurer should:

(i) provide quantitative disclosure of the range of values within which those inputs would lie if these inputs had been determined from a market participant perspective; or

(ii) disclose that it believes those inputs do not differ from those of a market participant.

3. This paper does not discuss:

(a) any issues related to the identification of the unit of account for measurement purposes (eg how and whether to account for any diversification benefits arising as insurance contracts are grouped together). Those issues will be addressed in a future meeting

(b) disclosure requirements relating to the risk adjustment that also apply to other accounting estimates in the insurance contracts model (eg the 'methods and inputs' disclosures). Those disclosures are discussed in agenda paper 3D / 73D *Disclosures*.

Background

Risk adjustment objective

4. At its May 2011 meeting[1], the IASB decided that the measurement of an insurance contract liability should include an explicit risk adjustment. To make operational the determination of a risk adjustment, we need to specify an objective that describes how to translate the risk in the insurance contract into a single monetary amount.

5. At their 21 March 2011 joint meeting[2], the boards concluded that the objective of the risk adjustment is to be 'the compensation the insurer requires to bear the risk that the ultimate cash flows could exceed those expected', and agreed to provide application guidance that this amount would reflect both favourable and unfavourable changes in the amount and timing of fulfilment cash flows.

6. Also, the boards directed the staff to further consider how to capture in that 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.

Confidence level equivalent disclosure

7. The amount of the risk adjustment considers both the probability distribution of cash flows and the (entity-specific) risk aversion of the insurer. Some board members stated that the effects of an entity-specific risk aversion in the estimate of the risk adjustment should be clearly explained to users of financial statements. These board members stated that such information would be provided by the proposal in the ED that insurers should disclose the confidence level to which the risk adjustment estimated under those methods corresponds, if the insurer uses a risk adjustment technique other than the confidence level technique. In their view, this would allow users to understand 'how far' actual cash flows could be from those expected and how, all else being equal, this assessment might differ from entity to entity. However, most respondents to the

[1] Agenda paper 3/68 series; the FASB tentatively decided at that meeting that the insurance contract measurement model should use a single margin rather than an explicit risk margin.
[2] Agenda paper 12D/61D *Objective for an explicit risk adjustment*.

ED objected to this disclosure requirement as they thought it would not achieve its intended objective and would thus impose excess cost for little benefit, particularly for those entities utilizing a different methodology for determining the risk adjustment than a confidence level technique.

Risk estimates and subjectivity in IFRS 13/ASC 820 and Insurance Contracts

The issue

8. In financial markets, premiums for risk (ie risk adjustments) are implicit in market prices. IFRS 13 and ASC 820 would consider observable prices (including the embedded risk premium) as Level 1 measurements (where there are active markets) or Level 2 measurements (where there are no quoted prices included in Level 1). For insurance contracts, observable prices for insurance liabilities do not exist and therefore risk adjustments need to be estimated using valuation techniques. This holds true also in IFRS 13 and ASC 820, for determining risk premiums when observable inputs are not available, such as when there is little, if any, market activity at the measurement date (Level 3 measurements).

9. When risk is measured by using valuation techniques, it can only be measured through the lenses of an individual's (or an entity's) risk appetite or its degree of risk aversion. 'Risk-appetite' defines the amount of risk that an individual is willing to bear for each unit of monetary reward (a risk premium).

10. When an individual requires higher rewards for riskier financial positions than for those that are exposed to lesser uncertainty, this individual is referred to as being risk-averse. IFRS 13 and ASC 820 measure risk using the lens of a risk-averse market participant, while the proposed insurance contracts model would measure risk using the risk-aversion of the insurer. However, because it is not possible to observe directly the risk-aversion of a market participant, in practice the insurer applying an IFRS 13 / ASC 820 model would apply Level 3 measurement and use entity-specific inputs, in the absence of evidence that market participant inputs would differ. (as discussed in agenda paper 3C/73C).

11. Applying a valuation technique and using entity-specific inputs to determine risk adjustments, either for Level 3 fair value measurement purposes or for insurance contracts, necessarily involves some degree of subjectivity.

12. Depending on whether the risk premium estimates are anchored to a 'benchmark' level of risk-aversion (ie, in IFRS 13 and ASC 820, the market participant's view of risk) or to the entity-specific risk-aversion (ie the insurer-specific view, for insurance contracts), this subjectivity and the resulting diversity in practice and lack of comparability are present to varying degrees.

To exemplify…

13. This implies, for example, that based on the same cash flow distribution two insurers having different degrees of risk aversion could determine different risk adjustments. In contrast, under fair value measurement, these two insurers should, in principle, come up with a similar (if not the same) estimate of a market participant's degree of risk aversion because they are attempting to satisfy the same objective, and therefore with similar (if not the same) risk adjustment. (Of course, in practice, given the need for estimates, the two insurers would not necessarily come up with the same risk adjustment.)

Ways to address the issue

In fair value measurement

14. In IFRS 13, where Appendix A (ASC 820-10-20) defines the risk premium (or adjustment) as the compensation sought by risk-averse market participants for bearing the uncertainty inherent in the cash flows of an asset or a liability, explicit assumptions about risk are considered to be Level 3 inputs and paragraph 88 of IFRS 13 and ASC 820-10-35-54 warn that:

> **A measurement that does not include an adjustment for risk would not represent a fair value measurement if market participants would include one when pricing the asset or liability.**

15. Furthermore, B16 of IFRS 13 and ASC 820-10-55-8 state:

> **A fair value measurement should include a risk premium reflecting the amount that market participants would demand as compensation for the**

uncertainty inherent in the cash flows. Otherwise, the measurement would not faithfully represent fair value.

16. In the context of fair value measurement, the Fair Value Expert Advisory Panel – a panel that comprised experts from preparers and users of financial statements, as well as regulators and auditors (including representatives of the insurance industry) – reported[3] that:

> **Regardless of the valuation technique used, an entity includes appropriate risk adjustments that market participants would make. An entity exercises judgment when making these decisions. As a result of applying judgment, two entities might arrive at different estimates of the fair value of the same instrument even though both still meet the objective of fair value measurement. This could be the case when, even if the two entities use the same model, the unobservable inputs used in the model are different.**

17. The issue of the subjectivity associated with the risk adjustment in IFRS 13 is then dealt with by:

    (a) setting the objective to determine the risk premium *through the eyes* of a hypothetical market participant (including the inputs that, although derived from entity-specific data, are believed to be consistent with those that a market participant would have selected); and

    (b) requiring appropriate disclosures (these are discussed in agenda paper 3D / 73D *Disclosures*).

In insurance contracts

18. In the ED, the IASB acknowledged the fact that applying judgment differently, as well as using different techniques, might result in diversity in measuring the risk adjustment, with the consequence of reducing comparability of financial statements.

[3] October 2008 Report: Measuring and disclosing the fair value of financial instruments in markets that are no longer active, available at http://www.ifrs.org/NR/rdonlyres/0E37D59C-1C74-4D61-A984-8FAC61915010/0/IASB_Expert_Advisory_Panel_October_2008.pdf

19. The ED proposed to address the issue of lack of comparability and diversity in practice that would arise from the existence of inherent subjectivity in the risk adjustment estimate through:

    (a) specifying the objective of the risk adjustment,

    (b) limiting the techniques permitted to determine the risk adjustment and

    (c) requiring the disclosure of a confidence level equivalent.

    This paper and agenda paper 3C/73C *Risk adjustment: techniques and inputs* reconsiders this approach.

The market participant's view and the objective of the risk adjustment

A more robust measurement objective

20. Although similar, the measurement approaches in IFRS 13 and the insurance contracts model differ in the fact that under fair value measurement the entity estimates risk using its interpretation of the degree of risk aversion of a third party in a hypothetical transaction (the market participant's view), whilst in insurance contracts the insurer estimates risk using its own degree of risk aversion. In both cases, the estimate of the risk adjustment involves some degree of judgement. This difference, some believe, would ultimately cause the risk adjustment as estimated according to the insurance contracts proposals to *be* less comparable among entities than the risk premium as measured according to IFRS 13.

21. In sum, some argue that IFRS 13 would present a *more robust objective* than the one proposed for insurance contracts that reflects entity-specific risk aversion, because it refers to the market participant's degree of risk-aversion.

22. The comparison drawn in paragraph 20 would suggest that, in order to make the risk adjustment as robust as a level 3 fair value measurement, the risk adjustment objective should be aligned to that in fair value measurement.

23. Staff considered including in the objective of the risk adjustment for insurance contracts the market participant's view. However, this would result in introducing an exit or entry notion in the estimate of the risk adjustment, and the

boards have indicated that they do not view this as appropriate. Furthermore, most commentators objected to the proposal in the IASB's Discussion Paper *Preliminary Views on Insurance Contracts* (2007) to measure insurance contracts based on an exit notion, ie considering the assumption that the insurer would transfer its liabilities to another party (current exit value notion). They suggested instead that insurance contracts be measured considering that insurers hold their liabilities until maturity to fulfil them (fulfilment notion).

24. Consistently with the feedback received, in March 2010, staff suggested that the boards consider a point-of-indifference notion as the basis to quantify the amount of compensation the insurer requires to bear the risk inherent in the insurance liability. The argument here is that: if the insurer assumes the liability with the intention of fulfilling it, the estimate of the risk adjustment should reflect the assumption that the liabilities would *stay* on the insurer's balance sheet until it fulfils the associated obligations. Any attempt to refer to an entry notion or an exit notion would imply performing an artificial exercise.

25. Based on the above considerations and consistently with the Board's consensus, the issues of subjectivity and promoting comparability are best addressed for insurance contracts by complementing a clear measurement objective for the risk adjustment with disclosures that explain the subjectivity inherent in the measurement of the risk adjustment.

Tweaking the objective to gain overall consistency across IFRSs

26. Notwithstanding this difference in perspective– ie estimating the market's participant risk aversion in IFRS 13 vs. estimating the insurer's specific risk aversion for insurance contracts – staff believe that the wording of the objective of the risk adjustment for insurance contracts could be further clarified by aligning it with IFRS 13. This could be done whilst retaining the notions of: (a) the point of indifference; and (b) the two-sided nature of the risk adjustment (covering both favourable and unfavourable outcomes). (The boards have previously agreed to include those notions in the objective of the risk adjustment or in guidance supporting that objective.) This would result in the following wording (marked up for changes to IFRS 13):

[The] compensation ~~sought by~~ ~~risk-averse market participants~~ the insurer requires for bearing the uncertainty inherent in the cash flows ~~of an asset or a liability~~ that arise as the insurer fulfils the contract.

27. In the following paragraphs we consider how the application guidance could help better understanding (a) the underlying notion of the point of indifference and (b) the two-sided nature of risk.

What compensation?

28. Both risk adjustments (ie for fair value measurements in IFRS 13 and for insurance contracts in the proposed model) build on a notion of the 'compensation' required, in one case by the market participant and, in the other one, by the insurer.

29. We noted in March 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 that this uncertainty imposes on the insurer. In other words, the measurement would be the amount that the insurer would require to persuade it to accept or retain that burden.

30. As staff noted in paragraphs 32 and 33 of agenda paper 3G *Explicit risk adjustment* for the main February joint meeting, the risk adjustment is intended to measure the additional amount that a risk-averse 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.

31. 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.

32. 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 so not fulfil) that obligation.

33. Staff therefore suggest that the application guidance clarify that the compensation for bearing the risk shall be described in the application guidance as follows:

> **The compensation shall be the amount that makes the insurer indifferent between:**
>
> **(a) fulfilling the insurance contract; and**
>
> **(b) fulfilling an obligation to pay an amount equal to the expected present value of the cash flows that will arise from the insurance contract.**

A two-sided notion of risk

34. Some respondents to the ED felt that the use of the words 'the risk that the ultimate fulfilment cash flows exceed those expected' in the objective proposed in the ED would be inconsistent with the fact that the risk adjustment should convey information to users of financial statements about 'the effects of uncertainty about amount and timing of the cash flows arising from an insurance contract' (paragraph B68).

35. Particularly, these respondents felt that term 'exceed' could exclude scenarios where claims are lower than expected. Therefore they felt that a two-sided notion of risk (considering both favourable and unfavourable events) should be included in the objective for the risk adjustment to clarify that not only unfavourable but also favourable events would influence the estimate of the risk adjustment.

36. In other words, under this view, retaining the term 'exceed' would result in a one-sided depiction of the risk that would disregard the mitigating effect of the possibility of favourable cash flows scenarios, thus limiting the measurement of

the risk only to the uncertainty associated with unfavourable cash flows scenarios.

37. Staff believe that this was not the Board's intention. The use of the term 'exceed' was aimed at indicating that while entities should consider both favourable and unfavourable outcomes of the cash flow distribution, they should put more weighting on unfavourable scenarios than on favourable scenarios: the objective was to convey a risk-aversion notion (see paragraph 10).

38. Staff believe that the misunderstandings arising from the former use of the term 'exceed' would be resolved if:

    (a) the reference to the term 'exceed' is deleted from the objective in insurance contracts, consistently with the objective in fair value measurement; and

    (b) the application guidance clarifies that, in estimating the risk adjustment, insurers should consider both favourable and unfavourable outcomes of a cash flow distribution and place more weight on unfavourable outcomes than on favourable outcomes.

Staff recommendation

39. In table 1 we summarise the proposed tweaks to the risk adjustment objective and the proposed alignment with the objective for the risk premium in fair value measurement:

Table 1

Insurance Contracts (March 2011)	IFRS 13	Issue	Proposed tweaks to the wording of the risk adjustment objective for insurance contracts
The compensation	The compensation	Clarifying what compensation	• No tweaks – deal with it in the application guidance o Specify in the application guidance for insurance contracts that the compensation should be determined based on the point of indifference notion.

the insurer requires	sought by risk-averse market participants		• <u>No tweaks</u> – different notions (market participant vs. entity-specific) o Retain for insurance contracts the reference to 'the insurer' (as the market participant's view would be inconsistent with the objective of getting to a fulfilment, entity-specific view of the risk).
to bear the risk	for bearing the uncertainty	Ensure that a two-sided notion of risk is considered	• Substitute the term 'risk' with 'uncertainty' o The term uncertainty would suggest that an entity considers the whole cash flow distribution when estimating the risk. o Distinguishing between risk and uncertainty is not important for the purpose of the standard on insurance. For the sake of consistency and clarity we would suggest using the term 'uncertainty as in IFRS 13 and ASC Topic 820.
that the ultimate cash flows would exceed those expected.	inherent in the cash flows.	Ensure that a two-sided notion of risk is considered	• Remove the reference to 'exceed' o Specify in the application guidance that the insurer in estimating the risk should consider both favourable and unfavourable outcomes in a way that reflects its degree of aversion and that a risk adverse insurer would place more weight on unfavourable outcomes than on favourable ones.

40. In other words, staff recommend that the objective for the risk adjustment be aligned to the objective for the risk adjustment in fair value measurement as set out in paragraph 26.

Question 1 – Aligning the objective of the risk adjustment with fair value measurement
Does you agree that the objective of the risk adjustment should be:

'The compensation the insurer requires for bearing the uncertainty inherent in the cash flows that arise as the insurer fulfils the insurance contract'?

Question 2 – Application guidance on risk adjustment objective

Does you agree that the application guidance should clarify that:

(a) the risk adjustment measures the compensation the insurer would require to make it indifferent between
  (i) fulfilling the insurance contract liability; and
  (ii) fulfilling an obligation to pay an amount equal to the expected present value of the cash flows that will arise from the insurance contract

(b) in estimating the risk adjustment, the insurer should consider both favourable and unfavourable outcomes in a way that reflects its degree of aversion

(c) a risk adverse insurer would place more weight on unfavourable outcomes than on favourable ones?

Retaining the market participant's view for disclosures

41. We discussed in paragraphs 20-25 that some believe that fair value measurement presents a more robust objective for the risk adjustment than the objective proposed for insurance in that it requires entities to consider risk from the perspective of a hypothetical market participant.

42. Using the viewpoint of a hypothetical market participant to determine the hypothetical transfer value of insurance liabilities, would contradict the objective of measuring the value of fulfilling those liabilities.

43. However, adopting an entity-specific approach introduces a degree of subjectivity into the measurement of the risk adjustment. This subjectivity could impair the overall comparability of financial statements to such an extent that the risk adjustment information would no longer be a faithful representation of the risk in the contract.

What notion of comparability?

44. The underlying cause of the possible divergence in practice and the resulting loss of comparability in the estimate of the risk adjustment lies in its inherent subjectivity, but that fact does not necessarily imply that comparability cannot be achieved. Rather it suggests that a different – no less relevant – notion of comparability should be considered.

45. While the notion of comparability in the *Conceptual Framework for Financial Reporting* (Framework) is primarily one of '*direct* comparability' (BC3.33):

> **Relevant and faithfully represented information is most useful if it can be readily compared with similar information reported by other entities and by the same entity in other periods. […]**

46. The Framework in QC21 also warns that:

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

47. Conceptually, the use of different techniques should lead to the same risk adjustments if the same inputs (including the same degree of risk aversion) are used by different insurers. This aspect highlights the fact that understanding similarities and differences among risk adjustments implies either:

    (a) knowing a measure of the degree of risk aversion of an individual insurer which can be used to make comparisons among insurers; or

    (b) identifying a 'yardstick' set of inputs that could indicate *how far* an individual insurer's specific estimate of risk stands from the 'yardstick' or 'benchmark' view of risk.

48. Regarding (a), at present, there are no explicit measures of risk aversion that would not require a significant degree of subjectivity and that therefore would result in more comparable results than the estimate of the risk adjustment itself.

49. The alternative in (b) is somewhat in the spirit of the fair value measurement approach where entities are required to set out their own view of a third party's view of the risk in a hypothetical transaction, ie the market participant's view. For insurance contracts, such yardstick measure would imply requiring insurers to determine the risk adjustment in the market participant's view. Speaking

more practically, the insurer would need to assess whether market participants would adopt the same inputs as the insurer in determining the risk adjustment.

Key role of disclosures in promoting comparability

50. Where subjectivity is present to a significant degree, disclosures play a key role in promoting comparability. In discussing the subjectivity that is inherent in measuring risk adjustments, the basis for conclusions in IFRS 13 and ASU No. 2011-04 states that (BC192 and BC86, respectively):

> **The boards concluded that the information required by the disclosure will facilitate comparison of the inputs used over time, providing users with information about changes in management's views about particular unobservable inputs […].**

51. Similarly, in the ED the IASB proposed to require that an insurer should translate its risk adjustment, when determined under a cost of capital or a conditional tail expectation approach, into a confidence level equivalent for disclosure purposes.

Confidence level equivalent disclosure: feedback received

52. However, comments received on the ED generally opposed this proposed requirement. Respondents disagreed that this requirement would achieve the objective of facilitating comparability for at least three reasons (Appendix A presents a more detailed summary of the comments received on the usefulness of the confidence level equivalent disclosure):

    (a) there is no single generally accepted technique to perform a one-to-one translation of a risk adjustment as determined under any particular technique into a confidence level interval;

    (b) although this translation might prove to be to some extent reliable in cases where specific techniques are used to calculate underlying the risk adjustment (eg Tail Value at Risk, where tested methods exist), such methods do not exist for other techniques that might be used;

    (c) requiring a disclosure based on a specific measurement technique would be inconsistent with general feedback to remove the limitation

of techniques proposed in the ED to measure the risk adjustment (this is discussed in agenda paper 3C/ 73C).

Confidence level equivalent disclosure: rationale and counter-arguments

53. In developing the ED, some board members used the expression 'Pick a number' to describe their concern at what they viewed as the arbitrariness involved in measuring the risk adjustment. In other words, they suggested that, if the board were not to impose any boundaries around the measurement of the risk adjustment, entities would be left free to choose their own risk adjustment. They believe that the disclosure of the confidence level equivalent would indirectly limit the level of diversity in how insurers estimate the risk adjustment by providing users with an indication of *how risk-averse* an insurer has been to get to its estimates of the risk adjustment. In the Board's intention, in fact, this indication would ultimately allow users to understand how and if the degree of risk aversion differs among insurers based on the confidence level equivalents they present in their notes.

54. However, the response in the comment letters suggested that this disclosure requirement would rather seem to result in 'Picking two numbers', ie in the first place, the estimate of the risk adjustment with the methodology chosen for measurement purposes and secondly, the translation of that estimate – which in its turn represents another estimate - in terms of the confidence level equivalent. This would result in additional estimation uncertainty and in a further effort for users to understand the processes used (a) to estimate of the risk adjustment for measurement purposes; and (b) to translate that estimate into the confidence level equivalent.

55. Staff think that this approach would not help users of financial statements highlight the similarities and differences in the underlying set of inputs being chosen and that it would even make it more difficult.

An alternative disclosure requirement to promote comparability

56. Instead, staff propose as a better means of promoting comparable information that insurers should provide disclosure of the 'benchmark' risk aversion of the market participant, along the lines of the fair value measurement requirements.

This would allow users of financial statements to understand the extent to which the measurement of the risk adjustment is affected by an insurer's risk aversion, compared to the benchmark risk aversion.

57. Because of the importance of the *inputs* to a risk adjustment technique in determining the amount of the risk adjustment, staff propose that an insurer should not be required to perform a full calculation of the risk adjustment by putting itself 'in the shoes' of the market participant. Instead, staff propose that for the key inputs the insurer used to determine the risk adjustment, the insurer should:

    (a) provide quantitative disclosure of the range of values within which those inputs would lie if these inputs had been determined from a market participant perspective; or

    (b) disclose that it believes those inputs do not differ from those of a market participant.

To exemplify…

58. An insurer applying a cost of capital technique discloses the capital rate and the confidence level as well as the time horizon being considered as inputs for measurement purposes as part of the disclosure package (discussed in agenda paper 3D/ 73D *Disclosures*.

59. In applying the disclosure staff propose in this paper, the insurer should also disclose, as applicable:

    (a) had the insurer determined the risk adjustment from a market participant perspective, it would have chosen a capital rate within the range of [x% - y%], a confidence level within the range of [z% - q%] and a time horizon of x-years.

    (b) that it believes those inputs do not differ from those of a market participant.

60. In the staff's view, this disclosure would help users to understand how different (or similar) an entity-specific estimate of the risk is compared to the market view of the risk or the market risk aversion.

Staff recommendation

Question 3 – Disclosure of the market participant's inputs
Does you agree: (a) not to confirm the requirement to disclose the confidence level equivalent? (b) for the key inputs the insurer used to determine the risk adjustment, the insurer should: (i) provide quantitative disclosure of the range of values within which those inputs would lie if these inputs had been determined from a market participant perspective; or (ii) disclose that it believes those inputs do not differ from those of a market participant.

Appendix A

Comments regarding the usefulness of confidence level disclosure

A1. Some respondents thought that the disclosure of the confidence level equivalent would provide useful information on an insurer's approach to managing risks and would permit comparisons of risk margins measured by different insurers because it would refer to the technique – ie confidence intervals – which, some respondents believe, is most readily understood by users of financial statements. These respondents, including some of those that favour a composite margin approach, suggest that this disclosure should be accompanied by information regarding the method used to estimate the risk adjustment and the reason for selecting that method.

A2. On the comparability of information and the role of disclosures one respondent commented that:

> […] we do not believe that it should be prescribed that entities with similar risks must have comparable risk adjustment margins. We would rather see a situation where management decides the appropriate level of the risk margin along with robust disclosures concerning the entity's approach to measuring and managing risk which would allow users of financial statements to draw individual conclusions about entities' risk adjustment margins.

A3. One respondent suggested that a possible alternative would be to require insurers to disclose information regarding the relative magnitude of the risk adjustment compared to total insurance liabilities rather than prescribing the use of a confidence level equivalent.

A4. Also, some respondents that favoured the proposed disclosure of confidence level said that its relevance would depend on the extent to which the boards provide guidance around the inputs to the confidence level calculation, such as the impact of correlations in the determination of the risk adjustment under this technique. One respondent noted that disclosing the confidence level equivalent would enhance comparability only if it were disclosed at an entity

level, so as to acknowledge the full diversification effects arising for an insurer. This respondent commented as follows:

> The confidence level corresponding to a given risk adjustment depends on the way in which the business is structured in portfolios, reinsurance arrangements and the degree of diversification recognised. As a result, confidence levels for individual portfolios are unlikely to be comparable, either within or between insurers.

A5. Although the boards intended the proposed disclosure to require the translation into a confidence level equivalent of the *output* of either a CTE or a cost of capital technique, some misinterpreted this proposal as requiring entities to disclose the confidence level which is used as *input* in the measurement of the risk adjustment under either a CTE or cost of capital technique. It was based on this misinterpretation that some respondents concluded that this disclosure:

(a) does not impose additional burdens on insurers; and

(b) provides information on the level of prudence adopted by an insurer in setting the risk adjustment which they believe would be more akin to a regulatory type of information.

A6. Most respondents believed that the requirement to disclose the confidence level equivalent would not add comparability because that could only be achieved if different insurers used the same underlying probability distribution to measure the risk adjustment. Even then, the information provided by this disclosure would be relevant to users only if:

(a) the underlying distribution were not particularly skewed; and

(b) specific requirements are set to indicate how correlations (and the related diversification benefits) should be factored into the confidence level calculation.

A7. Some commentators suggested that this requirement would result in:

(a) a duplication of the efforts which would be necessary for determining risk adjustments. Respondents doubted the benefit of this duplication.

(b) a false impression of precision because CTE or CoC techniques already involve some uncertainty in the selection of the underlying assumptions

and parameters and this uncertainty would increase as a result of the translation of the risk adjustment to confidence levels.

(c) the risk of irrelevant information if entities ultimately choose to apply the confidence level technique to avoid the extra costs involved in a double calculation of the risk adjustment, even when the characteristics of the underlying cash flow distribution would make that technique less appropriate (eg if the probability distribution presents fat tails, as discussed in paragraph B95 of the ED).

(d) a false impression that the boards favour confidence level techniques over other techniques.

A8. Some commentators said that, at present, no widely accepted technique has been developed to translate risk adjustments determined under CTE or CoC into confidence levels and that this exercise might result in divergence in practice and in the disclosure of information that is more uncertain, rather than more comparable. However, at one of the risk adjustment education sessions, one of the presenters stated that it would be straightforward to do this translation.

A9. Most respondents suggested that comparability of the risk adjustment should be achieved instead by disclosing:

(a) the technique(s) applied;

(b) reasons for choosing a specific technique;

(c) changes in significant assumptions; and

(d) sensitivity analysis.

(We note that these suggestions are included in the disclosures discussed for estimates more generally in agenda paper 3D / 73D *Disclosures*.)