



Appendix 2

Characteristics of Risk margins

(Excerpt from IASB Agenda Paper 5A, April 2009)

46. Appendix F of the DP includes a draft discussion of ~~those attributes~~ the attributes of a risk margin. It proposes the following:

- (a) Risk margins should be explicit, not implicit. That is an important change from many existing practices that rely on estimates incorporating an implicit (and often unstated) degree of conservatism or prudence. Separating explicit estimates of future cash flows from explicit risk margins should improve the quality of estimates and enhance transparency.
- (b) The risk margin for an insurance liability should reflect all risks associated with the liability
- (c) The risk margin for an insurance liability should not reflect risks that do not arise from the liability, such as investment risk (except when investment risk affects the amount of payouts to policyholders), asset-liability mismatch risk or general operational risk relating to future transactions.
- (d) The approach should be implementable at a reasonable cost and in a reasonable time, and be auditable.
- (e) The approach should not ignore the tail risk in contracts with very skewed pay-offs, such as contracts that contain embedded options (eg the interest guarantees and other financial guarantees embedded in many life insurance products) or that cover low-frequency high-severity risks (such as earthquake), or portfolios that contain significant concentrations of risk.
- (f) The approach should make it easy to provide concise and informative disclosure, and for users to benchmark the insurer's performance against the performance of other insurers.

- (g) The approach should not overlook model risk (the risk that a model is not a good description of the underlying process) or parameter risk (the risk that a model uses estimates of parameters that differ from the true parameters, or that the parameters may change over time). However, because it may be difficult to quantify these risks and price them, care should be taken in building them into a model.
- (h) ~~For an exit notion, the margin should be as consistent as possible with observable market prices.~~ [We have deleted this paragraph since it is only relevant for a current exit value which the boards have ruled out for measurement of insurance liabilities.]

47. The characteristics of the risk margin are likely to include the following:

- (a) The less that is known about the current estimate and its trend, the higher the risk margin should be.
- (b) Risks with low frequency and high severity will have higher risk margins than risks with high frequency and low severity.
- (c) For similar risks, long duration contracts will have higher risk margins than those of shorter duration.
- (d) Risks with a wide probability distribution will have higher risk margins than those risks with a narrower distribution
- (e) To the extent that emerging experience reduces uncertainty, risk margins will decrease, and vice versa.

48. The DP explained that, if more than one approach is compatible with the criteria described in paragraph 46 and 47, it is preferable to select an approach that builds on models that insurers use (or are developing) to run their business. For example, an insurer may be able to build on an economic capital model, an embedded value model or a model developed for solvency, if the resulting approach is compatible with the above criteria.

49. Although the DP described the risk margin as conceptually separate from the other building blocks (expected cash flows, discount rate), the staff believes that the IASB did not intend to preclude ‘replicating portfolio’ approaches. If a replicating asset exists for all (or, more likely, some) of the cash flows, the insurer can estimate the relevant

