

Board meeting 19 September 2011

## Insurance Accounting Alert

# Boards discuss risk adjustment and composite margin

## Overview

On September 19, the International Accounting Standards Board and the Financial Accounting Standards Board (the IASB and FASB, respectively and collectively, the Boards) continued their re-deliberations on the tentative decisions in the IASB's Exposure Draft, *Insurance Contracts* (ED), and the FASB's Discussion Paper, *Preliminary Views on Insurance Contracts* (DP). At this meeting, the Boards discussed certain aspects of the risk adjustment and disclosures.

## Risk adjustment

The IASB discussed the objective of the risk adjustment and tentatively decided that 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 amount will be determined from the insurer's perspective, not from a market participant perspective. Therefore, the IASB acknowledged that the compensation amount would result in the insurer being indifferent to fulfilling a fixed liability or one with a range of possible outcomes. When estimating the risk adjustment, an insurer should consider both favourable and unfavourable outcomes. The IASB understood that all insurers would not equally consider those outcomes and noted that a risk-averse insurer would place more weight on the unfavourable outcomes to reflect its degree of risk aversion.

### What you need to know

- ▶ The IASB discussed risk adjustment and made several decisions, including: clarification of the objective; removal of the limitation on techniques; and retention of the confidence interval equivalent disclosure.
- ▶ The Boards made several decisions on disclosures, although they disagreed on dropping the proposed analysis of measurement uncertainty.
- ▶ As part of the disclosure discussion, the Boards acknowledged that within the same currency more than one yield curve could be applied.

The IASB decided to drop the limit on the range of acceptable risk adjustment techniques because it would not fit within the principle-based nature of the standard. Instead, the IASB believes that disclosure can be used as a more appropriate way to provide users with information that enables comparison between financial statements. The IASB noted that the standard will need to retain the ED application guidance, including the list of risk adjustment characteristics. The IASB also decided that, even though there will be no restriction on the techniques, the application guidance should retain the three techniques included in the ED (confidence levels, conditional tail expectation, and cost of capital) as examples.

The IASB staff suggested replacing the risk adjustment confidence level disclosure with the disclosure of a range for the risk adjustment inputs as if it had been viewed from the market participant's perspective. The IASB decided to retain the confidence level equivalent disclosure because a disclosure of market participant inputs would contradict the fulfilment objective and prove difficult to implement.

The FASB participated in the risk adjustment discussion, but did not make any specific decisions because their approach uses a single (composite) margin.



### How we see it

The IASB clarified the objective for the risk adjustment but, at the same time, despite several objections by respondents in their comment letters to the ED, it retained the disclosures around confidence levels. Insurers will need to consider if characterising the risk adjustment as compensation implies that it has a necessary relationship either to pricing considerations or to actual premiums.

Given that the IASB continues to express its strong desire for users to be able to compare the risk adjustments across companies, insurers may want to consider providing input to the Boards on alternatives. Insurers should consider what additional information they think necessary to enable comparability.

## FASB decisions on composite margin

The FASB provided an update from their last meeting on how to determine the amortisation of the single (composite) margin under the building block approach, and the accounting for liabilities for incurred claims under the premium allocation approach that is considered for certain types of contracts. It decided that the margin should be released as the insurer is released from risk under the building block approach, which is determined by the reduction in uncertainty of the remaining future cash flows.

The FASB also decided that when the premium allocation approach is used to recognize revenue over the coverage period, the related incurred claim liability should not include a margin. This would mean that the liability during the claims handling period would only be the expected present value of the claims payments.

### How we see it

At the end of the day, both the IASB and FASB approaches will ultimately present the same cumulative income, but the varying Boards' approaches to margins means that the timing of those results could be significantly different.

## Disclosures

The Boards' discussions focused on the level of disaggregation of information within disclosures, disclosures of changes in inputs and methods, and the liability maturity analysis. They will discuss a comprehensive disclosure proposal at a future meeting.

The Boards confirmed that the objective of the requirements is to ensure that the insurer aggregates or disaggregates information so that what is useful is not obscured by either the inclusion of a large amount of insignificant detail or the aggregation of items that have different characteristics. They agreed with the staff proposal to remove the requirement from the ED/DP to disaggregate disclosures to the reportable segments. However, they decided that the standard should mention that one appropriate level of aggregation might be at the reportable segment level.

The Boards decided that when cash flows are not dependent on the performance of specific assets (i.e., non-participating contracts), the yield curve(s) or range of yield curves is to be disclosed. As part of this debate, they acknowledged that, within a currency, more than one yield curve could be applied. The staff noted that the need for more than one yield curve could be caused by differences in how the liquidity adjustment of a discount rate is estimated.

The Boards agreed with the staff's recommendation that changes in inputs and methods from prior periods, including specific reasons for the change, should be disclosed along with the types of contracts affected by the change. However, the Boards took different views on the measurement uncertainty analysis proposed in the ED/DP. The IASB tentatively decided to remove this disclosure and seek alignment in due course with the disclosure requirements of IFRS 13 *Fair Value Measurement*, as appropriate. The FASB decided to retain the measurement uncertainty analysis.

The Boards also discussed the insurance liability maturity analysis disclosures. The staffs proposed changing the ED disclosures to remove the option to disclose contractual maturities and require the disclosure of expected net cash flows instead. The time line for this disclosure would be each year for the first five years, and in the aggregate for maturities beyond five years. The IASB agreed with the staff recommendation. The FASB noted that it would rely on its recent tentative decisions relating to risk disclosures for financial institutions, as those disclosures would also apply to insurers.

### How we see it

The decision to remove the requirement to disaggregate disclosures to the reportable segments will probably be welcomed by insurers as a relief from what could have become overly burdensome disclosure. This raises the challenge for insurers to determine what level of aggregation would be appropriate for a disclosure. This assessment will require judgement, and the conclusion may differ from one type of disclosure item to another. Nevertheless, insurers may have to provide information at the reportable segment level in certain cases to meet the Boards' disclosure principle.

The disclosure of changes in inputs and methods could, if made at the right level, provide valuable insight into the insurer's operations and experience. This disclosure may become a key aspect in understanding the movements in liabilities and provide more transparency about the effects on profit and loss.

### Next steps

During the summer, the IASB extended its timetable and plans to make a decision on whether to re-expose or move to a review draft of the standard by the end of 2011, or in the course of 2012. It will set a publication date for the final standard in due course. The FASB currently aims to issue its exposure draft in the first half of 2012.

As part of this time line, the boards will have their next discussion on insurance during the October Board meetings; the topics for those meetings have not been announced. Further, the IASB plans to hold its next Insurance Working Group meeting on October 24.



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