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The Risk Adjustment—Accounting Perspectives

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Actuaries are accustomed to considering how much conservatism is appropriate in their estimates, whether made for pricing or for measurement of liabilities. In the proposals for a new standard on accounting for insurance contracts, this conservatism is referred to by the International Accounting Standards Board (IASB) and the Financial Accounting Standard Board (FASB) of the United States as the risk adjustment. Colloquially it is also known as the risk margin. The title of this article reflects that there are several perspectives on the risk adjustment. At this stage, the IASB and the FASB disagree about the necessity of a risk adjustment. Furthermore, within IFRS there are different (but not necessarily inconsistent) approaches to the consideration of risk in the measurement of liabilities, depending on the nature of the liability and on the specific accounting standard that must be applied. [See the sidebar on pg. 21 for a summary overview of the proposals for accounting for insurance contracts.]

This paper addresses the proposals of the two boards as expressed in the IASB's Exposure Draft *Insurance Contracts* (ED) and the FASB's discussion paper *Preliminary Views on Insurance Contracts* (DP) and as modified by subsequent deliberations of the boards since the publication of the ED and the DP. Note that the boards are very active with the insurance project and their thinking may have evolved since the time the article was written.

THE IASB'S VIEW

Under the IASB's proposal for insurance contracts, the risk adjustment is one of the building blocks; it is a component of the insurance liabilities. The IASB believes that a risk adjustment is necessary to properly portray the uncertain nature of insurance liabilities.

"The risk adjustment conveys information to users of financial statements about the effects of uncertainty about the amount and timing of the cash flows arising from an insurance contract." (ED, para. B68)

As explained in the *Basis for Conclusions* to the ED, most notably in para. BC112, the risk adjustment distinguishes uncertain liabilities from those that are

risk-free. The presence of a risk adjustment is more consistent with the measurement of financial instruments. It conveys the reduction in risk in the contracts that occurs with the passage of time and hence provides a more appropriate basis for the release of the liability into revenue than would the use of a single composite margin, the release of which the IASB sees as inherently somewhat arbitrary.

THE FASB'S VIEW

The FASB's view can be found in the DP, notably in para. 69-71. The FASB believes that the composite margin reflects the amount of risk and uncertainty priced into the contracts and that the determination of an explicit quantification of risk is highly judgmental.

The benefits of a composite margin are:

- Consistency with the proposed standard on revenue recognition;
- The elimination of the need to use subjective methods for measuring the risk adjustment margin; and
- A simple and more understandable approach to account for the difference between the expected inflows and outflows.

The IASB's Characterization of the Risk Adjustment

The IASB has tentatively decided that the risk adjustment should be the compensation that the insurer requires to bear the risk that the ultimate cash outflows could exceed those expected. Hence, the risk adjustment is the value of the risk in the eyes of the insurer, rather than an estimate of the market price of the risk. This characterization of the risk adjustment is consistent with the notion that the measurement attribute for insurance contracts is not a fair value or an exit value. The characterization corresponds with the idea that the expected cash flows that are the first building block are those that the insurer requires to fulfill its obligations under the contracts. The risk that is being quantified relates to the possibility that the fulfillment cash flows may be greater than expected.



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RISK ADJUSTMENT OR NOT—WHAT DIFFERENCE DOES IT MAKE?

Except when a contract is onerous, as discussed below, the risk adjustment is in effect an allocated part of the total margin in a portfolio of contracts. It serves the purpose of timing the release into income of that part of the total margin. The risk adjustment is re-measured at the valuation date to reflect the current perception of the risk for the remaining cash flows. The release of the risk adjustment into income extends beyond the coverage period to include the claims period.

On the other hand, the boards have indicated that the composite (FASB) or residual (IASB) margin will be released over the period of coverage of the contracts. The composite or residual margin is not re-measured.

The biggest difference in the timing between the two approaches—with or without a risk adjustment—occurs for contracts with long-tailed claims. The bottom-line effect of the difference in the two board proposals is that income would be recognized faster under the FASB approach because the FASB would not

require that claims liabilities include a risk adjustment. This difference is potentially large.

When claims liabilities have no risk adjustment, they are a drag on an entity's return on equity. An insurer must hold capital for the uncertainty associated with the claims, but there is no margin to be released along with the payout of claims to compensate the insurer for the cost of capital. Any margin in the premium would have been released over the coverage period and the insurer would have been compensated prematurely for the cost of capital related to the claims period. The insurer may welcome the benefit to the bottom line when it occurs during the coverage period, but may well have preferred to delay it until the claims period.

The other difference between the approaches of the two boards relates to onerous contracts. When using the building blocks, insurers may sometimes find that at inception the present value of the outflows, plus a risk adjustment in the case of the IASB, exceeds the present value of the inflows. In other words, the contracts are loss-making. In this case, the insurer cannot defer the loss but must recognize it in income immediately. If there is a risk adjustment in this calculation, the size of the loss is greater than if there were no risk adjustment. Members of the IASB are aware that the inclusion of a risk margin in the measurement of the liability for a loss-making contract represents an amount that is expected to reverse itself in the future. Judging from their discussions, one can infer that they find it undesirable to create an expense that is expected to reverse into income in a later period. They are reluctant to remedy this situation because they are wed to the idea that the liability includes a risk adjustment. They also see difficulties with the subsequent measurement of liabilities if there is a modification at inception; it is not clear how an insurer would measure the risk adjustment at subsequent valuation dates if there had been some sort of constraint on the risk adjustment at the date of inception.

The IASB's tentative decision on onerous contracts is understandable, but it leads to a semantic problem. If a portfolio of contracts is onerous, then the risk adjustment is not the amount of compensation that the insurer



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SIDEBAR: OVERVIEW OF THE IASB'S PROPOSED ACCOUNTING FOR INSURANCE

The proposed guidance for insurance contracts would apply to contracts that meet the definition of insurance. For all practical purposes, the definition is carried over from the existing guidance for insurance (IFRS 4), with a small number of specific types of contracts specifically included or excluded. The board has tentatively decided to add to the current definition that the insurer should consider the time value of money in assessing the significance of the insurance benefit and that there must be a scenario of commercial substance in which the insurer could have a loss. The insurance contract is recognized on the date when the coverage period begins, or sooner if the contract is onerous (i.e., when there's a loss at issue).

The insurance liability for contracts other than certain short duration contracts (as discussed below) is measured according to three building blocks. These are a current unbiased estimate of future cash flows (an estimate of the mean or expected value), an adjustment for the time value of money, and an adjustment for risk. Cash flows are determined for a portfolio of contracts. Cash outflows are benefits, including participating features, and direct expenses, including acquisition costs. Inflows include premiums for the duration of the contract. The contract duration is the period until the contract terminates or until the insurer has the right to reassess the risk and re-price the contract.

The adjustment for the time value of money is the effect of discounting. The discount rate is based on the current market rate for contracts with observable prices that have characteristics that are similar to insurance contracts. The observed rate is adjusted to reflect differences in characteristics between the insurance contracts and the reference instruments. For contracts for which the cash flows depend to some extent on the results of specific investments, the measurement can reflect that dependence.

The risk margin is the compensation the insurer requires to bear the risk that the ultimate cash flows could exceed those expected.

A fourth component of the liability is the margin, which is set at inception to defer any profit at issue. The board proposes to amortize the margin over the period of coverage but is undecided on whether the margin should be adjusted to offset the effects of changes in expected cash flows or of changes in discount rates.

The board seems likely to adopt an allocated premium approach, essentially an unearned premium approach, as an alternative to the building blocks. It would be used for pre-claims liabilities of contracts that are short duration in nature, which are those of approximately one year in duration or less. Claims liabilities would be measured by the building blocks.

The board has decided to require unbundling of embedded derivatives, essentially retaining current IFRS 4 requirements. The board is undecided to what extent it will require separation of service and financial features from insurance contracts.

The main differences of the FASB's proposal from the IASB's are:

- There is no explicit adjustment for risk, the margin is a composite rather than a residual margin. As a consequence, claims liabilities would have no margin; and
- The amount of acquisition costs that could be considered would include only costs associated with successful efforts, which is potentially a significantly lower amount than direct costs at the portfolio level. ■

The insurance standard is only one area of guidance where the IASB has had to consider the topic of risk adjustment.

requires to bear the risk, as patently it has not required the customers to compensate it adequately (otherwise the contracts would not be onerous). Perhaps the risk adjustment should be characterized as the compensation the insurer would like to require, and sometimes does.

DISCLOSURES

The insurance standard will require insurers to disclose the amount and the movement in the amount of the risk adjustment. Insurers will also disclose the methods and inputs used to calculate the risk adjustment.

The IASB is looking for ways to make the information comparable among insurers. They are seeking a way to help users understand what the risk adjustment says about the relative uncertainty in the estimated cash flows. In the ED the IASB proposed that insurers would disclose the confidence level of the risk adjustment if the use of a confidence level was not the approach taken to determine the risk adjustment. This proposal was very unpopular with insurers, who commented that there would be a duplication of effort. They also stated that if the confidence interval was not seen by the insurer as the most appropriate approach to set the risk adjustment, its relevance as a disclosure was dubious. In subsequent deliberations of the decisions in the ED, the IASB has moved away from asking for disclosure of confidence intervals, but is still pursuing a means of helping users assess the information about risk adjustments.

GETTING FROM THE WORDS TO THE NUMBER

After the conceptualizing is done, it falls to the actuary to produce a number that represents the compensation that the insurer requires to bear the risk that the ultimate cash flows could exceed those expected. The IASB

intends to provide some application guidance that may be helpful. In its discussions the IASB has talked about the idea that the risk adjustment should make the insurer indifferent between fulfilling the uncertain liability and fulfilling a certain liability of the same value.

Take for example the choice between a certain liability of 100 and an uncertain liability with an expected value of 100 that has a range of possibilities from 85 to 115. Because it is risk adverse, the insurer would not be inclined to take a chance of a gain or loss on the uncertain liability of 100 if it could instead have a certain liability of 100. At some larger amount of certain liability, say 110, it would be quite happy to have the uncertain liability. The prospect of a gain of up to 25 would be attractive, notwithstanding that there is a possibility of a loss of up to five (assuming of course that the probability distribution is not skewed towards the loss). But at what amount of risk adjustment would the insurer be indifferent between the two possibilities? In this example, the answer lies somewhere between zero and 10. The question is one that each insurer must answer for itself. It must rationalize its position and articulate its policy in a manner that can be associated with the quantity.

The insurer is not limited in the choice of techniques for calculating the risk adjustment, (as had been originally proposed in the ED). Even without limits, it is a challenge to the actuary to find the calculation technique and the calibration of the risk models that provides a number that can be said to represent the point of indifference. The final answer is likely to be more subjective than will be apparent. For this reason the disclosures around the risk adjustment will be important.

RISK ADJUSTMENT IN OTHER IFRS STANDARDS

The insurance standard is only one area of guidance where the IASB has had to consider the topic of risk adjustment. Other areas that are relevant to insurers are financial instruments, revenue recognition, and general liabilities.

The measurement of financial instruments is either by fair value or by the effective yield method, more com-

monly known as amortized cost. A fair value measure includes a risk adjustment because market participants price risk into the value of the instrument. If the measurement of a financial instrument is an observed price, the risk adjustment is not separately identified, but it is presumably in the price. If the financial instrument is measured by a model, the risk adjustment is a component of the model and the risk adjustment is based on consideration of market factors.

The price of a financial instrument measured by amortized cost reflects the market assessment of risk and the risk is in turn reflected in the effective interest rate. Subsequent measurement retains this rate. The risk adjustment is not re-measured unless the instrument is impaired.

The emerging standard on revenue recognition will apply to contracts for which consideration is given in exchange for goods or services. Contracts that are addressed elsewhere, such as insurance contracts, are not in the scope. The approach to revenue recognition is an allocation of the consideration to the period in which the goods or services are delivered. The allocation process starts by recognizing an initial liability, the performance obligation, which is measured as the value of the consideration. At subsequent dates, the liability is the amount of the performance obligation that has not yet been released into revenue. When a contract is onerous, the entity must add an amount to the performance obligation to cover the expected loss. A contract is onerous when the amount of the performance obligation is not sufficient to provide for the cost of settling the contract. The IASB decided that the liability for an onerous contract does not include a risk adjustment, notwithstanding the possibility that the expected loss may be uncertain. This is one clear point of difference between the insurance standard and other guidance.

Although currently inactive, the IASB has a project on modifications to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets (IAS 37)*. IAS 37 provides general guidance on the recognition and measurement of liabilities that are not specifically addressed elsewhere, such as liabilities arising from lawsuits. In January 2010 the IASB issued an exposure draft, *Measurement of Liabilities in IAS 37*, presenting

its view on how general liabilities should be measured. In this exposure draft the IASB concludes that the measurement should be the amount that the entity would rationally pay at the end of the reporting period to be relieved of the obligation. This is an exit value, akin to a fair value, and includes a risk adjustment. Interestingly six board members disagreed with the choice of the measurement attribute and in particular with the decision to include a risk adjustment. They gave an alternative view in the ED. They disagreed with the idea that a liability should be measured as an exit value. Their objection to the risk adjustment was largely related to the fact that the risk adjustment would create an expense in the period in which it was recognized that would likely reverse and generate income in later periods. They stated that they believe this effect on the timing of income would be inappropriate.

CONCLUSION

In summary it can be seen that the rationale for inclusion or exclusion of a risk adjustment is largely a function of the measurement objective. The selection by the board of the measurement objective can be contentious, between the boards or even among board members. The difference in the views of the FASB and the IASB reveals a divide in their respective understanding of the measurement objective for insurance contracts and of the value of the information provided by the presence of an explicit risk adjustment. If, in the end, the insurance standard requires a risk adjustment, it will be challenging for insurers and for the actuaries, who must do the heavy-lifting, to determine the number that meets the measurement objective. ■