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Dear Peter,

### **Insurance Contracts project: The need for separate risk and residual margins**

The European Insurance CFO Forum has noted the recent deliberations around margins as part of the joint boards' discussions on the insurance contracts project. We would like to take this opportunity to reiterate our support for a separate explicit risk margin (or "adjustment") in order to present an economic valuation of the insurance contract liability and to explicitly identify the risk and uncertainty in the discounted probability weighted cash flows underlying that liability. We believe that a model incorporating separate risk and initial profit ("residual") margins is significantly more appropriate than one aggregating these two elements together in a single composite margin. The exact geography of the residual margin as part of the insurance contract liability or otherwise is not considered herein.

In arriving at this view the key issues we believe should be considered are as follows.

#### **An explicit risk adjustment provides greater transparency over the true position of the contract**

Given the often stated objective of the IASB and FASB to provide decision-useful information in financial statements we believe that it would appear strange if an important indicator of the risk and uncertainty in the expected cash flows is not disclosed. The composite margin is a balancing figure and hence does not provide meaningful information to users. This lack of usefulness contrasts with a separate risk margin, which provides valuable information on uncertainty of cash flows, and residual margin, which represents the expected profit to be earned over the contract's life.

#### **There is a considerable weight of opinion behind the need for a separate risk margin, including from regulators and users**

We are aware that a number of significant commentators in the insurance industry support the presentation of an explicit risk margin. In particular, we understand that this includes many international regulators and also users of financial statements. We note that a PwC survey of insurance analysts published in November 2009 showed that a significant majority of analysts outside the US favoured an explicit risk margin and 58% of US analysts also supported this view.

### **Risk margins are determined for several other purposes, both in relation to external reporting and internal management of the business**

The inability to develop a robust basis of calculation for the risk adjustment has been put forward as a key factor in support for a composite margin. We would note that insurers already calculate risk margins for internal economic capital and pricing purposes as well as externally reported supplementary information such as embedded value reporting and, in Australia, for statutory financial reporting. In addition, the European insurance industry will be required to calculate and present a risk margin as part of their valuation of technical provisions under Solvency II, an exercise that will be required for all their global group entities.

### **Consistent application will develop through market practice aided by an appropriate disclosure regime**

Another challenge often presented to the explicit risk adjustment camp is focused on the concern that a lack of consistency of application will emerge without pre-prescribed methodologies for determining a risk adjustment. Appropriate disclosures, including, for example, basis of calculation of risk adjustments, impact of changes in basis and historical development of risk adjustments over time, will provide transparency and hence encourage consistency across the industry. There is evidence that such a situation emerged in Australia when the risk margin concept was introduced. Given that Solvency II prescribes a cost of capital approach to the calculation of the risk margin, and this is widely considered to be the most appropriate methodology, insurers in Europe will, want to adopt this approach for IFRS Phase II as well, leading to convergence of methodology within Europe. As Solvency II gets rolled out in some form in other jurisdictions around the world, it is likely that the cost of capital approach will receive further impetus internationally. Since IFRS financial statements and regulatory reporting will be subject to external auditor and regulatory review, this will lead to a further drive towards consistency in approach in addition to market discipline.

### **Excluding a risk adjustment raises issues around the liability adequacy test**

The need to carefully define a liability adequacy test ("LAT") is amplified in a composite margin model. The question is raised as to whether such a test would include a risk margin or not. Given that one of the key reasons put forward for not including a risk adjustment is the difficulties around robust calculation it would appear illogical to then require such calculation in a LAT situation. However, consider an example where premiums are 100, BEL 90 and risk adjustment 20. In a composite margin model with a LAT that does not consider a risk adjustment the contract will be valued at 100 (BEL 90, composite margin 10). With a risk adjustment model the contract would be valued at 110. The former does not appropriately reflect the economic value of the contract.

### **The composite margin model gives rise to complicated issues around the period and pattern of recognition and would inhibit transparent reporting**

Under a risk adjustment model it would be anticipated that the risk adjustment is released over a period up to ultimate settlement in a pattern that reflects release from risk. The residual margin would, however, be recognised over the contract coverage period. The IASB have tentatively agreed such a model. However, as a composite margin comprises a number of different elements it is unclear how appropriate patterns and periods of release of this margin could be achieved in a transparent manner without explicitly separating those elements, notably the risk component. Without explicit separation the total margin may have to be recognised over a period through to ultimate settlement, thus delaying profit recognition in many non-life contracts in particular (unless a complex release pattern is used). This approach would be complex, not sensitive to risk and opaque. Given these issues we would stress that transparency of disclosure of performance is best achieved through explicit separate risk and residual margins.

**The lack of remeasurement of the composite margin will result in no consideration of changes in risk over a contract's life**

Whereas the IASB propose to remeasure the risk adjustment at each reporting period, there will be no remeasurement of the composite margin under the FASB model. Accordingly, there will be no means to reflect changes in risk when cash flow estimates change over the contract life. Take a very simple example to illustrate this point:

***Fact pattern:***

*At inception:*

Premium 100; Discounted probability weighted cash flows ("BEL") 60; Risk adjustment 20; Residual margin 20; hence, composite margin 40

*Subsequent measurement:*

BEL 75

Risk adjustment (Scenario 1) 25

Risk adjustment (Scenario 2) 10

[i.e. Different scenarios can be envisaged where an expectation of increased cash outflows could either increase the risk and uncertainty around those cash flows or reduce that risk]

***Results:***

*Under risk adjustment model:*

Scenario 1 – Liability value is 120 (assuming no amortisation of residual margin); Income statement charge in subsequent period is 20 (15 for increased BEL and 5 for increase in risk adjustment)

Scenario 2 - Liability value is 105 (assuming no amortisation of residual margin); Income statement charge in subsequent period is 5 (15 for increased BEL and minus 10 for decrease in risk adjustment)

*Under composite margin model:*

Scenario 1 – Liability value is 115 (assuming no amortisation of composite margin); Income statement charge in subsequent period is 15 (for increased BEL)

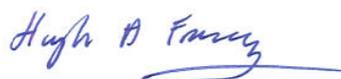
Scenario 2 - Liability value is also 115 (assuming no amortisation of composite margin); Income statement charge in subsequent period is also 15 (for increased BEL)

Under the composite margin model there is no reflection in the liability value or in earnings of the effect of changes in risk surrounding the expected future cash flows.

In summary we believe that the only basis to transparently present the insurance contract liability and its corresponding movement over time is through use of separate risk and residual margins.

We will be happy to expand on the points raised in this letter if you consider that useful.

Yours sincerely



Hugh Francis  
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Cc Hans van der Veen - IASB staff, Mark Trench - FASB staff