

RISK ADJUSTMENT

2017 Insurance IFRS Seminar

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Session 11



Risk adjustment for non-financial risk

Agenda

- Allowing for non-financial risks – the risk adjustment
- Reflecting uncertainty – key characteristics of the risk adjustment
- Worked example – reflecting degree of risk from the entity's point of view
- Examples of measurement approaches that meet the required characteristics
- Impact of the risk adjustment on profit pattern

Allowing for non-financial risks

The risk adjustment for non-financial risks

Contractual
service margin

Risk
adjustment

Probability
weighted
discounted
expected
present value of
cash flows

General measurement model

Risk adjustment for non-financial risks

- Reflects compensation that entity requires for bearing uncertainty from non-financial risks in the fulfilment cash flows
- Scope: insurance and other non-financial risks associated with the contracts (e.g. lapses, expenses, but not general operational risks)
- Measures compensation to make entity indifferent between:
 - Range of possible outcomes
 - Fixed cash flows with same expected value
- The CSM is unlocked for changes in risk adjustment for future coverage and other services
- The time value of money is independent of the value of future cash flows, so the risk of changes in discount rates is not part of the risk adjustment. So, for example, reinvestment risk for long-term bonds to determine appropriate discount rates for liabilities will not affect amount of risk adjustment

Paragraph 37

An entity shall adjust the estimate of the present value of the future cash flows to reflect the compensation that the entity requires for bearing the uncertainty about the amount and timing of the cash flows that arises from non-financial risk.

Paragraph 64 [Reinsurance contracts held]

Instead of applying paragraph 37, an entity shall determine the risk adjustment for non-financial risk so that it represents the amount of risk being transferred by the holder of the group of reinsurance contracts to the issuer of those contracts.



Reflecting uncertainty (1 of 2)

Key considerations in determining the risk adjustment

Entity's view of risk and diversification (B88)

- The risk-adjustment for non-financial risk reflects the compensation the entity would require for bearing the non-financial risk arising from the uncertain amount and timing of the cash flows
- The risk adjustment also reflects the degree of diversification benefit the entity includes when determining the compensation it requires for bearing that risk.
- Both favourable and unfavourable outcomes should be reflected, in a way that reflects the **entity's** degree of risk aversion

Although risk adjustment applies to the entity, in practice it will need to be allocated at least to groups of contracts (76 (a))

- the fulfilment cash flows allocated to the group are adjusted to eliminate the present value of the future cash flows and risk adjustment for non-financial risk relating to the rights and obligations that have been derecognised from the group

Scope – non-financial risks relating to the contract only, and no financial risks (B89)

- The purpose of the risk adjustment is to measure the effect of uncertainty in the cash flows that arise from insurance contracts, other than uncertainty arising from financial risk.
- So the risk adjustment should reflect all non-financial risks **associated with the insurance contracts**.
- It should **not** reflect the risks that do not arise from the insurance contracts, such as general operational risk.

Explicit inclusion in the measurement – not implicit in the cash flows and avoid double counting (B90)

- The risk adjustment should be included in the measurement in an explicit way – it's conceptually separate from the estimates of future cash flows and the discount rates that adjust those cash flows.
- There should be no double-counting of non-financial risks by, for example, also including a risk adjustment for non-financial risk implicitly when determining the estimates of future cash flows or the discount rates.

Reflecting uncertainty (2 of 2)

Key characteristics of the risk adjustment

B91

IFRS 17 does not specify the estimation technique(s) used to determine the risk adjustment for non-financial risk. However, to reflect the compensation the entity would require for bearing the non-financial risk, the risk adjustment for non-financial risk shall have the following characteristics:

- (a) risks with low frequency and high severity will result in higher risk adjustments for non-financial risk than risks with high frequency and low severity;*
- (b) for similar risks, contracts with a longer duration will result in higher risk adjustments for non-financial risk than contracts with a shorter duration;*
- (c) risks with a wider probability distribution will result in higher risk adjustments for non-financial risk than risks with a narrower distribution;*
- (d) the less that is known about the current estimate and its trend, the higher will be the risk adjustment for non-financial risk; and*
- (e) to the extent that emerging experience reduces uncertainty about the amount and timing of cash flows, risk adjustments for non-financial risk will decrease and vice versa.*

B92

An entity shall apply judgement when determining an appropriate estimation technique for the risk adjustment for non-financial risk. When applying that judgement, an entity shall also consider whether the technique provides concise and informative disclosure so that users of financial statements can benchmark the entity's performance against the performance of other entities.



Worked example

Reflecting degree of risk from the entity's point of view

Two insurance contracts, each covering a range of scenarios, but with identical insurance liabilities. Uncertainty giving rise to the scenarios comes from insurance, lapse, expense and other non-financial risks associated with the contracts.

Contract 1

Scenario	Net cash inflows/ (outflows), CU	Probability	Probability-weighted outcome, CU
1	(10,000)	5%	(500)
2	-	15%	-
3	5,000	7%	350
4	15,000	73%	10,950
Total			10,800

Contract 2

Scenario	Net cash inflows/ (outflows), CU	Probability	Probability-weighted outcome, CU
1	10,000	84%	8,400
2	15,000	16%	2,400
Total			10,800

Which of these should have a higher risk adjustment?

Measurement approaches

Examples of approaches that meet the required characteristics

- BC209: *As noted in paragraph BC17, the measurement model is not intended to measure the current exit value or fair value, which reflects the transfer of the liability to a market participant. Consequently, the risk adjustment for non-financial risk should be determined as the amount of compensation that the entity—not a market participant—would require.*
- No limitation on techniques, and choice of technique requires judgement. Examples of techniques that may be acceptable:

Cost of capital

- Cost of setting up the economic capital required for the lifetime of the portfolio. No prescribed capital or percentage cost. Is market practice likely to drive ultimate requirement?

Confidence level

- Value at risk; used to measure the expected loss on the portfolio at the specified confidence level over specified time horizon. Disclosure may lead insurers to “target” a certain level?

Conditional tail expectation

- Tail value at risk; used to measure the expected loss on the portfolio as an average of outcomes occurring above the specified confidence level over the specified time horizon.

Why confidence level for disclosure?

BC217 ...the confidence level technique has the benefit of being relatively easy to communicate to users of financial statements and relatively easy to understand...

The Board expects that many entities will have the information necessary to apply the cost of capital technique because that information will be required to comply with local regulatory requirements. However, the Board decided not to impose the more onerous requirements on entities when a simpler approach would be sufficient.

Revenue impact and disclosures

The impact on profit pattern

Profit and loss – two key considerations

Allocation of change in risk adjustment

- An entity is not required to disaggregate the change in the risk adjustment for non-financial risk between the insurance service result and insurance finance income or expenses. If an entity does not make such a disaggregation, it shall include the entire change in the risk adjustment for non-financial risk as part of the insurance service result.

Derecognition

- Derecognition requires risk adjustment to be allocated to groups of contracts
- Para 76 (a): *the fulfilment cash flows allocated to the group are adjusted to eliminate the present value of the future cash flows and risk adjustment for non-financial risk relating to the rights and obligations that have been derecognised from the group*

Impact

- Expected changes in the measurement of the risk adjustment for non-financial risks related to the current reporting period are recognised as revenue, and they affect net profit reported during the period if an entity makes an accounting policy choice not to separate the effect of changes in discount rates from measurement of the risk adjustment.
- The pattern of revenue recognition and emergence of profit will differ depending on the risk adjustment measurement technique used, as well as the drivers influencing the risk adjustment.
- For example, the price of capital will affect the risk adjustment if a cost of capital technique is used.
- Even though IFRS 17 does not specify the technique for measuring the risk adjustment, an entity will be required to disclose the confidence level to which the risk adjustment corresponds. This may lead to convergence of market practice in terms of techniques and targeting of an 'acceptable' level.

Thank you



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