

To	Christian Levac, Director of Communications and Membership, IAA
From	Institute of Actuaries (Australia) IFRS 17 Insurance Taskforce
Date	27 February 2017
Subject	IAA Exposure Draft - Educational Monograph: Risk Adjustment Under IFRS

1. Introduction

The Actuaries Institute IFRS 17 Taskforce is pleased have the opportunity to comment on the IAA's Exposure Draft (ED) Educational Monograph entitled '*Risk Adjustment Under IFRS*' dated October 2016. Our comments draw on our Australian experience with use of risk adjustments in reporting for general insurance and reflect on perspectives in life and health insurance as well.

2. Purpose of the Monograph

The over-arching purpose of this Monograph was not clear upon review. We assume that it's role is solely educational, and potentially for Continuing Professional Development (CPD) purposes and that it would not of itself become basis for mandatory guidance for the actuarial profession in respect of IFRS 17 Insurance Contracts. We recommend outlining this clearly at the beginning of the Monograph.

3. Overall Reaction

We note that the Monograph overall has a heavy focus on the theory underpinning the determination of risk adjustment for Insurance Contracts under the forthcoming IFRS. This makes the Monograph difficult to read easily. This includes Chapters 2 and 3, which are very detailed and much of Chapter 3 is theory that may be best suited for appendices or addendum to leave the content focussed on key issues and judgements.

While there is discussion of the considerations and judgement involved in applying theory, as well as some use of examples, we believe that these aspects need to be strengthened to make the Monograph more practical for adoption by the Global profession.

We note that there are number of instances whereby more practical approaches to setting risk adjustments (or risk margins) already exist:

- The Australian Actuaries Institute published a paper titled *A Framework for Assessing Risk Margins*, which widely used by many general insurance in Australia and New Zealand. This framework provides a practical approach to setting risk margins by separating the risk into independent error, internal systemic and external systemic risk. The systemic risk elements are estimated by fitting quantitative scales to qualitative risk assessments. We encourage the use of a practical framework such as this because, in our experience, only independent error can be modelled easily but systemic risk is much more significant in practical terms than independent error.
- It is noted that South-East Asian countries include requirements for a Provision for Adverse Deviation (PAD) in their insurance liabilities. A common practical approach to setting a 75th percentile is to include half the prescribed margins for regulatory capital in the calculation of insurance liabilities. We would suggest that such 'rules of thumb' be

considered to make the approach more practical for smaller insurers or insurers without credible historical data.

- When dealing with skewed distributions, APRA GPS 320 sets the 75th percentile to the higher of the modelled 75th percentile and the mean plus half a standard deviation. This is practical adjustment to overcome limitations of the confidence interval approach.

We appreciate that wide range of different product, regulatory and business structures around, means that development of practise and judgement will involve both global and local contexts. This will therefore include a wide range of types of insurers, big and small, with some not adequately resourced or able to carry out comprehensive analysis on their own experience. Particularly for small insurers, a qualitative approach is necessary, drawing much more on clear principles, separate from theory.

Therefore we believe that it is unrealistic to expect the Monograph to do more than provide a framework.

4. Further detail and summary

We also have a number of comments on specific sections and points of detail. The attachment to this letter sets out these additional technical points.

If you would like to discuss any of these points with us further, we would be happy to help. Please get in touch with us via the details below.

Kind regards

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ATTACHMENT: Specific comments and points of detail

Specific Comments

Section 3.1 – Techniques for risk adjustments

We note that the Monograph does not make any distinction between expired and unexpired risk. It is suggested that this be considered because the expired risk adjustments would be simpler to calculate with no catastrophe or tail risk.

Section 5.4 – Level of aggregation

To reflect the Nov 2016 tentative decisions, the risk adjustment effectively needs to be allocated down below portfolio (potentially to individual contracts) to enable identification of contracts in the portfolio written in the reporting year that were onerous at inception, separately from those at risk of becoming onerous and those not at risk. This should be reflected in the illustrative graph and considerations involved in allocating down to this level developed.

Section 6.5 – reinsurance

It would be useful to include a discussion of the effect of per-risk or per-event non-proportional insurance (commonly referred to as “excess of loss”), which are very common in General Insurance in particular. These type of treaties modify risk differently to stop loss reinsurance (which is discussed).

Section 10 – Further Examples

It would be valuable to include an example illustrating the derivation of a risk adjustment in the case of reinsurance where the contract boundary differs from the underlying contract bound between the insured and the insurer, for example where the underlying contracts can be fully repriced at anniversary, hence have one year contract boundary, but the reinsurance contract captures future renewals and cannot be repriced.

Section 10.5.– Risk adjustment for a block of participating contracts:

This is an important example that needs to be fully developed for participating business that qualifies for the variable fee approach.

Points of Detail

Page 15 - Current fulfilment value, paragraph 3

As “fulfilment cash flows” is defined term in IFRS X including the time value and risk adjustment, as well as the cash flows, these elements need to be included in explaining what is meant by fulfilment values and fulfilment cash flows in used consistently, suggested edit below:

In comparison, IFRS X Insurance Contracts requires ~~a measurement of current fulfilment value measurement~~ at the end of each reporting period, based on fulfilment cash flows (i.e the present value of the cash flows arising from insurance contracts (i.e., ~~an~~ as the entity would fulfils its obligation by delivering those cash flows adjusted for risk). The use of a current fulfilment value measurement model for the insurance contract liability provides transparent reporting of changes in the insurance contract liability and complete information about

changes in estimates, as well as a measure of the economic value of options, ~~and~~ guarantees, and insurance risk embedded in insurance contracts.

Page 18 – Building block three

It would be cleaner and more consistent with the way the IASB explains the general model, for building block three only to be about the risk adjustment and exclude the references to CSM. The three building blocks would then relate to the current measurement of the fulfilment value.

Whereas the CSM relates to appropriate recognition of revenue, an accounting rather value concept and its updating depends not just on “the estimated risk adjustment at the end of each period” but also on changes in estimates relating to future cash flows as well as to the risk adjustment.

That part of the second paragraph relating to CSM, would then become a separate subsection after building block three”

In addition, the clarity of the second to last sentence, by amending as follows:

“Thus, the mean of those cash inflow is effectively reduced by an offsetting increase in the ~~positive increment to the risk adjustments~~”

Page 22- Legal environment risks

We note the comment under this bullet point, that “under IFRS X Insurance Contracts, the expected cash flows and the risk adjustment are based on current laws and circumstances, such that risks from unknown future changes in the legal environment are not considered relevant in estimating the risk adjustment”.

This implies that what is normally referred to as superimposed inflation (i.e. growth in settlements at a faster rate than economic inflation, that largely arises from known or unknown changes to the social, legislative and political environment) is excluded from the risk adjustment. This can be an important element in an entity's consideration of risk and pricing for some portfolios. It is not clear to us this is actually required under IFRS17 Insurance Contracts.

Pages 35 to 38: Additional Comments Regarding Use of Best Estimate under IFRS X

This seems to be noted as a potential appendix for the Monograph, based on the heading near the top of page 35. Our view is that this detailed discussion is not required and does not appear to reach a conclusion. It might be helpful though, to simply note that under IFRS Insurance Contracts, the present value of the cash flows against which the risk adjustment is applied, is required to be an unbiased expected value.

Page 88 - Second paragraph

Remove hanging 'and' at end of second dot point.

Page 101 - Section 7.1.3 – second dot point

It would be clearer and more consistent to change the second bullet as follows:

“Process Management — Clear pProcess management is established: one approach is designate an owner for each process involved who is responsible for its development, documentation, improvement, and controls.”

Page 121 - Table 10.1.2 Estimated Cash Flows

The label for number of deaths and lapses are incorrect – they need to be swapped around.

It would also add clarity if it was noted that the fulfilment cashflows are shown on a per policy basis, not for the portfolio as a whole.

In addition, the stated acquisition expense of 56 shown is inconstant with the CU 75 per policy acquisition expense shown in table 10.1.1 further above.

Page 125 - Second paragraph of Section 10.3

Reference to section 12.2 should be to 12.2.

Page 127 - Section 10.4.4 – second table

The Standard deviation inputs (e.g. 0.21 in 2009) shown in column three, should be rounded to 2 decimal places to enable the reader to independently derive the future payments shown in column 5.

Page 131 - Section 10.7.2

Input assumptions such as the Initial capital % (of 39%) and the discounted unpaid % should be rounded to 2 decimal places to enable the reader to work through the example and derive the results. The total risk adjustment figure of 4.5% in the table at top of page 133, cannot be obtained due to rounding of inputs.