

# **The Group of North American Insurance Enterprises**

## **Discussion Paper**

### **Risk Margins**

#### **Introduction**

This discussion paper has been developed by the GNAIE Technical Committees in response to the questions raised by the IASB staff in their February papers and further discussed at the April 1-2 meeting of the Insurance Working Group. Specifically, this paper has been developed to respond to questions contained in Agenda Papers 7, 7A, 7B, 7C, 7D, and 7E for the April 2008 meeting of the IASB Insurance Working Group. (GNAIE also has a separate discussion paper specifically on Day One Profit and Loss, the subject of Paper 7D.)

At the request of the members of the Working Group during the meeting, we have copied all the members. Please feel free to circulate these to any others you feel may benefit from the discussion. They will also be posted on the GNAIE Website, along with any other contributions of documents or ideas.

#### **Questions and Responses**

**From Agenda Paper 7C (Risk Margins- cost or required compensation):**

- 21. This paper presents two views of the purpose of a risk margin in general purpose financial reporting: (a) View 1: risk margins represent the cost of bearing risk; (b) View 2: risk margins represent the compensation an entity requires for bearing risk.**
- 22. Will these two views lead to different results in practice? If so, which view will result in the most decision-useful information for users of an insurer's financial statements?**
- 23. If you favour a different view of the purpose of risk margin, please describe it. Why do you prefer it?**

GNAIE's response to these issues from a Life perspective are as follows:

We do not believe that further discussion of the nature of the risk margin is very meaningful. Ultimately, the most important characteristic of the margin is that it determines how profits emerge if experience emerges as expected.

Which of the two descriptions is chosen is more likely to influence the choice of methodology than the actual results under our principles. This is because, whatever the methodology chosen to calculate the risk margin, we believe those margins must still be calibrated to create no gain or loss at issue unless the policy is expected to produce a loss over its lifetime.

In reality, the two descriptions can deliver the same result. In either case, the margin is related to the risk profile of the business and the cost of bearing that risk is likely to be the required compensation for it. In other words, if the cost of bearing a risk is 125, then the required compensation for bearing that risk is also likely to be 125.

**From Agenda Paper 7E (Service Margins):**

**16. Should the cash flows for providing other services be based on the cost of outsourcing the services? Why or why not?**

**17. If not, should the insurance liabilities include a service margin? Why or why not?**

We do not believe that a service margin is necessary. There is nothing to be gained by splitting the margin into two pieces.

**From Agenda Paper 7D (Day One Profit):**

**26. Can a significant profit arise at the inception of an insurance contract? If so, how should an insurer account for that profit?**

**27. How should an insurer treat the portion of the premium that pays for acquisition costs?**

(Note. Several choices are listed in the Agenda Paper as possible answers to these questions; but those choices are not repeated here.)

- Based on the SOA study that was recently published, day one profits are not only possible, they are quite probable and significant for many products. Equally disturbing, based on the same study, significant and unwarranted losses are possible and probable for products that are expected to be profitable over their lifetime. The products, moreover, that show the greatest losses are products such as immediate annuities and long-term care, products that are expected to be particularly important as our population ages. The requirement to recognize large losses at issue could well drive many companies out of this important market, even though there is extensive experience and strong economic bases to expect that these products will be profitable over their full terms.
- GNAIE believes that profits should only be recognized on a release from risk basis. Since there has been no risk released as of day one, there should be no profit recognized as of that time.
- GNAIE believes that day one profits should not occur. The point of sale is the only point at which a real life calibration of margins is possible. Accordingly, we believe that if the liabilities are to have a strong coherent framework for insurance liability financial reporting, they must be consistent with this one observable calibration point. Such a calibration would be well understood by users and stand on a solid platform of reality. Other approaches that have been proposed (including the margin building block proposed in the Discussion Paper) would be extremely difficult to calibrate to any deep set of real transactions.

Accordingly, we propose that if day one profits would otherwise occur, margins should be adjusted to eliminate them.

An additional question that is not asked here, but may arise is the treatment of diversification between portfolios. GNAIE's position is that such diversification credit should only be reflected



## Risk Margins

to the extent it is reflected in pricing. In other words, if the company does not feel confident enough to reflect it in what they charge policyholders, then neither should the accounting authorities. Calibration to no gain at issue automatically accomplishes this result.

### **From Agenda Paper 7A (Risk margins – interaction between balance sheet and performance statement):**

#### **13. Do you have any comments on the interaction between (a) risk margins and (b) the subsequent release of those margins?**

As the insurer is released from risk, the margins related to that risk are also released from the liability calculation. Those margins therefore flow into earnings. If experience follows the expected path, earnings will equal the margins being released.



40 Exchange Place, Suite 1707  
New York, New York 10005  
Douglas Wm. Barnert  
Executive Director  
(212) 480-0808  
doug.barnert@gnaie.net