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## **IFRS 17 *Insurance Contracts*** **Use of coverage units vs cohorts** **(for background only)**

### **Objective**

- 1 The objective of this paper is to inform EFRAG TEG members on the analysis made by EFRAG Secretariat on some of the methods used by case study participants to replace the use of annual cohorts by relying on coverage units.

### **Background and scope of this paper**

- 2 As part of the EFRAG case studies, respondents were asked to demonstrate whether it was possible for them to replicate the release pattern of the contractual service margin of their chosen portfolios by using coverage units alone (“coverage units”), instead of annual cohorts and coverage units (“annual cohorts”).

#### *Full case study*

- 3 Some of the respondents did not find material differences between coverage units and annual cohorts for specific portfolios (savings, unit-linked portfolios, fully or significantly mutualised contracts).
- 4 Of those respondents that used coverage units, one noted that their findings were based on a mature portfolio and acknowledged that bundling together all cohorts may not necessarily lead to the same outcome since, as cohorts are spread over time, more differences in the volume of business, its profitability as well as in the percentage of the CSM to be recognised in a given year are observed. One respondent applied the coverage units method to a fully mutualised portfolio in which the profit margin declined with 29% over a 4-year period and found little differences between using coverage units and cohorts. Another respondent noted that, even in a mutualised portfolio, material differences were found between using cohorts or coverage units.
- 5 Finally, one respondent used assets under management, sums insured, expected profit/variable fee as coverage units and found significantly different outcomes between the methods used.
- 6 In all these cases no calculations (only end amounts and graphic representations) were provided in the case study results.

#### *Simplified case study*

- 7 One respondent used the following drivers as coverage units:
  - (a) The value of technical reserves;
  - (b) The emergence of financial margin; and
  - (c) The discretionary participation payment.
- 8 No calculations (only numerical results and graphic representations) were provided.

*Scope limitation*

- 9 In this paper, attention is paid to coverage units and annual cohorts where technical reserves, mathematical reserves and gross written premiums were used as profit drivers.

**Definitions used in this paper**

- 10 *Gross written premiums*: sum of direct premiums written before the effect of ceded reinsurance.
- 11 *Technical reserves*: net present value of all potential future cash flows that can be incurred in meeting liabilities to policyholders from existing insurance contracts.
- 12 *Mathematical reserves*: the main component of the technical reserves and defined as the provision for unearned premiums. Technical provisions would also include separate provisions for bonuses or discounts in the contracts. Other differences may also exist.

**EFRAG Secretariat analysis**

- 13 As technical and mathematical reserves relate to premiums written, the analysis of issues is combined for all drivers. This analysis will be expanded if other issues are identified.

*Provision of services*

- 14 It has not been demonstrated how each of the above drivers reflect the provision of services to the policyholder. Gross written premiums (and the calculation of reserves) will increase when (expectations of) claims occur. IFRS 17 notes that services are provided over the entire duration of the contract and not mainly at the point in time when claims arise.

*Investment component*

- 15 The drivers used would include an investment component. The IASB TRG is currently discussing the scope of contracts whereby an investment component, as well as an insurance component, can be used to run-off the CSM. This will be particularly important for contracts accounted for in accordance with the general model.

*Maturity of the portfolio*

- 16 The findings of replacing annual cohorts with coverage units were based on a mature portfolio. This raises the question whether material differences between the two methods would arise:
- (a) In the growth phase of the portfolio; and
  - (b) In a portfolio in run-off.

*Contract boundary*

- 17 If the CSM allocation were to be based on a driver that considers contract renewals (Solvency II technical reserves), then an allocation of profit beyond the duration of the cohort/group of contracts could arise.

*Discounting*

- 18 The technical and mathematical reserves are discounted in some cases. The question arises how the discount rate used is aligned with the one required by IFRS 17. This is particularly important for contracts under the general model where the CSM is accounted for using a locked-in discount rate. Using a current discount rate to run-off the CSM could require additional adjustments.

*Zillmerisation*

- 19 Zillmerisation can be described as a day one adjustment to the reserves. This is done by increasing the amount of future net premiums in order to compensate for the difference between the capital an insurer needs to hold for new business and the initial premium being paid (i.e. new business strain).
- 20 It is not clear how such a day one adjustment to the driver for the CSM can be aligned with the treatment of the fulfilment cash flows under IFRS 17.

**EFRAG IAWG comments**

- 21 EFRAG IAWG members discussed this analysis in their meeting on 12 July 2018.
- 22 EFRAG IAWG members did not comment on the technical issues raised in the paper.
- 23 Some EFRAG IAWG members and one observer noted that the objectives of the annual cohort requirement can be met without using annual cohorts. These objectives were identified as (i) recognising losses when incurred, (ii) providing trends in profitability; and (iii) recognising profit over the duration of the group (and not beyond).
- 24 Several EFRAG IAWG members noted that it was mathematically very difficult or even impossible to achieve a similar result using annual cohorts on the one hand or coverage units on the other hand. In contrast several other EFRAG IAWG members noted that the case studies provide proof that the run-off of the CSM can be done either using annual cohorts or using coverage units, even if the results were different.
- 25 Although mutualisation was considered by some to play a role in the ability to apply coverage units instead of annual cohorts, one EFRAG IAWG member noted that coverage units were able to replace annual cohorts for all portfolios, irrespective of whether mutualisation had been applied.

**Question to EFRAG TEG**

- 26 Do EFRAG TEG members have questions on the issues raised in this paper?