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IFRS 17 – Towards a consultation paper on level of aggregation Issues Paper

Objective

- 1 The objective of this paper is to provide a first draft of a consultation paper on the level of aggregation requirements of IFRS 17 *Insurance Contracts*.

Questions for EFRAG TEG

- 2 Does EFRAG TEG have comments on this consultation paper?

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Introduction

- 3 This consultative document deals with the level of aggregation requirements in accordance with IFRS 17 *Insurance Contracts* and is part of the preparation for the EFRAG endorsement advice on the Standard. Overall EFRAG will publish three consultative papers on the IFRS 17 requirements. Other consultative papers will address:
 - (a) The allocation of CSM; and
 - (b) Transition requirements.
- 4 Insurers issue a large number of insurance contracts knowing that some contracts will or may result in claims and others will not. That is, depending on the portfolio, some insurance contracts will result in claims, but the timing is uncertain (eg life insurance), and in other areas of insurance, claims are only expected from some insurance contracts, but it is not possible to determine in advance which contracts will lead to claims (eg property and casualty insurance).
- 5 As a result, insurers generally manage insurance contracts at a higher level of aggregation than the individual contract. IFRS 17 respects this business practice and allows insurers to use a unit of account that is higher than the individual contract level.
- 6 This level of aggregation requirements determines the unit of account to be used when applying IFRS 17. Applying the level of aggregation requirements is not limited to simply adding up similar contracts, instead their use has more far reaching effects as it determines how the performance of the insurer will be affected by allocating the contractual service margin (CSM) to insurance revenue. This important knock-on effect of the level of aggregation is outside the scope of this paper and is discussed separately in the "CSM allocation consultation paper". In order to break down the complexity, EFRAG has chosen to discuss the two topics separately, allowing non-insurance specialist constituents the opportunity to follow the issue.
- 7 Please respond with your comments, either on the detailed questions in this document or in general, **by 30 April 2018**.

What do insurers do today?

- 8 Today, insurers use different units of account for different purposes. Based on the results of the 2017 EFRAG IAWG Questionnaire on current accounting practices the following practices were reported (summarised).
- 9 *Except for reinsurance and with-profit contracts, the (large) majority of respondents to the Questionnaire used the individual contract as the unit of account. However other units of account were used for different purposes and depending on the different insurance contract types. For example:*
 - (a) *Line of business or group level: measuring the provision for administration expenses deficiency or the provision for financial yield deficiency, measurement and impairment testing of deferred acquisition costs and acquired value in force (life and health contracts);*
 - (b) *Portfolio or group level for the IBNR claims calculation (non-life contracts);*
 - (c) *By risk or group of contracts for specific technical provisions to cover targeted deficiencies (investment contracts); and*
 - (d) *Total fund level for unallocated distributable surplus (unit-linked contracts).*
- 10 *For both reinsurance ceded and assumed, only a minority referred to the individual contract level. Others referred to portfolio or group level or based the unit of account on the underlying insurance contracts.*

The level of aggregation principles explained

Step 1: Portfolio level

- 11 IFRS 17 requires an entity to identify portfolios of contracts subject to similar risks and being managed together. This classification of insurance contracts is done when contracts are issued and is not subsequently revised.
- 12 Contracts within a product line would be expected to have similar risks and hence are expected to be in the same portfolio when being managed together. Contracts in different product lines are not expected to have similar risks and hence are expected to be in different portfolios.
- 13 Contracts in different business lines are expected to be managed in a different way because the underlying risks are different. For example, providing a price incentive on the premium required for house insurance when the policyholder installs a burglar alarm has no impact when managing a portfolio of life insurance contracts where the insurance risk is health related.

Step 2: One year issuing period

- 14 IFRS 17 requires a portfolio of contracts to be divided into annual time buckets (cohorts), i.e. only contracts issued less than one year apart can be grouped together.
- 15 This requirement can be explained as follows. Insurers issue insurance contracts at a particular profitability level which remains stable for a certain period (i.e. a few months or sometimes longer than one year). Changes in economic circumstances may oblige an insurer to adapt its pricing over time. Thus, over time, the expected profitability of these contracts at inception may fluctuate. For example, new market opportunities may permit insurers to charge high profitability margins, but with increased competition in the same field, profitability may drop over time.
- 16 In the absence of a requirement to follow the profitability of insurance contracts at the individual contract level, a method was found to approximate the profitability trend of issued insurance contracts by using cohorts. The role of cohorts is closely related to the release of the CSM to insurance revenue over time. In considering the use of cohorts, the following table provides an overview of the steps to be considered and in which EFRAG consultation paper these steps are being considered:

	Description	EFRAG consultation paper
Step 2A	Determination of one annual cohort	Level of aggregation
Step 2B	Determination of consecutive annual cohorts	Level of aggregation
Step 2C	Trend information resulting from applying consecutive annual cohorts	Release of contractual service margin

Step 2A: Determination of one annual cohort

- 17 As a start, one cohort is being determined, it implies that a closed group of contracts is being defined. The cohort is not a standalone requirement, it is intrinsically related to the dispensation of not having to track individual contracts and the release of the CSM. To understand the effect of this requirement, the following needs to be borne in mind:
- (a) As IFRS 17 does not require insurers to track the profitability of individual contracts, an insurer does not know (or need to know) how much CSM to release to profit or loss at the moment of derecognition of a contract, rather the insurer can work with an average profitability for the cohort;
 - (b) Closing the group of insurance contracts ensures that all of the CSM that relates to a particular cohort is released to profit or loss at the moment the last contract of that particular cohort matures and the CSM is evenly spread over the coverage period as service is being provided (ignoring adjustments).
- 18 Hereafter we use an example to demonstrate the effect. Assume the following. In Year 1 an insurer issues an insurance contract with total CSM of €100, with a duration of 5 years. The contract represents 5 coverage units (Please refer to the paper on Release of CSM for further information). In accordance with the insurance service provided over the duration of the contract, every year an amount of €20 is released to profit or loss (one coverage unit of service is provided every year). For simplicity reasons, the one contract is considered to be a cohort in accordance with IFRS 17.

Example 1:

Year	Y1	Y2	Y3	Y4	Y5
	20	20	20	20	20

Step 2B: Determination of consecutive annual cohorts

- 19 In this simplified example, the release of CSM of one single cohort may seem meaningless because the CSM is distributed evenly over time. The reason for this is that, in accordance with IFRS 17, an insurer stands ready to provide service during the entire duration of the contract, not only when an insured event occurs. In reality however, the release of CSM of even one cohort will be affected by unexpected events leading to experience adjustments.
- 20 The full impact of the cohort becomes clear when applying consecutive cohorts as these will result in a trend of the underlying profitability of contracts.
- 21 To demonstrate this, we assume that the insurer:
- (a) Issues in Year 2 a contract with total CSM of €75. Duration, coverage units and provision of services remain identical;
 - (b) Issues in Year 3 a contract with total CSM of €60. Duration, coverage units and provision of services remain identical;
 - (c) Issues in Year 4 a contract with total CSM of €35. Duration, coverage units and provision of services remain identical;
 - (d) Issues in Year 5 a contract with total CSM of €50. Duration, coverage units and provision of services remain identical; and
 - (e) Issues in Year 6 a contract with total CSM of €85. Duration, coverage units and provision of services remain identical.
- 22 For simplicity reasons, each single contract is considered to be a cohort in accordance with IFRS 17.

Example 1 (continued):

Year	Y1	Y2	Y3	Y4	Y5	Y6	Y7	Y8	Y9	Y10
CU _s	1	2	3	4	5	5	4	3	2	1
	20	20	20	20	20					
		15	15	15	15	15				
			12	12	12	12	12			
				7	7	7	7	7		
					10	10	10	10	10	
						17	17	17	17	17

Step 2C: Trend information

- 23 When all of the above information is combined, a trend emerges that reflects the profitability per coverage unit of insurance service provided over time:

Example 1 (continued):

Year	Y1	Y2	Y3	Y4	Y5	Y6	Y7	Y8	Y9	Y10
CU _s	1	2	3	4	5	5	4	3	2	1
	20	20	20	20	20					
		15	15	15	15	15				
			12	12	12	12	12			
				7	7	7	7	7		
					10	10	10	10	10	
						17	17	17	17	17
profit per CU	20,0	17,5	15,7	13,5	12,8	12,2	11,5	11,3	13,5	17,0

- 24 For further discussion on the release of the CSM, please refer to EFRAG's consultation paper on "Release of the CSM".

Step 3: Group level

- 25 IFRS 17 requires an entity to divide portfolios of insurance contracts into a minimum of separate groups of:

- (a) onerous contracts, if any;
- (b) borderline contracts, if any; and
- (c) profitable contracts. (IFRS 17 paragraph 16)

Onerous contracts

Issued insurance contracts

- 26 In accordance with IFRS 17, paragraph 47, an insurance contract is onerous at the date of initial recognition if the fulfilment cash flows allocated to the contract, any previously recognised acquisition cash flows and any cash flows arising from the contract at the date of initial recognition in total are a net outflow.
- 27 The insurer recognises an immediate loss for the net outflow for the group of onerous contracts, resulting in the carrying amount of the liability for the group being equal to the fulfilment cash flows and the CSM of the group being zero.

Reinsurance contracts

- 28 For reinsurance contracts held, references to onerous contracts are replaced with a reference to contracts on which there is a net gain on initial recognition.

Profitable contracts

- 29 The group of contracts that have a significant possibility of becoming onerous could be described as contracts with a low profitability at inception (referred to as 'borderline contracts' above). In contrast, the group of contracts that have no

significant possibility of becoming onerous subsequently could be described as profitable contracts at inception.

30 For example, assume that an insurer issues 20 insurance contracts each with CSMs ranging from 1% to 20% (for simplicity reasons, each contract represents one coverage unit). In accordance with the grouping requirement, these contracts could be grouped together as follows:

- (a) One group consists of contracts with a CSM ranging from 1% to (say) 10% (contracts with low profitability at inception); and
- (b) One group consists of contracts with a CSM ranging from 11% to 20% (contracts with high(er) profitability at inception).

31 The need for such a grouping requirement can be explained as follows.

32 As noted above, insurers do not manage contracts on an individual basis, but instead at a higher level of aggregation. If all contracts were to be aggregated together, the average CSM per coverage unit would be €10,5. By separating the low profitability contracts from the high profitability contracts the averages respectively €5,5 and €15,5.

Example 2:

Total average	Average group 1	Average group 2
€10,5	€5,5	€15,5

33 Why work with averages? If a contract is derecognised earlier than expected, the related part of the CSM needs to be released to profit or loss. To do this accurately would require tracking of the CSM at the individual contract level. To avoid the operational cost of individual tracking, the grouping requirements of IFRS 17 require the release of an average CSM for the group to profit or loss at the moment of derecognition of a contract.

34 Why work with different groups? Identification of onerous contracts aside, when the average profitability of insurance contracts is measured at portfolio level, the average CSM is likely to be different from the CSM for a specific contract. For example, assume in example 2, the contract with an initial CSM of €2 is derecognised. When the average is derived from all the contracts in the portfolio, an average CSM of €10,5 would be released to profit or loss. In contrast, by relying on groups of contracts, an average amount of €5,5 would be released, which is much closer to the real profitability of the derecognised contract.

35 The grouping requirements thus allow to determine performance of an insurer close to the real profitability of the insurance contracts while at the same time providing dispensation from tracking individual contracts.

Impact of regulation

36 Situations occur when law or regulation constrains the entity's ability to set a different price or level of benefits for contracts or policyholders with different risk characteristics, such as requiring identical pricing for contracts for male and female policyholders even though the risks are known to be different. In grouping insurance contracts, IFRS 17 includes an exception to the overall grouping requirements, that permits insurers to include such contracts in the same group.

Industry practices

Pooling of similar risks

- 37 Insurance implies taking on risks. By spreading those risks amongst a large group of policyholders, the negative impact of any of those risks occurring becomes shared between all policyholders. For example, the claim as a result of a fire destroying a house, is financed not only by the premiums of the policyholder affected, but by the premiums of a large number of policyholders.

Risk diversification

- 38 The diversification effect of a portfolio of risks is the difference between the sum of the risk measures of stand-alone risks in the portfolio and the risk measure of all risks in the portfolio taken together. Risk diversification reduces the aggregate risk. For example by providing life insurance and annuities, the entity is exposed to both mortality risk and financial risk, however these two risks are not correlated and an increase in one of these two risks, will not affect occurrence of the other risk.

Differences between pooling of similar risks and risk diversification

- 39 Statistically, the average of a randomly selected sample from a large population is likely to be close to the average of the whole population. Put more simply, the more units of something that are measured, the closer that sample average will be to the real average of all of the units. In insurance, this means that the larger the number of contracts written relating to a specific risk, the more accurate will be predictions of incidents resulting in loss.
- 40 Pooling of similar risks and risk diversification are related but not identical.
- (a) Pooling of similar risks (for example, aggregating a large number of similar insurance contracts) is a risk management tool allowing an entity to more accurately determine an average expected occurrence of the risk (as well as the size of the average claim) per policyholder. The larger the underlying set of contracts, the closer the average estimate will be to the actual average;
 - (b) In contrast, risk diversification is designed to take advantage of the correlation between different types of risk. Risk diversification can be achieved by offering contracts with uncorrelated risks or in different geographies or by investing in different markets or asset categories.
- 41 In summary, risk diversification reduces the possibility of all risks occurring at the same time while pooling of similar risks helps in estimating the occurrence and size of the average claim.

Risk-sharing

- 42 Some insurance contracts require that a participating contract share cash flows with other contracts (including future contracts). This is sometimes called 'mutualisation', but, as used in practice, the term covers a variety of effects such as individual contract requirements, risk-diversification or cross-subsidisation. Given the inconsistent use of the term in practice, IFRS 17 refers to sharing of risks which applies when insurance contracts in one group include conditions that affect the cash flows to policyholders in a different group). (IFRS 17, paragraphs B67-B71)

Example 3 – Sharing of risk



A has a minimum guarantee of 7%



B has a minimum guarantee of 2%



Same pool of underlying assets

- 43 An insurer has issued participating contracts to two policyholders (A and B) that share in the same pool of underlying items. The terms of the contracts are the same, except that A's minimum return guarantee is 7% and B's is 2%. Assume the actual return from the underlying items is 5%. For A, the 5% of actual return from the underlying items is less than the minimum return guarantee of 7%. The opposite is true for B. Based on the contractual terms for both policyholders, A receives 7% (minimum return guarantee), and B receives the residual return of 3% (5% less 2% additional return paid to A). The insurer therefore does not have to pay the difference between the actual returns and the minimum return guarantee to A. However, the insurer would need to pay where the return is insufficient to pay the minimum return guarantee to both policyholders such as where the return is less than 4.5%. B would be unable to absorb the additional losses and the insurer would need to step in.
- 44 The impact of sharing of risk is only relevant to the estimates of fulfilment cash flows when contracts that are sharing risks are in different groups. In such cases, the cash flows for each group should reflect the expected transfers between groups as illustrated above. In this case, the fulfilment cash flows for the group of contracts that A belongs to will include payments to be received and B's group would exclude payments to be made to another group. This is important for purposes of identifying onerous contracts and correct measurement of CSM.
- 45 The Basis of Conclusions of IFRS 17, paragraph BC 138 makes clear there are no exceptions to the level of aggregation requirements for contracts that share risks. However, paragraph BC138 confirms the general principle in IFRS Standards that specific procedures are not required if applying or not applying the annual cohort requirement has no impact on the measurement of insurance contracts.

Feedback requested

- 46 Please provide your comments on the level of aggregation that should be included in the draft endorsement advice on IFRS 17. Please answer in terms of:
- Relevance (i.e. information that help users to evaluate events; or to confirm or correct their past evaluations; or helping the assessment of the stewardship of management);
 - Reliability (i.e. information free from material error and bias; resulting in faithful representation and is complete within the bounds of materiality and cost);
 - Comparability (i.e. consistent accounting for like items and events through time and by different entities, and the opposite for unlike items and events);
 - Understandability (i.e. financial information should be readily understandable by users with a reasonable knowledge and the willingness to study the information with reasonable diligence);
 - Prudence (i.e. caution in conditions of uncertainty. It may require asymmetry in recognition such that assets or income are not overstated and liabilities or expenses are not understated); and
 - Costs and benefits.

Appendix 1: IFRS 17 requirements with regard to level of aggregation

- 14 *An entity shall identify portfolios of insurance contracts. A portfolio comprises contracts subject to similar risks and managed together. Contracts within a product line would be expected to have similar risks and hence would be expected to be in the same portfolio if they are managed together. Contracts in different product lines (for example single premium fixed annuities compared with regular term life assurance) would not be expected to have similar risks and hence would be expected to be in different portfolios.*
- 15 *Paragraphs 16–24 apply to insurance contracts issued. The requirements for the level of aggregation of reinsurance contracts held are set out in paragraph 61.*
- 16 *An entity shall divide a portfolio of insurance contracts issued into a minimum of:*
- (a) a group of contracts that are onerous at initial recognition, if any;*
 - (b) a group of contracts that at initial recognition have no significant possibility of becoming onerous subsequently, if any; and*
 - (c) a group of the remaining contracts in the portfolio, if any.*
- 17 *If an entity has reasonable and supportable information to conclude that a set of contracts will all be in the same group applying paragraph 16, it may measure the set of contracts to determine if the contracts are onerous (see paragraph 47) and assess the set of contracts to determine if the contracts have no significant possibility of becoming onerous subsequently (see paragraph 19). If the entity does not have reasonable and supportable information to conclude that a set of contracts will all be in the same group, it shall determine the group to which contracts belong by considering individual contracts.*
- 18 *For contracts issued to which an entity applies the premium allocation approach (see paragraphs 53–59), the entity shall assume no contracts in the portfolio are onerous at initial recognition, unless facts and circumstances indicate otherwise. An entity shall assess whether contracts that are not onerous at initial recognition have no significant possibility of becoming onerous subsequently by assessing the likelihood of changes in applicable facts and circumstances.*
- 19 *For contracts issued to which an entity does not apply the premium allocation approach (see paragraphs 53–59), an entity shall assess whether contracts that are not onerous at initial recognition have no significant possibility of becoming onerous:*
- (a) based on the likelihood of changes in assumptions which, if they occurred, would result in the contracts becoming onerous.*
 - (b) using information about estimates provided by the entity's internal reporting. Hence, in assessing whether contracts that are not onerous at initial recognition have no significant possibility of becoming onerous:*
 - (i) an entity shall not disregard information provided by its internal reporting about the effect of changes in assumptions on different contracts on the possibility of their becoming onerous; but*
 - (ii) an entity is not required to gather additional information beyond that provided by the entity's internal reporting about the effect of changes in assumptions on different contracts.*
- 20 *If, applying paragraphs 14–19, contracts within a portfolio would fall into different groups only because law or regulation specifically constrains the entity's practical ability to set a different price or level of benefits for policyholders with different characteristics, the entity may include those contracts in the same group. The entity shall not apply this paragraph by analogy to other items.*

- 21 An entity is permitted to subdivide the groups described in paragraph 16. For example, an entity may choose to divide the portfolios into:
- (a) more groups that are not onerous at initial recognition—if the entity's internal reporting provides information that distinguishes:
 - (i) different levels of profitability; or
 - (ii) different possibilities of contracts becoming onerous after initial recognition; and
 - (b) more than one group of contracts that are onerous at initial recognition—if the entity's internal reporting provides information at a more detailed level about the extent to which the contracts are onerous.
- 22 An entity shall not include contracts issued more than one year apart in the same group. To achieve this the entity shall, if necessary, further divide the groups described in paragraphs 16–21.
- 23 A group of insurance contracts shall comprise a single contract if that is the result of applying paragraphs 14–22.
- 24 An entity shall apply the recognition and measurement requirements of IFRS 17 to the groups of contracts issued determined by applying paragraphs 14–23. An entity shall establish the groups at initial recognition, and shall not reassess the composition of the groups subsequently. To measure a group of contracts, an entity may estimate the fulfilment cash flows at a higher level of aggregation than the group or portfolio, provided the entity is able to include the appropriate fulfilment cash flows in the measurement of the group, applying paragraphs 32(a), 40(a)(i) and 40(b), by allocating such estimates to groups of contracts.
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- 60 The requirements in IFRS 17 are modified for reinsurance contracts held, as set out in paragraphs 61–70.
- 61 An entity shall divide portfolios of reinsurance contracts held applying paragraphs 14–24, except that the references to onerous contracts in those paragraphs shall be replaced with a reference to contracts on which there is a net gain on initial recognition. For some reinsurance contracts held, applying paragraphs 14–24 will result in a group that comprises a single contract.