

## EFRAG SECRETARIAT PAPER FOR PUBLIC MEETING

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### **Insurance contracts phase II –Aggregation and mutualisation**

#### **Objective and Introduction**

- 1 The objective of this session is to provide EFRAG Board with a summary of the concerns raised by the EFRAG IAWG about the levels of aggregation and mutualisation relating to the forthcoming insurance contracts Standard. EFRAG IAWG have raised a number of concerns relating to these two topics which are described below. Note that contracts need to be aggregated:
  - (a) For loss recognition purposes (for onerous contracts); and
  - (b) For the allocation of the contractual service margin to profit or loss.
- 2 The Appendix provides a summary of the 2013 Exposure Draft ('ED') and IASB's tentative decisions relating to level of aggregation and mutualisation.

#### **EFRAG IAWG concerns on the level of aggregation and mutualisation**

##### *Issue 1 – Grouping criteria would lead to very granular units of account*

- 3 EFRAG IAWG have raised concerns that the grouping criteria based on individual contracts (as defined in paragraphs 2 and 3 of the Appendix to this paper) would result in a large number of very granular units of account. This grouping is seen to be very complex from an operational perspective and is viewed as not giving rise to a level of insight that justifies the cost.
- 4 EFRAG Secretariat notes that the IASB's June 2016 tentative decisions, as stated in the Appendix, have removed the reference to the level of aggregation reflecting the individual contract. In addition the tentative decisions have aligned the grouping criteria for the determination of onerous contracts and for the allocation of the contractual service margin to profit or loss. Therefore, EFRAG Secretariat considers that these tentative decisions (paragraph 6 of the Appendix) should lead to a reduction in the originally expected number of units of account.

##### *Issue 2 – Interaction between mutualisation and the level of aggregation*

- 5 It is not clear to some EFRAG IAWG members how mutualisation interacts with the level of aggregation. EFRAG Secretariat understands that mutualisation is where other policyholders form the first layer of risk absorption in some insurance contracts. Therefore, a group of insurance contracts may not be considered to be onerous if another set of policyholders bears those losses. EFRAG Secretariat understands that mutualisation is different from diversification of risk, discretion or cross subsidisation. However, some may consider that these are part of mutualisation.
- 6 EFRAG Secretariat understands that mutualisation is considered inherent in the cash flow guidance, and consequently *subject to* that guidance. As "cash flows are

cash flows” it does not matter where they are originated, so they can be originated within or across portfolios.

- 7 EFRAG Secretariat understands that the level of aggregation is determined based on whether contracts have cash flows that are expected to respond in similar ways to key drivers of risk and whether they have similar expected profitability. These determinations are by necessity made after the cash flows themselves have been determined. As a consequence, (a) the level of aggregation does not affect mutualisation; but (b) mutualisation might affect the level of aggregation.
- 8 This means that, for example:
- (a) a group of insurance contracts is not considered to be onerous if an entity expects cash inflows from other policyholders; and
  - (b) losses are only recognised in profit or loss from onerous contracts when the entity will need to bear the losses because cash flows from other policyholders are expected to be insufficient to bear those losses, i.e. when no other policyholder has the capacity (and obligation) to absorb those losses.
- 9 EFRAG further understands that the IASB has not defined mutualisation, nor will it refer to mutualisation directly or indirectly in the final Standard.

*Issue 3 – Effect of regulation on the level of aggregation*

- 10 The IASB tentatively decided, on 20 January 2016, that when regulation affects insurance contracts, contracts with dissimilar profitability may not be able to be grouped together for determining onerous contracts and for the allocation of the contractual service margin to profit or loss.
- 11 EFRAG IAWG is concerned about this IASB’s tentative decision as they consider that the effect of regulation should be reflected in the level of aggregation. An example of these contracts is a uni-sex health insurance contract which includes both male and female policyholders. As a result of the IASB’s tentative decisions, the entity may need to separately aggregate male and female policyholders as they are subject to different risks. Potentially, one could be loss-making while the other would be profitable.
- 12 EFRAG Secretariat understands that the distinction between the two types of policyholders is considered as cross-subsidisation and **not** mutualisation. Cross-subsidisation occurs where the insurer charges higher prices to one type of policyholder to compensate for the losses of other types of policyholders. There is no link between the policyholders, and no obligation on the part of one set of policyholders to the other set. Based on paragraph 8(a) above, there are no expected future cash inflows from the male policyholders to the female policyholders or vice-versa. Therefore, the male and female policyholders cannot be mutualised. According to the IASB, the difference in profitability between the types of policyholders, even if caused by regulation, is a real economic difference which should be reflected in accounting.

*Issue 4 – Whether reassessment of the level of aggregation is required*

- 13 EFRAG IAWG considers that clarifications are needed on the reassessment of grouping of the insurance contracts after inception. EFRAG Secretariat understands that the group of contracts is not reassessed after inception.

**Questions for EFRAG Board**

- 14 Do EFRAG Board members have any comments on the issues raised by EFRAG IAWG? Are there any other issues that need to be analysed relating to the level of aggregation or mutualisation?

## **Appendix - 2013 ED and subsequent IASB's tentative decisions**

- 1 The 2013 ED stated that the expected cash flows from a portfolio of insurance contracts equals the sum of the expected cash flows **of the individual contracts**. Therefore, the expected value of estimates made at the portfolio level reflects the expected value of the equivalent estimates of those amounts attributed **to the individual contracts**. [emphasis added]
- 2 Subsequent to the 2013 ED, at its meeting on 20 January 2016, the IASB tentatively decided to provide a number of criteria to be met in order to group contracts for loss recognition purposes (for onerous contracts) and for the allocation of the contractual service margin to profit or loss. Note that the level of aggregation in order to allocate the contractual service margin to profit or loss has an additional criteria to be fulfilled compared to the level of aggregation for loss recognition purposes. These criteria are as follows.

### *Criteria for the level of aggregation*

- 3 The IASB has tentatively decided to require a loss for onerous contracts to be recognised only when the contractual service margin is negative for a group of contracts, and that the group should comprise contracts that at inception:
  - (a) have cash flows that the entity expects will respond in similar ways to key drivers of risk in terms of amount and timing; and
  - (b) had similar expected profitability (i.e. similar contractual service margin as a percentage of the premium).
- 4 For the allocation of the contractual service margin to profit or loss, grouping is allowed subject to 3(a) and 3(b) above and that:
  - (a) the entity adjusts the allocation of the contractual service margin for the group in the period to reflect the expected duration and size of the contracts remaining after the end of the period.

### *Mutualisation*

- 5 The IASB did not provide any definition or guidance on mutualisation in the 2013 ED or in its subsequent tentative decisions.

### *June 2016 IASB's tentative decisions*

- 6 The IASB tentatively decided that:
  - (a) the objective for the adjustment and allocation of the contractual service margin should be that the contractual service margin at the end of a reporting period represents the profit for the future services to be provided **for a group of contracts**. [emphasis added]
  - (b) an entity should measure the contractual service margin using the group used for deciding when contracts are onerous. Consequently, an entity should measure the contractual service margin by grouping insurance contracts that at inception have:
    - (i) expected cash flows the entity expects will respond similarly in terms of amount and timing to changes in key assumptions.
    - (ii) similar expected profitability, i.e. the contractual service margin as a percentage of the total expected revenue. An entity can use as a practical expedient the expected return on premiums, i.e. the contractual service margin as a percentage of expected premiums.
  - (c) an entity should reflect the expected duration and size of the contracts remaining in the group at the end of the period when allocating the contractual service margin of the group of contracts to the profit or loss statement.