Level of aggregation
Issues Paper

Objective

1 The objective of this paper is to provide EFRAG TEG with further information as requested on the level of aggregation requirements of IFRS 17 *Insurance contracts*.

Description of the issues

2 At the October 2017 meeting of EFRAG TEG, the EFRAG Secretariat presented a summary of concerns raised by EFRAG IAWG members. EFRAG TEG requested further detail on the concerns with the IFRS 17 requirements on level of aggregation.

3 The concerns raised[1] by members of both EFRAG IAWG and EFRAG TEG were:

(a) The annual cohort requirement does not reflect the nature of insurance business and is costly. (IFRS 17, paragraph 22)

(b) The aggregation requirements will lead to a significant number of groups and it is unclear how it applies to mutualisation. It will increase implementation and operational costs. (IFRS 17, paragraphs 16 and 22)

4 The following interpretation issue[1] was also raised:

Identification of onerous contracts at inception: The level at which onerous contracts at inception should be identified is unclear. (IFRS 17, paragraphs 16 and 17)

5 Furthermore, EFRAG TEG requested further information on an alternative solution, i.e. consideration of maturity dates rather than issue dates for cohorts. These issues (apart from the interpretation issue, which is better suited to submission to the IASB Transition Resource Group) are discussed below.

6 As background, the Appendix to this paper includes relevant extracts from the working draft of the DEA.

Summary of the requirements in IFRS 17

7 The Standard allows fulfilment cash flows (including directly attributable expenses and the risk adjustment) to be estimated on a higher level of aggregation than either group or portfolio. However, the entity must be able to include the appropriate fulfilment cash flows in the measurement of the group by allocating the estimates to groups of contracts. (IFRS 17, paragraph 24)

8 The measurement of the CSM, as well as its allocation to profit and loss, is concluded on a group basis.

9 To establish the groups, IFRS 17 paragraph 14 requires an entity firstly to identify portfolios of contracts subject to similar risks and being managed together.

[1] As per EFRAG TEG paper 10-02, October 2017

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[2] are not expected to have similar risks and hence are expected to be in different portfolios.

10 IFRS 17, paragraph 16, requires an entity to divide portfolios of insurance contracts into a minimum of, where applicable, separate groups of:

(a) contracts that are onerous at inception, if any;

(b) contracts that have significant possibility of becoming onerous, if any; and

(c) contracts that have no significant possibility of becoming onerous subsequently.

11 IFRS 17 permits an exception to the overall grouping requirements, in that, when law or regulation constrains the entity's practical ability to set a different price or level of benefits for contracts or policyholders with different characteristics, insurance entities can include such contracts in the same group.

12 A group of contracts cannot include contracts issued more than one year apart (IFRS 17, paragraph 22).

EFRAG Secretariat analysis

Level of aggregation

13 The EFRAG Secretariat notes that in general, IFRS Standards specify accounting for an individual contract to provide the most transparent information. Some IFRS Standards, as a practical expedient, permit an entity to apply the requirements of those Standards to a portfolio of contracts with similar characteristics. As described above, IFRS 17 similarly allows the recognition and measurement of insurance contracts on a group and, in certain instances, a portfolio basis. Given that insurance entities utilise pooling of risks as part of their business model, this modification to the usual measurement requirements is considered appropriate. Furthermore, the cost-benefit implications to preparers of this exception are significant.

14 The EFRAG Secretariat considers the objectives of the level of aggregation requirements to be:

(a) the identification and recognition of losses on onerous contracts; and

(b) the appropriate allocation of CSM to profit and loss.

Onerous contracts

15 The identification of onerous contracts and the immediate recognition of related losses are fundamental to IFRS Standards from inventory to contracts with customers. The requirements in IFRS 17 aim to achieve timely recognition of losses on initial recognition and afterwards. This information is useful to users – both internally and externally – for making decisions.

16 The EFRAG Secretariat also notes that grouping of contracts means that favourable and unfavourable changes in estimates for individual contracts in a specific group of contracts are offset. Therefore, any change in estimates is recognised on a net basis in adjustments to the CSM of the group or recognised in profit or loss. The composition of the groups is not reassessed post inception, further reducing the operational burden.

[2] IFRS 17 paragraph 14 gives the example that single premium fixed annuities and regular term life assurance would not be in the same portfolio.

Appropriate allocation of CSM to profit and loss

17 The EFRAG Secretariat observes that at the September 2017 meeting of the EFRAG IAWG, members indicated that their main concern around level of aggregation relates to the annual cohort requirement.

18 The EFRAG Secretariat notes that the requirement to limit groups to insurance contracts issued within a year achieves the following objectives:

(a) The CSM is appropriately recognised over the coverage period; and

(b) The CSM will be fully allocated at the end of the coverage period of the group.

The reason for this is that the annual cohort requirement creates a closed group for calculating the CSM allocation. In the absence of this requirement, the averaging of the impacts on the CSM would continue indefinitely as new contracts would continue to be added to the group. Such averaging *over time* of the impacts of CSM could be avoided by tracking individual contracts, however this would reverse the benefit of grouping established by IFRS 17.

Role of grouping

19 The EFRAG Secretariat notes the grouping requirements, as described in paragraph 10 above (besides identifying onerous contracts) separate profitable contracts between two groups. The objective of this is to create groups of contracts with a low standard deviation of profitability for all the contracts in each group. By grouping this way, a foundation is built for permitting averaging of profits *within one and the same* group.

20 When standard deviation of the profit within one group is low (as compared to averaging on portfolio or entity basis), the allocation of CSM to profit or loss on an average basis is expected to be acceptably close to the real profitability of the underlying contracts. Thus the grouping provides a balance between avoiding the cost of tracking individual contracts and the relevance of the resulting profitability measure.

Role of cohorts

21 Profitability of contracts is not static, it evolves over time as it is influenced by market parameters (e.g. new opportunities allowing for large margins, or increased competition in a particular insurance segment reducing margins). Such trend information is very useful for users of financial statements in developing a view on the future prospects of an entity and on how to assess the stewardship of an entity.

22 The use of cohorts closes a portfolio of insurance liabilities after a period of (maximum) one year. By doing so, allocation of consecutive CSM's to profit or loss creates trend information. Thus, it avoids averaging *over tim*e of profits as the profitability of contracts issued in year X+3 may have little relationship with the profitability of similar contracts issued in year X (because of changes in market circumstances). With profitability changing over time, averaging *over time* may increase the standard deviation of the individual profitability of a contract compared to the average profitability of the open group. Consequently, it is the EFRAG Secretariat's view that an open group approach (allowing for averaging of profit *over time*) for the calculation of CSM would endanger the provision of useful trend information of the group which will result in less useful numbers being included in profit or loss.

23 Considering the above, the EFRAG Secretariat considers the annual cohort requirement is necessary:

(a) For identification of onerous contracts on a timely basis as well as the appropriate allocation of CSM to the profit and loss resulting in meaningful profit trends as well as ensuring systematic allocation of CSM over the coverage period;

(b) To maintain the closed portfolio concept in IFRS 17 and prevent continuous averaging of CSM information over time; and

(c) To create consistency in the industry and compared to other industries on these topics.

24 Furthermore, the use of annual cohorts for these purposes do not contradict the pooling of risks or mutualisation. This has been described in further detail in the draft of Appendix 2 of the Draft Endorsement Advice, with relevant parts included in the Appendix to this paper.

Grouping contracts based on maturity date

Description of the approach

25 Some have argued that insurance liability contracts could be grouped based on maturity date instead of inception date. The paragraphs below describe how this approach is applied by one particular insurance entity.

26 <u>Scope</u>: grouping by maturity date is applied to profit-sharing contracts with a combination of early guaranteed return and profit sharing in which 90% of the unrealised changes in the fair value of the portfolio assets held for each portfolio is allocated to the policyholder. Unbundling is used for separating the insurance risk from the savings component of the insurance contracts.

27 <u>Contractual maturity date</u>: all contracts in this category have a stated maturity date.

28 <u>Underlying asset buffers</u>: No collective (underlying asset) buffers are used. The entity relies on dedicated asset buffers that are kept separately for each contract. The guarantee is yearly as well as the profit-sharing, so assets need to be added to the portfolio if the return on the assets is insufficient to pay the guaranteed amount.

29 <u>Number of groups used</u>: The entity does not focus on the number of groups to be created, rather the aim is to reflect asset management by maximising returns given the entity's risk appetite.

30 That focus on the asset-liability management implies that the risk profile in the portfolio is reduced the closer that portfolio value is to the accrued minimum guaranteed amount and the closer to the start of paying out the value of the insurance policy.

31 The asset management is similar to that for "generation funds". These funds have a high-risk profile when there is a long time before they start to pay out, while the risk profile is much lower when it is close to payment. Therefore, there is no need to have an exact maturity profile matching. For example: all contracts with more than 20 years to maturity is held in one portfolio, 20 to 15 years are in another portfolio etc. So, when the liabilities fulfil the criteria to be moved to another portfolio, the liability as well as the corresponding assets values are transferred to the other portfolio.

32 How is profit determined? A distinction is made between the savings component, the insurance risk component and the administrative component.

(a) *Savings component*: the calculation is made for each separate insurance contract, as a result the entity has an exact proportion of each separate portfolio that "belongs" to the savings component of the insurance liability.

(b) *Insurance risk component*: Unbundling is used. The total pure insurance risk is calculated, regardless of maturity and compared with the initial balance of the insurance risk. Premiums received are allocated during the life of the insurance contracts. The net of the insurance premium income and the change in the insurance liability are recognised in profit or loss as risk result.

(c) *Administrative component*: the premiums for administrative services are recognised during the life of the insurance contracts and presented together with the cost of the management of the contracts.

33 Application of mutualisation: No mutualisation is applied for the savings component.

EFRAG Secretariat analysis

34 The EFRAG Secretariat notes that this approach as applied by the entity:

(a) Relates to particular insurance contracts only, not to all types of insurance contracts;

(b) Requires a follow up of the savings component at individual contract level, which may not be applied by the majority of European insurance companies; and

(c) Makes use of dedicated underlying asset funds. While this approach is more common, some European insurance entities rely rather on general asset funds to support (all or part of) their insurance liabilities.

35 In the EFRAG's Secretariat's view the approach to group contracts by maturity date is likely to lead to the creation of more groups compared to IFRS 17. This because, when writing life policies, for contracts written during 2017, groups could range from ending immediately (people dying immediately after subscribing an insurance) until for example 2087 (consider a 20-year old that subscribes a policy and is expected to live until 90 years old).

36 The EFRAG Secretariat understands that the creation of an excessive number of groups is avoided by combining groups into maturity bands spanning several years, even decades. This approach reduces the reliability of the assumptions to be used for calculating the insurance liability. For example, when using a discount rate for the 15-20-year time band, which discount rate is to be used? The one at year 15, year 20, an average of the data points on the discount yield curve spanning from year 15 till 20?

37 In addition, this approach does not clarify how changes in the yield curve across time bands is addressed in the measurement of the insurance liability. For example, a yield curve may go down in years 13 and 14, but move upwards in years 15 and 16 or vice versa.

38 Considering the above, the EFRAG Secretariat is of the view that the approach to group insurance contracts based on maturity dates:

(a) Has a limited scope where supporting assets relate directly to the insurance liabilities;

(b) May require a follow up of insurance contracts on individual basis;

(c) The grouping will not necessarily identify onerous contracts;

(d) If shortcuts are used, requires the continual creation of new groups of existing contracts, with consequent difficulties in allocating any unearned profits to groups on a consistent basis;

(e) If shortcuts are not used, increases the number of groups to be created; and

(f) In using shortcuts for constructing groups, reduces the reliability of the resulting measurement.

Questions for EFRAG TEG

39 Does EFRAG TEG consider:

(a) Information about onerous contracts at inception and subsequently to be useful to stakeholders?

(b) That the method used to allocate CSM should:

(i) Recognise the CSM appropriately over the coverage period; and

(ii) Ensure that the CSM will be fully allocated at the end of the coverage period of a closed group rather than being continually re-averaged through an open group.

(c) Aggregation based on remaining duration of contracts will achieve the objectives set by the IASB in developing the level of aggregation requirements?

Appendix: Relevant extracts from working draft of DEA Appendix 2

Introduction

1 The relevant paragraphs relating to level of aggregation as currently included in the document: Appendix 2 – Towards a DEA is reproduced here for ease of reference.

The details

2 Level of aggregation is currently discussed under Relevance and Prudence in Appendix 2.

Relevance

Level of aggregation

3 IFRS 17 requires an entity to identify portfolios of insurance contracts and then to divide that portfolio, at inception, into groups of insurance contracts. A group of contracts cannot include contracts issued more than one year apart. In assessing these requirements, EFRAG has considered the business characteristics of pooling of similar risks[3], risk diversification and the law of large numbers.

4 *Pooling of similar risks*: 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.

5 *Risk diversification*: 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.

6 EFRAG understands that 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 determine an average 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. 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. Risk diversification can be achieved by offering contracts with uncorrelated risks or in different geographies or by investing in different markets or asset categories.

7 In EFRAG's view, risk diversification reduces the possibility of all risks occurring at the same time while pooling of similar risks (through applying the law of large numbers) helps in estimating the average occurrence and height of the average claim.

[3] EFRAG notes the mechanism of risk pooling is not unique for insurance. For example, it is also applied by airline companies (codesharing) to optimise aircraft utilisation and avoidance of rerouting aircraft, thereby decreasing overall costs. Another example is the sharing of inventory between different retail outlets.

Step 1: Portfolio level

8 IFRS 17 requires an entity to identify portfolios of contracts subject to similar risks and being managed together. 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.

9 In assessing the first step in aggregating insurance contracts, EFRAG:

(a) Understands that insurers issue a large number of insurance contracts knowing that, depending on the portfolio, some contracts will result in claims and others will not. EFRAG also understands that, as a result, entities generally manage contracts at a portfolio level;

(b) Agrees that contracts in different business lines are expected to be subject to different risks as it applies the business practice of pooling of similar risks;

(c) Expects that contracts in different business lines are 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 relevance when managing a portfolio of life insurance contracts; and

(d) Notes that aggregating insurance contracts at portfolio level does not prevent the application of the law of large numbers.

10 EFRAG considers that the first step of identifying portfolios of contracts provides relevant information for users to analyse the risks associated with portfolios as each portfolio contains contracts with similar risks.

Step 2: Group level

11 IFRS 17 requires an entity to divide portfolios of insurance contracts into a minimum of, where applicable, separate groups of (i) contracts that are onerous at inception, if any; (ii) contracts that have significant possibility of becoming onerous, if any; and (iii) contracts that have no significant possibility of becoming onerous subsequently.

12 Some insurers assess the profitability of their insurance contracts at portfolio level, thereby taking into account cross-subsidisation between different contracts through the use of mutualisation[4]. In pricing their contracts, insurers consider that some highly profitable contracts provide support to contracts with low or no profitability. In doing so, the statistical possibility of particular contracts becoming onerous is lowered. Grouping contracts is seen by some as changing these statistical calculation practices and is hence considered not to lead to relevant information.

13 In assessing the second step in aggregating insurance contracts, EFRAG:

(a) Notes that insurance contracts in one group can have different pricing margins;

(b) Notes that IFRS 17 does not require the tracking of individual contracts, although, in certain circumstances, a group of insurance contracts can consist of one single contract;

(c) Notes that grouping of insurance contracts results in a profitability distribution within one portfolio. More precisely, grouping provides information on:

(i) which contracts are onerous (if any);

[4] Note from the EFRAG Secretariat: IFRS 17 does not mention the word 'mutualisation' but refers to 'sharing of risks' instead. However, the term 'sharing of risks' is to be read more narrowly than current mutualisation practices which includes non-contractual cross-subsidisation.

(ii) contracts that may become onerous over time (i.e. contracts with small margins, if any), described as 'remaining contracts' in IFRS 17; and

(iii) contracts that have no significant possibility of becoming onerous subsequently (i.e. contracts that have large margins).

Entities are not required to disclose the profitability distribution (with the exception of onerous contracts), instead, the grouping is used to build a relevant contractual service margin for each group;

(d) Notes that separating groups of insurance contracts is designed (i) to identify onerous contracts at inception and (ii) to produce a contractual service margin which can be allocated to insurance revenue over time without the need to track insurance contracts individually. Consequently, grouping:

(i) Limits cross-subsidisation between different groups of contracts within the same portfolio; and

(ii) Prevents disproportionate amounts of the contractual service margin being released for contracts lapsing within the same group; and

(e) Considers that pooling of similar risks can be applied at group level. In this regard, EFRAG notes that the groups created by large entities may be significantly larger, both in number of contracts and overall size, than an entire smaller insurance entity. EFRAG notes that all entities, large and small, are able to apply this business practice. EFRAG acknowledges however that pooling of similar risks may result in more accurate results the larger the number of contracts it is applied to.

14 Summarising, EFRAG assesses that grouping of insurance contracts results in profitability distribution which is subsequently used to build a relevant contractual service margin. The determination of the appropriate contractual service margin is a balance between the avoidance of the need to track individual contracts and reduction of cross-subsidisation between different levels of profitability of contracts with similar risks. EFRAG further assesses that grouping plays an essential role in the determination of unearned profit and its subsequent allocation to insurance revenue.

15 In addition, it is argued by some that entities should group contracts through the use of coverage units as it would be less burdensome. EFRAG considers that relying on coverage units alone – without grouping - would lead to showing an average result at portfolio level. EFRAG is of the view that the use of averages results in less relevant revenues and expenses because relying on coverage units alone allows for cross-subsidisation influencing the allocation of the contractual service margin to insurance revenue. Hence, it allows for earnings management.

Step 3: One year issuing period

16 IFRS 17 requires a group of contracts to be divided into contracts issued within one year.

17 EFRAG notes that, as the one year issuing period relates to a group of insurance contracts, the assessments provided for the second step (see paragraph 13 above) are equally valid for the third step of aggregation.

18 In addition, EFRAG assesses that the third step in aggregating insurance contracts provides relevant information as it would enable the users of financial statements to assess and evaluate the profitability of contracts over time because:

(a) Once all the contracts in a group are completed, the profit relating to that group would be fully recognised in profit or loss;

(b) The consecutive application of annual groups results in the development of trend information regarding the contractual service margin. The contractual service margin recognised in profit and loss is expected to vary over different annual periods. These changes over time result in a pattern that provides useful information about the increase or decrease in pricing power and cost management of the entity.

(c) Profit (i.e. the contractual service margin) is appropriately recognised in profit or loss in the relevant reporting periods and on a timely basis; and

(d) The remaining contractual service margin relates to the contracts that are still in-force within a group.

19 Overall, EFRAG assesses that the aggregation requirements of IFRS 17 provide relevant information to users of financial statements through the recognition of insurance revenue. In EFRAG's view, the aggregation requirements are compatible with the insurance industry practices of pooling of similar risks.

20 Although some entities are concerned that the one year issuing period is an artificial boundary and would prevent transfers of cash flows between generations of policyholders (i.e. by way of sharing of risks), EFRAG notes that the one year issuing period is fully compatible with transfers of cash flows between generations of policyholders. This is discussed in paragraphs 23 to 26 below.

Impact of regulation

21 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 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 permits an exception to the overall grouping requirements, that in such cases insurance entities are allowed to include such contracts in the same group.

22 EFRAG is of the view that this enhances the relevance of the resulting information as it aligns the accounting treatment with the regulatory requirement.

Sharing of risks

23 Some insurance contracts affect the cash flows to policyholders of other contracts by requiring the policyholder to share with policyholders of other contracts the returns on the same specified pool of underlying items. As a consequence, either of the policyholder groups may bear a reduction in their share of the returns because of payments to the other policyholder groups. Because such a sharing of risks between groups of policyholders is a normal insurance business practice, reflecting this business practice in the measurement of insurance liabilities enhances the relevance of the resulting measurement.

24 In determining the fulfilment cash flows of a group of insurance contracts, payments arising from the terms of existing contract to policyholders of contracts in other groups are considered, regardless of whether those payments are expected to be made to current or future policyholders. This effectively allows a transfer of cash flows between generations of policyholders (even when relying on closed groups of contracts).

25 Some argue that risk sharing as described by IFRS 17 does not reflect the economics of the insurance business and should include situations where cash flows are assigned to groups of insurance contracts based on discretion.

26 EFRAG considers that the risk sharing based on IFRS 17 should follow from the contractual terms of the insurance contracts. This would lead to relevant information as for some insurance contracts amounts based on discretion are not enforceable and their allocation may be subject to changes arising from internal and external factors. Further, the basis for any allocation may not be known to the affected group of policyholders and hence not be made available to users.

27 The aggregation requirements are assessed to be compatible with the industry practices of pooling of similar risks. In addition, grouping provides a meaningful contractual service margin to permit allocation to insurance revenue over the life of the group without the need to track individual contracts. Hence, application of the aggregation criteria is assessed to lead to relevant information for users. This also applies for the measurement of the insurance liability because it will provide current updated information about the effect of insurance contracts on an entity's financial position and risk exposure, as well as transparent information on expected profitability.

***Prudence*[5]**

Level of aggregation

28 IFRS 17 requires an entity to identify onerous contracts at initial recognition. The entity is required to recognise losses on those contracts immediately in profit or loss. Subsequently, the entity is required to regularly update the fulfilment cash flows and for:

(a) groups of onerous contracts: recognise in profit or loss any additional losses; and

(b) other groups of contracts: adjust the contractual service margin. If the contractual service margin for those groups of contracts is reduced to zero, changes relating to additional expected outflows are recognised in profit or loss.

29 EFRAG considers that these requirements will avoid understating liabilities and thus lead to prudent accounting.

[5] The Endorsement advice request does not refer to Prudence, only to stewardship.