Level of aggregation
Issues Paper

Objective

1 The IASB tentatively decided at its March 2019 meeting not to change the requirements around level of aggregation. This topic was included in the letter of EFRAG to the IASB in September 2018 and will be considered in the EFRAG Draft Comment Letter (DCL) on the forthcoming Exposure Draft.

2 EFRAG TEG and the EFRAG Board will consider the technical inputs for the DCL provided by IAWG in their next joint session in June.

3 The discussion will consider:

(a) The IASB's staff analysis and IASB discussion;

(b) The CFO Forum suggested solution and its presentation done in March 2019 to EFRAG TEG;

(c) The ANC technical papers updated in May 2019.

Agenda Papers

4 In addition to this cover note, agenda papers for this session are:

(a) Agenda paper 09-04: the IASB's March 2019 Paper 2A *Level of aggregation – Stakeholder concerns, implementation challenges and staff analysis*[1]*;*

(b) Agenda paper 09-05: the IASB's March 2019 Paper 2B *Level of aggregation – Requirements and Board's rationale;*

(c) Agenda paper 09-06: the IASB's March 2019 Paper 2C *Level of aggregation – History of the Board's decisions and stakeholder feedback;*

(d) Agenda paper 09-07: the ANC's letter to the IASB dated *6* May 2019 commenting the analysis and conclusions of the IASB March 2019 Board meeting;

(e) Agenda paper 09-08: the CFO Forum presentation to EFRAG TEG, March 2019; and

(f) Agenda paper 09-09: the ANC's analysis within its letter to the IASB dated *6* May 2019 in *IFRS 17 issues - Level of aggregation*

(g) Summary of issues and proposal – IASB staff

5 The IASB staff summarised issues in paragraph 8 of agenda paper 09-04 of this meeting as follows: "*Some stakeholders think:*

(a) *the requirements will not provide users of financial statements with useful information;*

(b) *implementing the requirements is a major challenge and the benefits do not outweigh the costs; and*

[1] Please note that certain arithmetic corrections to paragraphs 20-21 were updated on 12 March 2019 without changing the analysis in the paper.

(c) *the requirements are unnecessary because an entity can achieve the same outcome without applying those requirements.*"

6 The IASB staff discusses an example in paragraphs 37 to 45 with the fact pattern included in Appendix A of agenda paper 09-04.

7 The IASB staff proposed no changes to IFRS 17 on these issues with reasons as stated in paragraphs 16 to 52 with the conclusion in paragraph 53.

IASB tentative decision and discussion (March 2019)

8 All the members of the IASB agreed with the IASB staff proposal not to amend the level of aggregation requirements (including the requirement for annual cohorts) in IFRS 17.

9 The discussion included the following points:

(a) Several IASB members acknowledged that level of aggregation is a fundamental issue given the importance of unit of account for accounting purposes;

(b) IASB members acknowledged the cost implications of the requirements but referred to the benefits of which the majority resides in the level of aggregation requirements. Some considered abandoning those requirements would fundamentally change IFRS 17.

(c) IFRS 17 already allows simplification compared to other standards requiring a contract by contract unit of account;

(d) The objectives of the level of aggregation requirements are:

(i) To appropriately depict trends in an entity's profit over time,

(ii) to recognise profits of contracts over the duration of those contracts, and

(iii) timely recognition of losses.

All of this are to be balanced with the operational challenges such an approach poses. Therefore, the current requirements are considered best to accomplish these objectives.

(e) The annual cohort requirement is a compromise from previous principles-based proposals using similar margins and contract duration in order to reduce the operational burden at implementation. Paper 09-06 describes the long process of how the IASB concluded on the current requirements. The staff acknowledged that the grouping requirements represent a loss of information about timely recognition of losses and profit emergence within an annual cohort compared to accounting on a contractual basis.

(f) IASB members observed that the numeric examples were very useful in understanding the issue. The example showed a scenario where policyholders share in the returns of the underlying items in a way that no individual contract would become onerous until all the contracts in the portfolio became onerous. This, however, did not mean that the contracts contribute equally on average to the profit of the insurer.

(g) They also consider that without grouping, the result would be the averaging of profits and recognition of profits beyond the coverage period of the group which would distort the profit reporting from different generations of insurance contracts and obscure inherent risks of the business model. The annual cohort requirement therefore provides useful information for users of the financial statements.

(h) It was noted that the example is intended to illustrate the working of the requirements rather than to prescribe a particular approach. IASB members also commented that IFRS 17 paragraph BC138 allows different approaches to be applied if they arrive at the same outcome. The example is not meant to show a specific approach but rather the expected outcome.

(i) An IASB member commented on the 'artificial' cash flows in the example in the agenda paper, which were created to transfer cash flows from one group to another. The staff explained that these cash flows are not artificial as they are based on the contractual terms of the contract which allows that cash flows for one group of insurance contracts are paid to the policyholders of another group.

EFRAG case study results (see Appendix 2 for details)

10 In EFRAG case study results, in some cases, the annual cohort requirement made a significant difference in the amounts released to CSM compared to not applying cohorts while in other cases, there was not a significant difference. The portfolios significantly impacted by the application of the annual cohort requirement included those that share risks as meant by paragraphs B67 and B68.

11 Descriptions for mutualisation/intergenerational transfers in the case study included: a transfer of wealth between contracts issued at different points in time and unrealised gains being used as an intergenerational transfer to support future generations of policyholders[2]. However, most respondents from the case study did not provide quantifications of this mutualisation/intergenerational transfers as they did not have this information to hand. The few that did, showed very minor impacts.

Illustration of the "mutualisation" business model

12 The following is a high level of illustration of how 'mutualisation' works in the French insurance sector. The EFRAG Secretariat understands that this business model applies similarly and with variations to other jurisdictions in continental Europe.

13 The illustration is based on the following assumptions:

(a) The entity operates 3 business lines:

(i) Health insurance (liability amount measured under local GAAP CU 200),

(ii) Life-saving business (liability amount under local GAAP CU 1000),

(iii) Unit linked (liability amount under local GAAP CU 500);

(b) There is only one pool of assets of CU 1300;

(c) Shareholders' equity is CU 100;

(d) For purposes of the example, assume the assets serving the unit linked liability is segregated and with a value of CU 500 (local GAAP);

(e) The cash flows from the investment activity from the General Fund for the period (dividends, coupons, realised net gains upon disposal) are 100 CU. This is the amount to be allocated between the policyholders and the shareholders;

(f) In the Life-saving business for a total amount of CU 100 CU are contractually entitled to a minimum return of 5% each year and the remainder have a 0% guaranteed minimum return.

14 The following is the simplified balance sheet

[2] The ANC solution proposes that '[r]isks are fully shared among policyholders when policyholders share a significant amount of the financial returns and of the insurance risks across generations so that no set of contracts within the group could possibly become onerous alone.'

ASSETS		LIABILITIES	
Underlying assets	1,300	Equity	100
		Health insurance	200
		Life-saving insurance	1,000
Unit linked fund	500	Unit linked	500
	1,800		1,800

15 According to the French applicable regulation, 85% of the annual returns from the General Fund (CU 100) shall be allocated to policyholders (minimum distribution ratio). For example for the Life-saving business, its share is determined in proportion of the liability (CU 1,000) on the total liability funding the General Fund (CU 1,300).

16 The allocation of the cash flow will be as follows:

(a) 85%*1000/1300*100 = CU 65 will be allocated to the Life-saving insurance policyholders;

(b) From the available CU 65, the first allocation goes to the minimum guaranteed, in this example 5%*100 = CU 5;

(c) Management has discretion over the allocation of the residual CU 60, which can be allocated either to existing or future policyholders that will be entitled to cash flows from the same pool of assets in the General fund, for up to 8 years in the future. The discretion is exercised by the management mainly considering commercial opportunities/risks and future loss-absorption capacity;

(d) The allocation is done at contract level based on the capital (i.e. premiums paid plus amounts allocated in previous years);

(e) Past allocation decisions cannot be revised in future years. If in a given period the realised return is negative, the payment of the minimum guaranteed will be funded by allocating the unallocated liability (as per c above) and, if necessary, eventually by the insurer;

(f) The regulator monitors the minimum distribution ratio, both from a cash flow perspective and from a solvency perspective.

17 From this example we may derive the following:

(a) Newly issued contracts join the population of beneficiaries of the total realised returns from the General fund;

(b) With the exception of the Unit-linked business, the mutualisation is done at entity level over the life of the contracts;

(c) The sharing of the risks among all policyholders (except the unit-linked holders) relate to both the technical and financial risk;

(d) The contracts in the Life-insurance business fully share the risks limited to the available distributable cash flow each year;

(e) Taking into account the running inter-generational mutualisation model, generally there will be no single onerous contract or group of onerous contracts until the life-saving business is onerous.

18 The EFRAG Secretariat understands that the contracts under this business model are mainly under the scope of the VFA but may also apply to contracts under the GM.

CFO Forum presentation to EFRAG TEG in March 2019

19 The CFO Forum suggests that IFRS 17 paragraph 22 should be amended as follows[3]:

An entity shall not include contracts issued more than one year apart in the same group. The annual cohort application is not required when the entity has reasonable and supportable evidence to conclude that contracts issued more than 12 months apart would be classified into the same profitability group as defined in paragraph 16. To achieve this the entity shall, if necessary, further divide the groups described in paragraphs 16-21.

20 In its presentation[4] to EFRAG TEG in March 2019, commenting the remaining concern after the tentative decisions, the industry considers:

(a) the prohibition to aggregate contracts that are issued more than one year apart as unduly complex. It will give rise to very material operational burdens.

- It will require the capture of cash flow and other data at an annual cohort level and subsequent annual updating of output at each reporting period.
- The requirement to make significant changes to existing valuation systems and processes would result in extensive resource requirements and increased costs.
- As the CSM is a retrospective calculation, output will need to be stored, referenced and updated at each subsequent reporting period.
- Projected cash flows will need to be segmented and stored at an annual cohort level to facilitate roll-forward and unlocking of the CSM despite the fact that no information will be presented externally on this basis.

(b) The prohibition to aggregate contracts issued more than one year apart results in groupings that are inconsistent with the way firms manage their business. This is particularly evident for business where mutualisation between different generation of policyholders exist.

(c) In addition, the second profitability bucket (no significant possibility of becoming onerous) is highly subjective and adds to the complexity.

21 The following three illustrative examples are provided to reflect the concerns (pages 69/71 of the presentation):

(a) The first example illustrates where there is risk sharing (similar to that envisaged in paragraphs B67-71) between cohorts of policyholders.

(b) The second example illustrates how a group with a large number of contracts less sensitive to changes in the expected liability for claims. According to the presentation, using a higher level of aggregation, the total CSM can absorb a higher amount of adjustments.

(c) The third example illustrates how for a unit-linked business with protection riders, the insurance service result would be similar using the annual cohort requirement and without. Profitability of the business written over the four-year

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[3] Text in red are additions to the IFRS 17 requirements.

[4] http://efrag.org/Assets/Download?assetUrl=%2Fsites%2Fwebpublishing%2FMeeting%20Documents%2F1902201018475037%2F06-01%20CFOF%20EFRAG%20Presentation.pdf&AspxAutoDetectCookieSupport=1

period varied in line with changes in the mix of business as well as changes in financial and non-financial assumptions.

ASAF Meeting April 2019

22 While commenting on the IASB's tentative decisions, three ASAF members (ANC, ASBJ and OCI) mentioned that stakeholders in their jurisdictions have remaining concerns about the implementation challenges of the level of aggregation requirement.

May 2019 paper from the ANC

23 The ANC analysed the issue in several papers since November 2018 and has updated their considerations in response to the IASB's discussions in two ways:

(a) A detailed paper with other discussion papers in a letter to the IASB and EFRAG (agenda paper 09-09); and

(b) A separate letter to the IASB (agenda paper 09-07, also on 6 May 2019 on level of aggregation. This letter updates its analysis for the discussion and conclusions of the IASB at its board meeting in March 2019, with a summary in paragraphs 1 to 29.

24 The detailed analysis of the ANC is set out as follows:

(a) The level of aggregation requirements in the standard as well as TRG discussions in paragraphs 1-71 (pages 1 to 16);

(b) A description of the issue in respect of the business model, an illustrative example as well as a comparison of IFRS 17's consistency with other standards in paragraphs 72 to 133 (pages 17 to 24);

(c) Suggested solutions in paragraphs 133 to 154 (pages 25 to 28); and

(d) Examples in paragraphs 155-234 and 235-304.

25 In the letter to the IASB commenting the analysis and conclusions of the IASB's Board meeting, the ANC summarises the following conclusion and suggestions:

(a) *Current IFRS 17 provisions (and especially IFRS 17.B67-B71) make it possible to reflect the intergenerational mutualisation, even if removing cohorts would probably better reflect the business practice as well as the contractual and legal situation.*

(b) *Adding annual cohort in that context is however a very burdensome route to follow with no conceptual substance. The additional information provided does not prove to be useful but artificial.*

(c) *In our view, such case has already been addressed by the board, as mentioned in IFRS 17.BC 138. We therefore suggest crystallising that exception in an amendment to annual cohorts in that specific context (see also our draft paper on the Level of Aggregation).*

Arguments that support the IASB tentative decision

Financial reporting objective of IFRS 17 revenue recognition requirements

26 The major benefit that IFRS 17 is expected to bring, in addition to comparability, is to overcome the limits of the current accounting practices applied under IFRS 4. In particular with existing accounting for insurance contracts, investors and analysts find it difficult to identify which groups of insurance contracts are profit making or loss making; and analyse trend information about insurance contracts (see IFRS 17 Project Summary, May 2017).

27 As illustrated in paragraph 14 of Agenda Paper 09-06 (IASB Agenda Paper 2C March 2019), the revenue recognition outcome that the IASB wanted to achieve was that the contractual service margin should be allocated to periods in a way that reflects the service provided by the contracts. The annual cohort requirement has been designed to serve this objective.

28 Those that support the level of aggregation requirements agree that the IASB's objectives are appropriate and required for the recognition of revenue in the context of insurance contracts. They consider that these requirements achieve these objectives, i.e. the provision of trend information, timely recognition of onerous losses and avoidance of continued CSM recognition for derecognised insurance contracts.

(a) The annual cohort requirement is a trade-off between tracking of individual contracts whilst limiting cross-subsidisation between contracts with similar risks with different levels of profitability.

(b) As mentioned above, to provide trend information relating to profitability from one year to the next requires some mechanism to ensure closed groups. Without the annual cohort or some alternative mechanism, groups would remain open indefinitely, resulting in a continuous re-averaging of the CSM and a loss or obscuring of trend information.

(c) The annual cohort requirement is somewhat arbitrary and in and of itself results in the loss of some information compared to if the CSM allocation was done on an individual contract basis but is a trade-off between costs/operational burden and appropriate accounting.

(d) It should also be noted that the financial statements are not presented on a cohort level but are aggregated in order to provide an overall view of the entity's financial performance and position. Further, limiting the size of the group of insurance contracts (which the annual cohort requirement does) limits the extent to which contracts that become onerous subsequent to initial recognition are shielded by profitable contracts.

(e) Some argue that contracts (with similar profitability) but different durations included within a group, the contracts with the shortest duration do not comply with the objective of allocating the contractual service margin to reflect services provided under the contract. However, this ignores the mitigating impact of the coverage unit requirements as well as the derecognition requirements relating to CSM and coverage units, although the impact may not be fully countered.

(f) Disclosures are not a substitute for appropriate recognition and measurement and therefore, provision of trend information in the form of disclosures is insufficient.

29 Eliminating the annual cohort requirement, as proposed by the CFO Forum, does not prevent the re-averaging of CSM over time. The requirements in paragraphs 16, 17 and 19 of IFRS 17 does not relate to profitability but rather the likelihood of the contract to become onerous or not. For example different sets of contracts with differing profitability may still be classified in the same group; such as a group of contracts that are currently highly profitable may be considered to be highly sensitive to specific variables, resulting in it being classified in the remaining group of contracts rather than with those having no significant possibility of becoming onerous later.

30 The IFRS 17 approach is at a significantly higher level of aggregation than in other areas of IFRS (e.g. IFRS 9 and IFRS 15, which are based on individual contracts[5]). Furthermore, the accounting requirements often do not correspond to the way that businesses manage or view their results. For example, retailers may manage profitability on a departmental basis (such as clothing separately from fresh food separately from furniture) but would still need to recognise losses on individual items of inventory when the recoverable amount of these are below cost.

Intergenerational sharing of returns

31 IFRS 17 allows the intergenerational sharing of returns between cohorts to be reflected.

(a) This requires an allocation to the cohort level if the sharing of risks is determined at a higher level and that this may add to complexity although this is tempered by the fact that payments expected to be made to future policyholders do not need to be allocated to specific groups.

(b) The allocation of cash flows as required by B68 avoids the recognition of losses on onerous contracts at inception which many believes is a better reflection of the business model. This then results in the deferral of CSM from an 'earlier'/ 'different' cohort to the coverage period of the cohort receiving the expected cash flows. This is not the same as continual re-averaging.

It is not clear why contractual terms relating to sharing of risk between policyholders should impact or change the revenue recognition principles for the insurer beyond reflecting the contractual arrangements as per paragraph B68.

Observations on the CFO Forum examples:

Example 1

32 The comment is made that the liabilities should be measured at the rate of the assets. One of the fundamental principles in IFRS 17 is that the valuation of the liabilities is done separately from that of the related assets, even for assets using the VFA. This relates to the whole model of IFRS 17 and do not relate to the annual cohort requirement.

33 On annual cohorts, the example states that the fund should be considered in its entirety with no further division of policies as this represents the way the business is run and the only way the balance sheet can correctly reflect the contractual terms. IFRS 17 does not require the groups to be separately reflected on the balance sheet. See below for the analysis on the way the business is run and representing the contractual terms.

Example 2

34 The basis of selection of the two cohorts are not explained, but on the assumption that the preparer followed IFRS 17 paragraph 16, (and due to how the assets and liabilities are moving in different directions in the two cohorts) it seems that the cohort A (of 6 contracts) have a different susceptibility to becoming onerous compared to cohort B. Therefore, the example seems digress from the annual

[5] Paragraph 4 of IFRS 15 states that as a practical expedient, an entity may apply IFRS 15 to a portfolio of contracts with similar characteristics if the entity reasonably expects that the effects on the financial statements of applying this Standard to the portfolio would not differ materially from applying this Standard to the individual contracts within that portfolio.

cohort issue per se but suffice to say that this highlights why the differing levels of aggregation are required in order to recognise onerous losses on a timely basis.

Example 3

35 In this case, the use of annual cohorts did not make a material or significant impact on the result. The EFRAG Secretariat agrees with the CFO Forum and the IASB as per paragraph BC 138, that as long a similar outcome is achieved, the use of annual cohorts would not be necessary. However, as mentioned below, in certain cases, the use of annual cohorts do make a difference.

Arguments that support the elimination of the annual-cohort requirement

36 Today, most insurers use portfolios for the insurance liability where insurance contracts are added or removed continuously for as long as those insurers consider this consistent with the expected profitability, i.e. the way they manage the business. The same applies for the underlying assets. This happens in particular for contracts with inter-generational mutualization.

37 Please refer paragraphs 72 – 06 of agenda paper 09-06 for further details of these arguments.

38 EFRAG has heard the following concerns from preparers:

(a) The splitting of 'mutualised' amounts into groups of contracts is seen as artificial and different to how the business is managed. As the IASB pointed out in its discussion, the allocation of cash flows reflects the terms of the contract and what would happen in certain circumstances. Ignoring these transfers would ignore the economic consequences of the contractual terms and not reflect the reality.

(b) The proposed requirements would significantly change current practice of some insurers. Significant changes to systems and increase costs (both at implementation and subsequently) which will also lead to inconsistencies between accounting requirements and current business practices.

(c) The level of aggregation requirements will not reflect the level at which pricing, monitoring of profitability as well as risk management of insurance contracts is undertaken in most cases as this is generally done at a portfolio level.

(d) Applying IFRS 17 will change the identification of onerous contracts and may also affect the pricing of some contracts.

39 Numerous concerns have been expressed about the impact of the annual cohort requirement on complexity and cost, however, the costs related to this requirement has not been provided to the EFRAG Secretariat either in the case studies or through other outreach (including EFRAG IAWG meetings).

40 One user disagreed with the annual cohort requirement as it is not comparable with Solvency II and losses taken upfront may have a negative impact as it does not reflect the underlying earnings. Solvency II focuses on the ability of firms to continue under stress or unusual circumstances rather than performance reporting. The concept of early recognition of losses under onerous contracts are entrenched in IFRS and is prudent.

Questions for EFRAG TEG

41 Does EFRAG TEG have any comments on the feedback received from EFRAG IAWG?

42 Does EFRAG TEG have any further issues that they would like to raise with the EFRAG IAWG?

43	What do you consider to be the positive or negative impact from the IASB's tentative decision not to amend IFRS 17 on the level of aggregation requirements?

Appendix 1: Extracts from extensive case study on pricing

Introduction

1 In order to understand the calculation of profit on newly issued contracts, the details provided on pricing during the extensive case study may be relevant.

Step 4.1. Pricing

Question 9

Do you price contracts at individual contract level or at a higher level of aggregation?

2 This paper contains an overall description about those contracts priced at individual contract level and those that are priced at a higher level of aggregation.

3 For some contract types mixed approaches are being used; some risks are assessed and priced on individual level (eg. demographic), others are assessed and priced on a higher level of aggregation (eg. financial risks, costs).

4 About half of the selected portfolios were priced at individual contract level, the other half was priced at a higher level of aggregation. Examples of contracts that were priced individually were: annuities, personal motor, life business and reinsurance. Examples of contracts that were priced at a higher level of aggregation were annuities, life and health contracts, unit-linked contracts and credit insurance.

5 One participant did not answer this question.

Explain which components are included in setting a price;

6 The price setting differs between contract type. Examples of components that are included in setting prices are:

(a) Investment return assumptions; target asset mix or spread assumptions;

(b) Expenses, expense inflation, claims, acquisition costs per contract unit;

(c) Commissions;

(d) Capital assumptions and application of the risk margin;

(e) Existence of reinsurance;

(f) Biometric assumptions (e.g. mortality or longevity assumptions);

(g) Individual risk premiums based on underwriting questionnaire;

(h) Competitors’ pricing, specific marketing goals of the own company;

(i) Regulatory technical rates;

(j) Tax; and

(k) Impact on current IFRS results.

7 One respondent did not answer the question.

Specify whether and how expected asset returns are considered when setting a price for the contract; and

8 Examples of contracts where asset returns are considered were annuities, unit-linked contracts, life and health contracts and savings contracts. Examples of contracts where assets returns were (almost) not considered were property and casualty business, life business, unit-linked contracts and credit insurance.

9 One respondent did not answer the question.

In pricing insurance contracts, does the price charged considers automatic periodic renewal options of the contract by the policyholder?

(i) If yes, how many automatic renewals do you consider in setting your price? How do determine this number?

(ii) If yes, how do such automatic renewals affect the price charged?

(iii) Decrease the price that would otherwise be charged for one period by a range of:

- 0%-20%
- 21%-40%
- More than 40%

(iv) Increase the price that would otherwise be charged for one period by a range of:

- 0%-20%
- 21%-40%
- More than 40%

10 Five respondents did not answer the question. Generally, renewals are not considered relevant for the life business (three respondents). One respondent noted that renewals for the life business considered automatic periodic renewals with no fixed upper limit to the number of renewals.

11 In contrast for property and casualty business, one respondent noted that they consider renewals and so profitability is considered over the expected lifetime of the policy plus renewals measured at a portfolio level rather than an individual contract level. Performance of a portfolio is projected, allowing for the expected mix of new business and renewals. Optimisation techniques are used to determine the premiums charged. Another respondent noted that a full repricing is required for every renewal risk. Another respondent noted that renewals were not common. In most cases the price that would otherwise be charged for one period decreases by a range of 0%-20% from the previous period. In cases of contracts with guarantees provided by the reinsurer the price may increase by more than 40%.

Question 10

12 For each of the selected portfolios, please describe how the use of annual cohorts and the grouping requirements of IFRS 17 affect, if at all, your pricing methodologies.

13 For some respondents, pricing is not expected to be impacted by IFRS 17. For example, one respondent stated that a policy by policy approach will be applied in all portfolios, which has greater granularity than annual cohorts. The current pricing methodology will continue under IFRS 17. Another respondent noted that pricing of life business in the US already follows a cohort approach today (one respondent). Other comments included that mutualisation between generations will be taken into account under IFRS 17 (in the fulfilment cash flows) as is already taken into account in the current pricing.

14 One respondent noted that the use of annual cohorts and the grouping requirements under IFRS 17 will give rise to increased maintenance costs and the identification of some business as onerous does not reflect the pricing of the portfolio which is done on expected renewals basis.

15 Some respondents noted that it is too early to have a clear insight on the impact on pricing.

Appendix 2: Summary of information and EFRAG TEG/Secretariat analysis as at August 2018

Introduction

16 The following is the EFRAG TEG/Secretariat analysis on level of aggregation during August 2018. The information includes findings from the extensive case study as well as a summary of the debate by EFRAG TEG on the analysis of the EFRAG Secretariat on the topic.

Findings from the case study

17 Number of respondents addressing one or more aspects of these issues: 9

Level of aggregation

18 Some of the respondents did not find material differences between the pattern of CSM release using annual cohorts and the equivalent pattern using only coverage units for specific portfolios (savings, unit-linked portfolios, fully or significantly mutualised contracts). 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 difference between using coverage units and cohorts. These respondents argued that the annual cohort requirement adds cost and complexity and is unnecessary to provide a faithful representation.

19 However, other respondents demonstrated or acknowledged that the use of annual cohorts does or at least could change the pattern of CSM release. 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. Another respondent noted that, even in a mutualised portfolio, material differences were found between using cohorts or coverage units.

20 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.

21 In all these cases no calculations (only the results of the calculation and/or graphic representations) were provided in the case study results.

22 Two respondents calculated the impact on their portfolios only for one year which did not illustrate the effect on reported trends.

Costs relating to the annual cohort requirement

23 Four respondents quantified the costs specifically associated with applying the subdivision of products into subgroups and annual cohorts:

	Millions euros	% costs over total IFRS 17 costs for respondents that quantified	# of respondents who quantified
One-off costs	19.3	between 4% and 23%	3
Ongoing costs	17.4	10% and 75%	2

24 The respondent with 23% of one-off costs indicated that this was due to the need for a contractual service margin IT module by product (that will require a “pseudo P&L” at product level).

Sharing of risks (also known as mutualisation)

25 Most respondents did not provide information about the quantification of risk sharing/intergenerational transfers or indicated they were not able to quantify that effect. Those that provided information showed very minor impacts in 2016 ranging from 0.2% till 1% of the liabilities in the portfolios measured, even when indicating that 100% of risks were being shared.

26 The following table provides an overview of the amount of the selected liabilities that were subject to risk sharing.

Fully sharing risks	**Partially sharing risks**	**Benefit from intergenerational transfers**
478,462	104,410	669,469

27 Two respondents provided a description for the term “intergenerational transfer”:

(a) One respondent defined intergenerational transfer as the transfer of wealth between contracts issued at different points in time.

(b) Another respondent noted that unrealised gains are used as an intergenerational transfer to support future generations of policyholders.

Separating components within insurance contracts

28 Only one respondent encountered the issue from their selected portfolios in the case study. This respondent noted that certain participating contracts (written in a ring-fenced fund) have attaching insurance riders (written in a separate non-profit fund) that are funded by additional premiums. While there is significant uncertainty in the treatment of such riders under IFRS 17, particularly in light of recent discussion at the TRG, their initial assessment is that because a rider lapses if its host contract lapses the riders are sufficiently closely related to the host contract to prevent them being separated. However, the riders do not form part of the underlying items of the participating contract (shareholders receive 100% of the profits on the riders). It would therefore not be meaningful to include rider cash flows within the fulfilment cash flows of the host participating contract for which profits are shared between policyholders and shareholders on a 90:10 basis. As such, the separation requirements of IFRS 17 result in an outcome that does not reflect the economics of the business.

29 Four other respondents also raised the concern that some contracts issued by them include multiple types of insurance risk. For these respondents, the issue did not arise from their selected portfolios. These respondents were also of the view that an individual contract is not the lowest level of account as it is not in all circumstances consistent with how insurance risk is managed. They considered that the necessary flexibility needs to be achieved in order to also reflect the way insurance risks are managed and reported to the management for financial reporting purposes.

Other feedback regarding the level of aggregation

30 Although current practice does not include the level of aggregation requirements of IFRS 17, it is noteworthy that portfolios under current practice may be more granular than required by IFRS 17. Of the 40 portfolios where information was provided,

(a) 12 portfolios were smaller than required by IFRS 17;

(b) 19 portfolios were of a similar size to that required by IFRS 17;

(c) 9 were larger than the portfolios required by IFRS 17; and

(d) 11 portfolios were not specified.

31 To the extent that grouping is undertaken under current practice, 45 groups were reported, whereas under IFRS 17 this would increase to 343 in aggregate.

(a) Five respondents provided grouping details for one year resulting in 26 groups under current accounting and 56 groups under IFRS 17; and

(b) Four respondents provided grouping details for five years, i.e. over the testing period, resulting in 19 groups under current accounting and 287 groups under IFRS 17.

32 The type of contracts where onerous groups could arise were:

(a) VFA – unit linked;

(b) General model – long-term contracts;

(c) General model – other; and

(d) PAA motor and other.

33 One respondent stated that an onerous contract provision on the personal motor book would need to be recognised on day one representing 17% of profit on that book.

Appendix 3: Extracts from IFRS 17

Level of aggregation of insurance contracts

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.

Contracts with cash flows that affect or are affected by cash flows to policyholders of other contracts

B67 Some insurance contracts affect the cash flows to policyholders of other contracts by requiring:

(a) the policyholder to share with policyholders of other contracts the returns on the same specified pool of underlying items; and

(b) either:

(i) the policyholder to bear a reduction in their share of the returns on the underlying items because of payments to policyholders of other contracts that share in that pool, including payments arising under guarantees made to policyholders of those other contracts; or

(ii) policyholders of other contracts to bear a reduction in their share of returns on the underlying items because of payments to the policyholder, including payments arising from guarantees made to the policyholder.

B68 Sometimes, such contracts will affect the cash flows to policyholders of contracts in other groups. The fulfilment cash flows of each group reflect the extent to which the contracts in the group cause the entity to be affected by expected cash flows, whether to policyholders in that group or to policyholders in another group. Hence the fulfilment cash flows for a group:

(a) include payments arising from the terms of existing contracts to policyholders of contracts in other groups, regardless of whether those payments are expected to be made to current or future policyholders; and

(b) exclude payments to policyholders in the group that, applying (a), have been included in the fulfilment cash flows of another group.

B69 For example, to the extent that payments to policyholders in one group are reduced from a share in the returns on underlying items of CU350 to CU250 because of payments of a guaranteed amount to policyholders in another group, the fulfilment cash flows of the first group would include the payments of CU100 (ie would be CU350) and the fulfilment cash flows of the second group would exclude CU100 of the guaranteed amount.

B70 Different practical approaches can be used to determine the fulfilment cash flows of groups of contracts that affect or are affected by cash flows to policyholders of contracts in other groups. In some cases, an entity might be able to identify the change in the underlying items and resulting change in the cash flows only at a higher level of aggregation than the groups. In such cases, the entity shall allocate the effect of the change in the underlying items to each group on a systematic and rational basis.

B71 After all the coverage has been provided to the contracts in a group, the fulfilment cash flows may still include payments expected to be made to current policyholders in other groups or future policyholders. An entity is not required to continue to allocate such fulfilment cash flows to specific groups but can instead recognise and measure a liability for such fulfilment cash flows arising from all groups.

Basis for Conclusions: IFRS 17, paragraphs BC119 to BC138

BC119: The decisions about grouping in IFRS 17 were driven by considerations about reporting profits and losses in appropriate reporting periods.

BC120: The level of aggregation is also relevant to the recognition of the contractual service margin in profit or loss. … An entity should systematically recognise the remaining contractual service margin in profit or loss over the current and remaining coverage period to reflect the remaining transfer of services to be provided by the insurance contracts.

BC130: Some stakeholders nonetheless expressed the view that separating contracts that have no significant possibility of becoming onerous from other contracts that are not onerous was burdensome and unnecessary. The Board, however, concluded that in the absence of such a requirement, should the likelihood of losses increase, IFRS 17 would fail to require timely recognition of contracts that become onerous.

BC137: The IASB considered whether there were any alternatives to using a one-year issuing period to constrain the duration of groups. However, the IASB considered that any principle-based approach that satisfied the Board's objective would require the reintroduction of a test for similar profitability, which was rejected as being operationally burdensome. The IASB acknowledged that using a one-year issuing period was an operational simplification given for cost-benefit reasons.

BC136: The IASB noted that the decisions of dividing the portfolios in groups that reflect the three possible profitability baskets could lead to perpetual open portfolios. The Board was concerned that this could lead to a loss of information about the development of profitability over time, could result in the contractual service margin persisting beyond the duration of contacts in the group, and consequently could result in profits not being recognised in the correct periods. Consequently, in addition to dividing contracts into the groups, the Board decided to prohibit entities from including contracts issued more than one year apart in the same group. The IASB observed that such grouping was important to ensure that trends in the profitability of a portfolio of contracts were reflected in the financial statements on a timely basis.

BC138: The IASB considered whether prohibiting groups from including contracts issued more than one year apart would create an artificial divide for contracts with cash flows that affect or are affected by cash flows to policyholders of contracts in another group. However, the IASB concluded that applying the requirements of IFRS 17 to determine the fulfilment cash flows for groups of such contracts provides an appropriate depiction of the results of such contracts. The Board acknowledged that, for contracts that fully share risks, the groups together will give the same results as a single combined risk-sharing portfolio … the Board noted that the requirements specify the amounts to be reported, not the methodology to be used to arrive at those amounts. Therefore, it may not be necessary for an entity to restrict groups in this way to achieve the same accounting outcome in some circumstances.