



## **Suggestions for an exception to the annual cohorts' requirement for regulated insurance contracts with intergenerational risk sharing**

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- 1 IFRS 17 Insurance Contracts requires insurers not to include contracts issued more than one year apart in the same group ('annual cohort requirement' in paragraph §22).
- 2 EFRAG's final comment letter of 24th September 2019 to the IASB ED/2019/4 Amendments to IFRS 17 concluded that the annual cohort requirement leads to unnecessary cost in some fact patterns. EFRAG's constituents confirmed that the issue affects insurance contracts in some jurisdictions without the characteristics described in B67 – B71 of IFRS 17 for which cash flow matching techniques are applied across generations that will be measured under the general model<sup>1</sup>, among other contracts.
- 3 The objective of this note is to confirm the existence of this type of insurance contracts in Spain, which represent a significant amount of the in-force portfolio as of 31<sup>st</sup> December 2019 – around 50%–, and to provide a more detailed explanation of their main features and the regulation that applies to them.
- 4 In addition, this note suggests a practical solution to define the scope of an exception to the annual cohorts' requirement that would address the insurance contracts referred in the preceding paragraphs.

This proposed exception adequately captures the characteristics of contracts for which applying the annual cohort requirement would not provide relevant information to users of the financial statements and furthermore, requiring to apply annual cohorts to these contracts will lead financial reporting not reflecting faithfully their economic nature.

### **A. Main contractual features of insurance contracts to which cash flow matching techniques are applied across generations**

- 5 One of the most widespread type of insurance contracts used to promote the long-term savings of population in Spain is in the form of life annuities, both immediate and deferred annuities, although other accumulation contracts are also used such as life endowments with guaranteed interest rates.
- 6 Compared to other countries, Spanish insurers mainly provide a long-term fixed guarantee on interest rate to policyholders that does not change over time even if the market interest rates change.

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<sup>1</sup> These insurance contracts seem not to be eligible to be measured under the Variable Fee Approach (VFA) given that the contract does not specify the financial assets on which the guaranteed interest rate is based. The supporting investments are managed on a pool basis. Changes in the market value of the financial assets may not have a significant impact on the benefits expected to be paid to the policyholders. In particular, only in the case of surrenders before the maturity date the policyholder would receive the fair value of the underlying assets; however, surrenders are infrequent and not significant.





- 7 This guaranteed interest rate credited to the policyholder is set by companies based on the observable market yield of the investment portfolio assigned for the expected duration of the benefits (life expectancy in life annuities) when the contract is underwritten.
- 8 Considering the above pricing methodology, most Spanish insurers earn an expected constant financial margin in these contracts that is the difference between the internal rate of return of financial assets and the guaranteed interest rate credited to the policyholder, while they are exposed to other non-financial risks (basically, deviation from the assumptions used in pricing in relation to longevity risk, to the risk margin or to operating expenses) that would determine the overall margin.
- 9 It has been around 20 years that the Spanish regulation incorporated financial immunization and asset-liability management (ALM) as methodologies for covering interest rate and spread risks for this type of contracts. The experience is borne out by the effective role that they have played in the control of the interest rate provided to the policyholder and the spread credit risk assumed by life insurance undertakings even through different macroeconomic environments (high and low interest rates, different phases in the business cycle...). It is relevant to mention that the losses incurred as a consequence of asset default would be assumed by the insurer. This is the reason that justifies the strong restrictions included in the Spanish regulation regarding which financial investments are eligible for this methodology.

Additionally, only under exceptional circumstances, the policyholder will surrender. If this is the case, the amount of surrender will be closely linked with the market value of the underlying portfolio (i.e. insurance companies do not bear the underlying market risk in case of a surrender benefit payment).

- 10 Under cash flow matching techniques, insurers group contracts issued more than one year apart. The groups are mainly defined considering the aggregation of homogenous insurance and financial risks. The optimization of the asset and liability management mechanism and the underlying cash flows require that the size of these groups of assets and policies are big enough. The objective of these techniques is to ensure that the expected cash flows to be paid to policyholders match the future proceeds arising from the financial assets held by insurers (mainly fixed-debt instruments), in terms of timing, amount and currency. Calculations are prescribed by regulation and require monitoring the matching of the cash flows in monthly buckets until the extinction of the in-force group of contracts. There are also compulsory quarterly reviews to ensure there is not a mismatch. By applying these techniques, there is an intergenerational risk sharing among policyholders, in particular longevity and financial risks, which is also the basis on which the pricing of these contracts is based and how are built the internal actuarial statistical models used to estimate expected cash flows.
- 11 The management of the in-force contracts is consistent with how the contracts are grouped under the cash flow matching. Indeed, the above referred cash flow matching techniques are not only used for managerial and prudential purposes but also with an accounting perspective as financial reporting does not require to group contracts differently.





- 12 Although these contracts are economically matched and have specific backing portfolios of debt instruments supporting the cash flows to be paid to policyholders, they seem not to be eligible to be measured under the variable fee approach (VFA), as the policy contractually does not specify in all cases the financial assets on which the guaranteed profitability is based. This is not a requirement to apply cash flow matching techniques. The supporting investments are managed on a pool basis and companies do rebalance their position to be matched in terms of duration and yield to be paid to the policyholder but only when necessary to address a mismatch which is very infrequent. Furthermore, as mentioned above, when contemplating guaranteed benefits, the variation in the market value of the assets may not have a significant impact on the benefits expected to be paid to the policyholders. In particular, only in the case of surrenders before the maturity date the policyholder would receive the fair value of the underlying assets. This leads to companies assuming basically only default risk and reinvestment risk if there are deviations from expected duration (i.e. longevity risk).
- 13 To sum up, based on the above descriptions the main features of the insurance contracts to which cash flow matching techniques are applied across generations are the following:
- a) long-term life-saving contracts with a guaranteed interest rate which are only eligible to be measured under the general model,
  - b) managed under cash flow matching techniques which are regulated and necessary for insurers if they want to provide a guaranteed interest rate,
  - c) there is intergenerational risk sharing of longevity and financial risk, but
  - d) They do not share the features described in paragraphs B67-B71, as the cash flows to be received by one policyholder are not affected by cash flows of other policyholders or contracts or affect them.
- 14 One last remark is that the contracts featured in paragraph 12 have been granted a particular treatment under the prudential regime of Solvency II, using a matching adjustment when measuring the insurance contracts that permits insurers to adjust the risk-free rate term structure to avoid volatility in the Solvency II own funds. To be eligible for the matching adjustment, insurers must have in place robust and sound cash flow matching techniques, which reinforces the adequacy of these techniques to manage groups of contracts, and at the same time provide evidence that are generally accepted at European level.

## **B. Principles-based scope of a suggested exception to the annual cohort requirement**

- 15 We support a principle-based scope exception for the contracts described in Section 1 to be reflective of their economic characteristics.
- 16 Such exception could be introduced in IFRS 17 under two different approaches, both of them with the objective to capture the same scope of contracts:





### ***B.1 Exception criteria based on the use of cash flow matching techniques***

“An entity does not have to apply paragraph 22 to groups that are managed under cash flow matching techniques<sup>2</sup> that include contracts issued more than one year apart. The cash flow matching techniques applied should be consistent with the objective of having a replicating portfolio as described in B46. In this case, groups of contracts may be established reflecting how the insurance contracts are managed through the cash flow matching techniques.”

### ***B.2 Exception criteria based on the regulated nature of these contracts***

“In some jurisdictions, the accounting rules and the solvency legislation as well, permit insurance companies the use of cash flow matching techniques when providing long-term guaranteed interest rates to its policyholders. For example, such regulation of guaranteed interest rates may be part of a broader policyholder’ interest protection strategy or it may be introduced to ensure entities invest in financial assets that provide enough risk-adjusted yield to secure those guarantees and thus protect the resilience and financial stability of the insurance industry. In some of these cases, insurers need to include contracts issued more than one year apart in the same group to meet the regulation, existing a substantial intergenerational risk sharing of financial and longevity risks. A regulated set of contracts shall be considered a group for the purpose of applying the condition in paragraphs 22 if the group is linked to a replicating or immunizing portfolio of assets in order to avoid the exposure to financial and insurance risks”.

<sup>2</sup> Such as those described in article 77b of the Solvency II Directive.





## Appendix 1: Additional supporting information

- 17 The Spanish insurance business model is based on the active management of the interest rate (reinvestment) and insurance (longevity/survival) risks of a large pool of contracts by matching cash flows from the pool of assets to the expected benefits to policyholders. Rebalancing of assets is only made when there are changes in survival expectations and unexpected market events such a default of an instrument which is very unlikely considering the requirement to invest in high-quality credit bonds. This is a typical insurance activity that pools and shares risks, where actuarial calculations need enough policyholders in order to not suffer deviations in the expected future cash flows. For example, the real cash flows of one individual policyholder will never be equivalent to future cash flows weighted by the insured's probability of death/survival.
- 18 Unlike other models, insurance risk is managed based on expected cash flows and not on a contractual basis. Intrinsic insurance risk follows a specific statistic distribution based on which insurers estimate the future expected cash outflows; considering the statistic distribution a fairly large group of elements. The fact that a policyholder may die before than expected will be offset by other policyholders living longer than expected.
- 19 Since 1999 Spanish regulation requires insurance companies to apply an Asset and Liability Management (ALM) framework to manage financial and insurance risks derived from long-term savings products. This ALM framework includes cash flow matching techniques. Accordingly, companies manage insurance portfolios with policyholders of different ages, allowing them to mitigate exposure to interest rate and longevity risk, while creating an asset portfolio that guarantees payment of cash flows, including guaranteed interest for the insured.
- 20 The regulatory grouping of contracts under the cash flow matching techniques is stable over time. New business issued with non-homogenous features or actuarial assumptions (including different profitability levels) shall be considered a new separate group.
- 21 Insurers issuing long term insurance contracts do not manage their business on an annual cohort basis and measuring them on this basis would lead to excessive granularity, complexity and costs (one-off and increasing on-going costs as the number of cohorts becomes larger over time). In addition, we believe that the use of cohorts in such contracts would not generate useful information in particular when these contracts have been priced consistently with obtaining a stable margin that is sufficient to compensate for any negative deviation in longevity risk.
- 22 The fact that longevity risk is estimated on the basis of internal estimation models that group together a large number of elements covering a population of multi-year contracts, their grouping by cohorts introduces distortions in the profitability of these contracts that do not exist in a broader one-year view. As previously said, the pricing of these contracts is made on estimates of longevity risk which in turn are based on a broad population of elements.
- 23 Having a reduced number of contracts in the cohort together with a different profile composition (for example, significant differences in the individual amount





of the liability for remaining coverage for each policyholder) are factors that generate more variability in the adjustments in the contractual service margin – CSM – and increase the scope for “onerous” cohorts when based on actuarial assumptions supporting the product there would be a compensation across cohorts. Senior cohorts have a reduced number of policies from policyholders with a more similar age over time, resulting in a sample of contracts that are not representative of the expected behaviour of the global insured population, included in actuarial assumptions. Therefore, cohorts would generate this “artificial” variability in performance, not aligned with the economic performance of the product that is expected to provide a stable margin with no significant deviations from the assumptions used in pricing in relation to longevity risk of the global population.

- 24 Consequently, the Profit and Loss statement of insurers which will be obtained by adding the individual results of each cohorts for long-term contracts may not portray the performance of the product, especially when there are senior cohorts. This effect may be significant depending on the adjustments to future cash flows that relate to senior cohorts.
- 25 In our view the annual cohort requirement should not apply to contracts to which cash flow matching techniques are applied since there is an intergenerational risk sharing of interest rate and insurance risks which will not be depicted in the financial reporting if the regulatory groupings are required to be split into annual cohorts.

