

IFRS 17 *Insurance Contracts* and Level of Aggregation

A background briefing paper

This paper provides an overview of the main provisions in IFRS 17 that relate to the level of aggregation. It uses highly simplified examples to illustrate the application of certain aspects of IFRS 17. These examples do not necessarily illustrate the only way that IFRS 17 could be applied to the fact pattern described. It is necessary to read IFRS 17 for a full understanding of the relevant requirements.

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Introduction

- 1 This is the first of three background briefing papers on IFRS 17 *Insurance Contracts*. The aim of these documents is to provide simplified information on controversial areas of IFRS 17 to enable constituents to understand the issues and be in a position to comment on EFRAG's draft endorsement advice. Although this paper is not designed to elicit specific comments, constituents that wish to make specific comments can send such comments to EFRAG through the IFRS 17 mailbox (IFRS17Secretariat@efrag.org) before 30 April 2018.
- 2 This paper considers the level of aggregation requirements in IFRS 17. These requirements are an important aspect of IFRS 17 and have been the subject of extensive debate both during the development of the Standard and since its publication. Other background briefing papers will address:
 - (a) Release of the contractual service margin (CSM); and
 - (b) Transition requirements.
- 3 Whilst IFRS 17 applies to all entities that write insurance contracts, and not only insurance companies, it is expected that the biggest impact of IFRS 17 will be on insurance companies. For this reason, the paper focuses on, and refers to, insurance companies or insurers.

Why is level of aggregation an issue?

- 4 The level of aggregation of insurance contracts determines the unit of account to be used when applying IFRS 17. Among other things, the level of aggregation of insurance contracts affects the allocation of CSM to insurance revenue¹ and the level at which onerous contracts are identified. Accordingly, these requirements affect how the performance of the insurer will be reported in its financial statements.
- 5 Insurers issue a large number of insurance contracts knowing that some contracts will or may result in claims and others will not. In some areas of insurance all contracts will result in claims but their timing is uncertain (e.g. most life insurance). In other areas of insurance claims are expected only from some insurance contracts, but it is not possible to determine in advance which contracts will lead to claims (e.g. property and casualty insurance). The Basis for Conclusions to IFRS 17 notes that insurers often rely on an entity issuing a number of similar contracts to reduce risk (IFRS 17, paragraph BC118). The Standard itself acknowledges this by allowing insurers to use a unit of account for insurance contracts higher than the individual contract level.
- 6 The level of aggregation requirements of insurance contracts in IFRS 17 are nonetheless a significant change to today's financial reporting practices in many cases. EFRAG understands that insurers currently use different units of account for the recognition and measurement of different elements of their financial statements. The unit of account currently ranges from the individual contract level for some elements up to aggregation of contracts at entity level for others, depending also on the objective of the evaluation. Given the optionality provided by IFRS 4 *Insurance Contracts* (the existing standard applying to insurance contracts), these practices vary from one insurer to another insurer and across countries. Hence, the extent of the change brought by IFRS 17 will differ from insurer to insurer due to differences in how the unit of account for measuring and recognising insurance contracts is applied today.
- 7 EFRAG understands that the level of aggregation of insurance contracts required by IFRS 17 also differs from the level used by insurers for certain internal

¹ This important knock-on effect of the level of aggregation is outside the scope of this paper and is discussed separately in the "CSM release background briefing paper".

management purposes, e.g. when assessing risk, making pricing decisions and monitoring/reporting profitability. Some insurers refer to differences between the level at which insurance contracts are managed and the requirements of IFRS 17. EFRAG notes that the term ‘managing’ can cover a wide variety of activities – for example, contract administration, claims handling, risk assessment, pricing and internal performance monitoring and reporting - and that these tasks might be undertaken at different levels of aggregation. Accordingly, this paper does not refer to any single level at which insurance contracts are managed.

Industry practices to be considered when assessing level of aggregation

- 8 As noted above, taking on risk is inherent to the business models of insurers. Insurers use a wide range of sophisticated approaches to manage risks, including sharing risks among policyholders and mitigating the transfer of risks from policyholders to the insurer. These practices are relevant to the discussion on level of aggregation of insurance contracts because they often operate at the level of a population of policyholders that differs from the level of aggregation of insurance contracts in IFRS 17. The following paragraphs describe, at a high level, some of these practices. Other risk management practices, such as risk diversification and hedging, are not described in this paper. It should also be noted that the terminology used in this paper to describe certain practices is not defined in IFRS 17 and similar terminology might be used to describe other practices.

Pooling of similar risks

- 9 Insurance involves a transfer of risk(s) from the policyholder to the insurer. By taking on a large number of contracts that cover similar risks, the insurer is able to set prices based on estimates of the average occurrence of that risk. Losses on contracts that experience negative outcomes will be compensated by profits on contracts with positive outcomes. For example, a claim as a result of a fire destroying a house is paid for out of the premiums collected from a large number of policyholders. The insurer thus spreads its risks among a large group of policyholders who are subject to similar risks. This paper refers to this as pooling of similar risks.

Risk sharing

- 10 Paragraphs 11 to 24 below focus on life insurance business as risk-sharing in this business is particularly significant. The following simplified example illustrates one of the possible patterns of how this might work. Other patterns may exist depending on contractual agreements, regulation or legislation.

Example 1 – Risk sharing and guarantees



A has a minimum guarantee of 7%



B has a minimum guarantee of 2%



Same pool of underlying assets

- 11 *In this example, an insurer has issued participating contracts to two policyholders (A and B) that share in the same pool of underlying assets. The insurer has discretion on how to share the returns of the underlying assets but is bound by the minimum return guarantee in each individual contract. The terms of the contracts are the same, except that A's minimum return guarantee is 7% and B's is 2%. The pay-out of the returns to policyholder A and B are related as explained below.*
- 12 *Assume the actual return from the underlying items is 5%. For A, the 5% of actual return from the underlying items is less than the minimum return guarantee of 7%. The opposite is true for B. Based on the contractual terms for both policyholders, A receives 7% (minimum return guarantee), and B receives the residual return of 3% (5% less 2% additional return paid to A). Thus, the amount that in theory could be paid to B (if they participated equally in the returns i.e. 5%) is reduced in order to satisfy the minimum return promised to A, i.e. there is interdependency between the two pay-outs. So, policyholder B misses out on an opportunity gain.*
- 13 *The insurer does not have to pay the difference between the actual returns and the minimum return guarantee to B. At the insurer's discretion the "surplus" above the minimum return guarantees (i.e. 1%) could be paid either to A or to B or retained by the insurer.*
- 14 *However, the insurer would need to pay from other sources of funds where the return from the underlying assets is insufficient to pay the minimum return guarantee to both policyholders. In this case, if the return is less than 4.5%. B would be unable to absorb the additional losses and the insurer would need to step in.*
- 15 Risks shared could be insurance risk (e.g. death occurring), financial risk (e.g. the investments produce insufficient return to pay out the minimum guaranteed return) or expense risk (e.g. costs related to the insurance contract other than those related to the insurance or financial risk).
- 16 In understanding risk sharing, one needs to differentiate between:
- (a) the contractual cash flows a policyholder is sure to receive as a minimum pay-out from the contract; for example, a minimum guaranteed return (for policyholder B in the example above, this is 2%) or the amount to be paid out when certain risks (e.g. death) occur; and
 - (b) the cash flows a policyholder *can* receive over and above the minimum pay-out of the contract; for example, an additional return on the investments made over and above the guaranteed minimum return.
- 17 In some cases, the amounts and/or timing of payments to a particular population of policyholders is interdependent (as demonstrated by the example above). The nature and extent of this interdependence varies and could be defined contractually, by regulation or by legislation. This is sometimes referred to as 'mutualisation', although this term is not defined in IFRS 17 and this paper instead uses the IFRS 17 term 'risk sharing'. The economic effect of risk sharing is that a population of policyholders effectively act together and stand first in line to absorb losses, or accept reduced returns, when an adverse event occurs. The insurer itself incurs a loss only if the capacity of the population of policyholders is exhausted (i.e. the insurer, and ultimately its shareholders, act as risk-taker of last resort).
- 18 Sharing of risks may not affect all individual policyholders. Life insurance contracts come in different forms and can be "pure insurance" products, savings products or a combination of both. For some contracts the claim payment is a fixed amount, or determined based on a contractual formula, while for other contracts some or all of the claim payment is variable. Risk sharing is relevant in both cases:
- (a) In the case of policies with fixed or determinable claim payments, payments on the individual policies are not affected by the frequency or magnitude of

pay-outs on other policies (i.e. they are independent). However, the timing of the fixed payments can still affect the overall sum available to policyholders for whom some or all of the claim payment is variable; and

- (b) In the case of policies with claim payments that include a variable amount, payments on the individual policies in excess of any contractual minimum can be affected by risk sharing arrangements (i.e. they are interdependent).
- 19 In addition to the contractual risk sharing, the insurer may have some discretion (both in timing and in amount) over the amount of cash flows to pay over and above the contractual minimum to individual policyholders. Any such discretion is exercised within the limits of the contract and applicable law and regulation. Operating within those limits, the insurer may for example be able to hold back some of the returns to policyholders in more profitable years in order to increase the returns in less profitable years. In this way the insurer can share cash flows between insurance contracts during the same reporting period or over different periods, including between different generations of policyholders.
- 20 IFRS 17's requirements on discretionary cash flows are set out in the Appendix. In summary, IFRS 17's accounting model requires the use of estimates of the expected cash flows from the contracts, including cash outflows over which the entity has discretion.

What does IFRS 17 say about risk sharing?

- 21 IFRS 17 refers to sharing of risks to describe situations in which the insurance contracts in one group include conditions that affect the cash flows to policyholders in a different group). (IFRS 17, paragraphs B67-B71²).
- 22 Risk sharing as referred to in IFRS 17 applies when the contracts that share risks are in the same or in different units of account or 'groups' (see paragraph 27). When insurance contracts that share risks are in different units of account or groups, IFRS 17 requires that the cash flow estimates for each group should reflect the expected transfers of cash between groups. In Example 1, the fulfilment cash flows for the group of contracts that policyholder A belongs to will include payments to be received and policyholder B's group would exclude payments to be made to another group. This is important for the purposes of identifying onerous contracts and measurement of CSM.
- 23 The Basis for Conclusions to IFRS 17 notes that for contracts that "fully share risks", division into groups would result in the same outcome as using a single portfolio. However, to avoid complexity, IFRS 17 does not provide an exception to the grouping requirements for contracts that fully share risks. In addition, IFRS 17 does not explain exactly what is meant by "fully share risks".
- 24 IFRS 17's guidance also acknowledges the sharing of cash flows between existing policyholders and future generations of policyholders. Specifically, IFRS 17 explains that, 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. IFRS 17 goes on to state that 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. (IFRS 17, paragraph B71).

Issues raised with the level of aggregation requirements in IFRS 17

- 25 This paper has been developed as EFRAG has been made aware of concerns relating to the level of aggregation requirements of IFRS 17. As noted above, these

² Paragraphs in IFRS 17 that are referred to in this paper are included in the Appendix.

requirements are expected to represent a significant change to today's financial reporting practices in many cases. EFRAG has heard the following concerns:

- (a) Applying the annual cohorts' requirement (see below) would require significant changes to systems and increase costs;
- (b) Currently profitability is monitored internally based on a higher level of aggregation than required by IFRS 17;
- (c) Applying IFRS 17 will affect how onerous contracts are identified compared to current practices, and may also affect the pricing of some contracts;
- (d) The splitting of 'mutualised' amounts into groups of contracts is seen as artificial and different from current practices and how the business is managed. It is also seen as complex and costly to implement; and
- (e) Today, some insurers use portfolios for the insurance liability where insurance contracts are added or removed continuously for as long as those insurers consider this useful. The same applies for the underlying assets. The proposed requirements would change current practice of some insurers.

The level of aggregation requirements explained

- 26 The level of aggregation requirements as set out by the IASB aim to:
- (a) Identify onerous contracts on a timely basis and not to obscure onerous contracts by offsetting onerous contracts in one group with profitable contracts in another group (IFRS 17, paragraph BC119);
 - (b) Avoid perpetually open portfolios, in order to prevent a loss of information about the development of profitability over time (IFRS 17, paragraph BC136);
 - (c) Allocate CSM appropriately to profit or loss on a group basis resulting in meaningful profit trends as well as ensuring systematic allocation of CSM over the coverage period (IFRS 17, paragraph BC136); and
 - (d) Create more consistency in profit recognition both within the industry and between the insurance industry and other industries (IFRS 17, paragraph BC26 and page 80 of IASB's Effects Analysis).
- 27 The level of aggregation requirements of IFRS 17 arrange insurance contracts into groups based on three stages or levels:
- (a) By risk type and way of management (portfolio level);
 - (b) By time of issuance (one year issuing period); and
 - (c) By degree of profitability (group level).
- 28 Each of these stages or levels is explained further below.
- Step 1: Portfolio level*
- 29 IFRS 17 requires an entity to identify portfolios of contracts subject to similar risks and being managed together. This aggregation of insurance contracts is done when contracts are issued and is not subsequently revised.
- 30 Contracts within a product line would be expected to have similar risks (for example single premium fixed annuities) and hence are expected to be in the same portfolio when being managed together. Contracts in different product lines (for example regular term life insurance) are not expected to have similar risks and hence are expected to be in different portfolios.
- 31 Contracts in different business lines are expected to be managed in different ways because the underlying risks are different.

Step 2: One year issuing period

- 32 IFRS 17 requires a portfolio of contracts to be divided into annual ‘cohorts’ or time buckets. As a result, a group may not include contracts issued more than one year apart. A cohort can however be based on an issuing period that is less than one year.
- 33 This requirement can be explained as follows. Insurers issue insurance contracts at a particular pricing level which often remains stable for a certain period. Changes in economic circumstances or other factors may result in an insurer changing its pricing over time. For example, new market opportunities may permit insurers to charge higher margins, but with increased competition in the same field, margins may drop over time. Accordingly, over time the pricing and expected profitability of new contracts is expected to vary.
- 34 As noted above, one of the IASB’s objectives in setting IFRS 17’s requirements on level of aggregation was to avoid a loss of information about the development of profitability over time. One way to achieve this would be to require that profitability is measured at the individual contract level. However, the IASB rejected this approach and decided instead to introduce the annual cohort requirement as a mechanism to ensure that profitability trends are reported in the financial statements on a timely basis (IFRS 17, paragraph BC136).
- 35 The role of cohorts is closely related to the release of the CSM to insurance revenue over time. The use of cohorts is explained below by means of different steps. Only the first two steps are discussed in this paper. The third step is discussed in the EFRAG background briefing paper relating to release of the CSM.

	Description	EFRAG background briefing paper
Step 2A	Determination of one annual cohort	Level of aggregation
Step 2B	Determination of consecutive annual cohorts	Level of aggregation
Step 2C	Trend information resulting from applying consecutive annual cohorts	Release of CSM

Step 2A: Determination of an annual cohort

- 36 The process requires the identification of an annual ‘cohort’ by dividing all insurance contracts in a portfolio into subsets that are issued not more than one year apart. For example: all insurance contracts issued from 22 April 20X0 till 21 April 20X1. The use of a one year cut-off period may seem arbitrary but can be explained as a trade-off between the cost of implementation and the usefulness of information gathered at a higher level of aggregation than the individual contract (IFRS 17, paragraph BC137).
- 37 The CSM of all these insurance contracts is determined in aggregate, not at individual contract level. Consequently, the starting date and the end date of the cohort affect the pattern of CSM release over time. The treatment of onerous contracts is discussed in paragraph 53 below.
- 38 To understand the effect of this requirement, the following needs to be borne in mind:
- (a) As IFRS 17 does not require insurers to track the CSM at individual contract level, the amount of CSM released for any one contract (as coverage is

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provided during a reporting period and/or on derecognition) is based on an average CSM per coverage unit for the cohort;

- (b) Having a closed group of insurance contracts ensures that all of the CSM that relates to a particular cohort is released to profit or loss at the moment the last contract of that particular cohort matures; and
- (c) The aggregate CSM of contracts within the cohort is released over the coverage period as service is provided (ignoring adjustments), taking into account the coverage units provided in each period.

39 The following simplified example aims to explain how the aggregation requirements of IFRS 17 can be applied. Assume the following: in Year 1 an insurer issues an insurance contract with total CSM of €100, with a duration of 5 years. The contract represents 5 coverage units. In accordance with the insurance service provided over the duration of the contract, every year an amount of €20 is released to profit or loss (one coverage unit of service is provided every year). For simplicity, the single contract is considered to be a cohort in accordance with IFRS 17.

Example 2:

Year	Y1	Y2	Y3	Y4	Y5
Profit	20	20	20	20	20

Step 2B: Determination of consecutive annual cohorts

- 40 In this simple example, the CSM is released evenly over the coverage period. The reason for this is that, in accordance with IFRS 17, an insurer stands ready to provide service during the entire duration of the contract, not only at the time when an insured event occurs. In reality, however, the release of CSM of even one cohort will be affected by unexpected events leading to experience adjustments.
- 41 This example is simplistic in that it considers only one cohort comprising a single contract. The effect of the annual cohort requirement becomes clear when applying consecutive cohorts as these will depict a trend of the underlying profitability of contracts.
- 42 To demonstrate this, we assume that the insurer also issues one contract in each of Years 2 – 6, each with a duration of 5 years and 1 coverage unit per year. The CSM for each contract is as follows:
 - (a) Year 2 - €75
 - (b) Year 3 - €60
 - (c) Year 4 - €35
 - (d) Year 5 - €50
 - (e) Year 6 - €85
- 43 For simplicity, each contract is again considered to be a cohort in accordance with IFRS 17.
- 44 The numbers in the tables below represent how the total CSM is spread over the duration of the related contracts.

Example 2 (continued):

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

Step 2C: Trend information

- 45 When all of the above information is combined, a trend emerges that reflects the profitability of insurance services provided over time. Consequently, the objective of the table below is to demonstrate how trend information can be derived from using the grouping requirements in accordance with IFRS 17:

Example 2 (continued³):

Year	Y1	Y2	Y3	Y4	Y5	Y6	Y7	Y8	Y9	Y10
#contracts	6	6	6	6	6	6	6	6	6	6
	20	20	20	20	20	16	16	16	16	16
	25	15	15	15	15	15	15	15	15	15
	24	24	12	12	12	12	12	14	14	14
	23	23	23	7	7	7	7	7	13	13
	22	22	22	22	10	10	10	10	10	12
	21	21	21	21	21	17	17	17	17	17
reported CSM	135	125	113	97	85	77	77	79	85	87
release	22.5	20.8	18.8	16.2	14.2	12.8	12.8	13.2	14.2	14.5
CSM release per contract										

- 46 In the roll-over table above, we distinguish between existing business (in grey), newly added business (no colour) and future business (in grey). In this example, it is assumed that the insurer was able in the past to issue insurance contracts with a higher profitability. For example, the existing contract that ends in Y1 had an annual CSM release of €25. However, when replacing this contract in Y2, the new contract has only an annual CSM release of €15. A similar reasoning is followed to explain future business. The contract that was initially issued in Y1 ends in Y6 and had an annual CSM release of €20. It is replaced in Y6 with a future contract which is estimated to have an annual CSM release of €16.
- 47 The above table shows that the CSM evolves over the years. In Y1 the insurer issues a profitable contract (with an annual CSM release of €20). As explained in the previous paragraph, the insurer still has existing business that was issued at higher profitability margins. In total, a CSM is reported of €135 for Y1.
- 48 Over the following years, the profitability of newly issued contracts decreases, is restored and finally continues to decrease as from Y6.
- 49 The total reported CSM over the years fluctuates, but when calculated per number of contracts (in this example stable at 6) a trend emerges.

³ Each of the amounts relating to the cohorts is calculated considering the coverage units (cu) related to the contracts. For example, €20 in Year 2 is calculated as follows: (100-20)*1 (cu's released in year two)/4 (sum of cu's in current and future periods)

50 For further discussion on the release of the CSM, please refer to EFRAG's forthcoming background briefing paper on "Release of the CSM".

Step 3: Group level

51 IFRS 17 requires an entity to divide portfolios of insurance contracts 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.

Onerous contracts

52 In accordance with IFRS 17, paragraph 47, an insurance contract is onerous at the date of initial recognition if the fulfilment cash flows allocated to the contract, any previously recognised acquisition cash flows and any cash flows arising from the contract at the date of initial recognition in total are a net outflow.

53 The insurer recognises an immediate loss for the net outflow for the group of onerous contracts, resulting in the carrying amount of the liability for the group being equal to the fulfilment cash flows and the CSM of the group being zero.

Profitable contracts

54 The group of contracts that have a significant possibility of becoming onerous subsequent to initial recognition could be described as contracts with a low⁴ profitability at inception or as contracts where the profitability is highly variable. In contrast, the group of contracts that have no significant possibility of becoming onerous subsequently could be described as profitable contracts at inception, or as contracts where profitability is relatively stable.

55 In order to illustrate the effect of IFRS 17's grouping requirement, EFRAG has developed a hypothetical example.

56 Assume that an insurer issues 20 insurance contracts with CSMs ranging from €1 to €20 (for simplicity reasons, each contract represents one coverage unit). Thus, the insurer issues one contract with a profit of €1 and a further 19 contracts with the CSM increasing linearly from €2 to €20.

57 These contracts could be grouped together as follows for IFRS 17's purposes:

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

58 As noted above, insurers deal with certain aspects of insurance contracts at a higher level of aggregation than the individual contract. If all contracts were to be aggregated together, the average CSM per coverage unit (using the figures in the above paragraph) would be €10.5. By separating the low profitability contracts from the high profitability contracts the averages (using the figures in the above paragraph) respectively would be €5.5 and €15.5.

⁴ In this paper, the terms 'low' and 'high' profitability are used for illustrative purposes.

Example 3:

Total average	Average group 1	Average group 2
€10.5 ⁵	€5.5 ⁶	€15.5 ⁷

- 59 Why work with averages? If a contract is derecognised earlier than expected, the related part of the CSM needs to be released through an adjustment of the fulfilment cash flows. To do this accurately would require tracking of the CSM at the individual contract level. As noted by IFRS 17, paragraph BC118 the IASB Board decided that such an approach would not provide useful information about insurance activities, which often rely on an entity issuing a number of similar contracts to reduce risk. The Board concluded, therefore, that the contractual service margin should be measured at group level. IFRS 17 permits the CSM to be adjusted for the change in the fulfilment cash flows using an average at the moment of derecognition of a contract. In addition, the average will affect how CSM is released as coverage is provided over time.
- 60 Why work with different groups? Identification of onerous contracts aside, when the average profitability of insurance contracts is measured at portfolio level, the average CSM will be different from the CSM for most of the individual contracts. For example, assume in example 3 that the contract with an initial CSM of €2 is derecognised. When the average is derived from all the contracts in the portfolio, an average CSM of €10.5 would be released. In contrast, by relying on groups of contracts, an average amount of €5.5 would be released. This amount does not exactly equal the CSM for the individual contract but is closer to it than the average amount calculated at portfolio level.
- 61 According to the example illustrated above grouping contracts into three profitability levels has the effect that the reported performance of an insurer more closely corresponds to profitability of the individual contracts that provided coverage in the period.
- 62 In addition, the grouping requirements increase the likelihood that losses will be identified and recognised for contracts that become onerous after initial recognition. The insurance contracts in the group with low profitability are more likely to become onerous subsequently than the insurance contracts in group with higher profitability. When all insurance contracts are aggregated at portfolio level, the insurance contracts with low profitability would be combined with the insurance contracts that have a high(-er) profitability. Accordingly, under a portfolio approach, the losses on onerous contracts would be 'shielded' to a greater extent by profitable insurance contracts.

Reinsurance contracts

- 63 A detailed discussion of IFRS 17's requirements on reinsurance contracts held is outside the scope of this paper. The main point of relevance to this discussion is that the same requirements on level of aggregation (grouping) apply with some changes. The main change of relevance to this paper is that the net gain or net cost on purchasing reinsurance is measured as a CSM and spread over the coverage period as services are received. Accordingly, there is no possibility of recognising a 'day1' profit or loss for reinsurance contracts held, unless the net cost of purchasing

⁵ Calculated as 1+2+3+4+....+19+20 divided by 20

⁶ Calculated as 1+2+3+4+....+9+10 divided by 10

⁷ Calculated as 11+12+13+14+.....+19+20 divided by 10

reinsurance coverage relates to events that occurred before the purchase of the group of reinsurance contracts, in which case the cost is accounted for as expense in profit or loss (IFRS 17, paragraph 65 (b)).

Impact of regulation

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

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

Extracts from IFRS 17

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

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characteristics, the entity may include those contracts in the same group. The entity shall not apply this paragraph by analogy to other items.

- 21 *An entity is permitted to subdivide the groups described in paragraph 16. For example, an entity may choose to divide the portfolios into:*
- (a) more groups that are not onerous at initial recognition—if the entity’s internal reporting provides information that distinguishes:*
 - (i) different levels of profitability; or*
 - (ii) different possibilities of contracts becoming onerous after initial recognition; and*
 - (b) more than one group of contracts that are onerous at initial recognition—if the entity’s internal reporting provides information at a more detailed level about the extent to which the contracts are onerous.*
- 22 *An entity shall not include contracts issued more than one year apart in the same group. To achieve this the entity shall, if necessary, further divide the groups described in paragraphs 16–21.*
- 23 *A group of insurance contracts shall comprise a single contract if that is the result of applying paragraphs 14–22.*
- 24 *An entity shall apply the recognition and measurement requirements of IFRS 17 to the groups of contracts issued determined by applying paragraphs 14–23. An entity shall establish the groups at initial recognition, and shall not reassess the composition of the groups subsequently. To measure a group of contracts, an entity may estimate the fulfilment cash flows at a higher level of aggregation than the group or portfolio, provided the entity is able to include the appropriate fulfilment cash flows in the measurement of the group, applying paragraphs 32(a), 40(a)(i) and 40(b), by allocating such estimates to groups of contracts.*
- 47 *An insurance contract is onerous at the date of initial recognition if the fulfilment cash flows allocated to the contract, any previously recognized acquisition cash flows and any cash flows arising from the contract at the date of initial recognition in total are a net outflow. Applying paragraph 16(a), an entity shall group such contracts separately from contracts that are not onerous. To the extent that paragraph 17 applies, an entity may identify the group of onerous contracts by measuring a set of contracts rather than individual contracts. An entity shall recognise a loss in profit or loss for the net outflow for the group of onerous contracts, resulting in the carrying amount of the liability for the group being equal to the fulfilment cash flows and the contractual service margin of the group being zero.*
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- 60 *The requirements in IFRS 17 are modified for reinsurance contracts held, as set out in paragraphs 61–70.*
- 61 *An entity shall divide portfolios of reinsurance contracts held applying paragraphs 14–24, except that the references to onerous contracts in those paragraphs shall be replaced with a reference to contracts on which there is a net gain on initial recognition. For some reinsurance contracts held, applying paragraphs 14–24 will result in a group that comprises a single contract.*
- 65 *The requirements of paragraph 38 that relate to determining the contractual service margin on initial recognition are modified to reflect the fact that for a group of reinsurance contracts held there is no unearned profit but instead a net cost or net gain on purchasing the reinsurance. Hence, on initial recognition:*

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- (a) *the entity shall recognise any net cost or net gain on purchasing the group of reinsurance contracts held as a contractual service margin measured at an amount equal to the sum of the fulfilment cash flows, the amount derecognised at that date of any asset or liability previously recognised for cash flows related to the group of reinsurance contracts held, and any cash flows arising at that date; unless*
- (b) *the net cost of purchasing reinsurance coverage relates to events that occurred before the purchase of the group of reinsurance contracts, in which case, notwithstanding the requirements of paragraph B5, the entity shall recognise such a cost immediately in profit or loss as an expense.*

101 *For insurance contracts other than those to which the premium allocation approach described in paragraphs 53–59 or 69–70 has been applied, an entity shall also disclose reconciliations from the opening to the closing balances separately for each of:*

- (a) *the estimates of the present value of the future cash flows;*
- (b) *the risk adjustment for non-financial risk; and*
- (c) *the contractual service margin.*

104 *An entity shall separately disclose in the reconciliations required in paragraph 101 each of the following amounts related to insurance services, if applicable:*

- (a) *changes that relate to future service, applying paragraphs B96–B118, showing separately:*
 - (i) *changes in estimates that adjust the contractual service margin;*
 - (ii) *changes in estimates that do not adjust the contractual service margin, ie losses on groups of onerous contracts and reversals of such losses; and*
 - (iii) *the effects of contracts initially recognised in the period.*
- (b) *changes that relate to current service, ie:*
 - (i) *the amount of the contractual service margin recognised in profit or loss to reflect the transfer of services;*
 - (ii) *the change in the risk adjustment for non-financial risk that does not relate to future service or past service; and*
 - (iii) *experience adjustments (see paragraphs B96(a), B97(c) and B113(a)).*
- (c) *changes that relate to past service, ie changes in fulfilment cash flows relating to incurred claims (see paragraphs B97(b) and B113(a)).*

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.

Extracts from the Basis for Conclusions to IFRS 17

Cash flows over which the entity has discretion (paragraph B65 of IFRS 17)

BC26 Overall, the measurement required by IFRS 17 results in:

- (a) *the measurement of the liability for remaining coverage and the resulting profit and revenue recognition being broadly consistent with IFRS 15, except that:*
 - (i) *for insurance contracts without direct participation features—the measurement is updated for changes in financial assumptions; and*
 - (ii) *for insurance contracts with direct participation features—the measurement is updated for changes in the fair value of the items in which the entity and the policyholder participate; and*
- (b) *the component relating to incurred claims being measured broadly consistently with IAS 37.*

BC118 For the contractual service margin, the Board considered whether contracts should be measured individually despite the resulting lack of offsetting. Doing so would be consistent with the general requirements in IFRS 9 and IFRS 15 and would reflect the fact that the entity's rights and obligations arise from individual contracts with policyholders. Measuring contracts individually would also provide a clear measurement objective. However, the Board decided that such an approach would not provide useful information about insurance activities, which often rely on an entity issuing a number of similar contracts to reduce risk. The Board concluded, therefore, that the contractual service margin should be measured at a group level.

BC119 Once the Board had decided that the contractual service margin should be measured for a group, the Board considered what that group level should be. The Board considered whether it could draw on requirements for groups set by insurance regulators. However, as noted in paragraph BC15, regulatory requirements focus on solvency not on reporting financial performance. The decisions about grouping in IFRS 17 were driven by considerations about reporting profits and losses in appropriate reporting periods. For example, in some cases the entity issues two groups of insurance contracts expecting that, on average, the contracts in one group will be more profitable than the contracts in the other group. In such cases, the Board decided, in principle, there should be no offsetting between the two groups of insurance contracts because that offsetting could result in a loss of useful information. In particular, the Board noted that the less profitable group of contracts would have a lesser ability to withstand unfavourable changes in estimates and might become onerous before the more profitable group would do so. The Board regards information about onerous contracts as useful information about an entity's decisions on pricing contracts and about future cash flows, and wanted this information to be reported on a timely basis. The Board did not want this information to be obscured by offsetting onerous contracts in one group with profitable contracts in another.

BC136 The Board noted that the decisions outlined in paragraph BC127 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 contracts 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 specified in paragraph BC127, the Board decided to prohibit entities from including contracts issued more than one year apart in the same group. The Board 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.

BC137 The Board considered whether there were any alternatives to using a one-year issuing period to constrain the duration of groups. However, the Board considered that any principle-based approach that satisfied the Board's objective would require the reintroduction of a test for similar profitability, which as set out in paragraph BC126, was rejected as being operationally burdensome. The Board acknowledged that using a one-year issuing period was an operational simplification given for cost-benefit reasons.

BC138 The Board 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. Some stakeholders asserted that such a division would distort the reported result of those contracts and would be operationally burdensome. However, the Board 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 (see paragraphs BC171–BC174). 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, and therefore considered whether IFRS 17 should give an exception to the requirement to restrict groups to include only contracts issued within one year. However, the Board concluded that setting the boundary for such an exception would add complexity to IFRS 17 and create the risk that the boundary would not be robust or appropriate in all circumstances. Hence, IFRS 17 does not include such an exception. Nonetheless, 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.

BC167 Some insurance contracts give policyholders the right to share in the returns on specified underlying items. In some cases, the contract gives the entity discretion over the resulting payments to the policyholders, either in their timing or in their amount. Such discretion is usually subject to some constraint, including constraints in law or regulation and market competition.

BC168 IFRS 17 requires the measurement of a group of insurance contracts to include an unbiased estimate of the expected cash outflows from the contracts. The expected cash outflows include outflows over which the entity has discretion. The Board decided to require this because:

- (a) it can be difficult to determine whether an entity is making payments because it believes that it is obliged to do so, rather than for some other reason that does not justify the recognition of a stand-alone liability. Those reasons could be to maintain the entity's competitive position or because the entity believes it is under some moral pressure. Thus, it could be difficult to make a reasonable estimate of the level of distribution that would ultimately be enforceable in the unlikely event that an entity asserts that its discretion to pay or withhold amounts to policyholders is unfettered.*
- (b) even if it were possible to make a reasonable estimate of non-discretionary cash flows, users of financial statements would not benefit from knowing how much might be enforceable in the highly unlikely event that an entity tried to avoid paying amounts to policyholders of insurance contracts when the entity and its policyholders currently expect that such benefits will be paid. That amount does not provide relevant information about the amount, timing and uncertainty of future cash flows. On the other hand, users of financial statements would want to know:
 - (i) how much of the cash flows will be unavailable to investors because the entity expects to pay them to policyholders. The requirements in IFRS 17 convey that information by including those cash flows in the measurement of the liability.*
 - (ii) how much of the risk in the contracts is borne by the policyholders through the participation mechanism and how much by the shareholders. This information is conveyed by the required disclosures about risk.**

BC169 The Board considered whether payments that are subject to the entity's discretion meet the definition of a liability in the Conceptual Framework for Financial Reporting (the Conceptual Framework). The contract, when considered as a whole, clearly meets the Conceptual Framework's definition of a liability. Some components, if viewed in isolation, may not meet the definition of a liability. However, in the Board's view, including such components in the measurement of insurance contracts would generate more useful information for users of financial statements.

BC170 The Board considered whether to provide specific guidance on amounts that have accumulated over many decades in participating funds and whose 'ownership' may not be attributable definitively between shareholders and policyholders. It concluded that it would not. In principle, IFRS 17 requires an entity to estimate the cash flows in each scenario. If that requires difficult judgements or involves unusual levels of uncertainty, an entity would consider those matters in deciding what disclosures it must provide to satisfy the disclosure objective in IFRS 17.