IFRS

STAFF PAPER

March 2019

IASB® meeting

Project	**Amendments to IFRS 17 *Insurance Contracts***
Paper topic	Level of aggregation—Stakeholder concerns, implementation challenges and staff analysis

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This agenda paper is reposted for arithmetic corrections to the examples included in paragraphs 20-21. Those corrections do not change the accounting analysis provided in this paper.

Purpose

1. This paper is part of a set of papers on the level of aggregation requirements in IFRS 17 *Insurance Contracts*. It sets out stakeholder concerns, implementation challenges and staff analysis.

2. The other papers in the set provide background information. Those other papers are:

   (a) AP2B *Level of aggregation—IFRS 17 requirements and Board's rationale*; and

   (b) AP2C *Level of aggregation—History of the Board's decisions and stakeholder feedback*.

Staff recommendation

3. The staff recommend the International Accounting Standards Board (Board) retain the IFRS 17 requirements on the level of aggregation unchanged.

Structure of the paper

4. This paper provides:

    (a) an overview of the concerns and implementation challenges expressed since IFRS 17 was issued (paragraphs 7−14 of this paper); and

    (b) the staff analysis, recommendation and a question for Board members (paragraphs 15−53 of this paper).

5. Appendix A to this paper provides an example of the effect of annual cohorts on groups of contracts with cash flows that affect or are affected by cash flows to policyholders of other groups of contracts.

6. Appendix B to this paper sets out an extract from the summary of the September 2018 meeting of the Transition Resource Group for IFRS 17 (TRG).

Concerns and implementation challenges expressed since IFRS 17 was issued

7. As set out in more detail in Agenda Paper 2B, IFRS 17 requires an entity to recognise and measure groups of insurance contracts. Groups are determined by:

    (a) identifying portfolios of insurance contracts. A portfolio comprises contracts subject to similar risks and managed together.

    (b) dividing a portfolio into a minimum of three groups (referred to in this set of papers as 'profitability buckets'):

        (i) a group of contracts that are onerous at initial recognition, if any;

        (ii) a group of contracts that at initial recognition have no significant possibility of becoming onerous subsequently, if any; and

        (iii) a group of remaining contracts in the portfolio.

    (c) dividing the profitability buckets into groups of contracts not issued more than one year apart (annual cohorts).

8. Consistent with the feedback the Board heard during the development of IFRS 17, some stakeholders have expressed concerns with the level of aggregation requirements in IFRS 17 (mainly relating to the annual cohort requirement). 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

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

9. In relation to paragraph 8(a) of this paper, some stakeholders have expressed the view that the level of aggregation requirements artificially segregate portfolios and will not properly depict business performance. They expressed the view that segregating portfolios into groups will not accurately reflect pooling of risks, which is fundamental to the insurance business model. Some stakeholders said that when risks are pooled, the only useful information about profitability is that which reflects the overall experience of the pool. Particularly, some stakeholders have expressed these concerns for applying the annual cohort requirement to insurance contracts with risk sharing between different generations of policyholders.

10. In relation to paragraph 8(b) of this paper, some stakeholders have expressed the view that the level of aggregation requirements are too prescriptive and too granular, particularly the annual cohort requirement. Those stakeholders explained that they manage their business at a higher level of aggregation, for example—at a portfolio level. Therefore, applying the level of aggregation requirements in IFRS 17 will require significant changes to existing systems which will be a major challenge and cost for many entities. Furthermore, some stakeholders expressed the view that the level they currently manage their business at provides both management and users of financial statements with the most useful information about profitability and risk management. As such, they see little benefit to the IFRS 17 requirements to justify the high cost.

11. On the profitability buckets requirement, some stakeholders think it is subjective and complex to identify and track separately a group of contracts that at initial recognition have no significant possibility of becoming onerous subsequently from other profitable contracts. Some stakeholders see little benefit to this requirement to justify the cost.

12. In relation to paragraph 8(c) of this paper, some stakeholders have said that they think that, in some circumstances, they can achieve the same outcome with and without the annual cohort requirement—for example, using coverage units. Some stakeholders have said this is the case because, for some types of insurance contracts, a group of insurance contracts is only ever onerous applying IFRS 17 if the whole portfolio is onerous.

13. Some stakeholders have suggested amendments to IFRS 17 that they think would address their concerns. Those amendments are:

    (a) reduce the number of profitability buckets by removing the profitability bucket ‘a group of insurance contracts that at initial recognition have no significant possibility of becoming onerous subsequently’. This would leave just two profitability buckets: a group of contracts that is onerous at initial recognition and a group of contracts that is profitable at initial recognition.

    (b) replace the requirements for the level of aggregation with approaches that reflect more closely the entity’s internal management.

    (c) remove the requirement for annual cohorts for variable fee contracts or variable fee contracts that ‘fully share risks’ between policyholders.

14. Some other stakeholders have expressed the view that the level of aggregation requirements are at an acceptable level for measuring insurance contracts. Those stakeholders have suggested a higher level of aggregation only for presentation purposes, which the Board tentatively decided to propose at its December 2018 meeting.

Staff analysis and recommendation

15. The staff analysis of the stakeholder concerns set out in paragraph 8 of this paper is structured as follows:
    (a) do the requirements in IFRS 17 provide useful information?
        (i) a high-level overview of the information provided by the requirements in IFRS 17.
        (ii) an analysis of the effect of stakeholders' suggested amendments on the information provided.
    (b) do the benefits outweigh the costs of implementing the requirements?
    (c) are the requirements necessary?

Do the requirements in IFRS 17 provide useful information?

16. An entity's rights and obligations are created by individual contracts with policyholders. Further, IFRS Standards generally require accounting for individual contracts. However, as explained in paragraphs 16–18 of Agenda Paper 2B, measuring the contractual service margin (CSM) of individual contracts would result in recognition of losses even when claims in a profitable group of contracts are developing exactly as expected. The Board concluded that such an approach would not provide useful information about insurance activities. Hence, in acknowledgment of the nature of insurance activities, as an exception to the general approach in IFRS Standards, IFRS 17 does not require measurement of individual contracts.

17. On the other hand, measuring insurance contracts at too high a level of aggregation could obscure three types of information the Board regards as fundamentally important:
    (a) trends in the entity's profits from insurance contracts over time (see example in paragraphs 18–19 of this paper);

(b) timely recognition of profit on profitable contracts so that all profit has been recognised by the end of the coverage period (see example in paragraphs 18–19 of this paper); and

(c) timely recognition of losses on onerous contracts (see example in paragraphs 20–21 of this paper).

18. The table below sets out a very simple example to illustrate the potential loss of information described in paragraphs 17(a) and 17(b) of this paper. Suppose:

(a) in Year 1, an entity writes 100 4-year contracts with profit of 120m; and

(b) in Year 2, the entity writes 100 4-year contracts with profit of 36m.

Profit recognised in p/l	**Y1**	**Y2**	**Y3**	**Y4**	**Y5**	**Total**
Group 1	30	30	30	30	0	120
Group 2		9	9	9	9	36
Total of separate groups 1 and 2	**30**	**39**	**39**	**39**	**9**	**156**
Combined group	**30**	**36**[1]	**36**	**36**	**18**	**156**

19. Without separate groups:

(a) the unearned profit of Group 1 contracts would be averaged with the lower profitability of Group 2 contracts and recognised over years 2–5. This means that Year 2 does not show the true effect of the new contracts (increase of profit to only 36, not 39).

(b) in **Year 5** a profit of 18m would be recognised, but contracts in force (Group 2 contracts) only have a profit of 9m. The other 9m is profit from Group 1 which no longer provides any coverage. The significant change in profit for in-force contracts is masked (in this case resulting in a difference of 100%).

[1] CSM at end of year 2 = 90 from group 1 plus 36 from group 2 = 126. Coverage units based on number of contracts = 200+200+200+100 = 700. CSM allocated to year 2 = 200 x 126/700 = 36.

20. The table below sets out a very simple example to illustrate the potential loss of information described in paragraph 17(b) of this paper. Suppose:

(a) in Year 1, an entity writes 100 4-year contracts with profit of 120m (expected profit of 30m for each year);

(b) in Year 2, the entity writes 100 4-year contracts with profit of 36m (expected profit of 9m for each year); and

(c) in Year 3, ~~due to~~ there are adverse changes in expectations of future cash flows of 47m, resulting in the group of contracts written in Year 2 ~~is now~~ becoming onerous (loss of 20m).

Profit recognised in p/l	**Y1**	**Y2**	**Y3**	**Y4**	**Y5**	**Total**
Group 1	30	30	30	30	-	120
Group 2		9	(20)	0	0	(11)
Total of separate groups 1 and 2	**30**	**39**	**30** **(20)**[2]	**30**	**0**	**109**
Combined group	**30**	**36**	**17.2**[3] ~~4~~	**17.2** ~~4~~	**8.6** ~~2~~	**109** ~~76~~

21. Without separate groups:

(a) in **Year 3** the entity would report a profit of 17.2m ~~4m~~ —it would not recognise the loss of 20m in profit or loss for contracts that are no longer profitable (Group 2 contracts) because the loss is combined with the profit in Group 1.

[2] The amounts shown as profits will be included in insurance revenue. The amount shown as a loss will be presented in insurance service expenses.

[3] CSM at beginning of Year 3 = 156 – 66 = 90. Change in expectations in year 3 about future service result in an adjustment of 47 ~~80~~, giving CSM at the end of Year 3 of 43 ~~10~~. Service provided in year compared to service in future years based on number of contracts is 200:300, so CSM of 17.2 ~~4~~ allocated to Year 3.

(b) the loss of 20m of contracts written in Group 2 would be averaged with the remaining profit of contracts written in Group 1 and recognised over years 3–5. The profit of <u>8.6</u> ~~2~~ in Year 5 arises from contracts in Group 1 which no longer provide coverage.

22. Agenda Papers 2B and 2C explain how the Board developed the requirements in IFRS 17 on the level of aggregation, balancing:

(a) the need for groups of insurance contracts to give useful information about insurance activities as described in paragraph 16 of this paper; and

(b) the loss of information about losses, profits and trends in an entity's profitability described in paragraph 17 of this paper.

23. In summary, the Board acknowledges that some aggregation of insurance contracts is necessary to avoid the recognition of losses when claims in a profitable group of contracts develop as expected. However, the Board does not agree with stakeholders that assert, for example, '*Within a pool of like risks, the only useful information about profitability reflects the overall experience of the pool—it matters not which contracts within the pool incurred a claim and which did not.'* The Board regards timely recognition of losses on onerous groups of contracts, profits on profitable contracts over the coverage period and information about trends in the entity's profits from insurance contracts as fundamentally important benefits of the application of IFRS 17. The Board thinks timely recognition of changes in profitability results in more transparent information than averaging profits and losses, or averaging different profits over time. Such transparency contributes to improving investor understanding of insurance activity and long-term financial stability by revealing useful information that will enable actions to be taken in a timely way. Feedback from investors since the issuance of IFRS 17 supports this view.

24. The Board acknowledges that the requirements in IFRS 17 involve some practical compromises. Within the groups created applying the requirements in IFRS 17, there will be some loss of information of the type described in paragraph 17 of this paper. As explained in Agenda Papers 2B and 2C, the Board tried to develop a principle-based approach to identifying groups that would eliminate that loss of information.

However, such an approach was rejected because of feedback from stakeholders that it would be unduly burdensome. The requirements in IFRS 17 strike a balance the Board found acceptable between the loss of useful information and the operational burden for entities.

25. In paragraphs 26–45 of this paper, the staff consider the effects on the information provided of the following suggestions provided by stakeholders:

    (a) removing the second profitability bucket;

    (b) replacing the requirements for the level of aggregation with approaches that reflect more closely the entity's internal management; and

    (c) removing the requirement for annual cohorts for contracts that 'fully share risks' between policyholders.

Removing the second profitability bucket

26. As noted in paragraphs 11 and 13(a) of this paper, some stakeholders have suggested removing the requirement in IFRS 17 to distinguish between profitable contracts—those that at initial recognition have no significant possibility of becoming onerous subsequently and other profitable contracts.

27. The staff think this distinction is important in ensuring that losses on onerous groups of contracts are recognised on a timely basis. The staff think that it will be relatively rare for an entity to issue onerous contracts (without a specific strategy). Onerous groups of contracts are more likely to arise from subsequent changes in expectations about groups of contracts that were initially expected to be profitable. Having only one bucket for all contracts that are profitable on initial recognition would increase the possibility of a subsequent adverse change in expectations that would make some contracts onerous being absorbed by the remaining profitability on other contracts. A loss would only be created by subsequent changes in expectations that made all profitable contracts in an annual cohort onerous. It could significantly delay the timing of loss recognition for onerous contracts (and/or result in losses for onerous contracts never being recognised) relative to the requirements in IFRS 17.

28. Hence, the staff think that there would be an unacceptable loss of useful information in removing the requirement to distinguish two buckets for profitable contracts—those that at initial recognition have no significant possibility of becoming onerous subsequently and other profitable contracts.

Replacing the requirements for the level of aggregation with approaches that reflect more closely the entity's internal management

29. As noted in paragraph 13(b) of this paper, some stakeholders have suggested replacing some or all of the IFRS 17 requirements on the level of aggregation with approaches that reflect more closely the entity's internal management. They think such approaches would result in a more principle-based set of requirements.

30. The first such suggestion is to remove the requirement for annual cohorts if an entity has reasonable and supportable evidence to conclude that contracts issued more than one year apart would be classified into the same profitability bucket described in paragraph 7(b) of this paper. The stakeholders suggesting this approach stated that it would avoid an excessive level of granularity, major implementation challenges as well as undue costs.

31. The staff observe that this suggestion would avoid the offset of losses on initial recognition on onerous contracts with gains on initial recognition of profitable contracts, because onerous contracts will join the group of onerous contracts, contracts that have no significant possibility of becoming onerous subsequently will join that bucket and the remaining contracts will join the remaining bucket.

32. However, the staff observe that the suggestion is likely to result in groups being only the three profitability buckets, with no time-based cohorts, because new contracts in the portfolio will always fall into one of the three profitability buckets. As a result, the three buckets for a portfolio could last for the entire life of the portfolio, each with a contractual service margin that averages the profitability of all the contracts in the bucket. Further, the contracts joining any of the three profitability buckets could have significantly different profitability from the other contracts in that bucket. This means the effect of the averaging of the profits across the contracts in the bucket could be substantial, leading to:

(a) a greater possibility that the contractual service margin of contracts will outlast the coverage period of those contracts (see example in paragraphs 18–19 of this paper); and

(b) a greater possibility of subsequent adverse changes in expectations that makes some contracts onerous being absorbed by continuing profitability of other contracts (see example in paragraphs 20–21 of this paper).

33. The staff accept the requirements in IFRS 17 involve some practical compromises, as discussed in paragraph 24 of this paper. For example, some averaging of profitability of contracts could occur within an annual cohort, resulting in the effects described in paragraphs 32(a) and 32(b) of this paper to some extent. However, the existence of annual cohorts substantially limits those effects, to an extent the Board thought acceptable when developing IFRS 17. The staff think without annual cohorts these effects would result in an unacceptable loss of useful information.

34. Other suggestions from stakeholders involve replacing all the level of aggregation requirements, not just the annual cohort requirement, with approaches that reflect more closely the entity's internal management. The suggestions were less specific: to determine the level of aggregation using an entity's asset and liability management strategy or internal business and risk management. However, the staff observe that the Board's objective for the level of aggregation requirements (summarised in paragraph 23 of this paper) is focused on providing useful information on a timely basis to users of financial statements about *periodic financial performance*. The staff do not think that focusing on asset and liability management or risk management will necessarily meet that objective. As explained in Agenda Papers 2B and 2C, the Board identified principle-based approaches that would meet its objective, but was persuaded by stakeholders that they were unduly burdensome.

35. Accordingly, the staff think those approaches suggested by stakeholders that reflect more closely the entity's internal management would lead to an unacceptable loss of useful information compared to the IFRS 17 requirements.

Removing the requirement for annual cohorts for contracts that 'fully share risks' between policyholders

36. Paragraph BC138 of the Basis for Conclusions on IFRS 17 refers to contracts that fully share risks in the context of contracts with cash flows that affect or are affected by cash flows to policyholders of other contracts. This section of this paper considers:

    (a) an example based on one provided by a stakeholder; and

    (b) what 'fully share risks' means.

37. Appendix A to this paper sets out an example of variable fee contracts that affect or are affected by the cash flows of other contracts. In the example, two groups of contracts are issued more than one year apart. The policyholders in the two groups of contracts share the returns on the same specified pool of underlying items, and terms of the contracts create intergenerational sharing of the returns on the underlying items. The fair value return on the underlying items declines in the period between the issue of the groups of contracts and the first group is remeasured to reflect this (column B compared to column A in table in paragraph 38 of this paper). Because of the intergenerational sharing of returns, the policyholders in the second group receive a better return than they would if the first group of contracts had not been issued, and the policyholders in the first group of contracts receive a lower return than they would if the second group of contracts had not been issued.

38. Paragraphs B67–B71 of IFRS 17 result in the fulfilment cash flows of the two groups reflecting the intergenerational sharing of returns, because in this example such sharing is part of the contractual terms. If the fulfilment cash flows did not reflect this effect, the first group of contracts would show an increased profit because of the lower returns received by the policyholders in that group and the second group of contracts would be regarded as onerous (column C in the table below).

Fact pattern and detailed calculations are given in Appendix A to this paper	**A**	**B**	**C**		**D**		**E**
	Initial recognition of Group 1	Remeasurement of Group 1 before recognition of Group 2	Immediately after group 2 contracts issued, without applying paragraphs B67–B71 of IFRS 17		Immediately after Group 2 contracts issued, applying paragraphs B67–B71 of IFRS 17		Immediately after Group 2 contracts, if groups 1 and 2 were combined
	Group 1	Group 1	Group 1	Group 2	Group 1	Group 2	
FCF	9,567	11,734	10,828	15,761	11,734	14,855	26,589
CSM	433	531	1,437	(761)[4]	531	145	676
Insurance contracts	**10,000**	**12,265**	**12,265**	**15,000**	**12,265**	**15,000**	**27,265**
Underlying items	**10,000**	**12,265**	**12,265**	**15,000**	**12,265**	**15,000**	**27,265**

39. The allocation of the cash flows to the groups required by paragraphs B67–B71 of IFRS 17 prevents a group of contracts being onerous when the loss is borne by policyholders of other groups of contracts (column D in the table in paragraph 38 of this paper). But it does not average the profits of the two groups of contracts. Each group has its own separately determined contractual service margin which reflects the profit the entity makes from each group, after taking into account the extent to which the group supports or is supported by contracts in other groups.

40. Some stakeholders think that determining the contractual service margin separately for each annual cohort does not provide useful information. They argue that because the returns on the underlying items are shared across policyholders in different annual cohorts, the profit should be regarded as arising from the combined groups that share those returns (column E in the table in paragraph 38 of this paper).

41. In contrast, the staff think that keeping the profit of the annual cohorts separate is necessary to avoid deferring the recognition of profit beyond the coverage period of a group and obscuring trends in profitability for an entity from its insurance contracts

[4] This amount would be recognised as a loss in profit or loss. Shown here as a negative CSM to ease comparison of the amounts across the columns.

over time (see paragraphs 17(a) and 17(b) of this paper). In the example in Appendix A to this paper, using annual cohorts, the contractual service margin from the first group of contracts is considerably higher than from the second group of contracts. This appropriately depicts the entity's share of the higher fair value returns generated by the first group of contracts. The entity allocates the *policyholders' share of fair value gain* on the underlying items that arises in Year 1 between the policyholders in the two groups. But that does not mean that the *entity's share of the fair value gain* is not created by the contracts in Group 1.

42. That higher profit is recognised over the five years of the first group of contracts. If the contractual service margin of the two groups were combined, the average profit of the combined group would be recognised over the six years that contracts in either group exist. Although the amount of the contractual service margin would reflect the different levels of service provided by the different number of contracts in each period, the contractual service margin per unit would be an average of the profit of the two groups. Hence, as illustrated in the following table:[5]

(a) the increase in the contractual service margin in Year 2 does not show the full effect of the new contracts issued in the period; and

(b) some of the higher profit in Group 1 would be included in the amount recognised for service in Year 6, after the contracts in Group 1 have ceased to provide service.

CSM recognised in P/L	**Y1**	**Y2**	**Y3**	**Y4**	**Y5**	**Y6**
Group 1	106	108	109	112	117	-
Group 2	-	29	30	30	31	33
Total of annual cohorts	**106**	**137**	**139**	**142**	**148**	**33**
If treated as combined group	**106**	**125**	**127**	**130**	**134**	**85**

[5] The allocation of the contractual service margin is based on coverage units that reflect the number of contracts in force, assuming 1,000 contracts in Group 1 and 1,500 in Group 2.

43. Hence, in this example, the staff think that removing the requirement for annual cohorts would lead to an unacceptable loss of useful information.

44. The stakeholders that suggested removal of the requirement for the annual cohorts when contracts fully share risk also discussed how 'fully share risks' should be defined. They referred to an example discussed at the September 2018 meeting of the TRG, in which the cash flows of the insurance contracts are 100% shared between policyholders, ie the entity bears no losses and receives no profit. Those stakeholders argue that the definition of 'fully share risk' should be broader than that example, and should include contracts like those in the example in Appendix A to this paper, and other contracts, where an individual contract can become onerous only when the whole portfolio of contracts becomes onerous. In the example in Appendix A to this paper, because of the sharing of the policyholders' share of the underlying items, no individual contract will become onerous until all the contracts in the portfolio become onerous.

45. The staff agree that such a definition of 'fully share risks' would identify contracts for which there could be no offsetting of a loss on an onerous contract with a gain on a profitable contract. Hence grouping such contracts together would result in no loss of information of the type described in paragraph 17(b) of this paper. However, as discussed in paragraph 41 of this paper, the fact that the policyholders' share of underlying items is shared across all policyholders does not mean that the *entity* receives an equal (average) profit from all contracts. As illustrated in paragraphs 41–43 of this paper, averaging of the different profitability of contracts issued at different times would result in deferral of recognition of some of the profit of a group beyond its coverage period and a loss of information about trends in the entity's profitability over time, information that the Board regards as fundamentally important and a key benefit of the application of IFRS 17.

Do the benefits outweigh the costs of implementing the requirements?

46. Paragraphs 16–24 of this paper explain why the level of aggregation is fundamental to providing useful information about onerous and profitable contracts on a timely basis and about trends in an entity's profitability over time.

47. Paragraphs 25–26 of Agenda Paper 2B explain how the Board considered a principle-based approach to the level of aggregation requirements when developing IFRS 17. Paragraphs 27–32 of Agenda Paper 2B go on to explain that such an approach could have been regarded as unduly operationally burdensome and hence how the Board developed the requirements in IFRS 17 to reduce that burden.

48. The Board concluded that the requirements in IFRS 17 struck an appropriate balance between costs for preparers and useful information for users of financial statements. The staff think that conclusion continues to be valid.

Are the requirements in IFRS 17 necessary?

49. As noted in paragraph 12 of this paper, some stakeholders think that, in some circumstances, they can achieve the same outcome with and without the annual cohort requirement. The staff accept this may be the case and paragraph BC138 of the Basis for Conclusions on IFRS 17 acknowledges this. At its September 2018 meeting, the TRG discussed examples when this might be the case. The summary of the TRG discussion is set out in Appendix B to this paper.

50. The Board considered whether to include an exception from the annual cohort requirement in IFRS 17 for cases where the requirement would not affect the outcome. However, as explained in paragraph 33 of Agenda Paper 2B, 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. In particular, the staff note that annual cohorts can result in a different outcome from not identifying annual cohorts when a group of insurance contracts is only ever onerous if the whole portfolio is onerous, for the reasons set out in paragraphs 44–45 of this paper.

Transition to IFRS 17

51. The staff note that the stakeholder concerns in paragraphs 7−14 of this paper are relevant both on transition to IFRS 17 and after. As explained in Agenda Paper 2B, the Board has already provided modifications and reliefs to simplify the requirements for profitability buckets and annual cohorts on transition. The staff think that those simplifications provide sufficient relief for entities and therefore do not recommend an amendment that is specific to transition.

52. The staff note that some stakeholders have expressed concerns that transition will be particularly difficult for insurance contracts issued many years ago because of lack of information. The staff expect for many of those contracts an entity will apply the fair value approach, which provides an optional relief from applying the annual cohort requirement.

Staff conclusion and question for Board members

53. The staff observe that providing information about timely recognition of losses on onerous contracts, profits on profitable contracts and trends in an entity's profitability from contracts over time is a key benefit of IFRS 17. The requirements on the level of aggregation in IFRS 17 are essential to providing that information. The staff accept that implementing IFRS 17 involves significant costs but observe that the IFRS 17 requirements on the level of aggregation already include simplifications to reduce their operational burden. The staff think all of the suggested changes to the requirements from stakeholders would result in an unacceptable loss of useful information, particularly in relation to information about trends in an entity's profitability over time. Therefore, the staff recommend the Board retain the IFRS 17 requirements on the level of aggregation unchanged.

Question for Board members
Do you agree the Board should retain the IFRS 17 requirements on the level of aggregation unchanged?

Appendix A—Example

A1. This example considers two groups of variable fee contracts. The groups are issued more than a year apart. They share the returns on a specified pool of underlying items and the entity has discretion over the timing of amounts credited to policyholders, enabling intergenerational sharing of the returns on the underlying items.

A2. Facts for Group 1, issued t0:

(a) premiums 10,000, duration of contract 5 years;

(b) policyholders receive 80% of fair value returns, with the entity having discretion over the timing and allocation across policyholders;

(c) expected returns on underlying items 5%, equal to market rate at the date the contracts are issued; and

(d) entity invests premiums in 5% fixed rate bonds.

A3. Facts for Group 2, issued t1:

(a) premiums 15,000, duration of contract 5 years;

(b) policyholders receive 80% of fair value returns, with the entity having discretion over the timing and allocation across policyholders;

(c) expected returns on underlying items 1%, equal to market rate at the date the contracts issued; and

(d) entity invests premiums in 1% fixed rate bonds.

A4. Measurement of Group 1:

	Initial recognition	**Remeasured at t1, to reflect fall in interest rates, before Group 2 issued**
FCF	9,567[6]	11,734[7]
CSM	433	531
Insurance contracts	**10,000**	**12,265**
Value of underlying items	**10,000**	**12,265[8]**

A5. When the entity issues the contracts in Group 2, it decides to reduce the amounts it expected to pay to the policyholders in Group 1 (based on the 5% return on the bonds acquired at t0) so that it can pay an equal return to the policyholders in both groups. The rate that gives all the policyholders an equal rate of return from t1 onwards is 2%.

[6] Return on underlying items = $(10,000 \times 1.05^5) - 10,000 = 2,763$. Policyholders' share = $2,763 \times 80\% = 2,210$. Future cash flows to policyholders = $10,000 + 2,210 = 12,210$. FCF = $12,210/1.05^5 = 9,567$

[7] FCF = $12,210/1.01^4 = 11,734$

[8] $12,265 = (10,000 \times 1.05^5)/1.01^4$

A6. If the groups of contracts were measured by including in each group the cash flows expected to be paid to the policyholders of the contracts in the group, the measurement of the groups at t1 would be as follows:

	Group 1	Group 2
FCF	10,828[9]	15,761[10]
CSM	1,437[11]	(761)[12]
Insurance contracts	**12,265**	**15,000**
Value of underlying items	**12,265**	**15,000**

A7. In the table above, the FCF of Group 1 has reduced and the CSM has increased compared to the measurement before Group 2 was issued, reflecting the fact that the amounts expected to be paid to Group 1 policyholders have been reduced from a rate of approximately 4% to 2%. Group 2 is shown as an onerous group, reflecting the fact that the amounts expected to be paid to the policyholders in Group 2 are based on a rate (2%) that exceeds the market rate (1%). However, this is not what IFRS 17 requires.

A8. IFRS 17 requires the measurement of Group 1 to include all the cash flows that arise because of the terms of the contracts in Group 1, regardless of to whom the payments are expected to be made. In this example, the terms of the contracts in Group 1 require the entity to pay 80% of the fair value returns on the underlying items to

[9] Expected future cash flows to policyholders based on 2% return for years 2–5 = 11, 267. (NB The calculation of the rate of 2% and hence this amount involved using goal seek in an excel spreadsheet, so cannot be replicated here). FCF = 11,267/1.01^4 = 10,828

[10] Expected future cash flows to policyholders based on 2% return for years 2–6 = 16,565. (NB The calculation of the rate of 2% and hence this amount involved using goal seek in an excel spreadsheet, so cannot be replicated here). FCF = 16,565/1.01^4 = 15,761

[11] For simplicity, in this table this amount ignores any recognition of the contractual service margin in profit or loss in the period before the issue of the contracts in Group 2.

[12] This amount would be recognised as a loss in profit or loss. Shown here as a negative CSM to ease comparison of the amounts across the columns.

policyholders. The entity uses its discretion to pay some of the fair value returns on the underlying items to policyholders in Group 2, but those amounts (the excess of the 2% rate paid to Group 2 over the market rate of 1%) are included in the measurement of Group 1 because the contracts in Group 1 create the obligation to pay those additional amounts. This leads to the following measurement of the two groups at t1:

	Group 1	**Group 2**
FCF	11, 734[13]	14,854[14]
CSM	531	146
Total	**12,265**	**15,000**
Value of underlying items	**12,265**	**15,000**

A9. The contractual service margin of Group 1 will be recognised in profit or loss as service is provided over years 1–5. The contractual service margin in Group 2 will be recognised in profit or loss as service is provided over years 2–6. The following tables show the allocation of the contractual service margin based on:

(a) coverage units that reflect the number of contracts in force, assuming 1,000 contracts in Group 1 and 1,500 in Group 2; and

(b) remeasurement of the contractual service margin reflecting changes in the fair value of the entity's share of the underlying items.[15]

[13] See table in paragraph A4 of this paper.

[14] 15,761 (see table in paragraph A6) less the cash flows included in the measurement of group 1, ie 11,734-10,828 = 906. 15,761 – 906 = 14,855.

[15] The tables may include rounding differences of numbers.

A10. Group 1 as a separate group:

CSM	Y1	Y2	Y3	Y4	Y5
Opening balance	433	425	323	219	112
Remeasurement	98	5	5	5	5
P/L	**(106)**	**(108)**	**(109)**	**(112)**	**(117)**
Closing balance	425	323	219	112	0

A11. Group 2 as a separate group:

CSM	Y2	Y3	Y4	Y5	Y6
Opening balance	146	118	89	61	31
Remeasurement	1	1	1	2	2
P/L	**(29)**	**(30)**	**(30)**	**(31)**	**(33)**
Closing balance	118	89	61	31	0

A12. One combined group for all contracts:

CSM	Y1	Y2	Y3	Y4	Y5	Y6
Opening balance	433	425	452	331	208	81
New contracts		146				
Remeasurement	98	7	7	7	7	4
P/L	**(106)**	**(125)**[16]	**(127)**	**(130)**	**(134)**	**(85)**
Closing balance	425	452	331	208	81	0

[16] Number of contracts in force in Year 2 = 1,000+1,500 = 2,500. Number of contracts expected to be in force in years 2–6 = 2,500+2,500+2,500+2,500+1,500 = 11,500. Proportion of service provided in Year 2 = 2,500/11,500. CSM recognised in Year 2 = (425+146+7) x 2,500/11,500 = 125.

A13. Comparison of amounts recognised in profit or loss:

CSM recognised in P/L	**Y1**	**Y2**	**Y3**	**Y4**	**Y5**	**Y6**
Group 1	106	108	109	112	117	-
Group 2	-	29	30	30	31	33
Total of annual cohorts	**106**	**137**	**139**	**142**	**148**	**33**
Combined group	**106**	**125**	**127**	**130**	**134**	**85**

Appendix B—Extract from summary of the Transition Resource Group for IFRS 17 *Insurance Contracts* meeting held on 26–27 September 2018

Annual cohorts for contracts that share in the return of a specified pool of underlying items (Agenda Paper 10)

B1. Agenda Paper 10 addresses a submission about annual groups of contracts with policyholders that all share in the return on a specified pool of underlying items, with some of the return contractually passing from one group of policyholders to another.

B2. The submission notes that paragraph BC138 of the Basis for Conclusions on IFRS 17 explains:

> … 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.

B3. The submission asks in what circumstances measuring the contractual service margin at a higher level than an annual cohort level, such as a portfolio level, would achieve the same accounting outcome as measuring the contractual service margin at an annual cohort level applying paragraph 22 of IFRS 17.

B4. TRG members discussed the analysis in Agenda Paper 10 and observed that:

(a) paragraph BC138 of the Basis for Conclusions on IFRS 17 explains the effect of the requirements of IFRS 17 and does not change those requirements.

(b) when a specified pool of underlying items consists of the insurance contracts issued to the policyholders that share in the returns of that pool, the criteria in paragraph B67 of IFRS 17 are met regardless of whether the policyholders share in 100% of the return on the pool of underlying items or only part of the return on the pool of underlying items.

(c) for contracts that share in 100% of the return on a pool of underlying items consisting of the insurance contracts, the contractual service margin will be nil. Therefore, measuring the contractual service margin at a higher level than the annual cohort level, such as a portfolio level, would achieve the same accounting outcome as measuring the contractual service margin at an annual cohort level applying IFRS 17.

(d) when contracts share to a lesser extent in the return on a pool of underlying items consisting of the insurance contracts, an entity could be affected by the expected cash flows of each contract issued. Therefore, the contractual service margin of the groups of contracts may differ from the contractual service margin measured at a higher level, such as the portfolio level. To assess whether measuring the contractual service margin at a higher level would achieve the same accounting outcome as measuring the contractual service margin at an annual cohort level, an entity would need to determine what the effect would be of applying the requirements in IFRS 17. To be able to measure the contractual service margin at a higher level, the accounting outcome would need to be the same in all circumstances, ie regardless of how assumptions and experience develop over the life of the contract.

B5. TRG members also observed that the examples in Agenda Paper 10 were not representative of many situations in practice. TRG members observed that in practice, cash flows would be determined at a higher level than in the examples, and that paragraph B70 of IFRS 17 would apply for allocating cash flows to the groups. Therefore, there may be some situations where the same accounting outcome is achieved using annual cohorts or a higher level of aggregation when applying the requirements of IFRS 17 to contracts that share 90% in the returns on a pool of underlying items consisting of the insurance contracts.