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Project	**Amendments to IFRS 17 *Insurance Contracts***
Paper topic	Level of aggregation—IFRS 17 requirements and Board's rationale

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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 the IFRS 17 requirements and the rationale of the International Accounting Standards Board (Board) for setting those requirements.

2. The other papers in the set are:

   (a) AP2A *Level of aggregation—Stakeholder concerns, implementation challenges and staff analysis*; and

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

Structure of the paper

3. This paper provides:

   (a) an overview of the requirements in IFRS 17 (paragraphs 4–18 of this paper); and

   (b) a summary of the Board's rationale for setting those requirements (paragraphs 19–38 of this paper).

IFRS 17 requirements

4. Generally, applying IFRS Standards, an entity is required to recognise and measure individual contracts. This general requirement is not applied in IFRS 17.

5. For the purpose of measuring and recognising profit on insurance contracts (the contractual service margin), an entity is required to aggregate contracts into groups of insurance contracts. To ensure that information about profitability is reflected in the financial statements in a timely manner, IFRS 17 sets a maximum level of aggregation using a top down approach.

6. Firstly, an entity is required to identify a portfolio of insurance contracts. A portfolio comprises contracts subject to similar risks and managed together. For example, this could be a product line such as motor insurance policies.

7. Next, an entity is required to divide a portfolio into a minimum of three groups (referred to in this set of papers as profitability buckets):

   (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 remaining contracts in the portfolio.

8. In principle, the assessment of the profitability bucket in which a contract belongs is done by considering individual contracts. However, if an entity has reasonable and supportable information to conclude that a set of contracts would be in the same profitability bucket, it can make the profitability bucket assessment on a set of contracts basis. For example, an entity might have reasonable and supportable information to conclude that all motor insurance policies sold to a specified demographic of policyholders would be in the same profitability bucket, and hence can assess all those policies together to determine into which bucket they fall.

9. In some circumstances, insurance contracts in a portfolio might fall into different profitability buckets 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 characteristics. For example, law or regulation may require an entity to

provide insurance coverage to policyholders at a price that does not reflect the risk that is being transferred to the entity. In those circumstances, as an exception, IFRS 17 permits an entity to include those contracts in the same group.

10. An entity is permitted to disaggregate groups of contracts further, for example, an entity may choose to divide groups further based on different levels of profitability.

11. An entity is not permitted to include contracts issued more than one year apart in the same group. To achieve this, the entity shall divide groups further (referred to in this set of papers as the annual cohort requirement).

12. To measure insurance contracts, an entity may estimate the fulfilment cash flows at a higher level of aggregation than the group or portfolio level, provided the entity is able to allocate the appropriate fulfilment cash flows in the measurement of the group of insurance contracts.

13. Groups of insurance contracts are established at initial recognition and the composition of the groups is not reassessed subsequently. Once an entity has established a group of insurance contracts, it becomes the unit of account to which the entity applies the requirements of IFRS 17. However, an entity will typically enter into transactions for individual contracts. IFRS 17 therefore includes requirements that specify how to recognise groups that include contracts issued in more than one reporting period, and how to derecognise contracts from within a group.

Transition

14. The transition requirements in IFRS 17 are applied on a group by group basis.

15. If an entity applies a full retrospective approach, the entity shall apply the level of aggregation requirements in IFRS 17 retrospectively. If an entity applies a modified retrospective approach or a fair value approach, there may be some differences in how the entity applies the level of aggregation requirements when compared to a full retrospective approach as a result of transition modifications and reliefs.

16. If an entity applies a modified retrospective approach, the entity can identify groups of insurance contracts using reasonable and supportable information at the transition

date to the extent, and only to the extent, it does not have reasonable and supportable information to identify groups retrospectively. Also, the entity shall not apply the annual cohort requirement to the extent, and only to the extent, it does not have reasonable and supportable information to apply that requirement.

17. If an entity applies a fair value approach, the entity can choose to identify groups of insurance contracts using reasonable and supportable information at the transition date. The entity can also choose not to apply the annual cohort requirement.

18. The following table summarises the level of aggregation modifications and reliefs:

Level of aggregation		**Portfolio**	**Profitability buckets**	**Annual cohorts**
Approach:	**Condition to use modification or relief:**	**Modification or relief:**		
Modified retrospective	Only to the extent permitted[1]	Use information at transition date	Use information at transition date	Do not apply
Fair value	Choice	Use information at transition date	Use information at transition date	Do not apply

Board's rationale

19. This section includes extracts from paragraphs BC115–BC139 of the Basis for Conclusions on IFRS 17. Agenda Paper 2C provides a history of the Board's decisions on the level of aggregation requirements, including feedback from stakeholders during the development of IFRS 17.

[1] An entity is permitted to use each modification only to the extent that an entity does not have reasonable and supportable information to apply a retrospective approach.

Background

20. A key issue in developing the measurement requirements for the contractual service margin in IFRS 17 was the level of aggregation of insurance contracts to which the requirements should be applied. Some aspects of the adjustments to the carrying amount of the contractual service margin result in gains being treated differently from losses or changes in estimates relating to current and past service being treated differently from changes in estimates relating to future service. These different treatments mean that the accounting result depends on the level of aggregation at which the adjustments are made, because amounts that would offset each other within the measurement of a group of insurance contracts would be treated differently (and hence not offset each other) if contracts were measured individually.

21. For example, suppose an entity issued a group of identical contracts expecting that there would be more claims from some of the contracts than others, but not knowing which contracts would be the ones with more claims. Subsequently it becomes apparent which contracts are likely to give rise to claims and which are not, and the number of contracts in each category is as expected. If the contracts were measured individually, the expected claims may cause the contracts for which they are likely to arise to become onerous, with an equal and opposite reduction in the fulfilment cash flows of the other contracts. The entity would recognise a loss for the onerous contracts immediately in profit or loss and an increase in the contractual service margin for the other contracts. That increase in the contractual service margin would not be recognised immediately in profit or loss but instead would be recognised over the current and future coverage period. In contrast, if the contracts were measured as one group, there would be no loss for a group of onerous contracts or increase in the contractual service margin to be recognised.

22. This issue does not arise in the measurement of the fulfilment cash flows. The fulfilment cash flows include all changes in estimates, regardless of whether they are gains or losses or they relate to past, current or future service. Hence, IFRS 17 allows an entity to estimate the fulfilment cash flows at whatever level of aggregation is most appropriate from a practical perspective. All that is necessary is that the entity is able

to allocate such estimates to groups of insurance contracts so that the resulting fulfilment cash flows of the group comply with requirements of IFRS 17.

23. 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 *Financial Instruments* and IFRS 15 *Revenue from Contracts with Customers* 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.

Characteristics of a group

24. 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, 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.

25. The level of aggregation is also relevant to the recognition of the contractual service margin in profit or loss. Following the Board's principle for the allocation of the contractual service margin, an entity should systematically recognise the remaining contractual service margin in profit or loss over the current and remaining coverage period to reflect the remaining transfer of services to be provided by the insurance contracts.

26. In many cases, the coverage period of individual contracts in a group will differ from the average coverage period for the group. When this is the case, measuring the contracts on:

    (a) an individual basis would mean that the contractual service margin associated with contracts with a shorter than average coverage period would be fully recognised in profit or loss over that shorter period; and

    (b) a group basis would mean that the contractual service margin associated with contracts with a shorter than average coverage period would not be fully recognised in profit or loss over that shorter period.

27. Thus, measuring the contracts as a group creates the risk that the contractual service margin for a group might fail to reflect the profit relating to the coverage remaining in the group, unless the entity tracked the allocation of the contractual service margin separately for groups of insurance contracts:

    (a) that have similar expected profitability, on initial recognition, and for which the amount and timing of cash flows are expected to respond in similar ways to key drivers of risk. In principle, this condition would ensure the contractual service margin of a particularly profitable individual contract within a group is not carried forward after the individual contract has expired.

    (b) that have coverage periods that were expected to end at a similar time. In principle, this condition would ensure the contractual service margin of an individual contract that expired was not carried forward after the contract had expired.

28. The Board concluded that it was necessary to strike a balance between the loss of information discussed in paragraphs 24 and 26–27 of this paper, and the need for useful information about the insurance activity as discussed in paragraphs 23 and 25 of this paper. The Board:

 (a) did not want entities to depict one type of contract as cross-subsidised by a different type of contract, but also did not want to recognise losses for claims developing as expected within a group of similar contracts; and

 (b) did not want the contractual service margin of an expired contract to exist as part of the average contractual service margin of a group long after the coverage provided by the contract ended, but also did not want to recognise a disproportionate amount of contractual service margin for contracts lapsing as expected within a group of similar contracts.

29. The Board concluded that the balance described above could be achieved in principle by:

 (a) requiring contracts in a group to have similar expected profitability—meaning that loss-making contracts could not be grouped with profitable contracts, whether at initial recognition or if changes in conditions make a previously profitable group loss-making. Hence, such a requirement would provide information about loss-making groups of insurance contracts.

 (b) requiring groups not be reassessed after initial recognition.

30. The Board also noted that, in principle, it would be possible to meet the objective of the recognition of the contractual service margin in profit or loss discussed in paragraph 25 of this paper either by grouping only contracts with a similar size of contractual service margin and the same remaining coverage period, or by reflecting the different duration and profitability of the contracts within the group in the allocation of the contractual service margin.

Practical considerations

31. The Board noted that entities could interpret the approach described in paragraphs 29–30 of this paper as requiring an excessively large number of groups that may provide insufficiently useful information to justify the operational burden that would be imposed by extensive disaggregation of portfolios. Accordingly, the Board sought a balance to reflect profit and potential losses in the statement of financial performance in appropriate periods and the operational burden.

32. To achieve that balance, the Board concluded that an entity should be required to identify portfolios of contracts subject to similar risks and managed together, and to divide a portfolio into profitability buckets, as described in paragraphs 6–7 of this paper.

33. On the topic of profitability buckets, the Board decided that to assess whether contracts that are not onerous at initial recognition have no significant possibility of becoming onerous subsequently, an entity should use the information provided by its internal reporting system but need not gather additional information. The Board concluded that such information would provide a sufficient basis for making this assessment and that it would not be necessary to impose costs of gathering additional information. Some stakeholders nonetheless expressed the view that separating contracts that have no significant possibility of becoming onerous from other contracts that are not onerous was burdensome and unnecessary. The Board, however, concluded that in the absence of such a requirement, should the likelihood of losses increase, IFRS 17 would fail to require timely recognition of contracts that become onerous.

34. Despite the development of an approach designed to respond to the practical concerns raised by stakeholders, some continued to argue that the level of aggregation set out in paragraph 32 of this paper might lead to excessive granularity that is, in their view, contrary to the essence of the insurance business. These stakeholders do not think that contracts that have been priced on the same basis by the entity should be in different groups. The Board noted that applying IFRS 17, an entity would not be expected under normal circumstances to group separately contracts priced on the same basis by

the entity. Groups are determined on the basis of information available to the entity at initial recognition of the contracts, which will be at their inception if they are onerous at inception. If contracts are onerous at inception, that will generally be the result of an intentional pricing strategy.

35. The Board noted that the decisions outlined in paragraph 32 of this paper could lead to perpetual open portfolios. The Board was concerned that this could lead to a loss of information about the development of profitability over time, could result in the contractual service margin persisting beyond the duration of contacts in the group, and consequently could result in profits not being recognised in the correct periods. Consequently, in addition to dividing contracts into the groups specified in paragraph 32 of this paper, 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 will be reflected in the financial statements on a timely basis.

36. 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 31 of this paper, 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.

37. 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. 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.

Transition

38. To support entities transitioning to IFRS 17, the Board included modifications in the modified retrospective approach and reliefs in the fair value approach to simplify the transition requirements in areas that the Board concluded might be impracticable to apply. For the level of aggregation requirements, the Board provided some modifications and reliefs, as set out in paragraphs 14−18 of this paper.