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Project	Transition Resource Group for IFRS 17 *Insurance Contracts*		
Paper topic	Annual cohorts for contracts that share in the return of a specified pool of underlying items		
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Introduction

1. We have received 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. For those contracts, 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 *Insurance Contracts*.

2. The objective of this paper is to provide background and an accounting analysis to support discussion at the Transition Resource Group for IFRS 17 (TRG).

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Structure of the paper

3. This paper includes the following:

   (a) background information;

   (b) implementation question; and

   (c) review of accounting requirements.

4. Appendix A to this paper includes two examples provided in the submission.

Background information

5. Paragraph 14 of IFRS 17 states:

   > 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.

6. Paragraph 16 of IFRS 17 states:

   > 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.

7. Paragraph 22 of IFRS 17 states:

> 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.

8. Paragraphs B67–B70 of IFRS 17 state:

> 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.

9. Paragraph BC138 of the Basis for Conclusions on IFRS 17 explains:

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.

Implementation question

10. The submission is about annual groups of contracts that all share in the return of a specified pool of underlying items, with some of the return contractually passing from one group of policyholders to another. The submission observes that this could be because of guarantees, proportionate sharing in the returns of the pool or because some contracts have lapsed or expired and the return due to them was not paid out at the time and so instead is accumulated and passed to future annual groups of policyholders.

11. The submission notes that on the topic of applying the annual cohort requirements in paragraph 22 of IFRS 17 to contracts with cash flows that affect or are affected by cash flows to policyholders of contracts in another group, 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.

12. For those contracts, 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. The submission expresses three views:

(a) View A—An entity is only able to consider the contractual service margin at a level of a single combined risk-sharing portfolio when 100% of the returns of the specified pool of underlying items are allocated back to the policyholders of the portfolio, with all existing policyholders sharing in the returns pro-rata at the time of allocation. The submission provides an example of a portfolio of insurance contracts in which policyholders share equally in 100% of the returns of the insurance contracts in the portfolio to demonstrate this view (Example 1 in Appendix A to this paper).

(b) View B—An entity is only able to consider the contractual service margin at a level of a single combined risk-sharing portfolio when a specified percentage of the returns of the specified pool of underlying items are allocated back to the policyholders of the portfolio, with all existing portfolio policyholders sharing in the returns pro-rata at the time of allocation. The submission provides an example of a portfolio of insurance contracts in which policyholders share equally in 90% of the returns of the insurance contracts in the portfolio with the remaining 10% belonging to the entity to demonstrate this view (Example 2 in Appendix A to this paper).

(c) View C—An entity is only able to consider the contractual service margin at a level of a single combined risk-sharing portfolio when a significant portion of returns of the specified pool of underlying items are allocated back to the policyholders of the portfolio, with all existing policyholders sharing in the allocation, but the allocation can be made

on a non-proportional discretionary basis. The submission does not provide an example to demonstrate this view.

Review of accounting requirements

13. Paragraph B67 of IFRS 17 identifies insurance contracts that affect the cash flows to policyholders of other contracts by requiring the policyholder to share with policyholders of other contracts the returns on the same specified pool of underlying items, and requiring either:

    (a) the policyholder to bear a reduction in their share of returns on the underlying items because of payments to policyholders of other contracts that share in that pool; or

    (b) the policyholders of other contracts to bear a reduction in their share of returns on the underlying items because of payments to the policyholder.

14. The payments that cause a reduction in a policyholder's share of returns on the underlying items include payments arising from guarantees made to other policyholders.

15. The staff observe that 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. This is because the payments to policyholders (including those arising from guarantees) reduce the ultimate return on the pool of underlying items that is shared by the policyholders. The staff observe that this is 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.

16. The staff observe that for some other types of contracts with policyholders that share in the return of a specified pool of underlying items, the underlying items do

not include the insurance contracts issued to those policyholders (for example, the underlying items are financial assets). Those insurance contracts also meet the criteria in paragraph B67 of IFRS 17, if the contracts require policyholders 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, applying paragraph B67(b) of IFRS 17.

17. Paragraph B68 of IFRS 17 requires that the fulfilment cash flows of each group of insurance contracts reflect the extent to which the contracts in that group cause the entity to be affected by the expected cash flows, whether to policyholders in that group or to policyholders in another group.

18. Contracts with policyholders that share in 100% of the returns on a pool of underlying items that includes the insurance contracts issued to those policyholders, ie that fully share all risks, do not cause the entity to be ultimately affected by the expected cash flows of each individual contract issued. For those contracts, applying paragraph B68 of IFRS 17, the contractual service margin will be nil. Therefore, for those contracts, an entity 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 paragraph 22 of IFRS 17. This is demonstrated in Example 1 in Appendix A to this paper.

19. Contracts with policyholders that do not fully share risks could cause the entity to be affected by the expected cash flows of each contract issued. The staff observe that paragraph B68 of IFRS 17 results in the effect of risk-sharing between policyholders to be reflected in the fulfilment cash flows, and hence in the contractual service margin, of the groups of contracts to the extent that risk-sharing exists. However, after factoring in the risk-sharing, if the risks are not fully shared the entity is still affected by the expected cash flows of each contract issued. Therefore, the contractual service margin of the groups of contracts may

differ from a contractual service margin measured at a higher level, such as the portfolio level. This is demonstrated in Example 2 in Appendix A to this paper.[1]

TRG discussion

Question to TRG members
What are your views on the implementation question presented above?

[1] Example 2 demonstrates the effect of less than 100% sharing by policyholders of the returns of underlying items that are the insurance contracts issued to the policyholders. The staff observe that less than full sharing of risk could also occur when the underlying items are financial assets rather than the insurance contracts issued and the policyholders do not share in the underwriting results.

Appendix A—Annual cohorts for contracts that share in the return of a specified pool of underlying items

A1. This appendix includes two examples provided in the submission:

(a) Example 1—policyholders participate in 100% of the returns on a specified pool of underlying items which are the insurance contracts issued to those policyholders; and

(b) Example 2—policyholders participate in 90% of the returns on a specified pool of underlying items which are the insurance contracts issued to those policyholders.

A2. Assume, for simplicity that the discount rates are 0% and the risk adjustment for non-financial risk is zero.

Example 1—policyholders participate in 100% of the returns on a specified pool of underlying items which are the insurance contracts issued to those policyholders

A3. An entity issues contracts to 10 groups[2] of policyholders, all forming a single portfolio of insurance contracts. Policyholders in each group pay a premium of 1,000 and each share equally in 100% of the overall returns on the portfolio of insurance contracts (ie the specified pool of underlying items). The returns on the pool are derived from the performance of the insurance contracts.

A4. Claims incurred in group 1 amount to 4,000, resulting in a net loss to the entity of 3,000 on that group before allocating to the group its share of the return on the pool of underlying items. No claims are incurred in groups 2-10, resulting in a gain to the entity of 9,000 on those 9 groups before allocating to each group its share of the return on the pool of underlying items.

[2] This example assumes that the entity has chosen to identify 10 groups of insurance contracts, applying paragraph 21 of IFRS 17, to illustrate the accounting outcome of measuring groups of insurance contracts (for example, annual cohorts) and of measuring a portfolio of contracts.

A5. The overall profit of the portfolio is 6,000. This profit belongs, in full, to the policyholders.

A6. Each group shares equally in 100% of the return on the portfolio and is therefore due 600 (6,000 / 10). The cash flows to each group are demonstrated in the following table:

	Group 1	**Each of groups 2-10**	**Groups 2-10**	**Groups 1-10 total**
Premiums	1,000	1,000	9,000	10,000
Claims	(4,000)	-	-	(4,000)
Net cash flows	**(3,000)**	**1,000**	**9,000**	**6,000**
Share of return on pool	(600)	(600)	(5,400)	(6,000)
Net cash flows	**(3,600)**	**400**	**3,600**	**0**

A7. If the groups of insurance contracts were unconnected (ie each group share in the returns of the group only), the cash flows for each group would have been be as follows:

	Group 1	**Each of groups 2-10**	**Groups 2-10**	**Groups 1-10 total**
Premiums	1,000	1,000	9,000	10,000
Claims	(4,000)	-	-	(4,000)
Share of return on pool	3,000	(1,000)	(9,000)	(6,000)
Net cash flows	**0**	**0**	**0**	**0**

A8. Therefore, applying paragraph B68 of IFRS 17, the groups of insurance contracts are measured as follows:

	Group 1	**Each of groups 2-10**	**Groups 2-10**
Premiums	(1,000)	(1,000)	(9,000)
Claims	4,000	-	-
Share of return on pool	600	600	5,400
Paragraph B68 of IFRS 17	(3,600)[3]	400	3,600[4]

[3] Fulfilment cash flows in group 1 exclude payments to policyholders in the group that have been included in the fulfilment cash flows of group 2-10.

[4] Fulfilment cash flows in group 2-10 include payments to policyholders of contracts in other groups.

Fulfilment cash flows	**0**	**0**	**0**
Contractual service margin	**0**	**0**	**0**

A9. The staff observe that for this example 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 paragraph 22 of IFRS 17.

Example 2—policyholders participate in 90% of the returns on a specified pool of underlying items which are the insurance contracts issued to those policyholders

A10. An entity issues contracts to 10 groups of policyholders, all forming a single portfolio of insurance contracts. Policyholders in each group pay a premium of 1,000 and each share equally in 90% of the overall returns on the portfolio of insurance contracts (ie the specified pool of underlying items). The returns on the pool are derived from the performance of the insurance contracts. The remaining 10% goes to the entity.

A11. Claims incurred in group 1 amount to 4,000, resulting in a net loss to the entity of 3,000 on that group before allocating to the group it's share of the return on the pool of underlying items. No claims are incurred in groups 2-10, resulting in a gain to the entity of 9,000 on those 9 groups before allocating to each group its share of the return on the pool of underlying items.

A12. The overall profit of the portfolio is 6,000. 5,400 belongs to the policyholders (6,000 x 90%) and 600 belongs to the entity (6,000 x 10%).

A13. Each group shares equally in 90% of the return on the portfolio and is therefore due 540 (5,400 / 10). The cash flows to each group are demonstrated in the following table:

	Group 1	**Each of groups 2-10**	**Groups 2-10**	**Groups 1-10 total**
Premiums	1,000	1,000	9,000	10,000
Claims	(4,000)	-	-	(4,000)
Net cash flows	**(3,000)**	**1,000**	**9,000**	**6,000**
Share of return on pool	(540)	(540)	(4,860)	(5,400)
Net cash flows	**(3,540)**	**460**	**4,140**	**600**

A14. If the groups of insurance contracts were unconnected (ie each group share in the returns of the group only), the cash flows for each group would have been be as follows:

	Group 1	**Each of groups 2-10**	**Groups 2-10**	**Groups 1-10 total**
Premiums	1,000	1,000	9,000	10,000
Claims	(4,000)	-	-	(4,000)
Share of return on pool	2,700	(900)	(8,100)	(5,400)
Net cash flows	**(300)**	**100**	**900**	**600**

A15. Therefore, applying paragraph B68 of IFRS 17, the groups of insurance contracts are measured as follows:

	Group 1	**Each of groups 2-10**	**Groups 2-10**
Premiums	1,000	1,000	9,000
Claims	(4,000)	-	-
Share of return on pool	(540)	(540)	(4,860)
Paragraph B68 of IFRS 17	3,240[5]	(360)	(3,240)[6]
Fulfilment cash flows	**(300)**	**100**	**900**
Contractual service margin	**0**	**(100)**	**(900)**
Loss component	**300**	**0**	**0**

A16. The staff observe that for this example measuring the contractual service margin at a higher level than the annual cohort level, such as a portfolio level, would not achieve the same accounting outcome as measuring the contractual service margin at an annual cohort level applying paragraph 22 of IFRS 17.

[5] Fulfilment cash flows in group 1 exclude payments to policyholders in the group that have been included in the fulfilment cash flows of group 2-10.

[6] Fulfilment cash flows in group 2-10 include payments to policyholders of contracts in other groups (4,140-900).