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STAFF PAPER

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Project	**Insurance contracts**		
Paper topic	Definition of a portfolio of insurance contracts		
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What is this paper about?

1. In February 2011, the boards tentatively decided that the final standard should require insurers to measure insurance contracts at the portfolio level, except where different requirements are specified for particular aspects of measurement.

2. This paper discusses a proposed definition of a portfolio of insurance contracts.

Staff recommendations

3. The staff recommend that the standard defines a portfolio of insurance contracts as:

   Insurance contracts that:

   (a) are subject to similar risks;

   (b) have similar expectations of profitability; and

   (c) are managed together as a single pool.

4. The staff also recommend that the boards add application guidance to help insurers interpret the terms ‘similar risks’, ‘similar expectations of profitability’ and ‘managed together’.

Background

5. The unit of account proposed in the ED/DP was a portfolio of contracts rather than individual contracts. The rationale for prescribing the portfolio as the unit of account was explained (in the context of risk adjustments) in paragraph BC119 of the basis for conclusions accompanying the ED. Paragraph BC119 is reproduced in appendix A to this paper.

6. Explicit reference to portfolios was made in several of the ED/DP proposals. Specifically, the ED/DP proposed that:

   (a) the estimate of cash flows used to measure insurance contracts should include all cash inflows and outflows that arise in fulfilling a portfolio of insurance contracts.

   (b) the risk adjustment should be measured at a portfolio level (risk adjustment in the ED currently allows for risk diversification within that portfolio but not between different portfolios or entities within a group). Agenda paper 7C/77C discusses further the unit of account to be applied in measuring the risk adjustment.

   (c) the residual margin or composite (now called 'single') margin should be determined at a level that aggregates insurance contracts into a portfolio and, within a portfolio, by similar date of initial recognition of the contract and coverage periods. Agenda paper 7B/77B discusses further the unit of account to be applied in measuring the residual and single margins.

   (d) to determine whether insurance contracts are onerous and, if applicable, to measure the amount of the additional liability, the insurer should aggregate the insurance contracts into a portfolio and, within a portfolio, by similar date of initial recognition of the contract and coverage periods. Agenda paper 7B/77B discusses the unit of account to be applied in measuring onerous contracts.

(e) portfolios that are in an asset position should not be aggregated in the statement of financial position with portfolios that are in a liability position.

(f) for transitional purposes, insurers should measure each portfolio of insurance contracts at the present value of fulfilment cash flows.

7. Furthermore, tentative board decisions reached as part of ED/DP redeliberations have used the concept of a portfolio in determining:

(a) *acquisition costs*—the ED/DP proposed that insurers should include only acquisition costs that are incremental at a contract level in the measurement of the insurance contract liability. However, both the IASB and FASB have since tentatively decided that other direct acquisition costs that relate to a portfolio of insurance contracts should be included in the measurement of insurance contract liabilities. (The decisions differed on whether those direct costs should be restricted to those relating to successful efforts only.)

(b) *the contract boundary*—the boards have tentatively decided that one of the criteria in setting the boundary of a contract is whether the insurer has the right or practical ability to reassess the risk of the portfolio that the contract belongs to, and, as a result, can set a price that fully reflects the risk of that portfolio.

8. The ED/DP proposed to define a portfolio of insurance contracts as:

> insurance contracts that are subject to broadly similar risks and managed together as a single pool.

9. The basis for conclusions accompanying the ED explained the rationale for this definition as follows:

> BC 119 (c) The Board concluded that [measuring risk adjustments at the level of individual portfolios] is the most practical solution and the most likely to produce relevant information for users at reasonable cost.

> Because the portfolio contains reasonably homogeneous contracts, it is the most natural level at which to estimate the probability distribution of the cash flows. Furthermore, although an insurer might expect to derive some diversification benefits by grouping together various portfolios, determining the extent of those benefits is difficult because of the lack of full fungibility between portfolios.
>
> BC120 In view of the above considerations, the Board proposes that an insurer should determine risk adjustments for a portfolio of contracts that are subject to broadly similar risks and managed together as a single pool. The Board acknowledges that this description of a portfolio is not fully rigorous, but it believes that a more rigorous definition is not attainable and that this description will provide information that is relevant to users and faithfully represents the extent of risk, at a reasonable cost.

Comments from respondents and field test participants

10. The ED/DP did not specifically invite comments on the definition of a portfolio of insurance contracts.

11. Some respondents supported the proposed definition in its entirety, because they believe it allows an insurer to define a portfolio in a manner that most faithfully depicts the aggregation of broadly homogenous risks. However, most respondents who commented disagreed with some aspects of the proposed definition. They thought that the definition could be subject to diverging and potential abusive interpretations, resulting in the aggregation of very different risks.

12. Almost all of the respondents who commented (representing 10% to 15% of the total population of comment letters) stated that risk management is the overarching principle that is followed in establishing/determining portfolios.

Consequently, they agree that the definition of a portfolio of insurance contracts should reflect the way in which an entity manages risk. However, a few respondents thought that it is not clear what 'similar risks' means. Some equate it to lines of business, whilst others equate it to risks that show similar risk distributions. Because of the uncertainty, some respondents think it is unclear at what level preparers should measure insurance contracts. Some indicated that they assess and price for risk based on a number of different criteria including product features and geographical location. They believe that such criteria should also be considered in defining a portfolio of insurance contracts.

13. Respondents also noted wide variations in the number of portfolios insurers typically manage. The number of portfolios managed by a single insurer can range between single digits to about one thousand. This can be a function of how many types of insurance coverage are provided, ie the number of 'product offerings'.

14. However, the number of portfolios can also be a function of the level at which insurers disaggregate pools of risks into more detailed or specific groups. One insurer could, for instance, group all its contracts into 3 portfolios, namely 'life'; 'non-life' and 'health'. Another insurer with the same product offering could group its contracts at a lower level. In extreme, a portfolio could have very specific characteristics, for instance motor insurance contracts issued to corporates in the city of Paris.

15. The results from field testing confirmed that variations exist in how portfolios are determined. Different aggregations are used by different insurers, and different levels of aggregation are appropriate for different purposes. Consideration is normally given to one or more of the following in determining a portfolio:

    (a) type of risk insured (for instance theft, fire, longevity, mortality, etc.);

    (b) geographical location (for instance across continents, countries, states, counties/provinces);

(c) product line (for instance, annuity, income protection, term assurance, unit-linked, auto, homeowners, etc.);

(d) type of policyholder (for instance, commercial or personal, individual or group);

(e) business unit (based on the organisational formation of the insurer); and

(f) distribution channel (for instance, broker channels or direct, etc.).

16. These differences led some to suggest that it would be preferable to either delete this defined term (ie the definition of portfolio of insurance contracts), confine its use to a single context, or clarify its meaning.

17. Some respondents expressed a view that the proposed definition of a portfolio does not accommodate contracts that cover more than one risk and stated that insurers do not pool contracts but risks. Accordingly, they suggested that the definition of a portfolio should focus on how risks are managed, rather than how contracts are managed. A few respondents believe the notion of portfolio should be consistent with the level of aggregation that is used for reporting to the entity's key management personnel.

18. Some indicated that the US GAAP definition of a portfolio of insurance contracts should be amalgamated with the definition in the ED because the US GAAP definition is more prescriptive. The US GAAP definition states that contracts should be grouped to be consistent with the insurer's manner of acquiring, servicing, and measuring the profitability of its insurance contracts.[1]

Staff analysis

Consequences of inconsistent interpretations

19. Different measurement results could be obtained if insurers do not interpret the definition of a portfolio of insurance contracts consistently. The consequences

[1] This definition is included in US GAAP in the guidance for the expensing of acquisition costs and determining when a premium deficiency should be recognized.

will depend on how many aspects of the measurement use portfolios as the unit of account—the consequences will be fewer if the IASB decide *not* to prescribe a unit of account for calculating the risk adjustment (as discussed in agenda paper 7C/77C). Such a decision would significantly alleviate the pressure on the definition of a portfolio.

Changes to the proposed definition

20. Staff thinks that there is general acceptance among respondents that the pooling of similar risks should form the basis on which insurers establish portfolios. In addition, there was support for including reference to the way in which contracts are managed within the definition. Consequently, staff proposes retaining these elements of the definition.

21. As noted above, some respondents to the ED stated that combining elements of the US GAAP definition of a portfolio would make the proposed definition easier to interpret. The US GAAP definition requires insurers to group contracts in a way that is consistent with an insurer's manner of acquiring, servicing and measuring the profitability of its insurance contracts.

22. Based on the US GAAP definition, the staff noted that in current practice, portfolios are typically designed by insurers to monitor, analyse, and project claims. This is consistent with the insurer's manner of acquiring, servicing and measuring the profitability of its insurance contracts and the notion of pooling risks. In property and casualty business, insurers evaluate whether the groupings of contracts have been (or are expected to be) subject to similar influences on frequency and severity over time. They assess whether the grouping has yielded (or is expected to yield) similar average severities over time. They also assess the mix of contracts in the groupings, ie commercial versus personal. The interrelationship between these attributes impacts an insurer's decision as to how to group contracts in portfolios because the attributes are drivers of pricing and claims management, which are in turn primary drivers of profitability.

23. Staff believes that contracts that are acquired and serviced in the same way are likely to be managed together. Staff thinks including application guidance to clarify this point would be helpful.

24. Staff notes that the definition of a portfolio proposed in the ED makes no reference to the profitability of contracts. However, staff believes that grouping contracts together that have very different drivers and expectations of profitability will result in the loss of useful information to users of financial statements. Consequently, staff proposes that the definition of a portfolio should include reference to profitability. Reference to profitability will also ensure that contracts for similar risks that are written in different years and have different expectations of profitability will be allocated to different portfolios.

25. Finally staff believes that the meaning of the word ‘broadly’ is vague and should be removed from the definition.

Need for more application guidance

26. Staff thinks that more guidance might be needed to avoid divergence in practice. Consequently, staff thinks that the boards could and should provide application guidance to explain the elements of the portfolio definition.

27. Staff considered other IFRSs and US GAAP guidance to help us identify possible principles applied for grouping items together. Staff noted that other IFRSs and US GAAP guidance considers the interrelationship between items in grouping them together for measurement purposes. Examples of this can be found in Appendix B.

28. In most other IFRSs and US GAAP guidance, the unit of account is usually an individual contract or item. However, larger units of account are prescribed if measurement of individual items separately either:

    (a) is not practically possible, for instance the measurement of inventory; or

(b) will not reflect the economic reality, for instance when the interrelationship of individual assets is to be considered in determining a cash generating unit.

29. Staff notes that when an IFRS or US GAAP pronouncement prescribes a unit of account at a level higher than an individual item or contract, it often prescribes the unit of account at the lowest level that achieves the particular measurement objective. Words such as ‘smallest’ and ‘lowest’ are used. Setting the unit of account at the lowest possible level that achieves the particular measurement objective helps to ensure that decision useful information does not get obscured.

30. Staff notes also that other IFRSs and US GAAP refer to the need to apply judgement when grouping contracts. The concept of applying judgement in grouping contracts also aligns with earlier conclusions reached by the Board in paragraph 120 of the Basis for Conclusion:

> BC120 In view of the above considerations, the Board proposes that an insurer should determine risk adjustments for a portfolio of contracts that are subject to broadly similar risks and managed together as a single pool. The Board acknowledges that this description of a portfolio is not fully rigorous, but it believes that a more rigorous definition is not attainable and that this description will provide information that is relevant to users and faithfully represents the extent of risk, at a reasonable cost.

31. Applying the principles described above to insurance contracts, if the portfolio is to be the default unit of account, we can conclude that a portfolio should *not*:

(a) group together risks that are not similar or product offerings that are unrelated (for example, protection against a policyholder defaulting on repaying money borrowed to purchase a house (credit insurance) and protection against fire for the house purchased).

(b) group contracts at a level higher than that used by management in assessing profitability.

Staff conclusions and recommendation

32. As discussed in paragraphs 20-25, staff recommends that the definition of a portfolio should:

    (a) retain reference to 'similar risks' and 'managed together as a single pool';

    (b) include reference to 'similar expectations of profitability';

    (c) be amended to delete the term 'broadly'.

33. A portfolio of insurance contracts would then be defined as follows:

    insurance contracts that:

    (a) are subject to similar risks;

    (b) have similar expectations of profitability; and

    (c) are managed together as a single pool.

34. The staff believe that application guidance incorporating some of the ideas developed in the staff analysis would help insurers interpret the proposed definition and address some of the concerns raised by respondents to the ED/DP regarding how to determine whether contracts are:

    (a) subject to similar risks; and

    (b) managed together as a single pool.

35. The staff suggest the following text for inclusion as application guidance:

    B1. A portfolio of insurance contracts is defined in this [draft] IFRS/ ASU as

    insurance contracts that:

    (a) are subject to similar risks;

    (b) have similar expectations of profitability; and

    (c) are managed together as a single pool.

    B2. A portfolio of insurance contracts shall not group together risks that are not similar or product offerings that are unrelated (for example, protection against a policyholder defaulting on repaying money borrowed to purchase a house (credit insurance) and protection against fire for the house purchased

B3. In determining whether a group of contracts is subject to similar risks, an insurer shall consider the following factors:

(a) type of risk insured (for instance, theft, fire, longevity, mortality, etc.);

(b) product line (for instance, annuity, income protection, term assurance, unit-linked, auto, homeowners, etc.);

(c) type of policyholder (for instance, commercial or personal, individual or group, etc.); and

(d) geographical location (for instance, across continents, countries, states, counties/provinces).

B4. In determining whether a group of contracts have similar expectations of profitability, an insurer shall consider the drivers of profitability. Contracts with similar drivers of profitability are likely to have similar expectations of profitability.

B5. A portfolio of insurance contracts shall not group together contracts at a level higher than that used by management in assessing profitability.

B6. In determining whether a group of contracts is managed together as a single pool, an insurer shall consider:

(a) the manner in which the contracts are acquired (for example, broker channels or direct marketing; purchased or originated business);

(b) the manner in which contracts are serviced;

(c) the business unit within which the contracts are managed (based on the organisational form of the insurer); and

(d) geographical location (for instance, across continents, countries, states, counties/provinces).

Questions for the boards

Definition of portfolio of insurance contracts
1. Do the boards agree that the insurance contracts standard should define a portfolio of insurance contracts as insurance contracts that: (a) are subject to similar risks; (b) have similar expectations of profitability; and (c) are managed together as a single pool? 2. Do the boards agree that the standard should include additional application guidance? 3. Do you have any comments on the draft application guidance suggested by staff in paragraph 35?

Appendix A Extract from the Exposure Draft

BC119 The Board considered the following levels of aggregation:

(a) Determining risk adjustments at the level of individual contracts. However, this approach would contradict the rationale of insurance, which is to pool risks by grouping similar contracts into a portfolio.

(b) Determining risk adjustments directly for a legal entity or for the entire reporting entity. However, this approach would require the insurer to undertake one of the following:

(i) to assume that all portfolios within that entity are fungible, ie that a surplus in one portfolio is available in full to cover a deficit in another portfolio. In the Board's view, this would be inappropriate because complete fungibility is rare in practice, for legal and regulatory reasons.

(ii) to consider the degree of fungibility in estimating the probability distribution. In the Board's view, this would be a difficult and burdensome exercise and would be so reliant on difficult judgements that it would not produce information that is relevant or represents faithfully the degree of fungibility that exists.

(c) Determining risk adjustments at the level of individual portfolios. The Board concluded that this is the most practical solution and the most likely to produce relevant information for users at reasonable cost. Because the portfolio contains reasonably homogeneous contracts, it is the most natural level at which to estimate the probability distribution of the cash flows. Furthermore, although an insurer might expect to derive some diversification benefits by grouping together various portfolios, determining the extent of those benefits is difficult because of the lack of full fungibility between portfolios.

BC120 In view of the above considerations, the Board proposes that an insurer should determine risk adjustments for a portfolio of contracts that are subject to broadly similar risks and managed together as a single pool. The Board acknowledges that this description of a portfolio is not fully rigorous, but it believes that a more rigorous definition is not attainable and that this description will provide information that is relevant to users and faithfully represents the extent of risk, at a reasonable cost.

Appendix B Areas where other IFRSs and US GAAP guidance considers the interrelationship between items and groups them together

B1. Inventory

(a) IAS 2: Inventories are usually written down to net realisable value item by item. In some circumstances, however, it may be appropriate to **group similar or related items** [emphasis added]. This may be the case with items of inventory relating to the same product line that have similar purposes or end uses, are produced and marketed in the same geographical area, and cannot be practicably evaluated separately from other items in that product line.

(b) ASC 330-10-35-8: Depending on the character and composition of the inventory, the rule of lower of cost or market may properly be applied either directly **to each item or to the total of the inventory (or, in some cases, to the total of the components of each major category)** [emphasis added]. The method shall be that which most clearly reflects periodic income.

(c) ASC 330-10-35-9: The purpose of reducing inventory to market is to reflect fairly the income of the period. The most common practice is to apply the lower of cost or market rule **separately to each item of the inventory** [emphasis added]. However, if there is only one end-product category, the cost utility of the total stock – the inventory in its entirety – may have the greatest significance for accounting purposes. Accordingly, the reduction of individual items to market may not always lead to the most useful result if the utility of the total inventory to the business is not below cost. This might be the case if selling prices are not affected by temporary or small fluctuations in current costs of purchase or manufacture.

B2. Impairment of assets

(a) IAS 36: An asset's cash-generating unit is the smallest group of assets that includes the asset and generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets. Identification of an asset's cash-generating unit involves judgement. If recoverable amount cannot be determined for an individual asset, an entity identifies the **lowest aggregation of assets that generate largely independent cash inflows** [emphasis added].

(b) ASC 360-10-35-23: For purposes of recognition and measurement of an impairment loss, a long-lived asset or assets **shall be grouped with other assets and liabilities at the lowest level for which identifiable cash flows are largely independent of the cash flows of other assets and liabilities** [emphasis added]. However, an impairment loss, if any, that results from applying this Subtopic shall reduce only the carrying amount of a long-lived asset or assets of the group in accordance with paragraph 360-10-35-28.

B3. Evaluation of impairment of financial assets

(a) **AG87 of IAS 39**: For the purpose of a collective evaluation of impairment, financial assets are **grouped on the basis of similar credit risk characteristics** [emphasis added] that are indicative of the debtors' ability to pay all amounts due according to the contractual terms (for example, on the basis of a credit risk evaluation or grading process that considers asset type, industry, geographical location, collateral type, past-due status and other relevant factors). The characteristics chosen are relevant to the estimation of future cash flows for groups of such assets by being indicative of the debtors' ability to pay all amounts due according to the contractual terms of the assets being evaluated. However, loss probabilities and other loss statistics differ at a group level between (a) assets that have been individually evaluated for impairment and found not to be impaired and (b) assets that have not been individually evaluated for impairment, with the result that a different amount of impairment may be required. If an entity does not have a group of assets with similar risk characteristics, it does not make the additional assessment.

(b) ASC 310-10-35-21: Some impaired loans have risk characteristics that are unique to an individual borrower, and the creditor shall apply the measurement methods described in paragraphs 310-30-30-2; 310-10-35-22 through 35-28; and 310-10-35-37 on a loan-by-loan basis. However, some impaired loans may have **risk characteristics in common with other impaired loans** [emphasis added]. A creditor may aggregate those loans and may use historical statistics, such as average recovery period and average amount recovered, along with a composite effective interest rate as a means of measuring impairment of those loans.