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What is this paper about?

1. This paper continues the discussions held at the 16 December 2011 joint meeting on the definition of a portfolio of insurance contracts and considers the level at which insurance contracts should be aggregated for measurement and other purposes.

2. The definition of portfolio of insurance contracts affects, among other things:

   (a) the determination of the residual/single margin at initial recognition and subsequently; and

   (b) identification and measurement of onerous contracts.

Staff recommendations

3. Some staff recommend that:

   (a) The unit of account used to **determine**[1] the residual/single margin and perform the onerous test should be the portfolio. A portfolio of insurance contracts should be defined as contracts that are:

      (i) subject to similar risks (paragraphs 14-15);

      (ii) managed together as a single pool (paragraphs16-18); and

      (iii) priced similarly relative to the risk taken on (paragraphs 19-29).

   (b) The unit of account used to **release**[1] the residual/single margin should not be prescribed. However, the release of the residual/single margin should be performed in a manner consistent with the objective of releasing the residual margin over the coverage period to the period(s) in which the service is provided [for the IASB]; or of releasing the single margin in the period(s) in which the insurer is released from risk [for the FASB]. For the IASB, the service is provided over the coverage period, and for the FASB the insurer is released from risk by a reduction in the variability of cash outflows.

[1] The determination of the residual/single margin refers to the assessment of whether a group of contracts have a positive or negative residual/single margin (ie assessing whether a group of contracts are profitable or loss-making). The release of the residual/single margin refers to the recognition of a positive residual/single margin in profit or loss.

4. Other staff recommend that:

   (a) The unit of account used to **determine**[1] the residual/single margin, **release** the residual/single margin, and perform the onerous contract test should be the portfolio.[2] A portfolio of insurance contracts should be defined as contracts that:

      (i) are subject to similar risks (paragraphs 14-15);

      (ii) are managed together as a single pool (paragraphs16-18);

      (iii) are priced similarly relative to the risk taken on (paragraphs 19-29); and

      (iv) have similar duration and similar expected patterns of release of the residual/single margin (paragraphs 30-51).

[2] These staff believe that the definition of portfolio proposed should achieve consistency with the principles for releasing the residual/single margin as stated in paragraph 3 (b).

Background

Definition of a portfolio of insurance contracts proposed in the ED/DP

5. The exposure draft/Discussion Paper (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."

6. 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 and BC120 of the Basis for Conclusions accompanying the ED. In summary, the rationale was that using the portfolio as the unit of account would be:

> "the most practical solution and the most likely to produce relevant information for users at reasonable cost."

7. Furthermore, in defining the portfolio, the IASB acknowledged:

> "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."

8. 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. We note that the estimate of cash flows is independent of the unit of account used; in other words, a different unit of account would not affect the estimate of cash flows made.

   (b) 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. The staff note that the definition of a portfolio in effect determines the unit of account for determining the residual/single margin.[3]

(c) the residual/single margin should be released at the cohort level, which is a subset of a portfolio. The unit of account for releasing the residual/single margin is discussed in paragraphs 30-51.

(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. Considering the generally short duration of the coverage period for contracts that fall within the scope of the premium allocation approach, the level of aggregation for the onerous contract test would be within the portfolio of insurance contracts, aggregated by similar date of inception.

(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. (At the 20 October 2011 meeting the boards confirmed this ED/DP proposal.)

(f) for transitional purposes, insurers should measure each portfolio of insurance contracts at the present value of fulfilment cash flows (to be discussed at a future meeting).

(g) the risk adjustment should be measured at a portfolio level (risk adjustment in the ED allows for risk diversification within that portfolio but not between different portfolios or entities within a group). At the

[3] The IASB has tentatively decided that the residual margin should be unlocked for changes in estimates of cash flows, which means that the residual margin also needs to be determined in periods after inception. The staff propose that the determination of the residual margin at inception and in subsequent periods should be based on the same unit of account, ie the portfolio, for consistency.

16 December 2011 meeting, the IASB tentatively decided that the unit of account to be used when calculating the risk adjustment should not be prescribed as long as the manner in which the risk adjustment is calculated achieves the overall objective of the risk adjustment.[4]

9. Furthermore, tentative decisions by both boards reached as part of ED/DP redeliberations have included the concept of a portfolio in determining the following:

   (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.

   (c) *Onerous contracts in the pre-coverage period.* At their joint meeting on 14 March 2011, the boards tentatively decided that insurance contract assets and liabilities should initially be recognised when the coverage period begins. This decision means that no liability is recognised, under both the building block and premium allocation approach, between the date the insurer becomes a party to the contract and the start of the coverage period (the pre-coverage period).

[4] The staff note that a unit of account for determining diversification benefits is not prescribed.

Consequently, the boards have tentatively decided also to require the recognition of an onerous contract liability in the pre-coverage period. Thus the boards also need to consider the unit of account that should be used when identifying or measuring onerous contracts in the pre-coverage period.

Staff analysis

10. The definition of 'portfolio' is important, because the staff propose that insurers should group contracts into portfolios to determine profitability. Consequently, the definition of 'portfolio of insurance contracts' affects:

    (a) the determination of the residual/single margin at initial recognition and subsequently; and

    (b) identification and measurement of onerous contracts.

11. At the 16 December 2011 joint board meeting, the staff recommended (agenda papers 7A/77A and 7B/77B) that:

    (a) the 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.

    (b) the boards should add application guidance to help insurers interpret the terms 'similar risks', 'similar expectations of profitability' and 'managed together'.

    (c) to ensure that the residual/single margin is fully released at the end of the coverage period (IASB) or when the insurer has been released from risk (FASB), an entity should group contracts into a 'sub-portfolio' within a portfolio if those contracts have similar:

i. inception dates;

ii. expected end dates; and

iii. expected patterns of release of the residual/single margin.

12. However, no decisions regarding the definition of portfolio were made at the 16 December 2011 meeting.

13. In this paper, the staff will address the board members' feedback from the 16 December 2011 meeting and consider whether the following components should be included in the definition of portfolio:

    (a) subject to similar risks;

    (b) are managed together as a single pool;

    (c) have similar concepts of profitability; and

    (d) similar duration and expected patterns of release of the residual/single margin.

Subject to similar risks

14. The staff believe there is general acceptance among respondents to the ED/DP and board members that the pooling of similar risks should form the basis on which insurers establish portfolios. Consequently, the staff propose retaining this element of the definition.

15. However, the staff also believe that 'subject to similar risks' can be interpreted in different ways. The other elements of the definition of portfolio considered in this analysis are intended to address this issue.

Managed together as a single pool

16. Some board members questioned whether contracts in the same portfolio needed to be 'managed together'. They noted that contracts that cover the same risks could

potentially be managed from different locations. For example, an insurer may underwrite Florida hurricane insurance from both London and Zurich. They noted that if the 'managed together' criterion were to be included in the definition of a portfolio it would, arguably, not be possible to group together the coverage written in London with the coverage written in Zurich.

17. The requirement that contracts should be managed together should not be read as meaning that they have to be underwritten in the same place. The location of underwriting can be, but is not always, an indicator that the contracts would be managed together. Most respondents to the ED/DP support including reference to the way in which contracts are managed in the definition. This will provide information about how the insurer's operations are managed and how it perceives the relationships between groups of contracts.

18. Consequently, the staff believe that reference to the way in which an insurer manages its contracts should be retained in the definition of a portfolio.

Similar concepts of profitability

19. Several board members raised concerns about a possible criterion that contracts in a portfolio should have 'similar expectations of profitability'. In particular:

    (a) Some noted that contracts that have similar risks would be likely to be priced in the same way and are likely to have the same expected profitability. Furthermore, contracts that have the same expected profitability will most probably be managed together. The requirement is thus unnecessary.

    (b) Some believed the reference to profitability implied that contracts with different levels of profit could not be combined; others believed that it simply implied that loss-making contracts could not be combined with profitable contracts. Some stated that including the notion of profitability was confusing, because the economic nature of insurance was a pooling of risks that involved supporting less profitable contracts with profitable ones.

(c) Some stated that referring to profitability will make the definition circular, because the profitability notion is used to define 'portfolio'; with the portfolio in turn being used to determine profitability.

20. Other board members preferred the retention of a profitability notion within the definition of a portfolio of insurance contracts as proposed by the staff. They believe that referring to profitability will address the risk of earnings management, as discussed in the next paragraph. They also indicated that more guidance needs to be included on how profitability should be interpreted.

21. Some board members noted that the definition of 'portfolio' without the notion of profitability is too broad and could arguably result in insurers combining contracts with significantly different expected loss ratios into the same portfolio. Some are concerned about earnings management, because without the notion of profitability in the definition of 'portfolio', insurers could combine contracts that have different profit percentages and thus delay the recognition of losses.

22. The staff included the reference to profitability within the proposed definition of a portfolio to ensure that:

(a) Contracts that are deliberately priced as loss-making (for example, loss leaders) would not be combined with contracts that are profitable.

(b) Contracts that have significantly different levels of profitability would not be combined. A group of contracts that have a loss ratio of 98 per cent are much more likely to become loss-making than a group of contracts with a loss ratio of 80 percent.

23. The staff note that different views exist among insurers about what constitutes similar risks. For example, some constituents argue that all property and casualty insurance is essentially based on risk protection, as opposed to life contracts, which are interest-sensitive. Consequently, they could potentially group contracts into life and non-life portfolios. At a lower level, some insurers combine all commercial

insurance products into one portfolio, because they argue that they are subject to similar risks and are managed together. This could include commercial multi-peril, commercial auto, workers compensation and surety contracts, among other lines of business. For life insurance, some insurers split interest-sensitive products from other life insurance products. Others combine all life insurance products, which could include life and protection (possibly grouping life insurance—both whole life and term life), long-term care and long-term disability, pensions and asset or wealth management (including annuities, pension contracts and variable products). However, these products have very different levels of profitability.

24. The staff are concerned that if reference to profitability is removed from the definition, the objectives discussed in paragraph 22 will not be achieved. Consequently, the staff have considered how to retain the concept of profitability and at the same time address the concerns raised by board members at the December 2011 meeting.

25. The staff originally considered whether the concept of profitability could more clearly be captured by referring to the pricing of the contracts in the definition of ‘portfolio’. Contracts that have similar pricing and are subject to similar risks are likely to have similar levels of profitability (this is because the profitability of an insurance contract is largely determined by the risks taken on by the insurer and the price charged as compensation for risk).

26. The staff believe that reference to similar pricing is more easily understood and less confusing than profitability. In addition it avoids the concerns raised by some board members that the nature of insurance is to combine loss-making contracts with profitable contracts.

27. The staff also note that, pricing, unlike expectations of profitability, does not change over time. It is established at contract inception. Consequently, the risk of contracts being re-grouped to avoid recognising losses is reduced by replacing the ‘similar expectation of profitability’ criterion with a ‘similar pricing’ criterion.

28. The staff note that pricing should be interpreted as similar pricing relative to the insurance risk. Said differently, ‘similar pricing’ does not mean similar pricing by

number of currency units (ie absolute values), but similar compensation for bearing similar insurance risks.

29. Consequently, staff propose including similar pricing relative to risk taken on as an element in the definition.

Similar duration and expected patterns of release of the residual/single margin

30. The IASB has tentatively decided that the residual margin should be released over the coverage period on a systematic basis that is consistent with the pattern of transfer of services provided under the contract.

31. The FASB tentatively decided:

    a) the insurance contract measurement model should use a single margin approach that recognises profit as the insurer satisfies its performance obligation to stand ready to compensate the policyholder in the event of an occurrence of a specified uncertain future event that adversely affects that policyholder.

    b) an insurer satisfies its performance obligation as it is released from exposure to risk as evidenced by a reduction in the variability of cash outflows.

32. Agenda paper 7B/77B for the 16 December 2011 joint board meeting proposed that, to ensure that the residual/single margin has been fully released at the end of the coverage period (IASB) or when the insurer has been released from risk (FASB), an entity should group contracts within a portfolio that have similar:

    a) inception dates;

    b) expected end dates; and

    c) expected patterns of release of the residual/single margin.

33. The grouping of contracts as outlined above was referred to as a 'sub-portfolio'.

34. Some board members raised concerns that the staff proposal was over-engineered and too prescriptive. They noted that it was sufficient only to state the principle

and objected to the introduction of an additional unit of account (the sub-portfolio). They also questioned whether it was practical to require insurers to group contracts into sub-portfolios, because keeping track of sub-portfolios in addition to portfolios would impose an unacceptable burden on insurers.

35. Other board members asked why the additional unit of account (sub-portfolio) was proposed to release the residual/single margin, but not for other uses in the standard' ie they asked if the sub-portfolio could be used for all purposes.

36. Some board members suggested that instead of referring to similar inception and end dates, the definition should refer to 'similar duration'.

37. Differences of opinion exist among the staff as to whether the unit of account for releasing the residual/single margin should be prescribed or not. These two views are discussed below.

Unit of account needs to be specified

38. Some staff believe that the concepts of duration and expected patterns of release of the margin (as described in paragraphs 30 and 31 above) must be included in the unit of account to ensure that the whole of the margin is released to profit or loss by the end of the contract and in the appropriate period. Including the concept of duration is similar to the approach in the ED/DP for releasing the margin, because this approach took the coverage period of the contract into consideration (paragraph BC130 of the ED explains this approach). In the ED, the IASB concluded that residual margins should be determined at a level that aggregates insurance contracts into a portfolio and, within each portfolio, by similar date of inception of the contract and by similar coverage period ('cohorts'). Similarly, paragraph 55 of the DP states that an insurer would determine the composite margin at a level that aggregates insurance contracts into a portfolio of insurance contracts and within a

portfolio, by similar date of initial recognition of the contract and coverage periods.[5]

39. The pattern of release from risk for a contract (ie the reduction in the variability of the expected cash flows) will not necessarily be on a straight-line basis. Some contracts' risks may reduce more in the early years and less in the later years or vice versa. Similarly, the pattern of transfer of services for a contract will not necessarily be on a straight-line basis. In addition, the pattern of profitability of some contracts may not be on a straight-line basis. To group these contracts for purposes of releasing the residual/single margin would be arbitrary and would not reflect the risks and related profitability characteristics inherent in those contracts. This is addressed in part by including the notion of similar pricing relative to risk in the definition, as discussed above, but the pattern of the release of profit is also important. In addition, as mentioned above, grouping contracts with different durations together could result in some of the available residual/single margin not being released to profit or loss or released in the incorrect reporting period. These staff believe that duration must be added to the definition to ensure that contracts with different durations, when grouped together, do not skew the release of the margin or affect whether it is released in the appropriate period.

40. Consequently, these staff believe that similar duration and expected patterns of release of the margin should also be included in the definition. If the definition of 'portfolio' does not include these elements, there would be nothing to prevent insurers from applying a level of aggregation that does not achieve the stated objective of fully releasing the residual/single margin in the appropriate period.[6]

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[5] The staff note that the ED and DP refer to similar date of inception of the contract and by similar coverage period. These staff propose 'duration' because it still retains the notion of timing, but better reflects the pattern of release of risk, because the date on which the contract began is not the only relevant date. These staff believe that when the contracts that have been grouped have similar durations, the pattern of release of risk is consistent within those durations.

[6] As discussed in paragraph 23, in practice, insurers interpret the current US GAAP definition of 'portfolio' differently. Because different insurers interpret the definition of 'portfolio' differently, some staff believe that without the concepts of duration and expected patterns of release of the margin in the proposed definition, the margin will be misstated.

41. These staff would also note that in non-life contracts, assumptions about the pattern of the release from risk and the duration of that risk are not applied downward from a portfolio level to an individual contract level, because the insurer does not know which contracts will result in claims, when those claims will be reported, or when an ultimate loss amount will be determined. Consequently, these staff believe that releasing the residual/single margin cannot be performed at the individual contract level in all circumstances. However, in life contracts, such assumptions that are determined at a portfolio level are typically applied downward to an individual contract level because of the nature of the risk the insurer is assuming (mortality assumptions, etc.). For that reason, in life contracts the release of the margin may happen at a lower level. These staff would suggest adding application guidance to the definition of 'portfolio' that clarifies that insurers are not precluded from releasing the margin at a lower level than the portfolio level.

42. These staff are also concerned that without specifying a unit of account for the release of the residual/single margin, in an unlocked residual margin environment, insurers could combine contracts that do not have similar risk, pricing, and duration characteristics. To not specify a level would allow insurers too much latitude in releasing the residual/single margin, resulting in decreased comparability. Furthermore, because insurers probably group contracts by issue year for life insurance and by accident year for non-life insurance, applying the definition of 'portfolio' that contains the reference to similar duration and expected patterns of release of the residual/single margin will not add additional complexity or cost to implement.[7]

43. Consequently, some staff believe that the definition of a portfolio of insurance contracts and the notion of a sub-portfolio should be combined. If this is done, the complexity of the standard will be reduced because a single unit of account will be used for:

[7] These staff also believe that to add the concept of 'similar duration and expected patterns of release of the residual/single margin' is less complex and prescriptive than the unit of account proposed in the ED/DP to release the residual/single margin.

a) determining the residual/single margin;

b) identifying and measuring onerous contracts; and

c) releasing the residual/single margin.

44. To ensure that the residual/single margin is fully released in the appropriate period, these staff also recommend that the definition of 'portfolio' should require that contracts must have similar durations and expected patterns of release of the residual/single margin.

45. These staff also note that the onerous contract test should be performed at the same level as that at which the residual/single margin is released, which should reflect the profitability of contracts. If it is performed at a higher level, it is not comparing the expected cash flows to the appropriate amount of residual/single margin that has not been recognised (corresponding to the portfolio of contracts in question for the onerous test).

Unit of account does not need to be specified

46. Some staff note that the objectives for releasing the residual/single margin could be achieved by calculating the release at the individual contract level.

47. However, in developing the ED/DP, the boards dismissed the idea of releasing the residual/single margin at an individual contract level on the grounds that it would be impracticable, per paragraph BC130:

> Paragraph BC120 explains that the risk adjustment should be determined at a portfolio of contracts level that groups together contracts subject to similar circumstances (ie contracts that are subject to similar risks and are managed together as a pool). However, because the residual margin is released over the coverage period, it is necessary to adopt a different level of aggregation for residual margins that group together only those contracts within the portfolio that have similar coverage periods. For this reason, the Board concluded that residual margins should be determined at a level that aggregates insurance contracts

> into a portfolio and, within each portfolio, by similar date of inception of the contract and by similar coverage period. An alternative would be to determine the release of the residual margin at an individual contract level, but the Board concluded that would be impracticable.

48. These staff agree that releasing the residual/single margin at the individual contract level could be impracticable. Furthermore, these staff agree with the comments raised by some board members at the December 2011 meeting that how an insurer chooses to ensure that the residual/single margin is released is an operational detail that should not be specified in the standard. Instead, the standard should simply state that the overall objective for releasing the residual/single margin, namely: to release the residual margin over the coverage period to the period(s) in which the service is provided [for the IASB]; or to release the single margin in the period(s) in which the insurer is released from risk [for the FASB]. For the IASB the service is provided over the coverage period, and for the FASB the insurer is released from risk by a reduction in the variability of cash outflows.

49. These staff therefore believe if the objectives of releasing the residual/single margin are clearly defined, it is unnecessary to specify the unit of account that should be used when releasing the residual/single margin. If the unit of account for releasing the residual/single margin is not specified, then it is unnecessary for the definition of a portfolio to refer to contracts with similar duration and expected patterns of release of the residual/single margin.

50. Furthermore, these staff believe that requiring that contracts in a portfolio should have the same expected pattern of margin release and duration would be over-engineering a principle-based standard. These staff also believe by specifying the unit of account for releasing the residual/single margin, other possible ways[8] of

[8] Other methods of releasing the residual margin exist. For instance, the grouping of contracts of *similar* duration is not necessary when the residual/single margin is released on a straight-line basis (ie the residual/single margin for a group of contracts can be released over the group's *average* duration).

achieving similar results may be prohibited. Additional costs and complexities with no added benefit could therefore be imposed on insurers.

51. These staff also note that to achieve the objectives of releasing the residual/single margin, insurers will have to release the residual/single margin at a fairly granular level (most probably lower than portfolio level). Consequently, the application of a principle-based approach to releasing the residual/single margin could result in the insurer using more than one unit of account.[9]

Application guidance

52. The staff propose application guidance to interpret the elements of the definition discussed above. Appendix B to this paper includes proposed wording for this application guidance.

Staff recommendation

53. Some staff recommend that:

    (a) The unit of account used to **determine**[10] the residual/single margin and perform the onerous test should be the portfolio. A portfolio of insurance contracts should be defined as contracts that are:

        (i) subject to similar risks (paragraphs 14-15);

        (ii) managed together as a single pool (paragraphs16-18); and

        (iii) priced similarly relative to the risk taken on (paragraphs 19-29).

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[9] Furthermore, the staff note that the IASB decided not to specify the unit of account when calculating the risk adjustment.

[10] The determination of the residual/single margin refers to the assessment of whether a group of contracts have a positive or negative residual/single margin (ie assessing whether a group of contracts are profitable or loss-making). The release of the residual/single margin refers to the recognition of a positive residual/single margin in profit or loss.

(b) The unit of account used to **release**[10] the residual/single margin should not be prescribed. However, the release of the residual/single margin should be performed in a manner consistent with the objective to release the residual margin over the coverage period to the period(s) in which the service is provided [for the IASB]; or to release the single margin in the period(s) in which the insurer is released from risk [for the FASB]. For the IASB the service is provided over the coverage period, and for the FASB the insurer is released from risk by a reduction in the variability of cash outflows.

54. Other staff recommend that:

(a) The unit of account used to **determine**[10] the residual/single margin, **release** the residual/single margin, and perform the onerous contract test should be the portfolio.[11] A portfolio of insurance contracts should be defined as contracts that:

(i) are subject to similar risks (paragraphs 14-15);

(ii) are managed together as a single pool (paragraphs16-18);

(iii) are priced similarly relative to the risk taken on (paragraphs 19-29); and

(iv) have similar duration and similar expected patterns of release of the residual/single margin (paragraphs 30-51).

[11] These staff believe that the definition of 'portfolio' proposed should achieve consistency with the principles for releasing the residual/single margin.

Question 1: Definition of a portfolio of insurance contracts

Do the boards agree that:

The unit of account used to determine the residual/single margin and perform the onerous test should be the portfolio. A portfolio of insurance contracts should be defined as contracts that are:

(i) subject to similar risks;

(ii) managed together as a single pool; and

(iii) priced similarly relative to the risk taken on.

The unit of account used to release the residual/single margin should not be prescribed. However, the release of the residual/single margin should be performed in a manner consistent with the objectives for releasing the residual/single margin.

Or do the boards agree that:

The unit of account used to determine the residual/single margin, release the residual/single margin, and perform the onerous contract test should be the portfolio. A portfolio of insurance contracts should be defined as contracts that:

(i) are subject to similar risks;

(ii) are managed together as a single pool;

(iii) are priced similarly relative to the risk taken on; and

(iv) have similar duration and similar expected patterns of release of the residual/single margin.

Appendix A—Feedback received from respondents on the unit account to be applied in determining and releasing the residual/single margin

A1. The ED/DP did not ask a specific question about which unit of account should be used when determining and allocating the residual/single margin. However, a small number of respondents articulated their views on the unit of account to be used when determining the residual/single margin.

A2. Some respondents agreed with the notion of determining the residual/single margin at the cohort level. However, of these respondents, some indicated that entities should be permitted to apply the phrase "similar date of initial recognition" in a flexible manner. These respondents expressed concern that calculating the residual/single margin at too granular a level would increase cost and complexity for preparers with little benefit to users.

A3. Some respondents instead expressed a preference for determining the residual/single margin at the portfolio level. These respondents expressed concern that aggregation of contracts at the cohort level would be too complex and burdensome with little benefit. Some of these respondents noted that the phrase "similar date of initial recognition" would not be interpreted consistently, which would lead to diversity in practice. Some constituents questioned whether this was by year, quarter, month, etc.

A4. One respondent also stated that determining the residual/single margin at the cohort level would lead to the question of whether. and to what extent. the offset of negative and positive amounts should be permitted. This respondent noted that the economic basis of insurance is the pooling of risks, through which more profitable contracts support less profitable contracts, and that determining the residual/single margin at too granular a level would distort the profitability of the portfolio.

A5. Some respondents requested more guidance on whether calculating the residual/single margin on an individual contract level is acceptable, because there may be practical advantages in doing so. Some insurers stated that the standard should not prescribe the level of measurement of the residual/single margin.

Appendix B—Suggested wording to be included in the application guidance on the definition of a portfolio of insurance contracts

B1. A portfolio of insurance contracts shall 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 together contracts for which the pricing, relative to the risk taken on, differs significantly.

B2. 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).

B3. 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 instance, broker channels or direct, etc.);

(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).

B4. Similar pricing should be interpreted as similar compensation required for taking on similar insurance risks and not as similar pricing by number of currency units (ie absolute values). In determining whether a group of contracts are similarly priced for the risk taken on, an insurer shall consider whether similar or different prices are charged for the same product offering (ie whether compensation required for taking on similar insurance risks is similar or different).