

## STAFF PAPER

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## IASB Meeting

<b>Project</b>	<b>Insurance contracts</b>		
<b>Paper topic</b>	Narrow exemption for the grouping of regulatory-affected pricing of insurance contracts		
<b>CONTACT(S)</b>	Joanna Yeoh	jyeoh@ifrs.org	+44 (0) 20 7246 6481

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## Introduction

1. This paper discusses a narrow exemption to the requirements for grouping insurance contracts when regulation or law constrains an entity from fully pricing or setting benefits that reflect the characteristics of a set of policyholders.

## Summary of staff recommendation

2. If an exemption for grouping contracts is provided, the staff recommend that it should apply only to contracts that would fall into different groups because law or regulation constrains the entity's practical ability to set a different price or level of benefits for policyholders with different characteristics.

## Background

### *Grouping of contracts*

3. The Board tentatively decided that an entity should measure groups of insurance contracts. A summary of the Board's tentative decisions are:
  - (a) An entity should be required to identify a portfolio of insurance contracts that comprises contracts that are subject to similar risks and managed together as a single pool. Contracts in different product lines would be expected to be in different portfolios.

- (b) An entity should be required to divide a portfolio into:
  - (i) a group of contracts that are onerous at initial recognition, if any;
  - (ii) a group of contracts that at initial recognition have no significant risk of becoming onerous, if any; and
  - (iii) a group of the remaining contracts in the portfolio, if any.
- (c) An entity should be permitted to subdivide the groups in paragraph 3(b) into more groups if its internal reporting systems support the identification of further groups.
- (d) An entity should not include contracts issued more than one year apart in the same group.

4. In IFRS Standards, the unit of account is typically the individual contract. Accordingly a loss on an onerous contract is recognised immediately in profit or loss and is not offset against other similar profitable contracts which are managed together. For example, the unit of account for IFRS 15 *Revenue from Contracts with Customers* is an individual contract, and an entity would recognise losses arising from a contract with customers in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.
5. The Board's reasoning for measuring specified groups of contracts in IFRS 17, rather than individual contracts, is to balance (a) that an entity makes estimates that are valid on average for each contract in a group of insurance contracts, even though the experience of an individual contract will ultimately differ from the average, with (b) the fact that grouping results in a loss of information because the losses of contracts within the group would be offset by the profits of other contracts within the group. This is important because losses for a group of onerous contracts are recognised immediately in profit or loss but profits for a group of profitable contracts are recognised over the coverage period. Accordingly, while grouping is needed to reflect the economics of issuing insurance contracts, grouping at too high a level would reduce the usefulness of information produced. A key consideration in the Board's determination on the appropriate grouping of contracts in November 2016 (see paragraph 3) was that

the information produced would faithfully reflect the insurance business and provide relevant information to users of financial information.

### ***When law or regulation affects the pricing of insurance contracts***

6. In some jurisdictions, law or regulation constrains the entity's ability to set the pricing and benefits paid in a way that reflects the different characteristics of individual policyholders. Restrictions through law or regulation are common when a jurisdiction requires mandatory insurance for some risks, eg health, flood, third-party motor insurance. Where such restrictions exist, the insurer may also need to seek regulatory approval for changes in the premiums and/or benefits.
7. When differences in a particular characteristic (eg geographical location, age, credit history) are associated with different degrees of risk and/or estimates of claims, entities would typically charge different prices to seek compensation for those differences. However, in some cases, law or regulation may constrain entities so that they may not be able to charge different prices, or may be limited in their ability to charge different prices, for a specific characteristic (eg gender, age, race or credit scores). In addition, entities in such jurisdictions may be unable to refuse to provide insurance coverage solely to some policyholders because of differences on that characteristic. Effectively, this results in an entity setting a price so that the policyholders with a characteristic that are less likely to claim (or are likely to claim a smaller amount) may cross-subsidise the policyholders with a different characteristic that are more likely to claim (or are likely to claim a larger amount), because of that difference in characteristic. Nonetheless, an entity may still be able to vary the prices charged based on other characteristics, therefore these constraints are unlikely to result in all policyholders paying the same premium for the same benefit level.

## Staff analysis

8. This paper considers the effect of law or regulation in the context of the Board's November 2016 decisions on the grouping of contracts outlined in paragraph 3. In January 2016, the Board considered and decided not to provide an exemption to the requirements for level of aggregation when regulation constrains the pricing or benefits. However, the staff note that this decision was taken in the context of the previous decisions on the level of aggregation. The Board has since made significant changes to those decisions.
9. Applying the Board's most recent tentative decisions about grouping contracts, an entity may need to divide contracts that disregard a specified characteristic in pricing into different groups, even if the reason the entity disregards that specified characteristic is because of law or regulation (see paragraph 3(b)). For example, the Board's tentative decisions mean that an entity must set an overall price or level of benefits for policyholders with different characteristics ignoring those differences. Accordingly, the entity may portray onerous losses in profit or loss in the period for policyholders with a particular characteristic and recognise profits over the coverage period for policyholders with a different characteristic. Some suggest that the recognition of losses and gains in this way is artificial and will be hard to explain to users of financial statements. They argue that this portrayal does not reflect the economic fact that law and regulation affects the pricing or level of benefits for all entities in the jurisdiction.
10. In addition, the Board has been asked to provide an exemption to the requirement to divide a portfolio into groups of contracts that are onerous at inception, not significantly likely to be onerous, and other contracts (see paragraph 3(b)) when law or regulation constrains the entity's ability to set the pricing and benefits paid in a way that reflects the different characteristics of individual policyholders.
11. In general, the Board seeks to minimise exemptions because they increase complexity for both users of financial statements and preparers and may have unintended consequences for future standard-setting activities. The Board previously considered an exemption to the level of aggregation when regulation constrains the pricing or benefits in the context of its previous decisions (see paragraph 8), but decided not to because of the following disadvantages:

- (a) A difference in the likelihood of a contract being, or becoming, onerous, even if caused by law or regulation, is a real economic difference between groups of contracts. There is no difference economically between when an entity has chosen to price ignoring significant differences in policyholder risk and when an entity is prohibited from using significant differences in policyholder risk. In addition, some argue that a multinational has a choice in which jurisdiction it operates in and therefore, can choose which law or regulation it chooses to operate under. Grouping contracts that have different likelihoods of becoming onerous reduces the information provided to users of financial statements.
- (b) It can be difficult to define when an entity's action is constrained by law or regulation and any distinction drawn by the Board could be considered arbitrary. The following situations could be considered economically similar to the situation considered for the exemption—the entity chooses to issue contracts in a jurisdiction where the law or regulation explicitly prohibits (or limits) the consideration of a specific characteristic—to where:
- (i) The entity sets the price for contracts without considering differences in a specific characteristic because it thinks using that characteristic in pricing may result in a law or regulation prohibiting the use of that specified characteristic in the future or because it is likely to fulfil a public policy objective. These practices are sometimes termed 'self-regulatory practices'.
  - (ii) The entity sets the price for contracts without considering differences in a specific characteristic because the law or regulation in a neighbouring jurisdiction explicitly prohibits consideration of differences in that specific characteristic.
  - (iii) The entity sets the price for contracts without considering differences in a specific characteristic because using differences in that specific characteristic may have a negative effect on the entity's brand and reputation.

- (c) providing an exemption for accounting for economic differences caused by the effect of law or regulation on pricing may create an undesirable precedent, given that such effects are not restricted to insurance contracts. (The staff note that a limited number of insurance contracts may be within the scope of the rate-regulated activities project).
12. However, the notion of grouping contracts to determine the profit or losses recognised is a specific feature of the requirements in IFRS 17. In deciding the appropriate grouping of contracts, the Board is seeking to balance the need to group contracts to reflect the economics of issuing insurance contracts against grouping at too high a level, which would reduce the usefulness of information produced (see paragraphs 4-5).
13. Many commentators have questioned whether the information that would be obtained from grouping separately contracts that an entity is required by law or regulation to group together for determining the pricing or level of benefits would be useful. This is because all market participants in that jurisdiction will be constrained in the same way and this creates an economic effect for that jurisdiction, particularly if such entities are unable to refuse to provide insurance coverage solely on the basis of differences in that characteristic. Accordingly, in this circumstance, some commentators argue that it would provide a better economic depiction if entities combine contracts in the same group that would otherwise be in different groups solely because of law or regulation.
14. The staff think that the argument that an economic effect is created when all market participants are constrained in the same way does not apply to self-regulatory practices such as those discussed in paragraph 11(b)(i). In substance self-regulatory practices are subject to the entity's discretion and do not affect the whole jurisdiction. Accordingly, self-regulatory pricing practices are economically equivalent to when pricing has been set at the entity's discretion (For example, as described in paragraph 11(b)(iii)).

15. If the Board were to provide an exemption when law or regulation creates an economic effect because all market participants are constrained in the same way, the staff recommend that:
- (a) the exemption is narrowly specified to apply only when law or regulation results in different groups applying paragraph 3(b).
  - (b) the Board explicitly states that this exemption should not be extended by analogy to regulatory-affected transactions accounted for in accordance with other IFRS Standards.
16. As a result, an exemption would:
- (a) distinguish pricing that is (i) constrained by law or regulation from (ii) self-regulatory practices such as those discussed in paragraph 11(b)(i) and the other circumstances described in 11(b)(ii)-11(b)(iii).
  - (b) be applicable only to the requirement that at minimum an entity should separately group contracts that are onerous at inception, not significantly likely to be onerous and other contracts (see paragraph 3(b)) and not to any other aspects of the measurement requirements.
  - (c) not result in the level of aggregation being the portfolio when law or regulation prohibits, or restricts the consideration, of specified characteristics because applying paragraph 3(b), the portfolio could be subdivided into further groups because of the presence of characteristics other than that the specified characteristics and when the contracts are written over a year apart.
  - (d) not be applicable to any other regulatory-affected transactions that are accounted for in accordance with other IFRS Standards.
17. At the same time, the narrow exemption would respond to the specific concern identified by commentators on the Board's decisions on the level of aggregation, without fundamentally changing the Board's tentative decision.
18. If the Board were to provide the exemption as set out in the staff recommendation, staff intend that the disclosure about the fact the exemption has been applied should be added to the disclosures of the effect of the regulatory frameworks in which an entity operates in that is already in IFRS 17.

**Recommendation and question for the Board:****Exemption for law or regulation constraints**

If the Board were to exempt entities from the requirements for dividing portfolios of insurance contracts into groups (see Appendix A paragraphs 16–19), the staff recommend that the exemption should apply if, and only if, constraints in law or regulation on the entity's practical ability to set a different price or benefit level for policyholders with different characteristics would cause the entity to divide the contracts in a portfolio into different groups. When this is the case, the entity may include those contracts in the same group and should disclose that fact.

Do you agree that such an exemption should be provided?

Appendix A sets out the current draft of the level of aggregation requirements in IFRS 17, modified to show how such an exemption would be implemented.



## Appendix: Extract from draft IFRS 17 of the level of aggregation decisions

A1. The paragraphs below show the latest staff draft of the level of aggregation requirements. If the Board agrees to provide an exemption for when constraints in law or regulation on the entity's practical ability to set a different price or benefit level for policyholders with different characteristics would cause the entity to divide the contracts in a portfolio into different groups, the marked-up paragraph shows how that exemption would be implemented. This drafting has been provided to aid in the Board's consideration of the issue. Additional paragraphs from the draft have been included to provide context to the proposed amendment. These additional paragraphs have yet to be reviewed by the Board and are subject to further editorial changes.

### Level of aggregation

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14. An entity shall identify *portfolios of insurance contracts*. A portfolio comprises contracts that are subject to similar risks and managed together. Contracts within a product line would be expected to have similar risks, and hence be in the same portfolio if they are managed together. Contracts in different product lines (for example single premium fixed annuities compared to regular term life assurance) would not be expected to have similar risks and hence would be expected to be in different portfolios.
15. Paragraphs 16–24 apply to insurance contracts issued. The requirements for the level of aggregation of reinsurance contracts held are set out in paragraph X.
16. 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 (see paragraph X, if any);
  - (b) a group of contracts that at initial recognition have no significant possibility of becoming onerous subsequently (see paragraph X), if any; and
  - (c) a group of the remaining contracts in the portfolio, if any.
17. For contracts issued to which an entity does not apply the premium allocation approach (see paragraphs X—X), an entity shall determine which contracts are onerous at initial recognition, by measuring:
  - (a) any sets of contracts, if using reasonable and supportable information the entity can determine that the contracts in the sets are either all onerous or all not onerous; or
  - (b) individual contracts.
18. For contracts issued to which an entity does not apply the premium allocation approach (see paragraphs X—X), an entity shall assess whether contracts that are not onerous at initial recognition have no significant possibility of becoming onerous:
  - (a) based on the likelihood of changes in assumptions which, if they occurred, would result in the contracts becoming onerous.
  - (b) using information about estimates provided by the entity's internal reporting. Hence:
    - (i) an entity shall not disregard information provided by the entity's internal reporting about the effect of changes in assumptions on different contracts on the possibility of their becoming onerous; but
    - (ii) an entity need not gather additional information beyond that provided by the entity's internal reporting about the effect of changes in assumptions on different contracts.

19. For contracts issued to which an entity applies the premium allocation approach (see paragraphs X—X), an entity shall assume that no contracts in the portfolio are onerous at initial recognition, unless facts and circumstances indicate otherwise. An entity shall assess whether contracts that are not onerous at initial recognition have no significant possibility of becoming onerous subsequently by assessing the likelihood of changes in applicable facts and circumstances.
20. If, applying paragraphs 16–19, contracts within a portfolio would fall into different groups only because law or regulation constrains the entity’s practical ability to set a different price or level of benefits for policyholders with different characteristics, the entity may include those contracts in the same group. The entity shall not apply this paragraph by analogy to other items.
21. An entity is permitted to sub-divide the groups described in paragraph 16. For example, an entity may choose to divide the portfolios into:
  - (a) more groups that are not onerous at initial recognition if the entity’s internal reporting provides information that distinguishes:
    - (i) more detailed levels of possibilities of contracts becoming onerous subsequent to initial recognition; or
    - (ii) different levels of profitability in addition to whether there is a significant possibility of becoming onerous; and
  - (b) more than one group of contracts that are onerous at inception, if the entity’s internal reporting provides information at a more detailed level about the extent to which the contracts are onerous.
22. An entity shall not include contracts issued more than one year apart in the same group. To achieve this, if necessary, the entity shall further divide the groups described in paragraphs 16–21.
23. A group shall comprise a single contract if that is the result of applying paragraphs 14–22.
24. An entity shall apply the recognition and measurement requirements of IFRS 17 to the groups of contracts issued determined by applying paragraphs 14–23. An entity shall establish the groups at the inception of the contracts, and shall not reassess the composition of the groups subsequently. To measure a group of contracts, an entity may estimate the fulfilment cash flows at a higher level of aggregation than the group or portfolio, provided the entity is able to include the appropriate fulfilment cash flows in the measurement of the group applying paragraphs X and X by allocating such estimates to groups of contracts.