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Paris, November 5th, 2018

Chairman

Mr Jean-Paul GAUZES
Chairman EFRAG Board
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PDC n° 105

Dear Jean-Paul,

ANC is currently working on the six concerns raised by EFRAG in the context of the endorsement process of IFRS 17.

As suggested during our September Board meeting, we wish to communicate to the board the outcome of our work on three concerns: level of aggregation, balance-sheet presentation, acquisition cash-flows. These three documents take into account comments received from a number of stakeholders consulted by ANC, but remain drafts for discussion at this stage. We intend to share these documents with the IASB also.

We are currently working on the other three concerns and we will share the outcome of our work with the board in due course.

Please do not hesitate to contact us should you want to discuss any aspect of these documents.

Yours sincerely,

Amities.

Patrick de CAMBOURG

IFRS 17 issues – Level of aggregation

Draft for discussion

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1 Current IASB requirements and TRG conclusions

1.1 IFRS 17 requirements

- 1 IFRS 17.14: 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.
- 2 IFRS 17.15: Paragraphs 16–24 apply to insurance contracts issued. The requirements for the level of aggregation of reinsurance contracts held are set out in paragraph 61.
- 3 IFRS 17.16: 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, 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.
- 4 IFRS 17.17: If an entity has reasonable and supportable information to conclude that a set of contracts will all be in the same group applying paragraph 16, it may measure the set of contracts to determine if the contracts are onerous (see paragraph 47) and assess the set of contracts to determine if the contracts have no significant possibility of becoming onerous subsequently (see paragraph 19). If the entity does not have reasonable and supportable information to conclude that a set of contracts will all be in the same group, it shall determine the group to which contracts belong by considering individual contracts.
- 5 IFRS 17.18: For contracts issued to which an entity applies the premium allocation approach (see paragraphs 53–59), the entity shall assume 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.
- 6 IFRS 17.19: For contracts issued to which an entity does not apply the premium allocation approach (see paragraphs 53–59), 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, in assessing whether contracts that are not onerous at initial recognition have no significant possibility of becoming onerous:

(i) an entity shall not disregard information provided by its internal reporting about the effect of changes in assumptions on different contracts on the possibility of their becoming onerous; but

(ii) an entity is not required to gather additional information beyond that provided by the entity's internal reporting about the effect of changes in assumptions on different contracts.

7 IFRS 17.20: If, applying paragraphs 14–19, contracts within a portfolio would fall into different groups only because law or regulation specifically constrains the entity's practical ability to set a different price or level of benefits for policyholders with different characteristics, the entity may include those contracts in the same group. The entity shall not apply this paragraph by analogy to other items.

8 IFRS 17.21: An entity is permitted to subdivide 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) different levels of profitability; or

(ii) different possibilities of contracts becoming onerous after initial recognition; and

(b) more than one group of contracts that are onerous at initial recognition—if the entity's internal reporting provides information at a more detailed level about the extent to which the contracts are onerous.

9 IFRS 17.22: 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.

10 IFRS 17.23: A group of insurance contracts shall comprise a single contract if that is the result of applying paragraphs 14–22.

11 IFRS 17.24: 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 initial recognition, 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 32(a), 40(a)(i) and 40(b), by allocating such estimates to groups of contracts.

12 IFRS 17.B37: The objective of estimating future cash flows is to determine the expected value, or probability-weighted mean, of the full range of possible outcomes, considering all reasonable and supportable information available at the reporting date without undue cost or effort. Reasonable and supportable information available at the reporting date without undue cost or effort includes information

about past events and current conditions, and forecasts of future conditions (see paragraph B41). Information available from an entity's own information systems is considered to be available without undue cost or effort.

- 13 IFRS 17.B38: The starting point for an estimate of the cash flows is a range of scenarios that reflects the full range of possible outcomes. Each scenario specifies the amount and timing of the cash flows for a particular outcome, and the estimated probability of that outcome. The cash flows from each scenario are discounted and weighted by the estimated probability of that outcome to derive an expected present value. Consequently, the objective is not to develop a most likely outcome, or a more-likely-than-not outcome, for future cash flows.
- 14 IFRS 17.B39: When considering the full range of possible outcomes, the objective is to incorporate all reasonable and supportable information available without undue cost or effort in an unbiased way, rather than to identify every possible scenario. In practice, developing explicit scenarios is unnecessary if the resulting estimate is consistent with the measurement objective of considering all reasonable and supportable information available without undue cost or effort when determining the mean. For example, if an entity estimates that the probability distribution of outcomes is broadly consistent with a probability distribution that can be described completely with a small number of parameters, it will be sufficient to estimate the smaller number of parameters. Similarly, in some cases, relatively simple modelling may give an answer within an acceptable range of precision, without the need for many detailed simulations. However, in some cases, the cash flows may be driven by complex underlying factors and may respond in a non-linear fashion to changes in economic conditions. This may happen if, for example, the cash flows reflect a series of interrelated options that are implicit or explicit. In such cases, more sophisticated stochastic modelling is likely to be necessary to satisfy the measurement objective.
- 15 IFRS 17.B40: The scenarios developed shall include unbiased estimates of the probability of catastrophic losses under existing contracts. Those scenarios exclude possible claims under possible future contracts.
- 16 IFRS 17.B41: An entity shall estimate the probabilities and amounts of future payments under existing contracts on the basis of information obtained including:
- (a) information about claims already reported by policyholders.
 - (b) other information about the known or estimated characteristics of the insurance contracts.
 - (c) historical data about the entity's own experience, supplemented when necessary with historical data from other sources. Historical data is adjusted to reflect current conditions, for example, if:
 - (i) the characteristics of the insured population differ (or will differ, for example, because of adverse selection) from those of the population that has been used as a basis for the historical data;

(ii) there are indications that historical trends will not continue, that new trends will emerge or that economic, demographic and other changes may affect the cash flows that arise from the existing insurance contracts; or

(iii) there have been changes in items such as underwriting procedures and claims management procedures that may affect the relevance of historical data to the insurance contracts.

(d) current price information, if available, for reinsurance contracts and other financial instruments (if any) covering similar risks, such as catastrophe bonds and weather derivatives, and recent market prices for transfers of insurance contracts. This information shall be adjusted to reflect the differences between the cash flows that arise from those reinsurance contracts or other financial instruments, and the cash flows that would arise as the entity fulfils the underlying contracts with the policyholder.

17 IFRS 17.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.

18 IFRS 17.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.

19 IFRS 17.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.

- 20 IFRS 17.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.
- 21 IFRS 17.B71: After all the coverage has been provided to the contracts in a group, the fulfilment cash flows may still include payments expected to be made to current policyholders in other groups or future policyholders. An entity is not required to continue to allocate such fulfilment cash flows to specific groups but can instead recognise and measure a liability for such fulfilment cash flows arising from all groups.
- 22 And bases for conclusions IFRS 17.BC 119, 121-123, 125, 130, 136-138, 140, 162, 171, 173 (see § 4 Appendix)

1.2 TRG

TRG Staff analysis (2018-09 AP10)

- 23 § 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 i.e. 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.

TRG Conclusion (2018-09 Summary)

- 24 § 40(d): when contracts share to a lesser extent [than 100%] in the return on a pool of underlying items consisting of the insurance contracts, an entity could be affected by the expected cash flows of each contract issued. Therefore, the contractual service margin of the groups of contracts may differ from the contractual service margin measured at a higher level, such as the portfolio level. To assess whether measuring the contractual service margin at a higher level would achieve the same accounting outcome as measuring the contractual service margin at an annual cohort level, an entity would need to determine what the effect would be of applying the requirements in IFRS 17. To be able to measure the contractual service margin at a higher level, the accounting outcome would need to be the same in all circumstances, i.e. regardless of how assumptions and experience develop over the life of the contract.

1.3 Current understanding of the accounting treatment

Group of contracts

- 25 IFRS 17 recognises the existence of portfolios of insurance contracts which comprise contracts subject to similar risks and managed together (IFRS 17.14).
- 26 For accounting purposes, portfolios must be divided into groups following two criteria:
- Onerous nature or not (IFRS 17.16),
 - Annual cohorts (IFRS 17.22).

- 27 Even if it is suggested to create groups following IFRS 17.16 first then to subdivide them following IFRS 17.22, in practical terms it seems to be more appropriate to operate the other way around.
- 28 The annual cohorts requirement will generally be irrelevant for contracts eligible to the PAA, when their coverage period is of “one year or less” (IFRS 17.53(b)).

Onerous nature or not

- 29 In order to apply the “onerous nature or not” criterion to divide portfolios when necessary, a first step is to investigate “sets of contracts” on the basis of reasonable and supportable information and conclude on their classification in one of the three relevant categories (onerous at initial recognition, no significant possibility of becoming onerous subsequently, other). If there is no reasonable and supportable information of a conclusive nature, the second step is to consider individual contracts. This way to proceed is a combination of a top-down approach (portfolio → “sets of contracts” → groups) and a bottom-up approach (individual contracts → groups) depending upon the quality of available information (IFRS 17.17).
- 30 In order to estimate fulfilment cash-flows, an entity may start from a higher level of aggregation than the group or portfolio, provided the allocation to each group is appropriate (IFRS 17.24).

Annual cohorts

- 31 Notice can be taken that there is no “inception” *per se* for an annual cohort because of the one year period.

Mutualisation

- 32 IASB decided not to refer to “mutualisation” since “that term is used in practice to refer to a variety of effects”¹.
- 33 IFRS 17 however addresses some of these effects:
- (a) By acknowledging that “fulfilment cash flows may be estimated at a higher level of aggregation than the group of portfolio” (IFRS 17.24)
 - (b) By introducing the concept of “contracts with cash flows that affect or are affected by cash flows to policyholders of contracts in another group” also described as “cross-subsidisation” (IFRS 17.B67-.B70)
 - (c) By considering the possibility of “contracts that fully share risks” (IFRS 17.BC 138)

Estimation of fulfilment cash flows at a higher level of aggregation

- 34 Opening the possibility of estimating fulfilment cash flows at a higher level of aggregation than the group or portfolio, the standard acknowledges that expected cash flows may not reliably or relevantly be determined at group or portfolio level but would rather result from a top-down pricing more efficiently set within a broader population.

Cross-subsidisation

- 35 IFRS 17 acknowledges the existence of “cross-subsidisation” among policyholders within the same portfolio² not only within a period but also over periods³.

¹ BC 171

- 36 The existence of such “contracts with cash flows that affect or are affected by cash flows to policyholders of contracts in another group” does however not require specific CSM provisions since the measurement at group level already “ensure[s] the fulfilment cash flows of any group are determined in a way that does not distort the contractual service margin, taking into account the extent to which the cash flows of different groups affect each other.” (IFRS 17.BC 171 and .BC 173).
- 37 IFRS 17.B70 provides guidance on when and how to apply IFRS 17.24 in such a group and IFRS 17.B68 concludes on the impact on the measurement of the CSM.
- 38 In addition, TRG staff has suggested that:
- B70 allows for “allocating the effect of the change in the underlying items to each group on a systematic and rational basis” only when an entity cannot identify the change in the underlying items and resulting change in the cash flows at the level of aggregation of the groups but at a higher level.
 - According to B68 the extent to which the contracts in the group cause the entity to be affected by expected cash flows is reflected in the fulfilment cash flows of each group. In other words, the effect on the insurer (i.e. the CSM) has to be calculated at the level of each group, not at portfolio level.

Fully shared risks

- 39 When mentioning “contracts that fully share risks”, IFRS 17.BC 138 (i) acknowledges that “the groups together will give the same results as a single combined risk-sharing portfolio” and (ii) notes that the requirements specify the amounts to be reported, not the methodology to be used to arrive at those amounts. In other words, the standard acknowledges that the level of aggregation proves unnecessary when contracts “fully share risks”.
- 40 TRG staff has very narrowly defined situations where “all risks are fully shared” as one which does “not cause the entity to be ultimately affected by the expected cash flows of each individual contract issued”, i.e. where the “contractual service margin will be nil”. TRG did not agree on a definition of “full risk sharing”.
- 41 In addition, TRG staff has suggested that, according to the standard, the annual cohort requirement applies except when not necessary to achieve exactly the same outcome. “Exact” meaning that the same outcome is expected at inception and achieved whatever happens.

2 Issue

2.1 Insurance business model and its representation

Managing insurance risks in portfolios

- 42 The insurance business model is based upon grouping contracts in portfolios in order to manage the (insurance and financial) risks. The law of large numbers provides insurers with a more reliable assessment of the probability and distribution of risks and therefore enables an appropriate risk management and pricing. Putting together

² BC 123(a)

³ BC 162(a)

risks within a portfolio enables this assessment and management, but does not in itself eliminate risks.

- 43 When managing similar risks together in a portfolio:
- The starting point for segregation is the “product line” level;
 - The risk is considered from the standpoint of the insurer rather than from the standpoint of the policyholder;
 - Additional guarantees generally belong to the same risk if not sold separately. For instance, loan insurance mainly provides death insurance coverage, i.e. indemnify the borrower in case of death. Additional optional coverages (such as job-loss) belong to the same risk and have not to be separately addressed.
- 44 The nature of risks in a portfolio priced and managed as such shall not be confused with the pattern or distribution of the occurrence of that risk within the population. In other words, the existence of drivers of the probability that a risk happens does not create a specific risk that would require dividing further the portfolio (except if actually not managed together). Accordingly, a portfolio has not to be further disaggregated, for instance:
- because of the age of a policyholder, even if the age is a factor increasing the probability that a risk happens (it changes the distribution of the risk, not its nature);
 - Similarly, different durations are not in themselves a separate risk that would require being isolated.
- 45 Managing the risks, an insurer may:
- Organise a mutualisation by sharing risks among policyholders and generations,
 - Hedge financial risk by investing in appropriate financial assets,
 - Hedge insurance risk by transferring risks to a third party (through reinsurance or derivatives),
 - Diversify its risk exposure in having different portfolios and activities.

Mutualisation, risk and pricing

Mutualisation and risk sharing

- 46 “Mutualisation” may be defined as the risk transfer accepted by a policyholder when he or she joins a defined population of policyholders the boundary of which is defined by the contract proposed by the insurer. The premium may be different from one policyholder to another because of certain characteristics of each policyholder (which may lead to introduce, within a single population of policyholders, different levels of risk intensity) and may also be adjusted from time to time on the basis of experience (in accordance with contractual terms), but once – and as long as – having joined the population on the agreed upon premium basis, each policyholder benefits from the same guarantees. This definition of “mutualisation” reflects what is happening in practice and also the policyholders’ understanding and acceptance of such practice.
- 47 Organising the mutualisation among policyholders is the primary goal of insurance activity. However, the insurer bears the risk that, ultimately, costs may exceed revenues so that the portfolio becomes onerous and that he will have to bear the loss (for instance in an investment contract with guaranteed participation features). Mutualisation therefore does not exclude sharing policyholders’ risks with the insurer who offers a second level of protection: if the organised mutualisation at policyholders’ level is not sufficient, the insurer will have to cover the gap.

Types of mutualisation

48 Mutualisation is a core feature of the insurance business, which is actually to organise the solidarity of policyholders against the emergence of an adverse event.

49 One may distinguish two types of mutualisation:

- Mutualisation by tariff: based on the law of large numbers, the insurer assesses the probability of occurrence of a risk within a population and shares *ex ante* the costs of that risk among policyholder through a pricing factoring the key drivers of risk. Mutualisation by tariff is a mutualisation since each policyholder pays a premium without knowing who will eventually benefit from it, but knowing that, thanks to this premium and the premiums of the other policyholders, the insurer will be in a situation to indemnify future claims (examples: life insurance risk within loan insurance).
- Mutualisation by cross-subsidisation: in addition to the mutualisation by tariff, a cross-subsidisation mechanism is contractually organised in order to allocate expected and unexpected cash-flows among policyholders and possibly among generations (example: mutual funds, life insurance with participating features).

Where both mutualisation mechanisms are not sufficient to cover risks and contractual commitments, the insurer provides for the difference (§ 47).

Correlation of risk and pricing; definition of onerous

50 The occurrence of an expected risk in a contract does not make the individual contract “onerous”.

51 A transaction is onerous for the insurer when the pricing does not sufficiently cover the insured risk. This may happen (i) at inception if the pricing does not reflect the expected distribution of risks within a portfolio in order to ensure a proper margin or (ii) when risks evolve in an unexpected manner and when the insurer has to bear a loss as a consequence (§ 47).

52 In a population where policyholders accept to share risks, a contract does not become onerous (for the insurer) before the cross-subsidisation among policyholders is not sufficient to cover the risks, so that the insurer is eventually exposed to a loss. There is no “onerous” contract in a mutualised population except if the whole population becomes onerous.

53 When the risk evolves with age, an insurer generally reflects this evolution in the pricing. He may however also decide not to reflect such changes but instead offer the same pricing along the duration of the coverage. A policyholder would accept a steady rate, i.e. to pay more in the first years (when the risk for the insurer is lower) if he gets a lower rate in the future. Such pricing mechanism may lead to group together policyholders currently having different risks priced the same. Steady pricing reflects levelling the risk distribution for one policyholder over the coverage period and is distinct from (but not contrary to) mutualising risks with several policyholders in a defined population.

Reflecting mutualisation

54 As a consequence, a fair representation of mutualisation implies the following:

- Where financial and insurance risks are mutualised / shared among policyholders, the evolution of the “underlying items” is the key parameter for the mutualised population and is not individually attributable to policyholders. Similarly, in case of an intergenerational mutualisation the “underlying items” are not individually attributable to generations.
- Consequently, the incidental residual risk and margin attributable to the insurer is also measured at mutualisation level and contracts/ groups cannot become onerous unless the whole population is.

Illustrative example 1 – attributable CSM

- 55 In a mutualised portfolio, assuming an insurer invested a premium received 3 years ago from policyholder A on a long term bond (10 years) the return of which is 5%. The current profitability of a new investment is 1%. The contract with policyholder A has expired and a new policyholder B has joined the portfolio. The insurer decides not to sell the high profitable bond but instead to use the policyholder B's premium to indemnify the lapse of policyholder A. The expected return on the asset is higher than current market conditions and leads therefore to an increase in the fair value of the bond. A portion of that gain contractually contributes to the insurer's margin.
- 56 When shall the insurer recognise the expected return (for the remaining 7 years) or the change in fair value on that asset?
- View 1: The high return has been generated by the past invested premium of policyholder A. The related contribution of that asset to the insurer's margin therefore has to be fully recognised before policyholder A leaves.
 - View 2: The premium of policyholder A enabled the insurer to take his investment's decision that goes beyond the term of the contract itself. The insurer rather considered the portfolio's duration in taking his investment decision. From the insurer's standpoint the performance of the asset shall be reflected as long as the asset provides returns to the portfolio taken as a whole. Insurer's margin therefore has to be recognised on the asset's duration.
 - View 3: The premium of policyholder A enabled the insurer to take his investment's decision that goes beyond the term of the contract itself. The insurer rather considered the portfolio's duration in taking his investment decision. From the insurer's standpoint the performance of the asset belongs to the portfolio taken as a whole. Depending on the general participation mechanism, benefits attached to the asset may finally be allocated to generations beyond the asset's duration. Insurer's margin therefore has to be recognised on the portfolio's duration.
- 57 View 3 appears to better reflect the economic substance of the portfolio's performance, of the insurer's investment decision and of the control of the investment at portfolio level rather than at contract level.

Illustrative example 2 – groups becoming onerous?

- 58 In a intergenerational mutualised portfolio where 80% of the returns on the underlying items are due to policyholders (and therefore 20% to the insurer), assuming an insurer invested a 100 CU premium received 3 years ago from Policyholder A (Group A) on a long term bond (10 years) the return of which is 5%. The return guaranteed to the Policyholder A is 3%. Interest rate has dramatically dropped. The current profitability of a new investment is 2% and the insurer decided to not guarantee any return on new contracts. Paying a premium of 100 CU each, policyholders B1, B2 and B3 have joined the portfolio this year, creating a new Group (Group B). The insurer decides to invest only in short term bonds (in order to possibly take advantage of a future increase in interest rate) providing a return of 2%.
- 59 Based on the expectation of a yearly return by 1 CU ($5\% \cdot 20\% \cdot 100$), the insurer assessed that Group A was profitable at inception. Similarly, based on a yearly expected return of 0,4 CU ($2\% \cdot 20\% \cdot 100$ CU) each contract in Group B has also been assessed profitable at inception.
- 60 One year after, however, interest rate further drops down to 1%. The yearly return at portfolio level is then $5 + 1 \cdot 3 = 8$ CU. The part due to policyholders is $8 \text{ CU} \cdot 80\% = 6,4$ CU.
- 61 Does the grouping in separate groups (A and B) better reflect the economic impact of successive decreases in interest rate and of a minimum guarantee? Do such groups actually have become onerous?

- View 1: Yes, Group A has become onerous since the return guaranteed to Policyholder A (3 CU) is higher than the related part in the return to policyholders ($6,4/4=1,6$ CU), so that Group B has to give up some of its expected return ($3-1,6=1,4$ CU);
- View 2: Yes, Group B has become onerous since the return actually generated at group level based on premiums initially paid ($1*80\%*3=2,4$ CU) is less than the amount expected to be paid ($6,4-3=3,4$ CU) and less than the amount the paid premiums were initially expected to return at inception ($2*80\%*3=4,8$ CU). Consequently, in order to pay a return to Group B, cash flows from the asset in Group A have to be transferred ($3,4-2,4=1$ CU)
- View 3: No, none of Group A or B is onerous, as long as the insurer still receives positive inflows ($8-6,4=1,6$ CU) from the portfolio. The existence of a guaranteed return on Group A and decreases in interest rate returns may however have changed the original allocation of the fulfilment cash-flows. Finally the allocation of yearly returns is as follows: Group A: 3 CU; Group B: 3,4 CU; Insurer:1,6 CU.

62 View 3 appears to better reflect the economic substance since the “onerous” feature should solely be assessed from the insurer’s standpoint irrespective of the cross-subsidisation within fulfilment cash flows (since mutualised). This example also demonstrates that there are several ways (View 1 or 2) to rationalise cross-subsidisation among policyholders in a mutualised population. Finally it also shows that the existence of guarantees granted to certain contracts in a mutualised population demonstrates a concentration of risk rather than contradicts the mutualisation mechanism among policyholders.

Useful information on performance of a mutualised portfolio

- 63 Annual cohorts are intended to preclude open portfolios, i.e. the perpetual extension of the portfolio’s term due to the addition of new business in an “open portfolio”. In fact, as soon as contracts have different durations within a cohort or group, contracts with the shortest duration do not comply with that requirement (BC 121-122). From a conceptual point of view there is no argument in prohibiting such effect at portfolio level and not at cohort level.
- 64 Actually, once a policyholder has joined a mutualised population, the margin contributed by this contract is linked to the mutualised portfolio and not to the sole contract. Accordingly there is no reason for capping the allocation period of the margin to the sole contract coverage duration. Conversely, prohibiting open portfolios (which are a current practice) is not required.
- 65 Adding new contracts seems to extend the portfolio duration indefinitely and make it “perpetual” where in fact cash-flows attributable to policyholders and the insurer are permanently added and consumed.
- 66 An analysis of the impact (contribution or dilution) of newcomers (new business) on an existing mutualised portfolio (Inforce) is usual and represents very useful information since it clearly indicates business profitability trends. By contrast, identifying which of the former generations of policyholders is actually “subsidising” a new coming one, or the other way around, is not usual and the information usefulness is questionable in particular if groups are numerous on the basis of a very granular approach to contracts grouping.
- 67 There is a large practice of listed life-insurers in Europe (and a large support of users) on the performance content of information on the “embedded value”. The financial communication on the embedded value is notably based on an analysis of inforce and new business. It generally provides for a reconciliation with IFRS financial

statements over several periods of time, providing useful information on profitability trends.

2.2 Illustration

EU Case study

- 68 According to the preparers, using annual cohorts for contracts with intergenerational risk sharing (i.e. VFA contracts) is not useful and requires implementing accounting processes which is unrelated with the business practice and which is complex, burdensome and costly.
- 69 The pricing of an insurance contract is reflecting its underlying risks and attributed costs. Since annual cohorts do not reflect a change in the risks or in the economics of insurance products, they are not expected to impact the pricing. However an inadequate level of aggregation, leading to recognise a structural loss component on some risks even if mutualised would have a negative impact on financial performance and on financial communication, and could indirectly increase the pricing.
- 70 That impact on pricing would however be limited by the competition with insurance companies that do not fall into the scope of IFRS 17 (for instance those applying local GAAP or US GAAP) and could therefore rather be regarded as an implementation cost (recurring as well as non-recurring).
- 71 Moreover, some case studies report that the level of aggregation will lead to a decrease in product offer since a more granular identification of onerous contracts might lead to:
- less insurance products offered to clients who cannot subscribe large contracts, especially in life business;
 - less insurance products offered to persons who display unfavourable risk profiles such as young drivers, elder people,...

General public good comment

- 72 The way insurers organise mutualised populations is a highly sensitive feature of insurance markets since it reflects and also shapes up a level of “social/societal” understanding of what is covered by insurance and what is left to the direct responsibility of the individual (natural or moral person). In this context the coherence and consistency of pricing and detailed coverage policies is a key element of stability and decision making for individuals and businesses in the development of their respective activities.
- 73 The perimeter of mutualised populations and the terms and conditions offered to them by insurers are the outcome of very long term evolutions and decisions reflecting fundamental choices made at the level of the society as a whole (explicitly via regulations, semi-explicitly when practices reflect or influence changes in behaviour). In many cases, the strategy of insurers is heavily influenced by a prevailing insurance environment (or culture) the evolution of which requires extensive debates.
- 74 Modifying the perimeter of mutualised populations for accounting purposes only may lead to unintended changes in the way insurers cover insurance risks. There is a significant difference between (i) reflecting, via accounting treatments, a slow and complex evolution of the insurance coverage system and (ii) introducing accounting treatments which may directly influence the way the insurance coverage system is organised. For instance, additional granularity as compared to the current understanding is a “social/societal” risk of reducing the current and accepted level of

mutualisation, since insurers would have to reduce the risk to have onerous groups the loss of which is today covered by mutualisation and which would have to be borne tomorrow day one. The terms and conditions, including pricing, of the insurance coverage would probably be affected as a consequence.

Other EU illustrations of the issue raised

- 75 There is limited evidence about the usefulness of the information provided by annual cohorts to users. For instance, the EFRAG's user outreach report refers to annual cohorts as a concern.
- 76 Conversely, users are generally interested in the effects of new business on inforce contracts, as referred to in the market consistent embedded value reports (see § 66-67).

AP 10 of TRG 2018-09

- 77 The following analysis of the examples provided in AP 10 of the September 2018 TRG should be considered. They both address contracts where "the policyholders participate of the returns on a specified pool of underlying items".
- 78 §A4 (example 1) and §A11 (Example 2) mention that "claims incurred in group 1 amount to 4,000". IFRS 17.32(a)(i) states that the fulfilment cash flows are measured at inception considering estimates of future cash flows, not actual ones. Consequently, the very specific assumption retained by the staff, that all claims were originally expected to happen solely on group 1 cannot be considered. Rather, absent any other information, it should be assumed that all contracts in the portfolio are exposed to the same risk and that therefore the risk of claim is evenly allocated on all contracts/groups within the portfolio. Consequently, the CSM, measured at portfolio level (600) could be evenly allocated to each of the 10 groups (i.e. 60). Other allocations methods may also be considered.
- 79 The allocation among groups does not depend on the percentage of insurer's participation to the risks and returns of the underlying items.
- 80 A change in the estimate of future cash flows due to changes in expectations (i.e. the expected claims would increase by 1,000 from 4,000 to 5,000) has to be reflected in the CSM. Due to the risk-sharing (mutualisation) it also affects the returns to each policyholder. Consequently, the impact has to be measured at portfolio level and then be allocated to groups. But unless such a change makes the whole portfolio becoming onerous, it does not lead to recognise a loss. Conversely, absent a mutualisation among policyholders, the insurer is directly affected at group level (not at portfolio level) and may actually incur a loss.

2.3 Consistency with other IFRS standards

Portfolio approach according to IFRS 15

- 81 A portfolio approach is possible under IFRS 15.4.
- 82 IFRS 15.4: This standard specifies the accounting for an individual contract with a customer. However, as a practical expedient, an entity may apply this Standard to a portfolio of contracts (or performance obligations) with similar characteristics if the entity reasonably expects that the effects on the financial statements of applying this Standard to the portfolio would not differ materially from applying this Standard to the individual contracts (or performance obligations) within that portfolio. When accounting for a portfolio,

an entity shall use estimates and assumptions that reflect the size and composition of the portfolio.

Onerous contracts according to IFRS 15

- 83 There is no “onerous test” (i.e. requirements for identifying and measuring onerous performance obligations in contracts with customers) under IFRS 15:
- 84 IFRS 15.BC 295: However, many respondents to the 2010 and the 2011 Exposure Drafts disagreed with the onerous test and highlighted a number of practical application difficulties. Furthermore, many explained that strict application of the onerous test would have resulted in recognition of liabilities in cases in which the outcome of fulfilling a single performance obligation was onerous but the outcome of fulfilling the entire contract would be profitable. A number of respondents suggested removing the onerous test from the revenue proposals because, in addition to being complex and difficult to apply, the requirements for recognition of onerous losses are already sufficiently addressed in other Standards. Those respondents commented that:
- (a) for IFRS, the onerous test in IAS 37 and the requirements in IAS 2 Inventories already provide sufficient guidance for determining when to recognise losses arising from contracts with customers.
- (b) for US GAAP, existing requirements for recognition of losses from contracts are adequate and if a change to those requirements is necessary, that change could instead be handled in a separate project that addresses liabilities in Topic 450.
- 85 IFRS 15.BC 296: The boards agreed that existing requirements in both IFRS and US GAAP could adequately identify onerous contracts. Furthermore, the boards noted that although their existing requirements for onerous contracts are not identical, they are not aware of any pressing practice issues resulting from the application of those existing requirements. Consequently, the boards decided that IFRS 15 should not include an onerous test. Instead, entities applying IFRS or US GAAP will use their respective existing requirements for the identification and measurement of onerous contracts.
- 86 The onerous test has been removed from IFRS 15 mainly because it “would have resulted in recognition of liabilities in cases in which the outcome of fulfilling a single performance obligation was onerous but the outcome of fulfilling the entire contract would be profitable”.
- 87 In addition, the same argument could apply to IFRS 15 contracts where the selling price is unique (i.e. electricity or telecom distribution with unique price across a territory) but service costs vary depending on the customer (i.e. risks/costs significantly differ from one area to the other).
- 88 Finally, there are similarities between the situation of a single obligation in an IFRS 15 contract and the situation of a single contract/group in an IFRS 17 portfolio where groups and contracts are mutualised.

3 Suggested solution (tentative)

3.1 Discussion

- 89 According to the bases for conclusions, the level of aggregation requirements in IFRS 17 aim at achieving 3 main objectives:
- Objective 1: Ensuring that onerous contract are immediately recognised in the P&L (BC 119 and BC 136) (=> see § 50-52 and § 83-88).
 - Objective 2: (i) Ensuring a “correct” allocation of the margin (CSM) during the contract (BC 120) and (ii) prohibiting open portfolios in order to ensure that the CSM is not allocated beyond the longest contract within the group (BC 123(b) and BC 136) (=> see § 55-65).
 - Objective 3: Providing information on “trends in the profitability of a portfolio” (BC 136) (=> see § 66 and 75).
- 90 The analysis of the current provisions of the standard and their adequacy to the insurance business model leads to suggest addressing the following two concerns:
- “Fully shared risks” and annual cohorts:
An exception to the application of annual cohorts should be considered when (as acknowledged by IFRS 17.BC 138) contracts fully share risks, so that “the groups together will give the same results as a single combined risk-sharing portfolio”. The field test has demonstrated that applying annual cohorts in the case of intergenerational risk-sharing (mutualisation) is not conceptually necessary, does not provide useful information and adds complexity and costs. The concept of “fully shared risks” has to be defined in a broader way than contemplated by TRG staff (and rejected by TRG members) in order to address, for instance, life contracts with direct participation features where policyholders share financial and insurance risks. Limiting the use of the concept of “fully shared risks” to contracts where the CSM is nil or cannot be affected does not reflect reality.
 - Contracts grouping and underwriting policies:
The relevance of subdividing a mutualised population at a level that does not reflect the insurer’s underwriting policy and the policyholders’ understanding and acceptance raises concerns regarding the onerous test. Current provisions in the standard may prove sufficient but a clarification may facilitate the implementation.

3.2 Suggested modifications to the standard related to “fully shared risks” and annual cohorts

General

- 91 We suggest exempting applying annual cohorts where insurance and financial risks are fully shared among the generations of policyholders. A definition of “fully shared risk” has to be added in the standard.
- 92 Limiting the exception to VFA contracts may prove efficient. But on the one hand it potentially leaves out reinsurance contracts under the general model, and on the other hand may improperly embed non mutualised VFA contracts.
- 93 As mentioned above, where “risks are fully shared”, a contract or group may not become onerous until the whole portfolio is.

Suggested definition of “fully shared risks”

- 94 Contracts where “risks are fully shared” are referred to in the extreme situation presented in the TRG where cash flows are 100% shared among policyholders so that the insurer’s share in the risks and returns is nil.
- 95 This feature is however not limited to that extreme scenario but should also be considered when:
- the existence of an insurer’s share in the risks or in the returns on underlying items of a mutualised population of policyholders does not prevent from having first a genuine mutualisation (full risk sharing) among policyholders (see § 47);
 - the existence of specific guarantees granted to certain policyholders, concentrating risks or returns on the underlying items on certain contracts, does not prevent from having also a genuine mutualisation (full risk sharing) among policyholders (see § 62).
- 96 Some suggested that in a portfolio where “risks are fully shared” among policyholders, the insurer’s share should remain stable (i.e. 10%) rather than being nil. This may actually address many situations but would not be sufficient. The key criterion is in fact the onerous nature or not of the group of contracts: a population actually becomes onerous when the insurer’s margin on a defined population decreases and its share in the risks increases to a point where the insurer is making or contemplating a loss.
- 97 We therefore suggest defining that “risks are fully shared among policyholders when policyholders are related to the same pool of underlying items, disregarding the date of underwriting and disregarding the insurer’s remaining share in the underlying items”.
- 98 In this definition, “fully” means that policyholders share all risks (financial as well as insurance) across generations. With regards to the classification referred to previously (§ 33), it is equivalent to a comprehensive cross-subsidisation scenario or to a broad definition of full risk sharing.

Suggested modifications

- 99 IFRS 17.22: An entity shall not include contracts issued more than one year apart in the same group. This provision does not apply to contracts belonging to a portfolio where insurance and financial risks are fully shared among generations of policyholders. Risks are fully shared among policyholders when policyholders are related to the same pool of underlying items, disregarding the date of underwriting and the insurer’s remaining share in the underlying items.[...]

3.3 Suggested clarification regarding contracts grouping and underwriting policies

General

- 100 The relevance of subdividing a mutualised population at a level that does not reflect the insurer’s underwriting policy and the policyholders’ understanding and acceptance raises concerns regarding the onerous test. These concerns may depend upon the accounting model used (PAA or general model).

Onerous test under the PAA

- 101 Under the PAA, IFRS 17.18 applies: rebuttable presumption that “no contracts in the portfolio are onerous at initial recognition, unless facts and circumstances indicate

otherwise". Similar presumption assessing whether contracts have "significant possibility of becoming onerous subsequently by assessing the likelihood of changes in applicable facts and circumstances." The standard does not provide for a definition of facts and circumstances.

Onerous test under the general model

- 102 Under the general model, the "onerous test" has to be performed at inception (IFRS 17.16) and subsequently (IFRS 17.19). Applying IFRS 17.17 the test is first performed for "a set of contracts". The standard does not provide a precise definition of "a set of contracts" but indicates its classification depends upon "reasonable and supportable information".
- 103 IFRS 17.33 and IFRS 17.37 provide information on the level of details required for performing an assessment of the expected cash-flows which may help setting the scope of the onerous testing. In order to make that assessment, the entity has to "incorporate, in an unbiased way, all reasonable and supportable information available without undue cost or effort". The concept of "undue cost or effort" is further detailed in IFRS 17.B36-B41. It is mentioned that "information available from an entity's own information systems is considered to be available without undue cost or effort". In providing this guidance, the standard does not refer to the relevance of the information, assuming there is no criterion for limiting drilling down to the lowest level of granularity (the contract).
- 104 Applying IFRS 17.33 and IFRS 17.37 for identifying "onerous" sets of contracts may eventually lead to performing the assessment at contract level and hence prove contrary to the top-down approach introduced by IFRS 17.17. As a matter of fact, the more detailed the available information would be, the lower the level of granularity of a "set of contracts" for onerous test purpose could be, disregarding the relevance and usefulness of such information, and only considering the cost of gathering it (not even the cost of using this information for setting the level of aggregation).
- 105 In order to prevent applying the "onerous test" at the same level of granularity as the level required for defining expected cash-flows requires clarifying what could be the "reasonable and supportable information" referred to in IFRS 17.17.
- 106 For instance, assuming the relevant information for users being related to the profitability of contracts, it could be assumed that the granularity should not be lower than the one used for pricing policy, whereas regarding expected cash-flows, the standard refers to "any information system" that may encompass very detailed information. Profitability finally results from the pricing policy set by management and therefore also reflects (i) the exposure to risks at a level considered relevant by management as well as (ii) the pricing mutualisation organised by management.
- 107 Introducing a linkage with the pricing policy may also have the merit to converge the onerous concept under IFRS 17 to the one applied in other standards such as IFRS 15 (see § 87-88).

Suggested amendment for clarification purposes

- 108 The following solution may be contemplated: relating the top down approach to the existence of a defined population with defined terms and conditions.
- 109 IFRS 17.17 could therefore be amended as follows for clarification purposes:
- 110 IFRS 17.17: If an entity has reasonable and supportable information to conclude that a set of contracts will all be in the same group applying paragraph 16, it may measure the set of contracts to determine if the contracts are onerous (see paragraph 47) and assess the set of contracts to determine if the contracts have no significant possibility of becoming onerous subsequently (see

paragraph 19). Such measurement shall take into account the terms and conditions of the insurance coverage organised by the entity and offered to the policyholders. If the entity does not have reasonable and supportable information to conclude that a set of contracts will all be in the same group, it shall determine the group to which contracts belong by considering individual contracts.

111 IFRS 17.19:

For contracts issued to which an entity does not apply the premium allocation approach (see paragraphs 53–59), 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, in assessing whether contracts that are not onerous at initial recognition have no significant possibility of becoming onerous:

(i) an entity shall not disregard information provided by its internal reporting about the effect of changes in assumptions on different contracts on the possibility of their becoming onerous; but

(ii) an entity is not required to gather additional information beyond that provided by the entity's terms and conditions of the insurance coverage ~~internal reporting about the effect of changes in assumptions on different contracts.~~

4 Appendix: Bases for conclusions

- 112 IFRS 17.BC 119: Once the Board had decided that the contractual service margin should be measured for a group, the Board considered what that group level should be. The Board considered whether it could draw on requirements for groups set by insurance regulators. However, as noted in paragraph BC15, regulatory requirements focus on solvency not on reporting financial performance. The decisions about grouping in IFRS 17 were driven by considerations about reporting profits and losses in appropriate reporting periods. For example, in some cases the entity issues two groups of insurance contracts expecting that, on average, the contracts in one group will be more profitable than the contracts in the other group. In such cases, the Board decided, in principle, there should be no offsetting between the two groups of insurance contracts because that offsetting could result in a loss of useful information. In particular, the Board noted that the less profitable group of contracts would have a lesser ability to withstand unfavourable changes in estimates and might become onerous before the more profitable group would do so. The Board regards information about onerous contracts as useful information about an entity's decisions on pricing contracts and about future cash flows, and wanted this information to be reported on a timely basis. The Board did not want this information to be obscured by offsetting onerous contracts in one group with profitable contracts in another.
- 113 IFRS 17.BC 121: In many cases, the coverage period of individual contracts in a group will differ from the average coverage period for the group. When this is the case, measuring the contracts on:
- (a) an individual basis would mean that the contractual service margin associated with contracts with a shorter than average coverage period would be fully recognised in profit or loss over that shorter period;
 - (b) a group basis would mean that the contractual service margin associated with contracts with a shorter than average coverage period would not be fully recognised in profit or loss over that shorter period.
- 114 IFRS 17.BC 122: Thus, measuring the contracts as a group creates the risk that the contractual service margin for a group might fail to reflect the profit relating to the coverage remaining in the group, unless the entity tracked the allocation of the contractual service margin separately for groups of insurance contracts:
- (a) that have similar expected profitability, on initial recognition, and for which the amount and timing of cash flows are expected to respond in similar ways to key drivers of risk. In principle, this condition would ensure the contractual service margin of a particularly profitable individual contract within a group is not carried forward after the individual contract has expired.
 - (b) that have coverage periods that were expected to end at a similar time. In principle, this condition would ensure the contractual service margin of an individual contract that expired was not carried forward after the contract had expired.

- 115 IFRS 17.BC 123: The Board concluded that it was necessary to strike a balance between the loss of information discussed in paragraphs BC119 and BC121–BC122, and the need for useful information about the insurance activity as discussed in paragraphs BC118 and BC120. The Board:
- (a) did not want entities to depict one type of contract as cross-subsidised by a different type of contract, but also did not want to recognise losses for claims developing as expected within a group of similar contracts; and
 - (b) did not want the contractual service margin of an expired contract to exist as part of the average contractual service margin of a group long after the coverage provided by the contract ended, but also did not want to recognise a disproportionate amount of contractual service margin for contracts lapsing as expected within a group of similar contracts.
- 116 IFRS 17.BC 125: The Board also noted that, in principle, it would be possible to meet the objective of the recognition of the contractual service margin in profit or loss discussed in paragraph BC120 either by grouping only contracts with a similar size of contractual service margin and the same remaining coverage period, or by reflecting the different duration and profitability of the contracts within the group in the allocation of the contractual service margin.
- 117 IFRS 17.BC 130: To identify whether contracts (or sets of contracts) are onerous at initial recognition, an entity measures the contracts (or sets of contracts) applying the measurement requirements of IFRS 17. The Board decided that to assess whether contracts that are not onerous at initial recognition have no significant possibility of becoming onerous subsequently, an entity should use the information provided by its internal reporting system but need not gather additional information. The Board concluded that such information would provide a sufficient basis for making this assessment and that it would not be necessary to impose costs of gathering additional information. Some stakeholders nonetheless expressed the view that separating contracts that have no significant possibility of becoming onerous from other contracts that are not onerous was burdensome and unnecessary. The Board, however, concluded that in the absence of such a requirement, should the likelihood of losses increase, IFRS 17 would fail to require timely recognition of contracts that become onerous.
- 118 IFRS 17.BC 136: The Board noted that the decisions outlined in paragraph BC127 could lead to perpetual open portfolios. The Board was concerned that this could lead to a loss of information about the development of profitability over time, could result in the contractual service margin persisting beyond the duration of contracts in the group, and consequently could result in profits not being recognised in the correct periods. Consequently, in addition to dividing contracts into the groups specified in paragraph BC127, the Board decided to prohibit entities from including contracts issued more than one year apart in the same group. The Board observed that such grouping was important to ensure that trends in the profitability of a portfolio of contracts were reflected in the financial statements on a timely basis.

119 IFRS 17.BC 137: The Board considered whether there were any alternatives to using a one-year issuing period to constrain the duration of groups. However, the Board considered that any principle-based approach that satisfied the Board's objective would require the reintroduction of a test for similar profitability, which as set out in paragraph BC126, was rejected as being operationally burdensome. The Board acknowledged that using a one-year issuing period was an operational simplification given for cost-benefit reasons.

120 IFRS 17.BC 138: 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.

121 IFRS 17.BC 140: The Board considered whether an entity should recognise the obligations and associated benefits arising from a group of insurance contracts from the time at which it accepts risk. Doing so would be consistent with the aspects of IFRS 17 that focus on measuring the obligations accepted by the entity. However, such an approach would differ from that required for revenue contracts within the scope of IFRS 15, which focuses on measuring performance. Under IFRS 15, an entity recognises no rights or obligations until one party has performed under the contract. That model would be consistent with the aspects of IFRS 17 that focus on measuring performance.

122 IFRS 17.BC 162: However, it may be more difficult to decide the contract boundary if the contract binds one party more tightly than the other. For example:

(a) an entity may price a contract so that the premiums charged in early periods subsidise the premiums charged in later periods, even if the contract states that each premium relates to an equivalent period of coverage. This would be the case if the contract charges level premiums and the risks covered by the contract increase with time. The Board concluded that the

premiums charged in later periods would be within the boundary of the contract because, after the first period of coverage, the policyholder has obtained something of value, namely the ability to continue coverage at a level price despite increasing risk.

(b) an insurance contract might bind the entity, but not the policyholder, by requiring the entity to continue to accept premiums and provide coverage but permitting the policyholder to stop paying premiums, although possibly incurring a penalty. In the Board's view, the premiums the entity is required to accept and the resulting coverage it is required to provide fall within the boundary of the contract.

(c) an insurance contract may permit an entity to reprice the contract on the basis of general market experience (for example, mortality experience), without permitting the entity to reassess the individual policyholder's risk profile (for example, the policyholder's health). In this case, the insurance contract binds the entity by requiring it to provide the policyholder with something of value: continuing insurance coverage without the need to undergo underwriting again. Although the terms of the contract are such that the policyholder has a benefit in renewing the contract, and thus the entity expects that renewals will occur, the contract does not require the policyholder to renew the contract. The Board originally decided that ignoring the entity's expectation of renewals would not reflect the economic circumstances created by the contract for the entity. Consequently, the Board originally proposed that if the entity can reprice an existing contract for general but not individual-specific changes in policyholders' risk profiles, the cash flows resulting from the renewals repriced in this way lie within the boundaries of the existing contract.

123 IFRS 17.BC 171: Sometimes insurance contracts in one group affect the cash flows to policyholders of contracts in a different group. This effect is sometimes called 'mutualisation'. However, that term is used in practice to refer to a variety of effects, ranging from the effects of specific contractual terms to general risk diversification. Consequently, the Board decided not to use the term but instead to include in IFRS 17 requirements that ensure the fulfilment cash flows of any group are determined in a way that does not distort the contractual service margin, taking into account the extent to which the cash flows of different groups affect each other. 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.

124 IFRS 17.BC 173: The Board considered whether it was necessary to amend the requirements in IFRS 17 relating to the determination of the contractual service margin for insurance contracts with cash flows that affect or are affected by cash flows to policyholders of contracts in another group. The Board concluded that it was not

necessary because the fulfilment cash flows allocated to a group described in paragraph BC171 result in the contractual service margin of a group appropriately reflecting the future profit expected to be earned from the contracts in the group, including any expected effect on that future profit caused by other contracts.

Draft for discussion

IFRS 17 issues – Balance sheet presentation

Draft for discussion

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1 Current IASB requirements and TRG discussions

1.1 IFRS 17

- 1 IFRS 17.32: On initial recognition, an entity shall measure a group of insurance contracts at the total of:
 - (a) the fulfilment cash flows, which comprise:
 - (i) estimates of future cash flows (paragraphs 33–35);
 - (ii) an adjustment to reflect the time value of money and the financial risks related to the future cash flows, to the extent that the financial risks are not included in the estimates of the future cash flows (paragraph 36); and
 - (iii) a risk adjustment for non-financial risk (paragraph 37).
 - (b) the contractual service margin, measured applying paragraphs 38–39.
- 2 IFRS 17.40: The carrying amount of a group of insurance contracts at the end of each reporting period shall be the sum of:
 - (a) the liability for remaining coverage comprising:
 - (i) the fulfilment cash flows related to future service allocated to the group at that date, measured applying paragraphs 33–37 and B36–B92;
 - (ii) the contractual service margin of the group at that date, measured applying paragraphs 43–46; and
 - (b) the liability for incurred claims, comprising the fulfilment cash flows related to past service allocated to the group at that date, measured applying paragraphs 33–37 and B36–B92.
- 3 IFRS 17.55: Using the premium allocation approach, an entity shall measure the liability for remaining coverage as follows:
 - (a) on initial recognition, the carrying amount of the liability is:
 - (i) the premiums, if any, received at initial recognition;
 - (ii) minus any insurance acquisition cash flows at that date, unless the entity chooses to recognise the payments as an expense applying paragraph 59(a); and
 - (iii) plus or minus any amount arising from the derecognition at that date of the asset or liability recognised for insurance acquisition cash flows applying paragraph 27.
 - (b) at the end of each subsequent reporting period, the carrying amount of the liability is the carrying amount at the start of the reporting period:
 - (i) plus the premiums received in the period;
 - (ii) minus insurance acquisition cash flows; unless the entity chooses to recognise the payments as an expense applying paragraph 59(a);

(iii) plus any amounts relating to the amortisation of insurance acquisition cash flows recognised as an expense in the reporting period; unless the entity chooses to recognise insurance acquisition cash flows as an expense applying paragraph 59(a);

(iv) plus any adjustment to a financing component, applying paragraph 56;

(v) minus the amount recognised as insurance revenue for coverage provided in that period (see paragraph B126); and

(vi) minus any investment component paid or transferred to the liability for incurred claims.

4 IFRS 17.59: In applying the premium allocation approach, an entity:

(a) may choose to recognise any insurance acquisition cash flows as expenses when it incurs those costs, provided that the coverage period of each contract in the group at initial recognition is no more than one year.

(b) shall measure the liability for incurred claims for the group of insurance contracts at the fulfilment cash flows relating to incurred claims, applying paragraphs 33–37 and B36–B92. However, the entity is not required to adjust future cash flows for the time value of money and the effect of financial risk if those cash flows are expected to be paid or received in one year or less from the date the claims are incurred.

5 IFRS 17.63: In applying the measurement requirements of paragraphs 32–36 to reinsurance contracts held, to the extent that the underlying contracts are also measured applying those paragraphs, the entity shall use consistent assumptions to measure the estimates of the present value of the future cash flows for the group of reinsurance contracts held and the estimates of the present value of the future cash flows for the group(s) of underlying insurance contracts. In addition, the entity shall include in the estimates of the present value of the future cash flows for the group of reinsurance contracts held the effect of any risk of non-performance by the issuer of the reinsurance contract, including the effects of collateral and losses from disputes.

6 IFRS 17.78: An entity shall present separately in the statement of financial position the carrying amount of groups of:

- insurance contracts issued that are assets;
- insurance contracts issued that are liabilities;
- reinsurance contracts held that are assets; and
- reinsurance contracts held that are liabilities.

7 IFRS 17.79: An entity shall include any assets or liabilities for insurance acquisition cash flows recognised applying paragraph 27 in the carrying amount of the related groups of insurance contracts issued, and any assets or liabilities for cash flows related to groups of reinsurance contracts held (see paragraph 65(a)) in the carrying amount of the groups of reinsurance contracts held.

1.2 TRG outreach

8 TRG staff is considering that presentation “challenges” reported by preparers via an outreach the conclusions of which have been reported to the TRG in May 2018 (TRG 2018-05 AP 06), are a mere implementation issue (e.g. not a conceptual one).

1.3 Current understanding of the accounting treatment

General model

- 9 Presentation follows the approach retained for measurement purposes (fulfilment cash flows (FCF), contractual service margin (CSM), liability for incurred claims (LIC)).
- 10 Applying the general model (IFRS 17.32-37), a group of insurance contracts recorded as a liability or an asset is measured including all future expected cash flows at the date of measurement. The standard is based upon a pure future cash-flows approach.
- 11 Consequently, the future cash flows aggregate a number of assets and liabilities the nature of which may differ from the liability for remaining coverage. For example and principally: liability for incurred claims (including IBNR), premium receivables, reinsurance collateral ...

Variable fee approach (VFA)

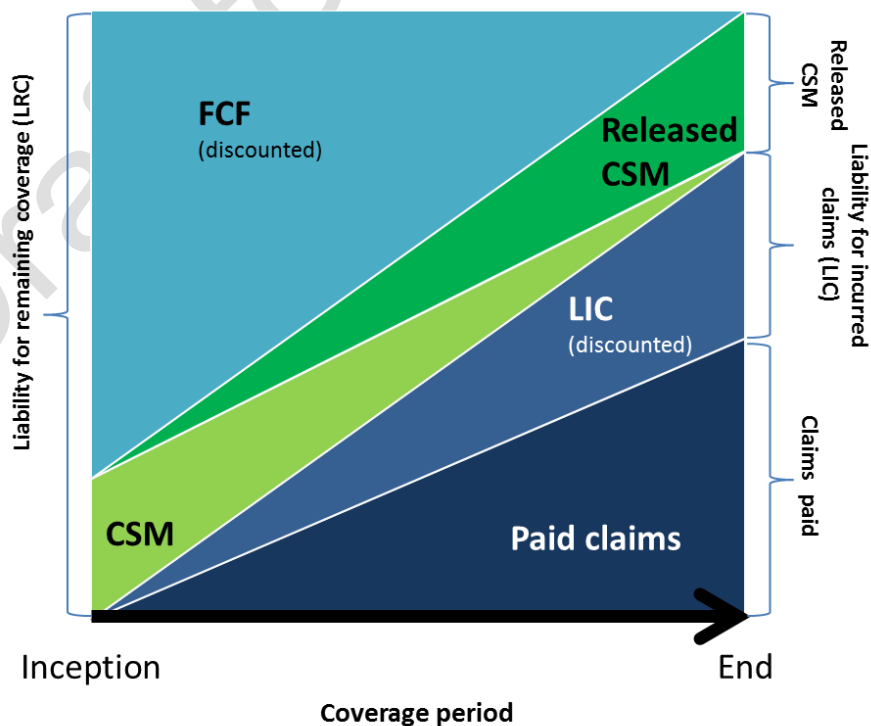
- 12 Recognition, measurement and presentation according to the VFA are based upon the same "expected" cash-flow basis.

Reinsurance contracts

- 13 Recognition, measurement and presentation of reinsurance contracts are based upon the same "expected" cash-flow basis.

Liability for remaining coverage under the premium allocation approach (PAA)

- 14 Recognition, measurement and presentation according to the PAA (IFRS 17.55 and IFRS 17.59) are based upon a pure premium received and liability for remaining coverage approach. Liability for incurred claims is an additional liability. See simplified diagram below.



2 Issue

2.1 Relevance of the B/S information

Cash basis approach

- 15 Standards are generally adopted on the basis of rights and obligations and recorded accordingly on an accrual basis and not on a cash basis.
- 16 From a general standpoint, B/S presentation is deemed to be useful when the following principles are met:
- providing insights on the nature and level of reliability of the recorded amounts in terms of valuation and liquidity of assets or liabilities;
 - excluding offsetting of assets and liabilities exposed to different risks and commitments, or counterparties (beneficiaries may differ from the policyholder);
 - reflecting the volume of or the relationship to activities;
 - being informative and predictive.
- 17 In the B/S presentation of insurance business, the emphasis is currently put on:
- Separating assets and liabilities in accordance with their respective nature and underlying key risks: credit risk on premium due, insurance risk on liabilities for remaining coverage, valuation risk on liabilities for incurred claims, liquidity risk and profitability on deposits;
 - Reflecting the asset/liability management key characteristics.
- 18 By contrast IFRS 17 (i) is based upon a cash basis approach for recognition, measurement and presentation purposes and (ii) aggregates assets and liabilities of a different nature in a combined amount for each and every group of contracts.
- 19 The decisions taken to elaborate IFRS 17 have the following consequences in terms of B/S presentation:
- 20 – **Premium receivables** (corresponding to a coverage period that has already started but for which payment has not yet been received) are not shown separately. This information is key for a proper understanding of the activity and risks involved. Generally, in case of non-payment, the coverage will remain in force for a period of time, i.e. until the contract is terminated following certain legally/contractually organised procedures. Following termination, the insurer is entitled to the payment of the premium up to that date and will have to cover any claim incurred during the coverage period.

Illustrative example 1: presentation of premium due in the general model

- 21 Assuming a one-year motor insurance policy is issued on 15 December N that covers third party liability. On 31 December N, the policyholder has still not paid the insurance premium of 240 CU. Under the local jurisdiction, not paying premium at the exact moment when due does not invalidate the insurance coverage. The estimates of future outflows relating to future claims and costs amount to 192.
- 22 As of 31 December N, applying IFRS 17.32-37, a liability for remaining coverage is recognised and measured as the difference between the premium due (240 CU), the other fulfilment cash flows relating to expected claims (192 CU) and the CSM ($48 \times 345 / 360 = 46$ CU). Finally, the amount presented for that insurance contract will be an asset amounting to 2 CU. The usefulness of information conveyed by the amount presented on the balance sheet and resulting from offsetting different components is questionable.

- 23 – **Liabilities for claims incurred and liabilities for remaining coverage** are not shown separately. This information is key for a proper understanding of the activity and risks involved. When an insured event occurs, there is a fundamental change in nature from liability for remaining coverage (LRC) to liability for incurred claim (LIC). The key factor for the former is the probability of occurrence in the future, the key factor for the latter is the quality of estimates (from very simple estimates to more complex ones and IBNR).
- 24 – **Collateral deposits related to reinsurance accepted and held** are not shown separately. This information is key for a proper understanding of the activity and risks of the reinsurer as well as of the cedant. The information on the liability for remaining coverage of the reinsurer does not depend on the nature of the guaranty provided by the reinsurer (deposit in cash, assets pledged or third party guarantee). This issue is the same for the insurer and the insurance contract held. Accordingly, deposits made or received are considered within the boundaries of the reinsurance contract.

Presentation as an asset or a liability at group level

- 25 According to IFRS 17.78, each group of insurance contracts has to be presented in the balance sheet either as an asset or a liability. This presentation does not provide useful information since it derives from accounting principles rather than from a business or conceptual approach. Moreover, implementing it would be very costly and burdensome and groups may move from a liability to an asset position or the contrary without such information being meaningful.

Presentation of the asset relating to acquisition cash-flows

- 26 According to IFRS 17.79, “an entity shall include any assets or liabilities for insurance acquisition cash flows recognised applying paragraph 27 in the carrying amount of the related groups of insurance contracts issued”. However, IFRS 17.27 addresses acquisition cash flows before their attribution to groups of insurance contracts issued.

2.2 Operational issues: modifying IT and management systems

- 27 Information systems of insurance companies generally distinguish:
- Underwriting, premium income and premium collection,
 - Claims, claims occurrence, claims handling, claims payments and claims estimates,
 - Actuarial estimates and models, in particular for the determination of the remaining coverage and, from a business perspective for the determination of pricing conditions.
- 28 The first two IT systems operate on an accrual basis reflecting risks and obligations. The third one reflects a number of assumptions and is reconciled with the other two in order to ensure consistency. The IT systems reflect a management structure organised to regroup competencies and promote efficiency. Modifying this typical structure and the related IT systems may prove costly and may be a challenge to efficiency.

2.3 Additional recognition and measurement issues

- 29 Decisions made to elaborate IFRS 17 create situations where, beyond presentation issues, rights and obligations are not properly reflected in substance.

Recognition and measurement of PAA contracts for which premium is not yet received

- 30 PAA only recognises and measures insurance contracts when the premium has been received, even if the coverage has already started. Consequently the insurance risk on contracts issued is not properly reflected until the premium has been paid.

Illustrative example 2: PAA

- 31 Assuming a motor insurance policy is issued on 15 December N that covers third party liability. On 31 December N, the policyholder has still not paid the insurance premium of 240 CU. Under the local jurisdiction, not paying premium at the exact moment when due does not invalidate the insurance coverage.
- 32 As of 31 December N, applying IFRS 17.55(a)(i), there is no recognition of:
- a premium receivable (240 CU)
 - a premium income ($15/360 \times 240 = 10$ CU)
 - a liability for remaining coverage ($345/360 \times 240 = 230$ CU).
- NB: if an event insured has occurred between issuance and closing, a liability for incurred claim is recorded anyway (IFRS 17.59).

Measurement of premium receivables and liabilities for incurred claims

- 33 The nature of premium receivables and liabilities for incurred claims may put them under IFRS 9. It remains to be demonstrated that the risks covered under IFRS 9 (in particular related to premium receivables) are properly taken into account in the estimated FCF following IFRS 17.32 and IFRS 17.40.

2.4 Illustration in the EU case study

Separating the presentation of certain assets and liabilities would provide a more understandable and relevant information

- 34 It is common practice to present components from insurance contracts in different financial statement line items. Some of these items are assets (e.g. premium receivables, deferred acquisition costs) others are liabilities (i.e. unearned premium reserve, loss reserve, aggregate policy reserve...). Each line item in the balance sheet addresses a specific information requirement that may be different from one component to the other.

Presenting insurance contract groups in aggregate does not provide understandable and relevant information and generates undue costs

- 35 Under IFRS 17, a presentation organised around groups of insurance contracts requires connecting accounting-, claim- and cash- management systems which are currently running separately and reconciled at a higher level¹.
- 36 This not only provides difficult to understand and irrelevant information for business purposes but is also very complex and costly. Costs may consequently exceed benefits.

¹ TRG 2018-05 AP 6.27

Consistency of IFRS 17 with internal and regulatory reporting

- 37 For steering purposes, reconciliation between IFRS 17 and Solvency II in the future closing process is useful because both frameworks have conceptual similarities. The approach retained for the presentation of insurance contracts in the balance sheet under IFRS 17 would complicate such reconciliation.

2.5 Consistency with other IFRS standards

- 38 Other standards are based upon an accrual approach.

2.6 Consistency with regulatory reporting (Solvency II)

- 39 According to Solvency II, the best estimate liability is based on a cash flow basis, but the regulation requires recognising certain accruals as separated assets and liabilities.
- 40 EIOPA Guideline 68 on the valuation of technical provisions states that “Insurance and reinsurance undertakings should establish the future premium cash-flows contained within the contract boundaries at the valuation date and include within the calculation of its best estimate liabilities those future premium cash flows which fall due after the valuation date. Insurance and reinsurance undertakings should treat premiums which are due for payment by the valuation date as a premium receivable on its balance sheet until the cash is received”.

3 Suggested solution (tentative)

3.1 Discussion

- 41 Presenting separately premium receivables, liabilities for remaining coverage, contractual service margin, liabilities for incurred claims and collaterals is useful information. In addition, it reflects the way the business is managed and information systems are organised. When possible relevant information shall rather be presented in the B/S instead of being disclosed in the notes (IFRS 17.100 on liabilities for remaining coverage and for incurred claims; IFRS 17.101(c) on the CSM).
- 42 The related future cash flows included in such separate assets and liabilities would be deducted from the fulfilment cash flows in the group of insurance contract.
- 43 Measurement issues should be investigated and if necessary addressed:
- recognition and measurement provisions in the PAA should be amended in order to include premium receivables;
 - potential impact of IFRS 9 measurement should be investigated.
- 44 The above would significantly improve understandability. It would also improve relevance. From an operational standpoint, implementation would be simplified and costs would be saved.
- 45 In addition to the modifications to the standard suggested below, amendments to IFRS 17.79 and disclosure requirements (IFRS 17.98-109) have to be revised consequently.

3.2 Suggested modifications to the standard

- 46 IFRS 17.78: An entity shall present separately in the statement of financial position the carrying amount of ~~groups of:~~
- (a) ~~insurance contracts issued that are assets~~ premium receivables related to insurance contracts,
 - (b) liabilities for remaining coverage (including contractual service margin) related to insurance contracts,
 - (c) liabilities for incurred claims related to insurance contracts,
 - (d) premium receivables (reinsurer) and payables (insurer) related to reinsurance contracts,
 - (e) liabilities for remaining coverage (reinsurer) and asset for reinsurance contracts held (insurer) for reinsurance contracts,
 - (f) liabilities for incurred claims (reinsurer) and assets for reinsurance contracts held (insurer) for reinsurance contracts,
 - (g) liabilities for deposits received (insurer) and assets for deposits made (reinsurer) related to reinsurance contracts.
 - ~~(b) insurance contracts issued that are;~~
 - ~~(c) reinsurance contracts held that are assets;~~
 - ~~(d) reinsurance contracts held that are liabilities.~~
- 47 IFRS 17.55: Using the premium allocation approach, an entity shall measure the liability for remaining coverage as follows:
- (a) on initial recognition, the carrying amount of the liability is:
 - (i) the premiums ~~received~~, if any, ~~received~~ received or to be received (applying measurement provisions of IFRS 17.32) at initial recognition;
 - (ii) minus any insurance acquisition cash flows at that date, unless the entity chooses to recognise the payments as an expense applying paragraph 59(a); and
 - (iii) plus or minus any amount arising from the derecognition at that date of the asset or liability recognised for insurance acquisition cash flows applying paragraph 27.
 - (b) at the end of each subsequent reporting period, the carrying amount of the liability is the carrying amount at the start of the reporting period:
 - (i) plus the premiums ~~received~~ received additional to the premiums taken into account in accordance to (a)(i), if any, in the period;
 - (ii) minus insurance acquisition cash flows; unless the entity chooses to recognise the payments as an expense applying paragraph 59(a);
 - (iii) plus any amounts relating to the amortisation of insurance acquisition cash flows recognised as an expense in the reporting period; unless the entity chooses to recognise insurance acquisition cash flows as an expense applying paragraph 59(a);
 - (iv) plus any adjustment to a financing component, applying paragraph 56;
 - (v) minus the amount recognised as insurance revenue for coverage provided in that period (see paragraph B126); and
 - (vi) minus any investment component paid or transferred to the liability for incurred claims.

IFRS 17 issues – Acquisition cash flows

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1 Current IASB requirements and TRG discussions

1.1 IFRS 17

- 1 IFRS 17.26: [...] An entity is required to determine whether any contracts form a group of onerous contracts applying paragraph 16 before the earlier of the dates set out in paragraphs 25(a) and 25(b) if facts and circumstances indicate there is such a group.
- 2 IFRS 17.27: An entity shall recognise an asset or liability for any insurance acquisition cash flows relating to a group of issued insurance contracts that the entity pays or receives before the group is recognised, unless it chooses to recognise them as expenses or income applying paragraph 59(a). An entity shall derecognise the asset or liability resulting from such insurance acquisition cash flows when the group of insurance contracts to which the cash flows are allocated is recognised (see paragraph 38(b)).
- 3 IFRS 17.35: An entity shall not recognise as a liability or as an asset any amounts relating to expected premiums or expected claims outside the boundary of the insurance contract. Such amounts relate to future insurance contracts.
- 4 IFRS 17.59: In applying the premium allocation approach, an entity:
 - (a) may choose to recognise any insurance acquisition cash flows as expenses when it incurs those costs, provided that the coverage period of each contract in the group at initial recognition is no more than one year.
 - (b) shall measure the liability for incurred claims for the group of insurance contracts at the fulfilment cash flows relating to incurred claims, applying paragraphs 33–37 and B36–B92. However, the entity is not required to adjust future cash flows for the time value of money and the effect of financial risk if those cash flows are expected to be paid or received in one year or less from the date the claims are incurred.
- 5 Appendix A: Insurance acquisition cash flows: Cash flows arising from the costs of selling, underwriting and starting a group of insurance contracts that are directly attributable to the portfolio of insurance contracts to which the group belongs. Such cash flows include cash flows that are not directly attributable to individual contracts or groups of insurance contracts within the portfolio.
- 6 IFRS17.B65: Cash flows within the boundary of an insurance contract are those that relate directly to the fulfilment of the contract, including cash flows for which the entity has discretion over the amount or timing. The cash flows within the boundary include:
 - (a) premiums (including premium adjustments and instalment premiums) from a policyholder and any additional cash flows that result from those premiums.
 - (b) payments to (or on behalf of) a policyholder, including claims that have already been reported but have not yet been paid (ie reported claims), incurred claims for events that have occurred but

for which claims have not been reported and all future claims for which the entity has a substantive obligation (see paragraph 34).

(c) payments to (or on behalf of) a policyholder that vary depending on returns on underlying items.

(d) payments to (or on behalf of) a policyholder resulting from derivatives, for example, options and guarantees embedded in the contract, to the extent that those options and guarantees are not separated from the insurance contract (see paragraph 11(a)).

(e) an allocation of insurance acquisition cash flows attributable to the portfolio to which the contract belongs.

(f) claim handling costs (ie the costs the entity will incur in investigating, processing and resolving claims under existing insurance contracts, including legal and loss-adjusters' fees and internal costs of investigating claims and processing claim payments). The cash flows within the boundary include an allocation of insurance acquisition cash flows attributable to the portfolio to which the contract belongs.

(g) costs the entity will incur in providing contractual benefits paid in kind.

(h) policy administration and maintenance costs, such as costs of premium billing and handling policy changes (for example, conversions and reinstatements). Such costs also include recurring commissions that are expected to be paid to intermediaries if a particular policyholder continues to pay the premiums within the boundary of the insurance contract.

(i) transaction-based taxes (such as premium taxes, value added taxes and goods and services taxes) and levies (such as fire service levies and guarantee fund assessments) that arise directly from existing insurance contracts, or that can be attributed to them on a reasonable and consistent basis.

(j) payments by the insurer in a fiduciary capacity to meet tax obligations incurred by the policyholder, and related receipts.

(k) potential cash inflows from recoveries (such as salvage and subrogation) on future claims covered by existing insurance contracts and, to the extent that they do not qualify for recognition as separate assets, potential cash inflows from recoveries on past claims.

(l) an allocation of fixed and variable overheads (such as the costs of accounting, human resources, information technology and support, building depreciation, rent, and maintenance and utilities) directly attributable to fulfilling insurance contracts. Such overheads are allocated to groups of contracts using methods that are systematic and rational, and are consistently applied to all costs that have similar characteristics.

(m) any other costs specifically chargeable to the policyholder under the terms of the contract.

7 IFRS 17.B125: An entity shall determine insurance revenue related to insurance acquisition cash flows by allocating the portion of the premiums that relate to recovering those cash flows to each reporting period

in a systematic way on the basis of the passage of time. An entity shall recognise the same amount as insurance service expenses.

- 8 IFRS 17.BC 176: The measurement approach required in IFRS 17 represents a change from many previous accounting models that measure insurance contract liabilities initially at the amount of the premiums received, with deferral of insurance acquisition cash flows. Such models treat insurance acquisition cash flows as a representation of the cost of a recognisable asset, which, depending on the model, might be described as a contract asset or a customer relationship intangible asset. The Board concluded that such an asset either does not exist, if the entity recovers insurance acquisition cash flows from premiums already received, or relates to future cash flows that are included in the measurement of the contract. The Board noted that an entity typically charges the policyholder a price the entity regards as sufficient to compensate it for undertaking the obligation to pay for insured losses and for the cost of originating the contracts. Thus, a faithful representation of the remaining obligation to pay for insured losses should not include the part of the premium intended to compensate for the cost of originating the contracts.

1.2 TRG

TRG Staff analysis (2018-02 AP04)

- 9 § 4 For a group of contracts accounted for under:
- (a) the general requirements, insurance acquisition cash flows are included in the measurement of the contractual service margin (see paragraph 38 of IFRS 17).
 - (b) the premium allocation approach, insurance acquisition cash flows reduce the liability for remaining coverage (see paragraph 55 of IFRS 17).
- 10 § 14: Incorporating all available information by applying paragraph 33 of IFRS 17, the acquisition cash flows are triggered solely when the contract is initially written. Therefore, the acquisition cash flows are within the boundary of the initially written contracts.
- 11 § 15: Additionally, even if the entity contemplates that most contracts will be renewed, applying paragraph 35 of IFRS 17, an entity cannot recognise part of the acquisition cash flows as an asset for future groups that will be recognised when the contracts are renewed. The renewals are outside the boundary of the initially written contracts. Applying this view, the acquisition cash flows are considered only in the measurement of the group to which the initially written contract belongs.

TRG Discussion (2018-02 Summary)

- 12 §19(e): When a “commission is paid unconditionally on the initially written contract (i.e. it is not refundable) [...] it cannot be allocated to future groups and accordingly the specified commission is included in the measurement of the group to which the initially issued contract belongs”.

1.3 IASB Staff suggested amendments (Board June 2018)

- 13 IFRS 17.27: An entity shall recognise an asset or liability for any insurance acquisition cash flows relating to a group of ~~issued~~ insurance

contracts issued or expected to be issued that the entity pays or receives before the group is recognised, unless it chooses to recognise them as expenses or income applying paragraph 59(a). An entity shall derecognise the asset or liability resulting from such insurance acquisition cash flows when the group of insurance contracts to which the cash flows are allocated is recognised (see paragraph 38(b)).

1.4 Current understanding of the accounting treatment

- 14 The accounting treatment of cash flows relating to the acquisition of insurance contracts is currently understood to be the following:
- 15 Before a group of contracts is issued or recognised, pre-recognition cash flows relating to the acquisition of issued contracts (or expected to be issued) are to be accounted for as an asset or a liability (IFRS 17.27). There is no specific requirement for an impairment of such an asset if the asset appears not recoverable, however the provisions relating to onerous contracts apply before recognition (IFRS 17.26).
- 16 At the time of recognition of the group of contracts, the asset or liability is transferred to the contractual service margin (IFRS 17.27). The post-recognition acquisition cash flows are part of the fulfilment cash flows and as a consequence affect also the contractual service margin (IFRS 17.B 65(e)).
- 17 According to the TRG staff analysis (TRG 2018-02 AP04.34), because acquisition costs incurred (pre and post-recognition) are paid unconditionally on the initially written contract, the commission is within the boundary of the initial contract and not to the group of contracts it belongs to and as a consequence may not relate to future groups to which the future contract once renewed would belong. This provision therefore prohibits keeping any asset or liability in relation to expected renewals irrespective of the underlying pricing assumptions.
- 18 In the provisions relating to the treatment of onerous contracts there is no specific provision allowing for excluding from the computation the acquisition costs related to expected renewals.
- 19 There is an option for expensing acquisition costs related to contracts accounted for under the premium allocation approach (IFRS 17.59(a)). This option applies to pre and post-recognition acquisition cash flows.
- 20 Provisions set out under IFRS 17.B65 indicate that acquisition costs or cash flows can be allocated on a portfolio approach (e) and, as a general rule, do consider an allocation of fixed and variable overheads that are directly attributable (l). As a consequence acquisition cash flows include both direct and indirect costs as well as both external and internal costs.

2 Issue

2.1 Substance of the transactions

- 21 Costs incurred for initiating a new insurance contract with a policyholder (acquisition costs *per se*) are generally significantly higher than costs incurred following inception for servicing (contract renewal with information update, premium determination and collection, claims handling costs, customer relationship programme...) that contractual relationship in the context of an ongoing stream of renewals (which are most of the time concluded tacitly, i.e. the initial contract is ongoing unless one of the

two parties - the policyholder or the insurer - takes the initiative of terminating the contractual relationship). Acquisition costs can be incurred before issuance of the contract, between issuance and recognition of the contract and after recognition. Incidentally ongoing servicing costs are incurred by the insurer either upon renewal (commissions for instance) or during the coverage period of the renewed contract and beyond (for instance claims handling costs).

- 22 The structure of commissions generally reflects such a situation. In other words, an analysis of costs incurred in the first period shall be performed in order to separate acquisition costs relating to the acquisition/creation of a new customer relationship from those relating to servicing the contractual relationship while performing the obligation. The former being in line with the definition of “insurance acquisition cash flows” in IFRS 17 as “costs of selling, underwriting and starting” insurance contracts attributable to a portfolio.
- 23 As a consequence, a fair representation of the substance of the transactions implies:
- linking acquisition costs relating to the creation of a new customer relationship with the period during which the insurer is actually expecting benefits from that relationship. This period includes the initial period as well as expected future periods derived from probable renewals, unless acquisitions costs are financed by the policyholder via a different premium in the first year (which appears to be seldom the case);
 - providing different accounting treatments for the two natures of costs incurred during the initial period: acquisitions costs *per se* and servicing costs.
- 24 In addition, when reflecting the substance of the transactions:
- the recognition of an asset for acquisition costs relating to the creation of a new customer relationship does not depend on whether such costs have already been paid or not.
 - the period to which acquisition costs relating to the creation of a new customer relationship are allocated does not depend on whether such costs are refundable or not. Acquisition costs are generally non-refundable.

2.2 Illustration

EU Case study

- 25 Participants to the EU case study have illustrated the impact of IFRS 17 requirements (and current TRG conclusions) on short term contracts in a motor portfolio applying the PAA. They noted that attributing the acquisition costs to new clients only can lead to identifying more onerous contracts (especially when the combined ratio of the underlying product is close to 100% as it is the case in the motor insurance sector). On the opposite, when spread over both new clients and renewals, no contract was identified as onerous. The latter better reflects the economic characteristics of the business, as a significant part of contracts related to new clients is underwritten with relatively high levels of commission initially paid to the intermediary. These commissions are then financed by the renewals of these new contracts.
- 26 If the volume of business is stable from one year to the other, similar results are expected, but there is an asset not accounted for.
- 27 Conversely in the development phase of a new portfolio, the new standard would have a negative impact in the first years.

Other EU illustrations of the issue raised

- 28 In addition to the case study itself, preparers have also explained that, in the case of a business combination, the separate recognition of an intangible including customer lists (which may be broader than existing customers) is required under certain conditions (IFRS 3.B33) to properly reflect the substance that would otherwise be accounted for in the goodwill. This intangible incorporates as a basis, but not exclusively, the acquisition cash flows that can be allocated to contracts expected to be renewed.

Macroeconomic approach

- 29 An « order of magnitude » approach, for illustration purposes only, can be derived from considering a significant market and estimating what could be the acquisition costs to be allocated to expected contracts at balance sheet level. Assuming (i) that the contracts eligible to the PAA model represent a premium income of 100 b€, this amount being assumed fairly stable and paid on January 1st and (ii) that any initiated contract is likely to be renewed four times, every percentage point of acquisition costs incurred should give rise at market level to assets of 0,6 b€ (premium income/5 x (1%+0,8%+0,6%+0,4%+0,2%)). For five/seven percentage points the assets would be 3,0/4,2 b€ for such a market. Incidentally, it must be considered that the issue appears to be significant for contracts eligible to the PAA.

2.3 Consistency with other standards

Consistency with IFRS 15

- 30 With regards to “revenue”, IFRS 15.99 states that incremental costs of obtaining a contract with a customer that are recognised as an asset “in accordance with paragraph 91 or 95 shall be amortised on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates. The asset may relate to goods or services to be transferred under a specific anticipated contract (as described in paragraph 95(a)).” Such an asset is also subject to impairments requirements according to IFRS 15.101-104.

Consistency with US GAAP ASC 944

- 31 Main features regarding to acquisition costs under US-GAAP are as follows:
- ASC 944-30-25 stipulates that costs that may be deferred are limited and that only acquisition costs resulting from actually acquiring a contract (i.e., successful efforts) can be capitalized as DAC (deferred acquisition costs)
 - The amortization method is required to be applied consistently over the expected term of the related contracts.
 - Under the new guidance, DAC is not subject to impairment testing. The principle is that deferred costs represent historical rather than future cash flows.

3 Suggested solution (tentative)

3.1 Discussion

- 32 The current standard already provides for:
- Recognising pre-recognition acquisition cash flows as a separate asset or a liability (IFRS 17.27);
 - Recoverability impairment test of such an asset tested according to IFRS 17.26;
 - Allocating acquisition costs to different groups, even if not yet issued, when they relate to different portfolios (IFRS 17.B 65(e));
 - Amortising acquisition costs (paid or not yet paid, i.e. in the fulfilment cash flows) for long duration insurance contracts over a duration that (i) may exceed one year and that (ii) may be less than the contractual term (taking into account the expected duration of a group, i.e. considering potential cancellation options). Accordingly, there is no “over-prudence” requiring immediately expensing such costs (the option offered to contracts with duration of less than one year is rather a practical expedient than prudence even if there is prudence as a consequence). In addition the amortisation period not only depends on the contractual period but also factors in certain economic behaviours (IFRS 17.B125).
- 33 The rationale of the accounting treatment is not convincing:
- BC 176 concludes on the reasons for not recognising acquisition costs as an asset for customer relationship in a way that does not correspond to the substance of the transactions:
 - “such an asset [...] does not exist, if the entity recovers insurance acquisition cash flows from premiums already received”. => there is confusion here between cash flows received from the initial premium and cash-flows expected from the future benefits linked with the asset. The comment does not consider the situation where the entity intends to recover insurance acquisition cash flows from premiums already received and from premiums expected to be received in the future following renewals. In addition, acquisition costs are related to a service provided by the intermediary facilitating insurance business. Once the commission is paid, the undertaking has the right to be part of the contract without paying further commissions. Thus, the asset reflects this right and needs to be allocated along all the service received, which is the whole relationship with the policyholder including future renewals. Therefore the asset does exist and reflects a right acquired by the undertaking.
 - “such an asset [...] relates to future cash flows that are included in the measurement of the contract. The Board noted that an entity typically charges the policyholder a price the entity regards as sufficient to compensate it for undertaking the obligation to pay for insured losses and for the cost of originating the contracts”. => assuming that such an asset only relates to the future cash flows of the contract (and potentially onerous because not properly priced) does not reflect the substance of the transaction (§ 2.1). This assumption leaves aside the situation where acquisition costs also relate to expected future renewals. The argument is not valid since the conclusion for not recognising a customer relationship asset is actually included in the assumption not to consider future renewals.
 - Recognising an asset would be required applying IFRS 3.B 33 in case of a business combination.

- There is no conceptual linkage between the non-refundability of costs and the duration of the expected benefits of incurring them.
- Immediately expensing acquisition costs in IFRS 17.59(a) is less an “option” than a “practical expedient”.

3.2 Suggested modifications to the standard

General

- 34 An interpretation does not appear sufficient to properly address the issue.
- 35 Amending IFRS 17.27 in order to separately recognise as an asset acquisition costs that (i) actually relate to the creation of a new customer relationship and (ii) are expected to generate benefits for the initial period and subsequent periods, (iii) provided that test of impairment/ onerousness is performed and (iv) disregarding the date of payment.
- 36 It would consequently be also required to provide additional information in the notes on the major assumptions retained on expected renewals as well as how the unallocated costs are allocated to renewals.
- 37 Finally, several solutions may be contemplated regarding the required valuation test of that asset:
- 38 (a) build on the “onerous” test included in IFRS 17.26 requiring “to determine whether **any contracts** form a group of onerous contracts applying paragraph 16 **before** [the recognition of that group] if facts and circumstances indicate there is such a group”. By contract, we may refer to the amendments proposed by the staff in IFRS 17.27 referring to “contracts issued or expected to be issued”. Accordingly, the standard as currently written would already require to assess whether a contract expected to be issued may be onerous before it is recognised.
- 39 (b) add an assessment on whether contract renewals happened as expected and where they did not, the associated unallocated acquisition costs being released to profit or loss immediately.
- 40 (c) add an impairment test.

Suggested modifications (on the basis of the staff suggestion)

- 41 IFRS 17.27 (marked-up): An entity shall recognise an asset or liability for any insurance acquisition cash flows relating to ~~a group of issued~~ insurance contracts issued or expected to be issued ~~that the entity pays or receives before the group is recognised~~, unless it chooses to recognise them as expenses or income applying paragraph 59(a). An entity shall derecognise the asset or liability resulting from such insurance acquisition cash flows when upon initial recognition of the group of insurance contracts and expected subsequent renewals to which the cash flows are allocated ~~is recognised~~ (see paragraph 38(b))
- 42 IFRS 17.27 (clean): An entity shall recognise an asset or liability for any insurance acquisition cash flows attributable to insurance contracts issued or expected to be issued, unless it chooses to recognise them as expenses or income applying paragraph 59(a). An entity shall derecognise the asset or liability resulting from such insurance acquisition cash flows upon initial recognition of the group of insurance contracts and expected subsequent renewals to which the cash flows are allocated (see paragraph 38(b))

Additional possible amendment 1

- 43 The following specific requirement might be added if IFRS 17.26 as it stands is not considered sufficient to address the valuation test of the asset recognised according to IFRS 17.27 (option B see § 39):

“An entity shall assess whether contract renewals happened as expected and where they did not, the associated unallocated acquisition costs being then released to profit or loss immediately”.

Or additional possible amendment 2

- 44 The following specific requirement might be added if IFRS 17.26 as it stands is not considered sufficient to address the valuation test of the asset recognised according to IFRS 17.27(option B see § 40):

“An entity shall recognise an impairment loss of the carrying amount of the assets related to expected renewals to the extent such amount is related to future groups expected to be onerous.

4 Appendix: extracts from IFRS 15

- 45 IFRS 15.101: An entity shall recognise an impairment loss in profit or loss to the extent that the carrying amount of an asset recognised in accordance with paragraph 91 or 95 exceeds:
- (a) the remaining amount of consideration that the entity expects to receive in exchange for the goods or services to which the asset relates; less
 - (b) the costs that relate directly to providing those goods or services and that have not been recognised as expenses (see paragraph 97).
- 46 IFRS 15.102: For the purposes of applying paragraph 101 to determine the amount of consideration that an entity expects to receive, an entity shall use the principles for determining the transaction price (except for the requirements in paragraphs 56–58 on constraining estimates of variable consideration) and adjust that amount to reflect the effects of the customer's credit risk.
- 47 IFRS 15.103: Before an entity recognises an impairment loss for an asset recognised in accordance with paragraph 91 or 95, the entity shall recognise any impairment loss for assets related to the contract that are recognised in accordance with another Standard (for example, IAS 2, IAS 16 and IAS 38). After applying the impairment test in paragraph 101, an entity shall include the resulting carrying amount of the asset recognised in accordance with paragraph 91 or 95 in the carrying amount of the cash-generating unit to which it belongs for the purpose of applying IAS 36 Impairment of Assets to that cash-generating unit.
- 48 IFRS 15.104: An entity shall recognise in profit or loss a reversal of some or all of an impairment loss previously recognised in accordance with paragraph 101 when the impairment conditions no longer exist or have improved. The increased carrying amount of the asset shall not exceed the amount that would have been determined (net of amortisation) if no impairment loss had been recognised previously.