

STAFF PAPER

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Project	Amendments to IFRS 17		
Paper topic	Level of aggregation—annual cohorts for insurance contracts with intergenerational sharing of risks between policyholders		
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Purpose of the paper

1. This paper discusses staff analysis and recommendations about the feedback in response to the Exposure Draft *Amendments to IFRS 17* relating to annual cohorts for insurance contracts with intergenerational sharing of risks between policyholders. This paper follows the tentative decision of the International Accounting Standards Board (Board), at its November 2019 meeting, to consider further the feedback from outreach and comment letters on this topic.

Summary of staff recommendations

2. The staff recommend the Board retain, unchanged, the annual cohort requirement in IFRS 17 *Insurance Contracts*.

Structure of the paper

3. This paper provides:
 - (a) background on the topic;
 - (b) an overview of the feedback on the Exposure Draft; and
 - (c) the staff analysis, recommendations and questions for Board members.

4. Appendix A to this paper includes examples of the effect of annual cohorts for insurance contracts that share risks across generations of policyholders.

Background

5. IFRS 17 requires an entity to recognise and measure groups of insurance contracts. Groups are determined by:
- (a) identifying portfolios of insurance contracts. A portfolio comprises contracts subject to similar risks and managed together.
 - (b) dividing a portfolio into a minimum of three groups (profitability buckets):
 - (i) a group of contracts that are onerous at initial recognition, if any;
 - (ii) a group of contracts that at initial recognition have no significant possibility of becoming onerous subsequently, if any; and
 - (iii) a group of the remaining contracts in the portfolio, if any.
 - (c) dividing the profitability buckets into groups of contracts not issued more than one year apart (annual cohorts).¹
6. When the Board considered proposing amendments to IFRS 17, it considered stakeholder concerns and challenges relating to the annual cohort requirement, particularly for insurance contracts with risk sharing between different generations of policyholders. Stakeholders expressed concerns that the requirement:
- (a) will not provide users of financial statements with useful information;
 - (b) is a major challenge and the benefits of the requirement do not outweigh the costs; and

¹ See Agenda Papers 2B *Level of aggregation—IFRS 17 requirements and Board’s rationale* and 2C *Level of aggregation—History of the Board’s decisions and stakeholder feedback* of the March 2019 Board meeting for further detail on the annual cohort requirement, the Board’s rationale and history of the Board’s decisions.

- (c) is unnecessary because an entity can achieve the same outcome without applying that requirement.²
7. The Board disagreed with some stakeholders' views that intergenerational sharing of risks between policyholders means that each generation of contracts is equally profitable for the entity and that identifying the contractual service margin for each annual cohort would be arbitrary.²
 8. The Board recognised that to identify the contractual service margin at an annual cohort level an entity may incur costs. However, the Board concluded that information about higher or lower profits earned by the entity from different generations of contracts is sufficiently useful information to justify such costs. Therefore, the Board decided to retain, unchanged, the annual cohort requirement.²

Feedback on the Exposure Draft

9. The Board did not ask a question on the annual cohort requirement in the Exposure Draft and therefore most respondents did not comment on that requirement. However, some respondents commented on the Board's decision to retain the requirements unchanged. Most of the respondents that commented on the annual cohort requirement were European stakeholders.
10. Of those respondents who commented on the annual cohort requirement:
 - (a) a small number of respondents, including users of financial statements, expressed support for the Board's decision not to amend the requirement and urged the Board to reaffirm that decision.
 - (b) some respondents would prefer the Board to amend or delete the requirement for all insurance contracts, but suggested that, at a minimum, IFRS 17 is amended so that the requirement does not apply to insurance contracts with intergenerational sharing of risks between policyholders. In those respondents' view:

² See Agenda Paper 2A *Level of aggregation—Stakeholder concerns, implementation challenges and staff analysis* of the March 2019 Board meeting for further detail on stakeholder concerns and challenges raised, and the staff analysis that led to the Board decisions described in paragraphs 7 and 8 of this paper.

- (i) implementing the requirement would be particularly costly and complex for those contracts and the cost would not outweigh the benefit; and/or
 - (ii) applying the requirement to those contracts would require arbitrary allocations and, therefore, the resulting information would not be useful.
 - (c) some respondents expressed support for the requirement generally, or did not comment on the requirement generally, but suggested the Board propose an exemption to the annual cohort requirement for insurance contracts with intergenerational sharing of risks between policyholders. A small number of those respondents suggested that the Board could require additional disclosures for the insurance contracts to which the exemption would apply.
 - (d) one respondent urged the Board not to provide an exemption to the annual cohort requirement for a specified sub-set of insurance contracts, because, in the view of this respondent, such an exemption would suggest that an entity cannot use a practical approach to achieve the objective of the annual cohort requirement for insurance contracts outside the scope of any such exemption.
11. Of those respondents who suggested the Board provide an exemption to the annual cohort requirement for insurance contracts with intergenerational sharing of risks between policyholders, some respondents suggested criteria for the scope of the exemption:
- (a) some respondents suggested the exemption apply specifically to insurance contracts accounted for applying the variable fee approach, while others suggested it apply also to insurance contracts accounted for applying the general model; and
 - (b) some respondents suggested the exemption apply to contracts to which paragraphs B67 and B68 of IFRS 17 apply (ie contracts that share risk with policyholders of other contracts), with some respondents suggesting that the risk sharing should be substantial, or for substantially all risks.

Staff analysis and recommendations

12. An entity's rights and obligations are created by individual contracts with policyholders. Further, IFRS Standards generally require accounting for individual contracts. However, as explained in paragraphs BC115–BC118 of the Basis for Conclusions on IFRS 17, measuring the contractual service margin of individual contracts would result in recognition of losses even when claims in a profitable group of contracts are developing exactly as expected. The Board concluded that such an approach would not provide useful information about insurance activities. Hence, in acknowledgment of the nature of insurance activities, as an exception to the general approach in IFRS Standards, IFRS 17 does not require measurement of individual contracts. Instead, IFRS 17 requires an entity to recognise and measure groups of insurance contracts as set out in paragraph 5 of this paper, including a requirement for annual cohorts.

13. At its November 2019 meeting, the Board tentatively decided:
 - (a) to consider further the feedback from respondents on annual cohorts for insurance contracts with intergenerational sharing of risks between policyholders; and
 - (b) not to consider further the feedback from respondents on annual cohorts for all other insurance contracts.

14. Hence, this paper analyses the question of annual cohorts only for insurance contracts with intergenerational sharing of risks between policyholders. The staff analysis includes:
 - (a) an analysis of the steps required to apply the annual cohort requirement to insurance contracts with intergenerational sharing of risks between policyholders (see paragraphs 15–22 of this paper);
 - (b) an analysis of the costs and benefits for insurance contracts with different features of intergenerational sharing of risks between policyholders (see paragraphs 23–26 of this paper);

- (c) an analysis of features of a contract that might result in the costs of the annual cohort requirement outweighing the benefits of the resulting information (see paragraphs 27–28 of this paper); and
- (d) an analysis of whether IFRS 17 should include an exemption from the annual cohort requirement for contracts with such features (see paragraphs 29–39 of this paper).

Steps required to apply annual cohorts to insurance contracts with intergenerational sharing of risks between policyholders

15. In Agenda paper 2A *Level of aggregation—Stakeholder concerns, implementation challenges and staff analysis* of the March 2019 Board meeting, the staff analysed an example of annual cohorts for contracts with intergenerational sharing of risks between policyholders and concluded that:
 - (a) the contractual service margin for annual cohorts could be determined in a non-arbitrary way; and
 - (b) the use of annual cohorts provides useful information about changes in profitability of contracts over time.
16. Feedback on the Exposure Draft has led the staff to consider additional aspects of applying the annual cohort requirement that were not addressed in the March 2019 example, in particular:
 - (a) the assumption needed to determine the effect of sharing of risks on the contractual service margin of a new annual cohort when an entity has discretion over the sharing of the returns on underlying items between the entity and the policyholders as a whole (in this paper ‘policyholders as a whole’ is used to describe all generations of policyholders that share in the same pool of underlying items); and
 - (b) the subsequent measurement of separate contractual service margins for each individual annual cohort.

17. The extended example and detailed staff analysis are set out in Appendix A to this paper. The staff observe:
- (a) the assumption described in paragraph 16(a) of this paper requires an entity to apply additional judgement if the entity has discretion over the split between its share of the returns and the share for the policyholders as a whole. Some respondents consider that additional judgement to be more subjective than other judgements required by IFRS 17. However, the staff note that such an assumption is required to determine the contractual service margin for new contracts, regardless of whether the existing contracts are divided into annual cohorts or not (see paragraphs A7–A12 of Appendix A to this paper). Paragraph 104 of IFRS 17 requires an entity to separately disclose the effects of contracts initially recognised in the period. In addition, an entity is required to disclose any significant judgements made in applying IFRS 17.
 - (b) the subsequent measurement of the contractual service margin of individual annual cohorts requires an entity to allocate:
 - (i) changes in expected cash flows related to features of a contract such as insurance claims and financial guarantees that are not cash flows from the participation in underlying items (‘fixed cash flows’)—to the individual annual cohorts that give rise to those cash flows (discussed in paragraphs 18–19 of this paper); and
 - (ii) changes in the amount of the entity’s share of the fair value of the underlying items—across all annual cohorts that participate in the same pool of underlying items (discussed in paragraphs 20–22 of this paper).
18. The example discussed at the March 2019 Board meeting did not include any ‘fixed cash flows’ as described in paragraph 17(b)(i) of this paper. However, an example of the effect of such cash flows on the contractual service margin of annual cohorts was discussed at the September 2018 meeting of the Transition Resource Group for

IFRS 17 (TRG).³ That example is set out in paragraphs A19–A24 of Appendix A to this paper and illustrates that:

- (a) the effect of changes in ‘fixed cash flows’ on the contractual service margin of the individual groups that give rise to those cash flows *is reduced* to the extent that the changes affect the amount of the participation cash flows payable to policyholders of contracts in all groups; but
- (b) the contractual service margin of the individual annual cohorts that give rise to those cash flows *is affected by the entity’s share* of the participation in the underlying items.

19. TRG members observed that the example was unrealistic because the entire effect of the changes in claims was allocated to one specific group. IFRS 17 allows for the identification of fulfilment cash flows at a higher level of aggregation than a group, as long as the entity is able to include the appropriate fulfilment cash flows in the measurement of a group through an allocation. The staff acknowledge that although claims are specific to each contract (and therefore to a group), claims development is expected to be less specific to time of issue. Hence changes in claims are likely to have a similar effect on all cohorts within a portfolio. However, this will not always be the case. Further, financial guarantees reflect specific interest rate environments, and therefore the terms of contracts issued are likely to change over time as interest rates change. A change in interest rate from 5% to 3% will have different effects on a group with guarantees of 4% and a group with guarantees of 1%.
20. Regarding the changes described in paragraph 17(b)(ii) of this paper, respondents have commented that IFRS 17 includes no requirements on how to allocate changes in the amount of the entity’s share of the fair value of the underlying items across annual cohorts that share in the same pool of underlying items. Some respondents expressed concerns that the allocation:
- (a) requires a level of tracking of specific underlying items for each annual cohort that is not possible; and/or

³ For simplicity, that TRG example considered 10 groups of insurance contracts all issued in the same year. However, the purpose of the example is to demonstrate the effect of applying paragraph B68 of IFRS 17 to insurance contracts with intergenerational sharing of risks between policyholders.

- (b) could result in misleading, rather than useful, information.
21. The staff agree IFRS 17 does not include any requirements on how to allocate the changes in the amount of the entity’s share of the fair value of the underlying items across annual cohorts that share in the same pool of underlying items. The staff observe:
- (a) the Board does not expect an entity to track specific underlying items for each annual cohort if the contract requires the policyholder to share with policyholders of other annual cohorts the returns on the same specified pool of underlying items—that would not be practicable, nor would it depict the nature of the sharing of the returns on the total pool of underlying items across the annual cohorts.
- (b) judgement needs to be exercised to avoid approaches to allocation that may not give useful information—for example, allocating the return on the total pool of underlying items pro rata to each annual cohort’s share of the total pool may not provide useful information because such an allocation would not reflect the different remaining durations of the contracts in different annual cohorts. But with appropriate judgement, allocation approaches can be identified that do provide useful information, albeit that determining which method of allocation provides the most useful information can be a difficult judgement to make.
22. The example in Appendix A to this paper illustrates one possible way of doing the allocation that provides useful information. The changes in the amount of the entity’s share of the fair value of the underlying items are allocated across all the annual cohorts pro rata to the balance of the contractual service margin in each cohort, resulting in the entity’s share of profit from each annual cohort growing at an equal rate of return (see paragraphs A13–A15 of Appendix A to this paper). The staff think this can be done in a relatively straightforward way, and appropriately depicts the equal participation of each cohort in the underlying items.

The balance between the costs of annual cohorts and the loss of information if they are not required

23. As noted in paragraph 17(a) of this paper, entities are required to identify the effect of new contracts to recognise them in the financial statements. This has to be done regardless of whether IFRS 17 requires annual cohorts. The question, therefore, is whether having identified the contractual service margin for new contracts, there is sufficient benefit in tracking those amounts subsequently for each individual annual cohort to justify the cost of doing so. In considering this, there are two types of information that would be lost if an entity did not apply the annual cohort requirement:
- (a) information about the effects of ‘fixed cash flows’, for example, insurance claims and financial guarantees. Where changes in these cash flows affect annual cohorts differently, they could make individual annual cohorts onerous, even if the portfolio as a whole is profitable enough to absorb the effects. The staff observe that information about the effect of financial guarantees is particularly important in the low interest rate environment currently existing in a number of jurisdictions.⁴
 - (b) information about trends in profitability for the entity’s share of the participation in the underlying items.
24. The staff observe that the likelihood of a group of contracts becoming onerous, thereby giving rise to the information described in paragraph 23(a) of this paper, varies depending on the features of the insurance contracts, in particular on:
- (a) the extent of the ‘fixed cash flows’ compared with the ‘participation cash flows’;
 - (b) whether changes in the ‘fixed cash flows’ affect the ‘participation cash flows’ (ie do policyholders share some or all of the risk arising from the fixed cash flows); and

⁴ Financial guarantees include a guarantee to pay to a policyholder at least the initial amount invested, a 0% guarantee.

(c) if (b) applies, the extent of the entity’s share of the participation in the ‘fixed cash flows’ (ie how much of the changes in the fixed cash flows ultimately affect the entity).

25. The staff also observe that an entity’s ability to change the way the returns on underlying items are shared between the entity and the policyholders as a whole affects the usefulness of the information described in paragraph 23(b) of this paper. If there is no discretion over the entity’s share (for example, it is fixed at 10% of the returns on underlying items), the staff think annual cohorts give useful information about how the value of the share varies over time (for example, 10% of a 5% expected return is better than 10% of a 1% expected return). But if the entity’s share is discretionary (ie might vary from the 10% in this example), the assumption that determines the initial amount of the contractual service margin for the new cohort becomes subjective, and the benefit of tracking these subjective amounts may be reduced.
26. In summary, the information described in paragraph 23 of this paper is a key benefit of IFRS 17. However, for insurance contracts with intergenerational sharing of risks between policyholders, the costs of applying the annual cohort requirement are relatively high. In some cases even when there is intergenerational sharing of risks there will be significant benefits in the information provided by annual cohorts— however the usefulness of the information is in some circumstances reduced. Therefore, the staff have considered whether there are contracts for which the costs outweigh the benefits of the resulting information.

Features of a contract that might result in the costs of the annual cohort requirement outweighing the benefits of the resulting information

27. Having performed the analysis in paragraphs 23–26 of this paper, the staff identified features of contracts that increase the costs of applying the annual cohort requirement compared to other contracts and/or reduce the usefulness of the resulting information. The features identified are:

	Feature	Reason
1	<p>Paragraphs B67 and B68 of IFRS 17 apply and the contract shares in the same pool of underlying items as other contracts in the group.⁵</p> <p>In addition, the entity has discretion over how it shares the returns from underlying items between itself and the policyholders as a whole.</p>	<p>Cost is potentially relatively high and the benefits of the resulting information potentially reduced.</p> <p>The sharing of risks across generations of policyholders, particularly when the entity has discretion over how it shares the returns from underlying items between itself and the policyholders as a whole, makes the determination of the contractual service margin for new groups of contracts subjective (see paragraph 25 of this paper).</p> <p>An entity would need to apply a high degree of judgement and might need a detailed analysis of future assumptions to determine a methodology that appropriately reflects all possible outcomes.</p> <p>Without that discretion, an entity could determine the contractual service margin objectively.</p>
2	<p>The contract meets the criteria in paragraph B101 of IFRS 17. This is the scope of the variable fee approach.</p>	<p>Cost is potentially relatively high. The application of the variable fee approach requires the contractual service margin to be remeasured for changes in the entity’s share of the fair value of the underlying items, resulting in the need for the allocations described in paragraphs 20 and 21 of this paper.</p> <p>Applying the annual cohort requirement to contracts in the general model does not require the contractual service margin to be remeasured for changes in the entity’s share of the fair value of the underlying items, making the application of the requirement for annual cohorts more straightforward.</p>

⁵ These paragraphs identify contracts whose cash flows affect or are affected by contracts with other policyholders, and specify how the effect should be included in the measurement of the groups to which the contracts belong.

	Feature	Reason
3	<p>If there are financial guarantees over returns on underlying items in the contract:</p> <p>(a) their effect is shared with other policyholders across generations; and</p> <p>(b) the entity’s remaining share is small.</p>	<p>The benefits of the resulting information are potentially reduced.</p> <p>In low interest rate environments, financial guarantees over returns on underlying items are increasingly likely to take effect, potentially making groups that include such contracts onerous. However, if the effect of the financial guarantee is shared with other policyholders to a large extent, there is less likelihood that the group will become onerous, because the contractual service margin of the group is affected only by the entity’s share of the effect of the financial guarantee.</p> <p>In contrast, if the entity bears the whole effect of changes in the cost of financial guarantees, the staff think that not having information about the effect of guarantees at a cohort level would be an unacceptable loss of useful information.</p>
4	<p>The contract includes only small amounts of ‘fixed cash flows’ the effect of changes in which is not shared with other policyholders.</p>	<p>The benefits of the resulting information are potentially reduced.</p> <p>‘Fixed cash flows’ other than financial guarantees are generally less variable than financial guarantees, and more likely to affect all groups in a similar way (see paragraph 19 of this paper). Even if their effect is borne entirely by the entity, if they form only a small part of the contract, the loss of information about their effect on the contractual service margin of individual annual cohorts may be limited.</p>

28. Features 3 and 4 in the above table each include a reference to something being ‘small’. What that might mean is discussed in paragraph 34(b) of this paper.

Should IFRS 17 include an exemption from the annual cohort requirement?

29. Having identified features of contracts that might make the cost of the annual cohort requirement relatively high and that also potentially reduce the usefulness of the resulting information, the staff considered whether those effects were sufficient to warrant the introduction of an exemption. The staff observe that the question of whether to provide an exemption is a question of balance in two regards:
- (a) the balance between the costs and benefits for specific contracts that might be covered by the exemption; and
 - (b) the balance between the costs and benefits for all those affected by IFRS 17.
- The balance between the costs and benefits for specific contracts that might be covered by an exemption*
30. On the one hand, annual cohorts provide useful information as described in paragraph 23 of this paper:
- (a) information about the effects of ‘fixed cash flows’, for example, insurance claims and financial guarantees. These effects could make individual cohorts onerous, even if the portfolio as a whole is profitable enough to absorb the effects. A key benefit of IFRS 17 is more transparent and timely information about loss-making contracts. Further, as noted in paragraph 23 of this paper, information about the effect of financial guarantees is particularly important in the low interest rate environment currently existing in a number of jurisdictions.
 - (b) information about trends in profitability for the entity’s share of the participation in the underlying items.
31. For contracts that include the features set out in paragraph 27 of this paper, information of the type described in paragraph 30(a) of this paper is less likely to occur, but it could—and when it does, its rarity would make it particularly important to understanding the performance of the entity. Information of the type described in paragraph 30(b) of this paper will depend on an entity’s judgements about the cross-subsidy expected to or from new contracts, and on the subsequent allocation methods, as described in paragraph 17 of this paper. However, such information could give

useful insights into how management expects business to develop and could help users hold management to account based on those expectations. Feedback from one user of financial statements expressed dissatisfaction that applying existing insurance accounting practices, entities often disclose expectations about new insurance contracts issued in the period, but do not subsequently disclose whether those insurance contracts developed as expected. Requiring entities to measure contracts at an annual cohort level would provide users of financial statements with that information about subsequent performance.

32. On the other hand, the costs of applying the annual cohort requirement for contracts that include features 1 and 2 discussed in paragraph 27 of this paper may be relatively high, because of the subjective assumption needed to determine the initial contractual service margin, and the complexity of allocating subsequent changes in the entity's share of the returns on underlying items. In addition, when the contracts also include features 3 and 4 discussed in paragraph 27 of this paper, information of the type described in paragraph 30(a) of this paper is less likely to occur and information of the type described in paragraph 30(b) of this paper will be very entity-specific and hence harder to understand and compare across entities.

The balance between the costs and benefits for all those affected by IFRS 17

33. Even if the costs of the annual cohort requirements were to outweigh the benefits for contracts with the features discussed in paragraph 27 of this paper, any exemption would need to unambiguously identify those contracts. In drafting exemptions, the Board always tries to ensure that the scope is as clearly defined as possible. Having a clear scope for the exemption is particularly important in this case because even with intergenerational sharing of risks there could be an unacceptable loss of information if contracts are inappropriately identified as falling within the scope of the exemption. The staff have considered suggestions from stakeholders such as 'contracts with the characteristics described in paragraphs B67–B71 of IFRS 17 that have substantial risk sharing'⁶ or 'contracts in the variable fee approach with significant mutualisation'.⁷ However the staff think that such drafting would be capable of being interpreted too

⁶ Comment letter 34 from the European Financial Reporting Advisory Group (EFRAG).

⁷ Comment letter 3 from the European Insurance CFO Forum and Insurance Europe.

broadly and inconsistent application would be likely to arise. As a result the scope in practice could include many more contracts than those with the features discussed in paragraph 27 of this paper.

34. Accordingly, the staff tried to develop a more precise scope to capture only contracts with the features discussed in paragraph 27 of this paper. However, in doing so the staff have become aware of many questions that would arise, for example:
- (a) how much discretion is needed over how the entity shares the returns from underlying items between itself and the policyholders as a whole (see feature 1 discussed in paragraph 27 of this paper)—is a limited level of discretion enough to increase the costs and reduce the benefits to an extent that would justify an exemption.
 - (b) what threshold should be set for ‘small’ (see features 3 and 4 discussed in paragraph 27 of this paper)—the staff considered whether it would be necessary to set specific quantitative thresholds for what ‘small’ meant in each feature. Applying quantitative thresholds would have the benefit of more precisely establishing the scope of the exception and reduce the risk of inconsistent application. However the staff could not identify an objective basis for establishing particular quantitative thresholds and invariably concerns would arise about the ‘cliff edge effect’ for contracts just inside and outside a quantitative boundary. On the other hand, applying qualitative criteria instead would require judgement and the development of a consensus across the industry on the interpretation of the new criteria, which might disrupt implementation. The staff also know that any scope of a possible exemption is likely to come under pressure, and think it is not possible to develop robust criteria that can be defended without quantitative thresholds.
 - (c) what is the meaning of ‘financial guarantees on returns on underlying items’—the staff have received feedback that although individuals involved in applying IFRS 17 have an idea of what ‘financial guarantees on returns on underlying items’ are, those ideas are not always the same.
 - (d) how the features identified in the table in paragraph 27 of this paper interact with the criteria for the scope of the variable fee approach.

- (e) how the features identified in the table in paragraph 27 of this paper interact with the scope of paragraph B67 of IFRS 17⁸, for example the extent to which contracts need to share in the same pool of underlying items.
 - (f) whether an entity would be able to separately identify the ‘fixed cash flows’ described in feature 4 in paragraph 27 of this paper, and/or would need to make arbitrary allocations for the purpose of this assessment.
 - (g) how different aspects of the identified features interact, and how that interaction would affect the assessment of the thresholds in features 3 and 4.
 - (h) whether an entity would be able to add contracts issued after the transition date to groups to which the entity has applied the modified retrospective approach or the fair value approach at transition.
35. Ultimately, the staff concluded that it is not possible to develop a precise scope, without drawing ‘bright lines’. Such ‘bright lines’ would inevitably be arbitrary. As such, they would be difficult to justify to users of financial statements and to preparers with contracts that fall just outside the boundary of any exemption.
36. The staff also observed that because the scope of the exemption would be linked to the scope of the variable fee approach and the identification of contracts that share risks with policyholders of other contracts (see paragraphs 34(d) and 34(e) of this paper), additional pressure would fall on those requirements of IFRS 17, with possible unintended consequences.
37. Further, adding an exemption to a Standard always adds complexity for users and preparers of financial statements, as well as for auditors. Users of financial statements need to understand the scope and implication of the exemption. Preparers need to assess which of their contracts meet the criteria for the exemption, and auditors need to audit that assessment. The questions listed in paragraph 34 of this paper indicate how complex this exemption would be. Such complexity would disrupt implementation of the Standard and reduce the benefits of its ongoing application.

⁸ Paragraph B67 of IFRS 17 identifies which contracts share risks with policyholders of other contracts

38. Balancing both the arguments in relation to the specific contracts that might be covered by an exemption and the broader arguments relating to the overall use of the Standard, the staff conclude that:
- (a) the reason for providing an exemption would be that the costs of the annual cohort requirement could exceed the benefits of the resulting information for some contracts. Those costs include the need to apply considerable judgement in some circumstances to determine the assumptions and allocations that result in information that faithfully represents the contracts.
 - (b) because of the pressure that would fall on any such exemption and the danger of losing information about the effect of financial guarantees in the current economic environment, the exemption would need to be robust and well-defined.
 - (c) however, there is no way to specify such an exemption without the use of ‘bright lines’ which would be arbitrary and difficult to justify, and without developing a particularly complex set of criteria.
 - (d) the resulting complexity would disrupt implementation of the Standard and reduce the benefits of its ongoing application.
39. Therefore, the staff recommend that the Board retain, unchanged, the annual cohort requirement in IFRS 17.

Question for Board members

Do you agree the Board should retain, unchanged, the annual cohort requirement in IFRS 17?

Appendix A—examples of applying the annual cohort requirement for insurance contracts with intergenerational sharing of risks between policyholders

Example 1—extension of example in AP2A of the March 2019 Board meeting

A1. This example develops the example used in Agenda Paper 2A of the March 2019 Board meeting to consider further information the staff have identified from the feedback on the topic of annual cohorts for contracts that share risks across generations of policyholders. The example is structured as follows:

- (a) paragraphs A2–A6 of this appendix set out the example from the March 2019 Board paper.
- (b) paragraphs A7–A12 of this appendix revise the example to show the effects of a discretionary change in the sharing of the returns on the underlying items between the entity and the policyholders as a whole. Such a change can affect the determination of the contractual service margin for new contracts.
- (c) paragraphs A13–A17 of this appendix extend the example to show how subsequent changes to the contractual service margin for each annual cohort can be determined.

Summary of example in the March 2019 Board paper

A2. The example considers two groups of variable fee approach contracts. The groups are issued more than a year apart. They share the returns on a specified pool of underlying items and the entity has discretion over the timing of amounts credited to policyholders, enabling intergenerational sharing of the returns on the underlying items.

A3. Facts for Group 1, issued t0:

- (a) premiums CU10,000, duration of contract 5 years;⁹
- (b) policyholders receive 80% of fair value returns, with the entity having discretion over the timing and allocation across policyholders;

⁹ In this appendix amounts are denominated in ‘currency units’ (CU).

- (c) expected returns on underlying items 5%, equal to market rate at the date the contracts are issued; and
- (d) entity invests premiums in 5% fixed rate bonds.

A4. Facts for Group 2, issued t1:

- (a) premiums CU15,000, duration of contract 5 years;
- (b) policyholders receive 80% of fair value returns, with the entity having discretion over the timing and allocation across policyholders;
- (c) expected returns on underlying items 1%, equal to market rate at the date the contracts issued; and
- (d) entity invests premiums in 1% fixed rate bonds.

A5. Detailed calculations are available to Board members on request.

	A	B	C		D		E
	Initial recognition of Group 1	Remeasurement of Group 1 before recognition of Group 2	Immediately after Group 2 contracts issued, <u>without</u> applying paragraph B68 of IFRS 17		Immediately after Group 2 contracts issued, applying paragraph B68 of IFRS 17		Immediately after Group 2 contracts, if groups 1 and 2 were combined
Market rate	5%	1%	1%		1%		1%
Total policyholder share	80%	80%	80%		80%		80%
Crediting rate going forward	4.075%	4.075%	2.004%		2.004%		
Underlying items	5% fixed rate bonds	5% fixed rate bonds	5% fixed rate bonds and 1% fixed rate bonds		5% fixed rate bonds and 1% fixed rate bonds		
	Group 1	Group 1	Group 1	Group 2	Group 1	Group 2	
Fulfilment cash flows	9,567	11,734	10,828	15,761	11,734	14,855	26,589
Contractual service margin	433	531	1,437	(761) ¹⁰	531	145	676
Insurance contracts	10,000	12,265	12,265	15,000	12,265	15,000	27,265
Underlying items	10,000	12,265	12,265	15,000	12,265	15,000	27,265

¹⁰ This amount is shown as a negative contractual service margin to ease comparison of the amounts across the columns.

A6. The table illustrates that:

- (a) the application of paragraph B68 of IFRS 17 prevents Group 2 from being depicted as an onerous group because it reflects the sharing of the cash flows between groups of policyholders. The premiums received from the policyholders in Group 1 and the fair value return on those premiums in the year subsidise the cash flows the entity expects to pay to Group 2. The resulting contractual service margin for Group 2 is the marginal contribution it makes to the entity's profit.
- (b) however, the cash flow subsidy between the policyholders of the different groups does not change the fact that the entity has benefited from its share of the fair value return. 20% of the returns on 5% fixed rate bonds is more profitable than 20% of the returns from the 1% fixed rate bonds. That profit for the entity should be recognised over the life of Group 1, not averaged over the life of the portfolio (in this example, the portfolio is made up of Group 1 and Group 2).

Revised example to show the effect of a discretionary change in the entity's share

A7. In the example above, the amounts in column B in the table in paragraph A5 of this appendix could be determined objectively based on the known sharing of returns between the entity and the policyholders (80%). In practice, an entity often has discretion over that ratio. The following table shows the results if the entity assumes at the end of year 1, it will increase the policyholders' share to 85% and reduce its share to 15%. Then when the new contracts are issued, the entity's assumption about the entity/policyholder share reverts back to 20%/80%. The rationale for such assumptions is described in paragraph A9 of this appendix. Detailed calculations are available to Board members on request.

	A	B	C		D		E
	Initial recognition of Group 1	Remeasurement of Group 1 before recognition of Group 2	Immediately after Group 2 contracts issued, <u>without</u> applying paragraph B68 of IFRS 17		Immediately after Group 2 contracts issued, applying paragraph B68 of IFRS 17		Immediately after Group 2 contracts, if groups 1 and 2 were combined
Market rate	5%	1%	1%		1%		1%
Total policyholder share	80%	85%	80%		80%		80%
Crediting rate going forward	4.075%	4.368%	2.003%		2.003%		
	Group 1	Group 1	Group 1	Group 2	Group 1	Group 2	
Fulfilment cash flows	9,567	11,867	10,827	15,759	11,867	14,720	26,586
Contractual service margin	433	398	1,438	(759) ¹¹	398	280	678
Insurance contracts	10,000	12,265	12,265	15,000	12,265	15,000	27,265
Underlying items	10,000	12,265	12,265	15,000	12,265	15,000	27,265

A8. The change in assumption about the entity/policyholder share at the end of year 1 changes the calculation of the contractual service margin for Group 2 (CU280 rather than CU145), even though the cash flows expected to be paid to the policyholders in Groups 1 and 2 stay the same as in the previous example.¹²

A9. The assumption about the entity/policyholder share at the end of year 1 can be described in two equivalent ways:

- (a) an assumption about the amounts the entity expects to pay to the existing policyholders based on the existing underlying items *without anticipating the effects of any new contracts*; or

¹¹ This amount is shown here as a negative contractual service margin to ease comparison of the amounts across the columns.

¹² In fact, the cash flows and crediting rates have changed slightly (for example, CU10,828 to CU10,827 for Group 1 and CU15,761 to CU15,759 for Group 2). This is because of a slight refinement to the calculation of the amounts based on an 80% share from the calculations in Agenda Paper 2A of the March 2019 Board meeting.

- (b) an assumption about the amounts the entity expects to pay to the existing policyholders based on expectation of new contracts, the resulting underlying items and *the expected subsidy from the existing policyholders to the new policyholders*.
- A10. Some stakeholders observe that the nature of insurance contracts that share returns across generations of contracts means that determining the assumption described in paragraph A9(a) of this appendix is not something they would expect to do in the course of their business. Equally, the assumption described in paragraph A9(b) of this appendix involves identifying how much of the entity’s share of returns will be used to subsidise cash flows to new policyholders. In the example above, the contractual service margin of Group 2 of CU280 is based on the assumption that the entity has reduced its share of profit from Group 1 from CU531 (table in paragraph A5 of this appendix) to CU398 (table in paragraph A7 of this appendix). Some stakeholders argue this is an arbitrary allocation of the entity’s profit across different groups.
- A11. The staff acknowledge these concerns. However, the staff observe entities have to make this assumption in order to measure the existing contracts at the reporting date, regardless of whether the existing contracts are divided into annual cohorts. Paragraph B68 of IFRS 17 requires comparison of existing contracts as a whole with new contracts in order to identify the marginal contribution of the new contracts. The only way to avoid this assumption would be to not apply paragraph B68 of IFRS 17, ie not to allow the transfer of cash flows between existing contracts and new contracts, and to account for each new cohort on a standalone basis, ie to ignore any effects of the sharing of risks across generations of policyholders. The staff do not think this would be a faithful representation of such contracts, nor do the staff expect it would meet stakeholders’ concerns.
- A12. Hence, given the contractual service margin for a new cohort has to be identified separately from any existing contractual service margin on initial recognition, the staff considered further how separate contractual service margins for new cohorts would be measured subsequently.

Subsequent measurement of the contractual service margins for annual cohorts

- A13. The example in Agenda Paper 2A of the March 2019 Board meeting did not explore the effect of changes in underlying items after Group 2 has been recognised. Some stakeholders expressed the view that it was unclear how they should allocate changes in value of the underlying items to the contractual service margins of annual cohorts, and that any allocation would be arbitrary.
- A14. The following table illustrates the effect of a change in interest rates and a further change in the ratio of sharing between the policyholders as a whole and the entity after Group 2 is recognised. Detailed calculations are available to Board members on request.

	A	B	D		E		
	Initial recognition of Group 1	Remeasurement of Group 1 before recognition of Group 2	Immediately after Group 2 contracts issued, applying paragraph B68 of IFRS 17		At the end of year 2		
Market rate	5%	1%	1%		3%		
Total policyholder share	80%	85%	80%		83%		
Crediting rate going forward	4.075%	4.368%	2.003%		2.13%		
	Group 1	Group 1	Group 1	Group 2	Group 1	Group 2	Total
Fulfilment cash flows	9,567	11,867	11,867	14,720	25,137		25,137
Contractual service margin ignoring p/l recognition	433	398	398	280	323	227	550
Insurance contracts	10,000	12,265	12,265	15,000	25,687		
Underlying items	10,000	12,265	12,265	15,000	25,687		

- A15. In the above table, the contractual service margin for each annual cohort has been calculated by allocating the change in the total contractual service margin to each annual cohort pro rata based on the opening contractual service margin balance. This depicts the entity’s profit from each annual cohort growing at an equal rate of return. The fulfilment cash flows are calculated only at the portfolio level, not the individual annual cohort level.
- A16. In this example, the only cash flows are from participation in the underlying items. Hence a pro rata allocation of the change in the contractual service margin reflects the fact that all cohorts share in the same pool of underlying items. But most insurance contracts include other cash flows, for example claims and guarantees (‘fixed cash flows’). If they affect different annual cohorts differently, information about the profitability of different cohorts would be lost if the total change in the contractual service margin of the portfolio were allocated on a pro rata basis. Instead, the effect of the ‘fixed cash flows’ on the contractual service margin of each annual cohort needs to be identified, and the remaining change in the total contractual service margin allocated on a pro rata basis.
- A17. For example, suppose five groups participate in a pool of underlying items. The entity gets 20% of the returns and the policyholders as a whole 80%. The policyholders in one group only, Group A, have a guaranteed return. The returns from the underlying items are shared after deducting any amounts needed to pay the guarantee. Suppose the underlying items decrease in value by CU1,000 and the effect of the guarantee increases the fulfilment cash flows by CU500. The staff note the following outcome:
- (a) the effect of the guarantee on the contractual service margin of Group A would be: Dr contractual service margin CU100, Dr fulfilment cash flows participation CU400, Cr fulfilment cash flows guarantee CU500; and
 - (b) the effect of the change in the underlying items allocated pro rata to the contractual service margins of each of the groups would be: Dr contractual service margin CU200, Dr fulfilment cash flows CU800, Cr insurance finance income or expenses CU1,000.
- A18. A similar example was discussed at the TRG meeting in September 2018, set out below.

Example 2—example from AP10 September 2018 TRG meeting

- A19. An entity issues contracts to 10 groups of policyholders, all forming a single portfolio of insurance contracts. Policyholders in each group pay a premium of CU1,000 and each share equally in 90% of the overall returns on the portfolio of insurance contracts (ie the specified pool of underlying items). The returns on the pool are derived from the performance of the insurance contracts. The remaining 10% goes to the entity.
- A20. Claims incurred in Group 1 amount to CU4,000, resulting in a net loss to the entity of CU3,000 on that group before allocating to the group its share of the return on the pool of underlying items. No claims are incurred in groups 2-10, resulting in a gain to the entity of CU9,000 on those nine groups before allocating to each group its share of the return on the pool of underlying items.
- A21. The overall profit of the portfolio is CU6,000. CU5,400 belongs to the policyholders (CU6,000 x 90%) and CU600 belongs to the entity (CU6,000 x 10%).
- A22. Each group shares equally in 90% of the return on the portfolio and is therefore due CU540 (CU5,400 / 10). The cash flows to each group are demonstrated in the following table:

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

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

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

A23. Therefore, applying paragraph B68 of IFRS 17, the groups of insurance contracts are measured as follows:

	Group 1	Each of groups 2-10	Groups 2-10
Premiums	1,000	1,000	9,000
Claims	(4,000)	-	-
Share of return on pool	(540)	(540)	(4,860)
Paragraph B68 of IFRS 17	3,240 ¹³	(360)	(3,240) ¹⁴
Fulfilment cash flows	(300)	100	900
Contractual service margin	0	(100)	(900)
Loss component	300	0	0

A24. The staff observe that for this example measuring the contractual service margin at a higher level than the annual cohort level, such as a portfolio level, would not achieve the same accounting outcome as measuring the contractual service margin at an annual cohort level applying paragraph 22 of IFRS 17.

¹³ Fulfilment cash flows in Group 1 exclude payments to policyholders in the group that have been included in the fulfilment cash flows of group 2-10.

¹⁴ Fulfilment cash flows in group 2-10 include payments to policyholders of contracts in other groups (CU4,140 - CU900).