FA Module 21: IFRS 17 Level of aggregation – exercises

(The attached PDF file has better formatting.)

Level of aggregation of insurance contracts

[Level of aggregation of insurance contracts in needed to identify onerous contracts; neither onerous contracts nor level of aggregation is tested on the final exam.]

Accounting entries for most firms are by transaction. For instance, each sale is a transaction, and net revenue is the sum of the transactions. Insurance contracts are aggregated into portfolios and then into groups within portfolios, before calculating the accounting entries.

- Forming probability distributions of future cash outflows for each insurance contract is expensive. Instead, insurers aggregate insurance contracts into portfolios: lines of business, regions, or business unit, and form probability distributions of future cash flows for the portfolio. Expected claims and benefits are more reliably measured for portfolios of contracts than for individual contracts.
- Insurers must separate their insurance portfolios into groups of those that are onerous (unprofitable), that have little chance of becoming onerous, and that may or may not become onerous.
    - The accounting for onerous vs non-onerous contracts differs. Within a group, non-onerous contracts offset onerous contracts, but a non-onerous group of contracts may not offset an onerous group.

The level of aggregation affects the timing of profit or loss among years.

- Profits are spread over the contract period for groups of non-onerous contracts.
- Profits are recognized immediately for groups of onerous contracts.

If each contract were its own group, insurers might show much up-front losses. If all contracts were in one group, insurers would show up-front losses only if all the contracts combined were unprofitable.

IFRS 17 paragraph 14 explains insurance portfolios:

> *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.*

The demarcation of portfolios (similar risks; managed together) is principles-based: insurers selling products in many countries, regions within country, and consumer markets may choose different levels of aggregation.

Each portfolios is divided into at least three groups:

- contracts that are onerous at initial recognition
- contracts that at initial recognition have no significant possibility of becoming onerous later
- the remaining contracts in the portfolio

IFRS 17 paragraph 17 explains the level of detail to assess whether contracts are onerous.

> *If an entity has reasonable and supportable information to conclude that a set of contracts will all be in the same group … it may measure the set of contracts to determine if the contracts are onerous … and assess the set of contracts to determine if the contracts have no significant possibility of becoming onerous subsequently …. 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.*

- If the insurer reasonably believes that a set of contracts will be in the same group (from the three listed above), it measures if the set of contracts is onerous or might become onerous later.
- If the insurer cannot place a set of contracts in the same group, it measures the contracts individually.

The premium allocation approach is a simplified measurement system that bases revenue on premiums, not on fulfilment cash flows. If insurers had to measure fulfilment cash flows to determine whether contracts were onerous, the cost benefits of the premium allocation approach might be lost. IFRS 17 paragraph 18 says that if the insurer uses the premium allocation approach, it "shall assume no contracts in the portfolio are onerous at initial recognition, unless facts and circumstances indicate otherwise…"

The basic exercises on the discussion forum show a single insurance contract and one or two claims. Some exercises speak of an onerous contract, a non-onerous contract that becomes onerous, or an onerous contract that becomes non-onerous. Actual accounting is for groups of contracts and groups that are onerous or non-onerous.

Exercise 21.1: Groups of contracts

IFRS 17, §14, requires a minimum of three groups for each portfolio:

- contracts that are onerous at initial recognition
- contracts that at initial recognition have no significant possibility of becoming onerous
- the remaining contracts

For this division of portfolios into groups, does the insurer

- examine each contract separately
- examine sets of contracts
- assume contracts are not onerous at initial recognition and assess whether assumptions might change

Solution 21.1: IFRS 17, paragraphs 17-18, has three scenarios:

- If contracts differ, the insurer assesses them individually. Commercial contracts and whole life insurance contracts are often assessed individually.
- If contracts in a set have similar attributes, the insurer may examine the set. Short duration and medium duration insurance contracts sold to individual policyholders, such as motor insurance, property insurance, and term life insurance, may be assessed as sets.
- Contracts measured by the premium allocation approach are often assumed to be not onerous at initial recognition, and they are assessed if "facts and circumstances" suggest that they might be onerous.

Illustration: Motor insurance contracts measured with the premium allocation approach use projections about claim frequency, claim severity, and loss cost trends. The insurer assesses whether these projections might change, causing the group of contract to perhaps become onerous.

Exercise 21.2: Level of aggregation

A. How are portfolios of insurance contracts defined?
B. Into how many groups is each portfolio of insurance contracts divided?

Part A: A portfolio comprises contracts subject to similar risks and managed together (paragraph 14).

- Contracts in a product line often have similar risks and are in one portfolio if they are managed together.
- Contracts in different product lines often have different risks and are in different portfolios.
- Contracts sold in different regions or countries or to different markets are not managed together and are in different portfolios.

Part B: Paragraph 16 requires at least three groups for each portfolio:

- contracts that are onerous at initial recognition
- contracts that at initial recognition have no significant possibility of becoming onerous
- the remaining contracts

Some groups may be empty. Many insurers do not expect any contracts to be onerous at initial recognition (when the contracts are issued), though the contracts may become onerous if business conditions change.

Some groups have one contract, An insurer may buy one reinsurance contract for a line of business, which forms its own portfolio and its own group.

Onerous refers to the liability for remaining coverage, not the liability for incurred claims. A group of motor insurance contracts with premium of 100 and a present value of claim payments of 150 is onerous. A claim that occurs for more than the expected amount does not make a contract onerous. The present value of the claim becomes a liability for incurred claims that affects profit or loss; it does not affect whether the contract is onerous.

Regulatory restrictions

Some countries do not permit classification by dimensions, such as sex or location, used to set rates. If an insurer would price contracts at different rates but prices them at the same rate to comply with the law, the insurer may include those contracts in the same group (IFRS 17 paragraph 20).

Exercise 21.3: Risk classification by gender

The European Union does not permit insurance risk classification by gender, so men and women pay the same rates for motor insurance. An insurer's motor insurance policies issued to male drivers are onerous at initial recognition, and its motor insurance policies issued to female drivers have little likelihood of becoming onerous. Does the insurer divide its motor insurance portfolio into groups of male vs female drivers?

Solution 21.3: If IFRS required that contracts under-priced because of constraints on risk classification to be treated as onerous contracts, opposition to the regulatory constraints might rise. Instead, IFRS 17 paragraph 20 says that

> *if 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.*

Insurers need not divide motor insurance contracts into groups of male vs female drivers.

Level of profitability

Insurers may sub-divide groups by level of profitability or other attributes. For example, groups may be divided into contracts whose expected rate of return exceeds the target return on capital vs contracts whose expected rate of return is less than the target return on capital.

IFRS 17 paragraph 21 says that an insurer may

> *choose to divide the portfolios into:*
>
> - *more groups that are not onerous at initial recognition …*
>   - *different levels of profitability*
>   - *different possibilities of contracts becoming onerous after initial recognition*
> - *more than one group of contracts that are onerous at initial recognition …*

IFRS 17 paragraph 22 says that a group may not include contracts issued more than one year apart. The groups are classified by issue date, not by the date the contract is in force.

Illustration: Life insurance contracts may stay in force many years. The groups might be contracts issued in 20X1, in 20X2, and so forth, not those in force during 20X1, during 20X2, and so forth.

IFRS 17 paragraph 47 (“onerous contracts”) refers to *fulfilment cash flows allocated to the contract*.

insurers form groups by whether the contract is onerous. But insurers estimate the fulfilment cash flows for the group of contracts and allocate the fulfilment cash flows to contracts.

IFRS 17 paragraph 40, “Subsequent measurement,” refers to “the fulfilment cash flows related to future service allocated to the group at that date” and “the liability for incurred claims, comprising the fulfilment cash flows related to past service allocated to the group at that date.”

The insurer may measure the fulfilment cash flows for the portfolio of insurance contracts and allocate them to the groups.

IFRS 17 *Basis for Conclusions* paragraph BC117 says

> IFRS 17 allows an entity to estimate the fulfilment cash flows at whatever level of aggregation is most appropriate from a practical perspective. All that is necessary is that the entity is able to allocate such estimates to groups of insurance contracts …

BC129 The objective of the requirement to identify contracts that are onerous at initial recognition is to identify contracts that are onerous measured as individual contracts. An entity typically issues individual contracts and it is the characteristics of the individual contracts that determine how they should be grouped. However, the Board concluded this does not mean that the contracts must be measured individually. If an entity can determine using reasonable and supportable information that a set of contracts will all be in the same group, then the entity can measure that set to determine whether the contracts are onerous or not, because there will be no offsetting effects in the measurement of the set. The same principle applies to the identification of contracts that are not onerous at initial recognition and that have no significant possibility of becoming onerous subsequently —the objective is to identify such contracts at an individual contract level, but this objective can be achieved by assessing a set of contracts if the entity can conclude using reasonable and supportable information that the contracts in the set will all be in the same group.

BC130 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.

BC131 In some jurisdictions, law or regulation specifically constrains the entity’s practical ability to set a different price or level of benefits for contracts or policyholders with different characteristics. The Board considered whether to give an exemption from dividing contracts into separate groups if the only reason that they would fall into different groups specified in paragraph BC127 is because of such constraints. In general, the Board seeks to minimise exemptions because they increase complexity for both users of financial statements and preparers and may have unintended consequences for future standard-setting activities. Further, providing an exemption for accounting for economic differences caused by the effect of law or regulation on pricing may create an undesirable precedent, given that such effects are not restricted to insurance contracts. However, the notion of grouping contracts to determine the profit or losses recognised is a specific feature of the requirements in IFRS 17. In deciding the appropriate grouping of contracts, the

Board sought to balance the need to group contracts to reflect the economics of issuing insurance contracts against grouping at too high a level, which would reduce the usefulness of information produced (see paragraph BC123).

BC132 The Board concluded it would not provide useful information to group separately contracts that an entity is required by specific law or regulation to group together for determining the pricing or level of benefits. All market participants in that jurisdiction will be constrained in the same way, particularly if such entities are unable to refuse to provide insurance coverage solely on the basis of differences in that characteristic.