STAFF PAPER

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IASB Meeting

Project	**Insurance contracts**
Paper topic	Level of aggregation

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Purpose of this paper

1. This paper considers a possible response to the feedback received on the level of aggregation in the external review of a draft of IFRS 17 *Insurance Contracts* (draft IFRS 17).

Staff recommendation

2. The staff recommend that:

   (a) the International Accounting Standards Board (the Board) retain the definition of portfolio in draft IFRS 17, ie that a portfolio is a group of contracts subject to similar risks and managed together as a single pool. The forthcoming insurance contracts Standard would provide guidance that contracts within each product line, such as annuities and whole-life, would be expected to have similar risks, and hence contracts in different product lines would be expected to be in different portfolios.

   (b) entities should be required to identify onerous contracts at inception and group them separately from contracts that are not onerous at inception.

   (c) entities should be required to measure insurance contacts that are not onerous at inception by dividing portfolios, at a minimum, into two groups—a group of contracts that have no significant risk of becoming onerous and a group of other profitable contracts. The forthcoming insurance contracts Standard would provide guidance that:

(i) an entity should assess the risk of the contracts in a group becoming onerous in a manner consistent with how the entity's internal reporting provides information about changes in estimates.

(ii) an entity should assess whether there is no significant risk of the contracts in the group becoming onerous, based on the sensitivity of the fulfilment cash flows to changes in estimates which, if they occurred, would result in the contracts becoming onerous.

(iii) an entity is permitted to divide portfolios into more than two groups. For example an entity may choose to divide the portfolios into more groups if the entity's internal reporting provides information that distinguishes at a more granular level the different risks of contracts becoming onerous.

(d) entities should be permitted to group only contracts issued within the same year.

(e) entities should be required to allocate the contractual service margin for a group of contracts over the current period and expected remaining coverage to be provided, on the basis of the passage of time. The allocation shall be based on coverage units, reflecting the expected duration and size of the contracts in the group.

(f) entities should be permitted to use a weighted-average discount rate for the accretion of interest, with an averaging period of as much as one year.

Background

The measurement model

3. The Board's model for the measurement of insurance contracts is asymmetric in the treatment of expected gains and losses: expected gains are recognised over the coverage period through the establishment and allocation of the contractual

service margin, while expected losses are recognised immediately in profit or loss, once the contractual service margin is exhausted. As described in paragraphs 6-7, this asymmetry in the accounting model results in the need to group contracts for measurement.

4. The contractual service margin is established based on information available at the inception of the contract, and is subsequently adjusted, accreted and allocated. In the general model, interest is accreted on the contractual service margin using a locked-in discount rate. Accordingly, the determination of the contractual service margin balance in periods after inception requires reference to previous information: an opening balance (which consists of the initial balance plus or minus previous adjustments, accretions and allocations), and the locked-in discount rate.

5. In contrast, the fulfilment cash flows are determined using only information at the measurement date.

Need to group contracts

6. The need for grouping to reflect the economics of issuing insurance contracts arises because an entity makes estimates that are valid on average for each contract in a group of insurance contracts, even though the experience of an individual contract will ultimately differ. Those estimates includes the cash flows that will arise as the entity fulfils the contracts, and about the period in which the entity provides service for each contract. The differences between the expected average estimates and the experience of any individual contract in the group will give rise to gains and losses. As the entity issued the contracts expecting those differences, it is appropriate that contracts issued under the same average assumptions should be grouped together so that favourable and unfavourable changes in estimates from the individual contracts in the group are offset, and only any *net* change in estimate is adjusted in the contractual service margin of the group or recognised in profit or loss.

7. Nonetheless, the Board previously indicated that it did not think that all expected losses from contracts issued by an entity that issues insurance contracts should offset expected gains of other contracts. The possibility of offsetting expected

losses from some contracts and expected gains from other contracts is not unique to insurers, and offsetting all expected losses and expected gains would fail to report economic effects that are reported for contracts other than insurance contracts. At heart, the question of the level of aggregation is in identifying which gains and losses should be offset.

Recognising the contractual service margin when the service is provided

8. The other aspect of accounting for insurance contracts, for which the level of aggregation is relevant, is the allocation of the contractual service margin. The Board's principle for the allocation of the contractual service margin is that an entity should recognise the remaining contractual service margin in profit or loss over the current and remaining coverage period in a systematic way that best reflects the remaining transfer of the services to be provided by insurance contracts.

9. In many cases, insurance contracts in a group have different expected durations and it is then expected that the coverage period of some contracts will end earlier than the average coverage period for the group and the coverage period of other contracts will end later than the average coverage period for the group.

10. For those contracts for which the coverage period ends earlier than the average coverage period for the group:

    (a) measuring the contracts on an individual basis would mean that the contractual service margin associated with those contracts would be fully recognised in profit or loss over the shorter period up to the point when the coverage period ends.

    (b) measuring the contracts on a group basis would not necessarily mean that the contractual service margin associated with those contracts would be recognised in profit or loss when the coverage period ends.

11. The staff notes that when the allocation of the contractual service margin is determined at a group level, the intended consequences of the principle in paragraph 8 are that the contractual service margin should not become an everlasting pot that cannot be related to existing groups of similar contracts. To achieve this, the contractual service margin for the group should reflect the

number and size of the contracts within the group that still have coverage to provide (ie have not lapsed or expired).

12. The Board concluded that it would be difficult in many cases to achieve the outcome in paragraph 11 unless the allocation of the contractual service margin was tracked separately for a group of contracts:

    (a) for which the amount and timing of cash flows are expected to respond in similar ways to key drivers of risk;

    (b) on inception had similar expected profitability (ie similar contractual service margin as a percentage of the premium); and

    (c) have coverage periods that are expected to end at a similar time.

13. Conditions (a) and (b) are needed so that the contractual service margin of a particularly profitable individual contract within a group is not carried forward after the individual contract has expired. Condition (c) is needed to prevent the contractual service margin being carried forward long after the contract has expired.

Previous tentative decisions about grouping

14. Draft IFRS 17 used for external testing stated in relation to the aggregation of contracts:

> **36 Having determined the measurement of individual contracts on initial recognition, an entity shall aggregate contracts into groups to determine whether to recognise a loss for a group o contracts and to measure the contractual service margin after initial recognition. Those groups comprise contracts that on initial recognition have:**
>
> **(a) future cash flows the entity expects will respond similarly in terms of amount and timing to changes in key assumptions; and**
>
> **(b) similar expected profitability. Unless paragraphs 50-54 apply, similar profitability means similar contractual service margin as a percentage of the total expected revenue. As a practical expedient, an entity may instead assess whether the contracts have a similar**

> **expected return on premiums, ie the contractual service margin as a percentage of expected premiums.**

15. In addition, draft IFRS 17 stated:

> **B107 An amount of the contractual service margin is recognised in the statement of profit or loss to reflect the service provided under the contract. In determining that amount, the objective is to allocate the contractual service margin for a group of contracts remaining (before any allocation) at the end of the reporting period over the coverage provided in the current period and expected remaining future coverage to be provided, on the basis of the passage of time. The allocation shall be based on coverage units, reflecting the expected duration and size of the contracts in the group.**

16. These paragraphs reflect the Board's tentative conclusions about when contracts that are onerous should be grouped with contracts that are profitable after inception as follows:

    (a) groups of contracts that have a greater risk of being onerous should not be grouped with groups of contracts that have a lower risk of being onerous (see paragraph 36 of draft IFRS 17); and

    (b) the contractual service margin should be allocated to periods in a way that reflects the service provided by the contracts (see paragraph B107 of draft IFRS 17).

17. In addition, those paragraphs reflect the Board's tentative conclusion that the contractual service margin for the group should reflect the number and size of the contracts within the group that still have coverage to provide (ie have not lapsed or expired).

18. There are two other conclusions that are consequential to those in paragraphs 16 and 17:

    (a) In order to determine how to group contracts for subsequent measurement an entity must assess the profitability of the individual contracts with policyholders (paragraph B36 of draft IFRS 17). This enables the entity to determine whether the contract is profitable or onerous at inception, and to determine the risk of the contract becoming onerous after inception.

(b) Although the measurement of the fulfilment cash flows is not affected by the level of aggregation, changes in the fulfilment cash flows need to be applied or allocated to the groups of contracts that are used for the determination of the contractual service margin.

Feedback received

19. Agenda paper 2B notes that the issue of the level of aggregation was the area of greatest concern for test participants and describes the feedback received on the level of aggregation in more detail. In summary:

(a) All test participants expected that applying the standard could result in very high numbers of groups, and low numbers of contracts in each group. Test participants stated that application of draft IFRS 17 would generally, but not always:

(i) result in a more granular level of aggregation that entities previously used;

(ii) be different from the way that many entities currently assess profitability or track contracts. The staff noted that the management approach varied between entities;

(iii) impose significant cost and complexity due to data storage requirements and granularity of analysis.

(b) Although the primary concerns about granularity were often identified as being operational, there was also a concern that the requirements in draft IFRS 17 would result in entities reporting losses on some contracts when other contracts were profitable when participants thought this did not reflect the economic circumstances.

(c) Some respondents noted that the existence of options for policyholders to select different coverage (eg in the form of riders) affected the assessment of the response of the cash flows of contracts to changes in key assumptions, because different options resulted in exposure to different risks. This increased the number of groups needed, significantly in some jurisdictions.

(d) The following factors affected the assessment of the profitability of contracts and thus the extent to which similar profitability affected the level of aggregation:

(i) interest rate changes could result in contracts with identical expected cash flows written on different dates having different expected profitability.

(ii) the profitability of different groups of contracts could be affected by the choice of allocation methods for overhead costs or because there were differences in the costs of different distribution channels.

(iii) when an entity charges a discounted premium because of the existence of other contracts, the allocation of the discount could affect the profitability of both contracts.

(e) Some test participants sought clarification about how the requirements for the allocation of the contractual service margin.

(f) A few test participants observed that the requirement to use locked-in discount rates for accreting interest on the contractual service margin in the general model would limit their ability to use open portfolios.

20. Some test participants did not agree with the Board’s conclusion that that there should be no exception to the requirement to group contracts with similar profitability if differences in profitability arose as a result of restrictions on pricing and underwriting imposed by regulators or law.

21. Most test participants assumed that the level of granularity for contractual service margin measurement would determine the granularity for the measurement of the fulfilment cash flows. Some test participants asked for clarification on the level of aggregation for assessing eligibility for the variable fee approach.

Staff analysis

22. The paragraphs below consider the following issues identified in the external testing for which the staff proposes the Board modify its tentative decisions:

(a) the number of groups that would be required (paragraphs 24-39); and

(b) the implications of changes in discount rates for determining the accretion of interest (paragraphs 40-42).

23. Paragraph 43 lists other issues identified in the external testing relating to the level of aggregation, for which the staff propose no action. However, the staff notes that the staff recommendations on the number of groups may reduce the extent to which those issue cause difficulties for entities.

Number of groups

24. The staff note that the results of the external testing and in particular the focus on the criteria “similar profitability” highlighted the extent to which entities interpreted draft IFRS 17 as requiring an excessively large number of groups. Test participants also highlighted the question of how useful information about contracts with different profitability would be at such a disaggregated level. The staff considered whether it would be possible to reduce the operational burden that would be imposed by a requirement for extensive disaggregation of portfolios, while still reflecting the Board's conclusions for determining the groups of contracts in paragraph 16.

25. To illustrate what the Board is being asked to change, the staff has illustrated, using simple examples to aid explanation, the outcome that would have been reached applying the conclusions in paragraph 16 and the words in draft IFRS 17 below.

Conclusion	Example	Grouping consistent with draft IFRS 17	Staff comment
1. Groups of contracts that are onerous at inception should not be grouped with groups of contracts that are profitable at inception.	**Loss leader vs profitable contract:** An entity issues 100 contracts with identical obligations to policyholders. However, the premium charged to 25 policyholders is lower than the risk-adjusted expected present value of the cash flows expected from the contract (ie the contracts are onerous). The premium charged to each of the other 75 policyholders, which exceeds the risk-adjusted present value of the cash flows expected from the contract, is such that the profitability of each of those contracts is the same. The entity expects to make a profit from the 100 contracts as a whole.	The entity has two groups: - the 25 onerous contracts together; and - the 75 profitable contracts.	The conclusion that losses from contracts that are onerous at inception should be recognised in profit and loss, and that expected gains at inception should be recognised as a contractual service margin was not challenged by test participants.

Conclusion	**Example**	**Grouping consistent with draft IFRS 17**	**Staff comment**
2. Groups of contracts that have a greater risk of being onerous after inception should not be grouped with groups of contracts that are at a lower risk of being onerous after inception.	**2A. Thin margin vs thick margin:** An entity issues 100 contracts with identical obligations to policyholders, all of which are expected to be profitable. However, the entity charges varying premiums to different policyholders, as follows: - 25 contracts have a 5% margin; - 25 contracts have a 25% margin; - 25 contracts have a 60%. margin; and - 25 contracts have a 90% margin. The margins are determined on the basis of the expected cash flows. However, there is a wide variability in possible outcomes, as follows: - There is 10% chance that the 5% margin contracts will be onerous; - There is a 1% chance that the 25% margin contracts will be onerous; - There is a 0.001% chance that the 60% margin contracts will be onerous; - There is a 0.000001% change that the 90% margin contracts will be onerous.	The entity divides the contracts into groups of 25 contracts with the contracts having different margins in different groups.	The staff agrees with test participants that the objective of separating groups of contracts that have a greater risk of being onerous after inception from groups of contracts that have a lower risk of becoming onerous after inception could cause a large number of groups. This was exacerbated by the fact that many testing participants were unclear about the extent to which differences in profit margin might be considered dissimilar (ie how to apply paragraph 36(a) in draft IFRS 17) and consequently took a narrow view of “similar” profitability. In addition, the staff notes a further difficulty arises. Examples 2A and 2B show clear differences between the profitability of the contracts, and in the likelihood of each group of contracts becoming onerous.

Conclusion	Example	Grouping consistent with draft IFRS 17	Staff comment
	2B. Different response to risks: An entity issues 100 contracts with identical obligations to policyholders and charges the same margin for each contract. For all contracts, the risk of an insured event occurring is affected by risk factor A. However, 60 of the contracts are more sensitive to changes in risk factor A than the remaining 40 contracts, such that: - A 10% increase in risk factor A leads to a 80% increase in the cash outflows for the 60 contracts that are more sensitive to risk factor A - A 10% increase in risk factor A leads to a 10% increase in the cash outflows for the 40 contracts that are less sensitive to risk factor A.	The entity divides the contracts into two groups comprising the 60 contracts that are sensitive to risk factor A and the remaining 40 contracts.	However, in most entities, there will be a continuum of margins and it may be difficult for entities to decide which contracts have similar profitability. In addition, the staff notes that the objective leading to this conclusion, ie in ensuring that the different effects of unlocking adjustments on contracts with different margins, would be met provided that an entity disaggregates contracts that are at a greater risk of becoming onerous (ie less resilient) from contracts that are at a lower risk of becoming onerous (ie more resilient). For example, in example 2A, the entity could determine that the contracts with a greater than 0.5% chance of becoming onerous are not resilient to becoming onerous and those with less than or equal to 0.5% chance of becoming onerous are resilient.

Conclusion	Example	Grouping consistent with draft IFRS 17	Staff comment
3. the contractual service margin should be allocated to periods in a way that reflects the service provided by the contracts.	An entity issues: - 30 contracts that have a margin of CU50 each and coverage period of 1 year; - 70 contracts that have a margin of CU5 each and a coverage period of 10 years. On average, the 100 contracts each have a margin of CU15.35.	The entity groups the 100 contracts together, but determines the allocation of the contractual service margin in a way that reflected the expected duration and size of the contracts in the group. The entity could also achieve this outcome by dividing the contracts into two groups so that it recognises CU1535[1] in the first year and CU35[2] in each of the following 9 years.	The conclusion that the allocation of the contractual service margin should reflect the expected duration and size of the contracts in the group was not challenged by test participants.

[1] (30x CU50) + (70 x CU5/10)

[2] 70xCU5/10

Conclusion	Example	Grouping consistent with draft IFRS 17	Staff comment
4. The contractual service margin for the group should reflect the number and size of the contracts within the group that still have coverage to provide (ie have not lapsed or expired).	**4A.contracts with different size of contractual service margin:** An entity issues contracts with a coverage period of 20 years. 100 contracts have a remaining contractual service margin of 50 per contract. 80 contracts have a remaining contractual service margin of 4 per contract. The entity allocates the contractual service margin in a way that reflects the relative size of the contractual service margin During the reporting period 30 of the contracts with a contractual service margin of 50 lapse unexpectedly.	The entity could group the contracts in two groups: - 100 contracts with a remaining contractual service margin of 50 per contract, of which 30 lapse. - 80 contracts with a remaining contractual service margin of 4 per contract.	The entity may also achieve the same outcome by grouping all the contracts together, but, if this were the case, it would need to track the contracts so that the unexpected lapse of the 30 contracts results in the contractual service margin for the group being reduced by 150.

Conclusion	Example	Grouping consistent with draft IFRS 17	Staff comment
	4B. contracts with different duration and size: An entity issues: - 100 contracts that have a remaining contractual service margin of 50 per contract and a remaining duration of 1 year; - 100 contracts that have a remaining contractual service margin of 5 per contract and a remaining duration of 5 years. The entity allocates the contractual service marginin a way that reflects the relative duration and size of the contracts.	The entity could group the contracts in two groups: - 100 contracts with a remaining contractual service margin of 50 per contract, all of which would be recognised in the next reporting period - 100 contracts with a remaining contractual service margin of 5 per contract, for which the entity would allocate 1 to each of the remaining 5 periods.	The entity may also achieve the same outcome by grouping all the contracts together, but if this were the case, would need to track the contracts so that the allocation of the contractual service margin reflects the shorter duration of the contracts with the larger contractual service margin.

26. We observe that some aspects of the Board's objectives could be met even if entities were permitted to aggregate contracts into bigger groups in some cases and that it appears as if this would have a significant benefit in terms of operational costs for preparers. We also observe that it is generally desirable to align accounting requirements with information that is consistent with internal reporting and risk management. Our assumption is that sensitivity to risk and amount of margin would generally be a key factor in the monitoring and management of insurance contracts.

27. In addition, the staff is sympathetic to the view, expressed by some test participants, that the focus should be on disaggregation of portfolios, rather than on the aggregation of individual contracts, since this is more consistent with the way contracts are managed.

28. Accordingly, the staff propose that the Board could provide operational relief to entities by:

    (a) being clear that what is intended by 'respond similarly to changes in key assumptions' is expected to be at the level of monitoring and management of the key assumptions by management. This is broader than many had interpreted.

    (b) approaching the issue by disaggregating the portfolios of contracts written by an entity using a top-down approach, focussed on separating groups of contracts only to the extent needed to meet the Board's objectives.

29. Accordingly, the staff propose that the Board modify the requirements for level of aggregation to:

    (a) retain the definition of portfolio in draft IFRS 17, ie that a portfolio is a group of contracts subject to similar risks and managed together as a single pool. The forthcoming insurance contracts Standard would provide guidance that contracts within each product line, such as annuities and whole-life contracts, would be expected to have similar risks, and hence contracts in different product lines would be expected to be in different portfolios.

    (b) require that entities identify any onerous contracts at inception and group them separately from contracts that are not onerous at inception.

(c) require that entities measure insurance contacts that are not onerous at inception by dividing portfolios, at a minimum, into two groups—a group of contracts that have no significant risk of becoming onerous and a group of other profitable contracts.

(d) provide guidance that:

  (i) an entity should assess the risk of the contracts in the group becoming onerous in a manner consistent with how the entity's internal reporting provides information about changes in estimates

  (ii) an entity should assess whether there is no significant risk of the contracts in the group becoming onerous, based on the sensitivity of the fulfilment cash flows to changes in estimates which, if they occurred, would result in the contracts becoming onerous.

  (iii) an entity is permitted to divide portfolios into more than two groups. For example an entity may choose to divide the portfolios into more groups if the entity's internal reporting provides information that distinguishes at a more granular level the different risks of contracts becoming onerous.

(e) retain the requirement that entities allocate the contractual service margin for a group of contracts over the current period and expected remaining coverage to be provided, on the basis of the passage of time. The allocation shall be based on coverage units, reflecting the expected duration and size of the contracts in the group.

30. The consequences described in paragraph 18 are affected as follows:

To enable an entity to determine whether it can add a contract to the group, it needs to assess whether the contract is profitable or onerous, and the risk of the contract becoming onerous after inception. This assessment must be performed at the individual contract level (B36 of draft IFRS 17).	The assessment at inception of which group a contract can be added to will still be performed at an individual contract level. However, draft IFRS 17 already comments explicitly that "just because measurement at initial recognition is an individual contract does not mean that, in practice, some aspects of that measurement cannot be achieved at a higher level of aggregation" (paragraph

	B36 of draft IFRS 17) and that “if an entity can determine [the characteristics of an individual contract] without measuring the individual contract, for example based on the information used to establish pricing, an entity may measure a group that meets the conditions [for aggregation] rather than the individual contracts” (paragraph 24 of draft IFRS 17). We noted that a few sought clarification as to what was intended by the reference to “pricing” in paragraph 24 of draft IFRS 17, and how that paragraph interacted with paragraph 36 of draft IFRS 17on the aggregation of contracts. No action is proposed, other than to clarify the drafting.
Although the measurement of the fulfilment cash flows is not affected by the level of aggregation, changes in the fulfilment cash flows need to be applied to the groups of contracts that are used for the determination of the contractual service margin.	No change. However, the groups will be larger under the proposed staff recommendation.

31. In the staff’s view, the proposed amendment to the previous decisions would respond to the comments in the following ways:

(a) The proposal would result in less granularity than draft IFRS 17, because the entity would need to separate groups only to the extent it thinks that the resilience of the contracts in the group to becoming onerous is significantly different. At a minimum, all contracts that have no significant risk of becoming onerous could be grouped together. Thus, in Example 2A, the entity would have two groups, rather than four groups.

(b) Division of the contracts into a group with no significant risk of becoming onerous and a group of other profitable contracts is intended to be consistent with how the entity's internal reporting provides information about changes in estimates.

32. However, the staff notes that this proposal may not provide as much information in the financial statements as would have been provided by the requirements in draft IFRS 17. For example, an unexpectedly large change in estimates may have otherwise caused some contracts to become onerous, however because those contracts are now grouped with other, more profitable contracts, this may no longer occur (see example 2A). Under draft IFRS 17, separating contracts by levels of profitability would mean that those different effects would be reflected in the measurement of the insurance contract and hence in the financial statements. In contrast, grouping contracts only into those that are resilient and those that are not resilient would ensure that losses would be reported if the contracts have a low likelihood of becoming onerous, but would not provide as much information about how quickly different contracts became onerous or the effect of any reversal in changes of estimates. That information would, however be available in the disclosures through the change in the contractual service margin.

33. In addition, grouping contracts in this way would also have consequences for the allocation of the contractual service margin. As described in paragraph 8-13, the Board's objective for the allocation of the contractual service margin would require that contracts are grouped if:

    (a) the amount and timing of cash flows are expected to respond in similar ways to key drivers of risk;

    (b) on inception the contracts had similar expected profitability (ie similar contractual service margin as a percentage of the premium); and

    (c) have coverage periods that are expected to end at a similar time.

34. Reducing the number of groups as proposed in paragraph 29 would mean that an entity might not achieve the intended consequences that the contractual service margin for the group should reflect the contracts within the group that still have coverage to provide (ie have not lapsed or expired).

35. Nonetheless, the staff thinks that the outcomes in paragraph 33 could be achieved to an acceptable degree if, for each of the groups within a portfolio (ie onerous at inception, no significant risk of becoming onerous, and other contracts that are not

onerous at inception), the Board were to instead restrict an entity to grouping contracts that are issued within the same year. In the staff's view, such a requirement would enable the Board to achieve the benefits of the reduced operational burden that results from removing the requirement for entities to group contracts according to profitability while still retaining the outcome it desires for the allocation of the contractual service margin.

One year cohorts and mutualisation

36. The staff have considered the effect on mutualised contracts of the requirement to restrict groups to contracts that are issued within one year. Contracts are mutualised if some policyholders have subordinated their claims to those of other policyholders, thereby reducing the direct exposure of the insurer to the collective risk of the group.

37. Without a requirement to restrict groups to contracts that are issued within one year, contracts that are fully mutualised would be in the same group. The question is whether dividing such a group, that is subject to mutualisation, into groups of contracts written within one year will distort the measurement of the contractual service margin in the annual groups. In particular, the staff considered whether a loss might arise because an annual group is regarded as onerous even though the combined mutualised group (the portfolio) is profitable. The staff do not think recognising such losses would provide useful information.

38. However, the staff note that draft IFRS 17 requires the cash flows of mutualised contracts to include the effect of the mutualisation. This can be done at the level of the portfolio, so to the extent that increases/decreases in the fulfilment cash flows for policyholders in one annual group are offset by decreases/increases in the fulfilment cash flows of other annual groups, there will be no change in the fulfilment cash flows. To the extent that there are changes in the fulfilment cash flows of the portfolio, after taking into account the effects of mutualisation, an entity will allocate those changes to the annual groups in a manner that reflects the effect of mutualisation on the contractual service margins of the groups.

39. The staff therefore concluded that requiring annual groups for mutualised contracts is operational. The staff accepts that, for fully mutualised contracts, the annual groups will give the same results as the single combined mutualised portfolio, and therefore considered whether the forthcoming insurance contracts Standard should give an

exception to the requirement to restrict groups to those issued within one year. However, the staff thinks that setting the boundary for such an exception would add complexity to the forthcoming insurance contracts Standard and creates the risk that the boundary would not be robust or appropriate in all circumstances.

Question for Board members: Number of groups

Does the Board agree:

(a) to retain the definition of portfolio in draft IFRS 17, ie that a portfolio is a group of contracts subject to similar risks and managed together as a single pool. The forthcoming insurance contracts Standard would provide guidance that contracts within each product line, such as annuities and whole-life contracts, would be expected to have similar risks, and hence contracts in different product lines would be expected to be in different portfolios.

(b) entities should be required to identify any onerous contracts at inception and group them separately from contracts that are not onerous at inception.

(c) entities should be required to measure insurance contacts that are not onerous at inception by dividing portfolios, at a minimum, into two groups—a group of contracts that have no significant risk of becoming onerous and a group of other profitable contracts. The forthcoming insurance contracts Standard would provide guidance that:

(i) an entity should assess if the risk of the contracts in the group becoming onerous in a manner consistent with how the entity's internal reporting provides information about changes in estimates.

(ii) an entity should assess whether there is no significant risk of the contracts in the group becoming onerous, based on the sensitivity of the fulfilment cash flows to changes in estimates which, if they occurred, would result in the contracts become onerous.

(iii) an entity is permitted to divide portfolios into more than two groups. For example an entity may choose to divide the portfolios into more groups if the entity's internal reporting provides information that distinguishes at a more granular level the different risks of contracts becoming onerous.

(d) entities should be permitted to group only contracts issued within the same year.

(e) entities should be required to allocate the contractual service margin for a group of contracts over the current period and expected remaining coverage to be provided, on the basis of the passage of time. The allocation shall be based on coverage units, reflecting the expected duration and size of the contracts in the group.

The implications of changes in discount rates for determining the accretion of interest

40. The staff observes that the effect of changes in discount rates on profitability will have less significant effect on the number of groups, given the proposal that entities should measure insurance contacts by dividing portfolios, at a minimum, into a group of contracts that has no significant risk of becoming onerous and a group of other profitable contracts.

41. However, that proposal does not affect the other issue that test participants identified, ie that changes in discount rates would mean that contracts need to be accreted at different rates, and this will result in entities need to track contracts with those different rates separately.

42. The staff propose to resolve this issue by providing guidance that an entity may use a weighted average discount rate for the accretion of interest, and that the averaging can occur up to one year.

Question for Board members: Locked in discount rates for accretion of interest

Does the Board agree that an entity should be permitted to use a weighted average discount rate for the accretion of interest, with an averaging period of up to one year?

Other issues related to the level of aggregation that the staff proposes the Board does not address

43. The following table lists other issues identified by test participants for which the staff propose no further action.

Issue	Comment
Effect of allocation on profitability Some test participants noted that the assessment of profitability could be affected by the choice of overhead allocation methods, or the allocation of discounts provided when a policyholder buys more than one contract.	The staff notes that this issue has a smaller effect on the number of groups if the Board accepts the proposal that an entity should divide profitable portfolios, at a minimum, into a group of contracts that has no significant risk of becoming onerous and a group of other profitable contracts. In addition, the staff observes that entities should be expected to allocate overheads and discounts in a systematic way.
Effect of distribution channels on profitability A few test participants noted that different assessment of profitability could arise if the entity used different distribution channels for the same product.	The staff notes that this issue has a smaller effect on the number of groups if the Board accepts the proposal that an entity should divide profitable portfolios, at a minimum, into a group of contracts that has no significant risk of becoming onerous and a group of other profitable contracts. In addition, the staff observes that the differences in profitability caused by different costs of distribution channels reflect economic phenomena.
Need to determine fulfilment cash flows at the level of the contractual service margin group Most test participants assumed that the level of granularity for contractual service margin measurement would determine the granularity for the measurement of the fulfilment cash flows.	Draft IFRS 17 already comments explicitly that "just because measurement at initial recognition is an individual contract does not mean that, in practice, some aspects of that measurement cannot be achieved at a higher level of aggregation" In particular, "if an entity can determine [the characteristics of an individual contract] without measuring the individual contract, for example based on the information used to establish pricing, an entity may measure a group that meets the conditions [for aggregation] rather than the individual contracts" (B36).
Effect of riders on assessing if contracts have similar risks Some respondents noted that the existence	The staff observes that when options or riders significantly modify the risk characteristics of the contract (and are separate contracts), this

of options for policyholders to select options for coverage (eg in the form of riders) affected the assessment of the response of the cash flows of contracts to changes in key assumptions, because different options resulted in exposure to different risks.	reflects economic differences between the contracts and it would be appropriate to group the contracts into different portfolios. See agenda paper 2G.
Balance sheet presentation Draft IFRS 17 requires presenting separately in the balance sheet the carrying amount of groups of insurance contracts in an asset and a liability position. A few test participants suggested that the benefit of presenting separate line items for groups of insurance contracts in an asset position, and groups of insurance contracts in a liability position would outweigh the costs. A few stated that entities should be allowed to disclose insurance contracts that are in an asset position and insurance contracts that are in a liability position at a portfolio level. In addition, one test participant requested that the contracts in a net asset or a net liability position should also be allowed to be determined on a due basis, and not only on a receipts basis. The test participant stated that the raising of the liability for remaining coverage on cash receipt basis would not be possible within current systems.	IAS 1 states that offsetting in the statement of financial position, except when offsetting reflects the substance of the transaction or other event, detracts from the ability of users both to understand the transactions, other events and conditions that have occurred and to assess the entity's future cash flows" (IAS 1.33). Because the contracts are measured as part of a group, the group is the unit of account. Groups of contracts may be in an overall asset position or an overall liability position. However, the groups will be larger under the proposed amendment compared to the previous decisions.
Scope of variable fee approach Some test participants asked for clarification on the level of aggregation for assessing eligibility for the variable fee approach.	Because the contracts are measured as part of a group, the group is the unit of account. The scope of the variable fee approach and in particular the assessment of expected cash flows is assessed on the basis of the cash flows of the group.
Aggregation for disclosure It was suggested that the Board clarify it is	The staff propose to ensure it is clear in drafting that the extent of aggregation for disclosures need not be the same as for

not always necessary to apply a consistent aggregation for all disclosure requirements and that judgement should be applied.	measurement. Paragraph 88 of draft IFRS 17 suggests that the aggregation for disclosure requirements would require an entity to apply judgement: "An entity shall consider the level of detail necessary to satisfy the disclosure objective and how much emphasis to place on each of the various requirements. The entity shall aggregate or disaggregate information so that useful information is not obscured by either the inclusion of a large amount of insignificant detail or by the aggregation of items that have different characteristics." We also do not require consistent aggregation for all disclosure requirements, it depends on the level of detail needed to satisfy the disclosure objective in each case.
Regulatory pricing Some test participants did not agree with the Board's conclusion that differences in profitability that arose as a result of restrictions on pricing and underwriting imposed by regulators.	The Board previously decided that there should be no exception to the level of aggregation for determining onerous contracts or the allocation of the contractual service margin when regulation affects the pricing of contracts, because: • A difference in profitability, even if caused by regulation, is a real economic difference between contracts, which provides information that should not be lost. • The effect of regulation on pricing is not restricted to insurance contracts and providing an exception for the effect of regulation on pricing would create an undesirable precedent. • An exception would not provide users of financial statements with information about when an entity can price the risks in the individual contracts, and when it cannot. • An exception would increase the complexity of the forthcoming insurance contracts Standard as a whole and may

	make the information produced more difficult to explain to users of financial statements as to why there are differences in results between contracts. However, the staff observes that the proposal that an entity should divide profitable portfolios, at a minimum, into a group of contracts that has no significant risk of becoming onerous and a group of other profitable contracts may result in the differences in profitability imposed by regulators being insufficient to require that the different types of contracts are grouped separately.