ISOA Position Paper

IFRS 17 – Annual cohort requirement: Italian market context

1. IFRS 17 Background

1.1. Summary of IFRS 17 Level of Aggregation requirements

i. With the aim to strengthen comparability and transparency among insurer preparers with the objective to provide faithfully and relevant information on insurance contracts to relevant stakeholders, IFRS 17 – among others – is requiring a very strict Level of Aggregation, namely defining a set of rules for grouping insurance contracts.

ii. These rules refer to the definition of[1]:

a) Contract Portfolios

IFRS17.14 *An entity shall identify portfolios of insurance contracts. A portfolio comprises contracts subject to similar risks and managed together. […]*

b) Profitability buckets

IFRS17.16 *An entity shall divide a portfolio of insurance contracts issued into a minimum of:*

(a) a group of contracts that are onerous at initial recognition, if any;

(b) a group of contracts that at initial recognition have no significant possibility of becoming onerous subsequently, if any; and

(c) a group of the remaining contracts in the portfolio, if any

c) Annual Cohorts

IFRS17.22 *An entity shall not include contracts issued more than one year apart in the same group. […]*

d) Grouping and Fulfillment Cash-flows calculation

IFRS17.24 *[…] An entity shall establish the groups at initial recognition and add contracts to the groups applying paragraph 28. The entity shall not reassess the composition of the groups subsequently. To measure a group of contracts, an entity may estimate the fulfilment cash flows at a higher level of aggregation than the group or portfolio, provided the entity is able to include the appropriate fulfilment cash flows in the measurement of the group, […] by allocating such estimates to groups of contracts.*

[1] Please note this applies to contracts under the IFRS 17 scope only, as outlined in paragraphs IFRS17.3-13.

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iii. An IFRS 17 Group of Contracts (so called Unit of Account - UoA - in the context of IFRS 17) is then defined according with principles set out in paragraph ii of this paper; consequently, an insurer would result in managing several UoAs, each of them with its own Contractual Service Margin (CSM) or Loss Component (LC) and related Income Statement impacts of the period.

iv. Explicit dispensations foreseen by IFRS 17 to the before mentioned Level of Aggregation are:

e) Premium Allocation Approach application

IFRS.18 *For contracts issued to which an entity applies the premium allocation approach […] the entity shall assume no contracts in the portfolio are onerous at initial recognition, unless facts and circumstances indicate otherwise. […]*

f) Law and regulation specific constraints

IFRS17.20 *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. The entity shall not apply this paragraph by analogy to other items.*

v. With direct reference to Annual Cohort requirement, however, IFRS 17 Basis for Conclusion state:

BC138 *The Board considered whether prohibiting groups from including contracts issued more than one year apart would create an artificial divide for contracts with cash flows that affect or are affected by cash flows to policyholders of contracts in another group. Some stakeholders asserted that such a division would distort the reported result of those contracts and would be operationally burdensome.*

However, the Board concluded that applying the requirements of IFRS 17 to determine the fulfilment cash flows for groups of such contracts provides an appropriate depiction of the results of such contracts […] Hence, IFRS 17 does not include such an exception. Nonetheless, the Board noted that the requirements specify the amounts to be reported, not the methodology to be used to arrive at those amounts. Therefore, it may not be necessary for an entity to restrict groups in this way to achieve the same accounting outcome in some circumstances.

1.2. IASB and industry discussion

vi. Several discussions around IFRS 17 accounting requirements took place over the past months aiming at addressing industry concerns as well as at clarifying possible interpretational doubts.

vii. Main issue arisen by insurer preparers refers to consequences (so called mutualization effect) stemming from IFRS17.22 for those contracts that affect or are affected by cash flows belonging to different Group of Contracts.

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viii. Industry strongest objection is that, in case mutualization applies, there is no correspondence between single cohorts and the underlying items (e.g. the assets backing a specific mutualized portfolio) due to the mutualization characteristic of the underlying business model. Indeed, the change in fair value of the underlying items could be used as an intergenerational transfer to support future generations of policyholders, according to the assets strategy and liquidity needs of the mutualized portfolio as a whole.

ix. As a consequence of Industry turmoil around IFRS 17 annual cohort requirement, IASB staff issued a discussion paper in February 2020 (*AP2B Level of aggregation—annual cohorts for insurance contracts with intergenerational sharing of risks between policyholders*) recommending IASB to retain, unchanged, the annual cohort requirement in IFRS 17 Insurance Contracts.

x. We highlight that, although the staff paper recommended to retain unchanged the annual cohort requirement, it included important consideration about the IASB expectations on its application. For instance, par. 21 of the paper states that:

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.

xi. In issuing the IFRS 17 Amended version in June 2020, IASB confirmed the position around the annual cohort requirement, deeply detailing underlying reasoning through the amended Basis for Conclusions (BC139F – BC139S), a brief summary of which is below provided:

BC139F *The Board considered but rejected a suggestion to exempt contracts from the annual cohort requirement […]* [since] *Such an exemption could result in a portfolio consisting of only the three groups of contracts […] that would each last for the entire life of the portfolio, which may be indefinite. The contractual service margin of each group would average the profitability of all contracts in the group over the life of the portfolio, resulting in the loss of useful information about trends in profitability.*

BC139G *Some stakeholders said that in some circumstances they could achieve at much less cost the same or a similar outcome without applying the annual cohort requirement as would be achieved applying that requirement. The Board concluded that it is unnecessary to amend IFRS*

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17 to reflect such circumstances. The Board reaffirmed its view that the requirements specify the amounts to be reported, not the methodology to be used to arrive at those amounts (see paragraph BC138). […]

BC139H *The Board recognised that entities will incur costs to identify the contractual service margin for each group of insurance contracts that is an annual cohort. However, the Board concluded that information about higher or lower profits earned by an entity from different generations of contracts is sufficiently useful to justify such costs.*

BC139J *Intergenerational sharing of risks between policyholders is reflected in the fulfilment cash flows and therefore in the contractual service margin of each generation of contracts […] Applying the variable fee approach […] the profit for a group of insurance contracts reflects the entity's share in the fair value returns on underlying items. […] Removing the annual cohort requirement for groups of insurance contracts with intergenerational sharing of risks between policyholders would average higher or lower profits from each generation of contracts, resulting in a loss of information about changes in profitability over time.*

BC139K *Nonetheless, the Board identified two aspects of applying the annual cohort requirement to some contracts with intergenerational sharing of risks between policyholders that could increase the costs of applying the requirement and reduce the benefits of the resulting information:*

(a) distinguishing between the effect of risk sharing and the effect of discretion […]; and

(b) allocating changes in the amount of the entity's share of the fair value of underlying items between annual cohorts that share in the same pool of underlying items […]

BC139L *The aspect set out in paragraph BC139K(a)* […] [provides] *that judgement is required to measure new contracts recognised in a period, so would be needed even without the annual cohort requirement.*

BC139M *The aspect set out in paragraph BC139K(b) […]* [implies that] *The Board acknowledged that an entity needs to apply judgement to choose an allocation approach that provides useful information about the participation of each annual cohort in the underlying items.*

BC139Q Consequently, the Board concluded the costs of the annual cohort requirement might exceed the benefits of the resulting information for only a very limited population of contracts. […]

BC139R Nonetheless, the Board considered whether it could create an exemption from the annual cohort requirement that would capture only that very limited population of contracts, without the risk of capturing a wider population.

However:

(a) any focused exemption would be complex […] therefore result in difficulties for entities and auditors […] and for users of financial statements in understanding which contracts had been exempted.

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(b) the purpose of any exemption would be to balance the costs and benefits. However, there is no way to specify the scope of the exemption other than by using arbitrary thresholds […]

1.3. EFRAG final endorsement advice on IFRS 17

xii. In April 2021, the European Financial Reporting Advisory Group (EFRAG) issued a letter to the European Commission regarding the endorsement of IFRS 17 Insurance Contracts as amended in June 2020[2].

xiii. In this letter, after having received comment letters from several stakeholders as well as conducted extensive case study and simplified case study with preparers, EFRAG positively welcome IFRS 17 application starting from 1st January 2023 (with early application allowed) apart from annual cohort requirement (IFRS17.22).

xiv. In its FEA, EFRAG outlines concerns about annual cohorts' requirement with specific regard to:

a) contracts with intergenerational mutualisation,

b) cash-flows matched contracts.

EFRAG furtherly specifies that *these contracts account for a significant share of the overall European insurance market*.

xv. More specifically:

a) Seven EFRAG members deem that IFRS 17 provides sufficiently benefits, even though annual cohort requirement, because the upcoming Accounting Standard addresses in a timely manner the current IFRS 4 issues. They, indeed, believe that *in the absence of an alternative principles-based approach to grouping of contracts, on balance the annual cohorts requirement provides an acceptable conventional approach that enables to meet the reporting objectives of the level of aggregation of IFRS 17*

b) Seven EFRAG members, conversely, believe that *the requirement does not depict any entity's rights and obligations and results in information that represents neither the economic characteristics of these contracts nor the entity's underlying business model. These EFRAG Board members also consider that this requirement is not conducive to the European public good because it (i) adds complexity and cost and does not bring benefits in terms of the resulting information, (ii) may lead to unintended incentives to change the way insurers cover insurance risks and (iii) may produce pro-cyclical reporting effects.*

c) Two EFRAG members, abstain from expressing a view on the annual cohort requirement. *They conclude that, on balance, the annual cohort's requirement should not in isolation prevent the endorsement of IFRS 17 as a whole.* [3]

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[2] Also known as EFRAG Final Endorsement Advice (hereafter in this paper referred as "FEA").

[3] Italic passages in this section are direct EFRAG FEA quotations

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2. Italian segregated funds

xvi. Segregated funds represent a peculiarity of Italian's insurance market regulated by ISVAP Regulation no. 38 of 3 June 2011 which provide for the establishment of an investment portfolio managed separately from the other assets held by the insurance company. This investment portfolio is used to cover future obligations arising from traditional With-Profit life insurance contracts of Insurance Class I and V. The overall value of the assets underlying the segregated funds should not be less than the amount of the statutory mathematical reserve. In the Italian market, at 31 December 2019, assets invested in segregated funds amounted to approximately 550 €/Bln and the mathematical reserve amounted to approximately 542 €/Bln.

xvii. The financial result of the segregated funds consists in the definition of a rate of return assigned to the policyholder. The rules are defined on the contractual terms and in particular the share of the rate of return assigned to the policyholder depends on the financial guarantees and on the profit share mechanism (minimum retained quota or percentage of retrocession).

xviii. Assets are accounted at segregated fund value. Capital gains generated, net of incurred capital losses, are accounted only in case of trading transactions, while coupons are calculated on accruals basis (i.e. the rate of return of the segregated fund is a book return and it does not reflect the market volatility until possible gains and losses are realized). With IVASS Provision no. 68 of 14 February 2018, the Regulator introduced the "Fondo Utili", a fund established by setting aside the net realised gains obtained from the sale of assets belonging the segregated fund. The profit fund ("Fondo Utili") has the nature of a mathematical provision and fully contributes to determining the average rate of return of the segregated fund.

xix. On the basis of these elements, the company chooses, at its discretion, which assets have to be realized or acquired and in which point of time the exit has to be negotiated as well as the release of the "Profit Fund" in compliance with the rules defined by the aforementioned Provision.

xx. One of the main objectives of the Italian insurance company is to maintain a stable financial return over time while ensuring equal treatment of all policyholders. The return achieved in a given reference period is recognised to all policyholders regardless of the year in which the contract was signed. Prospective analyses of assets and liabilities carried out jointly (Asset Liability Management), both performed on open and/or closed portfolio, aimed at strategic assets allocation and capital management, generally do not provide for asset segmentation by underwriting year of contracts.

3. Impacts of annual cohorts on segregated funds business

xxi. ISOA expectation is that segregated fund business will be measured under the Variable Fee Approach generally. This measurement model requires to adjust the Contractual Service Margin (CSM) of a Group of insurance contracts (GIC) by changes in the entity's share of underlying items (CES of UI). For segregated funds, underlying items are identified as the pool of assets included in the fund itself. According to the regulation and emerging market practice the CES of UI is mainly determined as the difference between:

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a. Change in Fair value of the underlying items (FV of UI)

b. Expected (i.e. unwinding) and unexpected economic variances (i.e. change in economic assumptions and economic experience variance) on fulfillment cashflows (FFCF).

xxii. The change in FV of UI is usually determined as the Total Return occurred over the reporting period related to the underlying items.

xxiii. IFRS 17 would require to determine these amounts at GIC level. This implies that in case the annual cohort requirement is applied, both the Total Return and the economic variances on FFCF shall be calculated considering the annual cohort segmentation. However, we highlight that the IASB allows to consider higher level of granularity when calculating items 1. and 2. above, namely:

a. IASB February 2020 meeting – Staff paper 2B - "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", and "judgement needs to be exercised to avoid approaches to allocation that may not give useful information"; this last concept is also highlighted by IFRS17.BC139m.

b. IFRS17.24 allows to determine FFCF at a higher level of aggregation than GIC and subsequently allocate them at GIC level.

xxiv. Considering the segregated funds business mechanic described in Section 2 of this document, assets included in the fund (i.e., the Underlying items - UI) are not directly assigned to each policyholder investing in the fund. As a consequence, new cohorts of policyholders participate generically to the whole pool of assets that is shared with old policyholders and not to specific subset of financial instruments specifically bought for them.

xxv. In this case, an artificial allocation of the Total Return calculated at segregated fund level to GIC using a certain driver will be necessary.

xxvi. Regarding the calculation of economic variances on liabilities, an analytical calculation at annual cohort level is feasible, but would require to consider the underwriting year as a key for grouping contracts in the actuarial platform. This approach would increase the implementation complexity in terms of timescales, model maintenance, databases preparation activities and control framework. Consequently, the simplification introduced by IFRS17.24 is preferable compared to an analytical approach since allows to determine variances on FFCF at segregated fund level and then allocate them down to annual cohorts, but implies potential biases in the final results.

xxvii. In addition, according to the rules included in ISVAP Regulation n.38, as reported in par. xviii of this document, the segregated fund return is determined on the whole pool of assets on an historical cost basis, i.e. not including unrealized gains and losses that are consequently inherited by new cohorts policyholders although referred to assets bought in the past with older policyholder contribution. This implies an intergenerational sharing of financial profits among cohorts (i.e. financial mutualization).

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xxviii. As per par. B68 of the standard and considering how CSM is determined, Fulfilment Cash Flows have to be determined considering cash flows interaction among groups, hence considering unrealized gains or losses affecting future cash flows. However, if we consider Unrealized Gains and Losses (UGL) when measuring New Business (NB) CSM we would have that:

a) future cash outflows are greater or lower due to UGL allocation coming from the EB, and

b) future cash inflows (e.g., premiums) are at their nominal amount.

xxix. As a consequence, this approach would underestimate or overestimate CSM at initial measurement.

xxx. In order to solve this inconsistency, NB CSM should be measured considering techniques that allow to disclose its real economic value (e.g. standalone or marginal approaches) but granting that the overall present value of future profits of the fund measured under IFRS 17 is consistent. Hence, an adjustment of Existing Business (EB) CSM is necessary (so called “mutualization adjustment”).

xxxi. In case the annual cohort requirement has to be applied, also the mutualization adjustment should be properly assigned to each cohort of existing business. If an analytical approach is chosen to determine the contribution of each old business cohort to the mutualization towards new business, a very high number of actuarial valuations should be performed leading to a substantial operational impracticability of the process.

xxxii. As a simplified approach, based on the allocation of the mutualization adjustment to each cohort of EB using a driver is unavoidable.

xxxiii. In this context, we do highlight the following concerns:

a) annual cohort requirement is not consistent with the way in which segregated funds business is managed;

b) allocation mechanism is unavoidable and could lead to an artificial and subjective allocation of Total Return and mutualization adjustment;

c) Potential loss components could be recognized and increase P&L volatility due to the allocation mechanism, therefore leading to pro-cyclical effects and potential impact on insurance product design;

d) allocation driver would be a subjective choice of each insurance company and consequently could affect comparability of results.

4. Conclusions

xxxiv. ISOA position regarding the application of the annual cohort requirement is aligned with EFRAG draft concerns included in the Final Endorsement Advice issued in April 2021.

In particular, ISOA highlight that the annual cohort requirement is not consistent with segregated funds mechanic, it could lead to a misrepresentation of the economic substance of this business, potential increase of P&L volatility and pro-cyclical effects in case of stressed macro-economic environment.

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xxxv. Consequently, ISOA deems that the annual cohort requirement should not be applied to Italian segregated funds business.

xxxvi. In case, the requirement would be retained, ISOA expect that the overall profitability of the segregated funds measured under IFRS17 considering all cohorts contribution is granted by the application of proper drivers to allocate to each cohort all relevant items needed to determine CES of UI (i.e. Total Return, mutualization adjustment, economic variances on FFCF).

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