Level of Aggregation

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This IFRS17 Working Paper aims to facilitate discussion among actuaries and other stakeholders to capture the range of opinions on the application of IFRS17 in the Singapore context and are not meant to serve as mandatory practice notes.

Any interpretation of IFRS17 set out in this Paper represents a plausible treatment given the text of IFRS17. However, it shall neither be construed as the only possible treatment nor the agreed interpretation for Singapore insurers. Users of this Working Paper shall be mindful that differences in the exact fact pattern and operating context facing each insurer may drive different interpretations. Users shall also be mindful that for the same fact pattern and operating context, there is scope for the substance of same transaction to be articulated differently depending on how the transaction is analysed. (For example, in substance, cash flows from a call option with strike price $X on an asset is equivalent to the combined cash flow from the underlying asset and a put option with strike price $X on the asset, less cash of $X.) Differences in articulation can give rise to a range of plausible treatments. An insurer remains responsible for justifying its choice of treatment after discussion with its auditor. Opinions expressed in the working papers are not representative of that of the Singapore Actuarial Society.

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1. IFRS17 Standards

The key passages in the IFRS17 standards that relate to level of aggregation are outlined below.

This paper is relevant for all direct insurance contracts and investment contracts within the scope of IFRS 17 regardless of measurement model used. Reinsurance contracts held and issued are not in the scope of this paper.

14. An entity shall identify portfolios of insurance contracts. A portfolio comprises contracts subject to similar risks and managed together. Contracts within a product line would be expected to have similar risks and hence would be expected to be in the same portfolio if they are managed together. Contracts in different product lines (for example single premium fixed annuities compared with regular term life assurance) would not be expected to have similar risks and hence would be expected to be in different portfolios.

15. Paragraphs 16–24 apply to insurance contracts issued. The requirements for the level of aggregation of reinsurance contracts held are set out in paragraph 61.

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.

17. If an entity has reasonable and supportable information to conclude that a set of contracts will all be in the same group applying paragraph 16, it may measure the set of contracts to determine if the contracts are onerous (see paragraph 47) and assess the set of contracts to determine if the contracts have no significant possibility of becoming onerous subsequently (see paragraph 19). If the entity does not have reasonable and supportable information to conclude that a set of contracts will all be in the same group, it shall determine the group to which contracts belong by considering individual contracts.

18. For contracts issued to which an entity applies the premium allocation approach (see paragraphs 53–59), the entity shall assume no contracts in the portfolio are onerous at initial recognition, unless facts and circumstances indicate otherwise. An entity shall assess whether contracts that are not onerous at initial recognition have no significant possibility of becoming onerous subsequently by assessing the likelihood of changes in applicable facts and circumstances.

19. For contracts issued to which an entity does not apply the premium allocation approach (see paragraphs 53–59), an entity shall assess whether contracts that are not onerous at initial recognition have no significant possibility of becoming onerous:
    a) based on the likelihood of changes in assumptions which, if they occurred, would result in the contracts becoming onerous.
    b) using information about estimates provided by the entity's internal reporting. Hence, in assessing whether contracts that are not onerous at initial recognition have no significant possibility of becoming onerous:
        (i) an entity shall not disregard information provided by its internal reporting about the effect of changes in assumptions on different contracts on the possibility of their becoming onerous; but
        (ii) an entity is not required to gather additional information beyond that provided by the entity's internal reporting about the effect of changes in assumptions on different contracts

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

21. An entity is permitted to subdivide the groups described in paragraph 16. For example, an entity may choose to divide the portfolios into:
    a) more groups that are not onerous at initial recognition—if the entity's internal reporting provides information that distinguishes:
        (i) different levels of profitability; or

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

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

22. An entity shall not include contracts issued more than one year apart in the same group. To achieve this the entity shall, if necessary, further divide the groups described in paragraphs 16–21.

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

24. An entity shall apply the recognition and measurement requirements of IFRS 17 to the groups of contracts issued determined by applying paragraphs 14–23. An entity shall establish the groups at initial recognition, and shall not reassess the composition of the groups subsequently. To measure a group of contracts, an entity may estimate the fulfilment cash flows at a higher level of aggregation than the group or portfolio, provided the entity is able to include the appropriate fulfilment cash flows in the measurement of the group, applying paragraphs 32(a), 40(a)(i) and 40(b), by allocating such estimates to groups of contracts.

47. An insurance contract is onerous at the date of initial recognition if the fulfilment cash flows allocated to the contract, any previously recognised acquisition cash flows and any cash flows arising from the contract at the date of initial recognition in total are a net outflow. Applying paragraph 16(a), an entity shall group such contracts separately from contracts that are not onerous. To the extent that paragraph 17 applies, an entity may identify the group of onerous contracts by measuring a set of contracts rather than individual contracts. An entity shall recognise a loss in profit or loss for the net outflow for the group of onerous contracts, resulting in the carrying amount of the liability for the group being equal to the fulfilment cash flows and the contractual service margin of the group being zero.

61. An entity shall divide portfolios of reinsurance contracts held applying paragraphs 14–24, except that the references to onerous contracts in those paragraphs shall be replaced with a reference to contracts on which there is a net gain on initial recognition. For some reinsurance contracts held, applying paragraphs 14–24 will result in a group that comprises a single contract.

BC51. An entity's rights and obligations arise from individual contracts with policyholders. However, a fundamental aspect of much insurance activity is that the entity issues a large number of similar contracts knowing that some will result in claims and others will not. The large number of contracts reduces the risk that the outcome across all the contracts will differ from that expected by the entity. This aspect of insurance activity, combined with the requirements of IFRS 17 that require different timing of recognition of gains and losses (for example losses on onerous contracts are recognised earlier than gains on profitable contracts), means that the level of aggregation at which contracts are recognised and measured is an important factor in the representation of an entity's financial performance.

BC115. A key issue in developing the measurement requirements for the contractual service margin in IFRS 17 was the level of aggregation of insurance contracts to which the requirements should be applied. Some aspects of the adjustments to the carrying amount of the contractual service margin result in gains being treated differently from losses or changes in estimates relating to current and past service being treated differently from changes in estimates relating to future service (see paragraphs BC21–BC24). These different treatments mean that the accounting result depends on the level of aggregation at which the adjustments are made, because amounts that would offset each other within the measurement of a group of insurance contracts would be treated differently (and hence not offset each other) if contracts were measured individually.

BC116. For example, suppose an entity issued a group of identical contracts expecting that there would be more claims from some of the contracts than others, but not knowing which contracts would be the ones with more claims. Subsequently it becomes apparent which contracts are likely to give rise to claims and which are not, and the number of contracts in each category is as expected. If the contracts were measured individually, the expected claims may cause the contracts for which they are likely to arise to become onerous, with an equal and opposite reduction in the fulfilment cash

flows of the other contracts. The entity would recognise a loss for the onerous contracts immediately in profit or loss and an increase in the contractual service margin for the other contracts. That increase in the contractual service margin would not be recognised immediately in profit or loss but instead would be recognised over the current and future coverage period. In contrast, if the contracts were measured as one group, there would be no loss for a group of onerous contracts or increase in the contractual service margin to be recognised.

BC117. This issue does not arise in the measurement of the fulfilment cash flows. The fulfilment cash flows include all changes in estimates, regardless of whether they are gains or losses or they relate to past, current or future service. Hence, 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 so that the resulting fulfilment cash flows of the group comply with requirements of IFRS 17.

BC118. For the contractual service margin, the Board considered whether contracts should be measured individually despite the resulting lack of offsetting. Doing so would be consistent with the general requirements in IFRS 9 and IFRS 15 and would reflect the fact that the entity's rights and obligations arise from individual contracts with policyholders. Measuring contracts individually would also provide a clear measurement objective. However, the Board decided that such an approach would not provide useful information about insurance activities, which often rely on an entity issuing a number of similar contracts to reduce risk. The Board concluded, therefore, that the contractual service margin should be measured at a group level.

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2. Interpretation of Standards

The level of aggregation will be used to apply recognition and measurement requirements of IFRS 17.

Groups are established at initial recognition, and not reassessed 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.

Broadly, the interpretation of the IFRS17 standards can be generally grouped into two main areas of consideration:

- **Aggregation of contracts based on management practice and similar risks:**
  Companies are required to aggregate contracts that are managed together and contain similar risks. If contracts that are managed together are subject to dissimilar risks, these contracts are required to be segregated into different portfolios

- **Profitability of contracts:**
  Generally, a company is required to further sub-divide contracts into the following profitability groups:
  - Onerous at inception;
  - Have no significant possibility of becoming onerous;
  - Others

3. Identification of portfolios

Companies should aggregate contracts that are managed together and contain similar risks. If contracts that are managed together are subject to dissimilar risks, these contracts are required to be segregated into different portfolios.

Some considerations are:

- Contracts in different product lines should be segregated (for example single premium fixed annuities and regular term life assurance);
- Contracts classified as VFA should be disaggregated from those that are classified as GMM;
- Contracts that contain mainly longevity risks should be classified in separate portfolios from contracts that contain mainly mortality risks, to the extent this separate aggregation is material;

For example, companies might have at least the following portfolios, which are considered to be managed together and contain similar risks:

- Non Participating (with morbidity risk as primary risk);
- Non Participating (with longevity as the primary risk);
- Participating;
- Unit linked;
- Universal Life

Portfolios can be more granular than the above, and companies can also consider the granularity of internal management reporting.

Gains and losses on individual contracts within a group of contracts may be offset with each other within a portfolio.

Cohorts

Portfolios should not contain contracts issued more than 12 months apart (paragraph 22).

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4. Grouping into profitability groups

The IFRS17 standards require contracts to be further sub-divided into the following profitability groups:

- Onerous at inception;
- Have no significant possibility of becoming onerous;
- Others

GMM, VFA

For all sets of contracts / products which are not onerous at inception, an insurer is required to determine the possibility of contracts becoming onerous in subsequent measurements. Assessment should be based on the likelihood of changes in assumptions which, if reflected in the fulfilment cashflows, would result in the contracts becoming onerous. This applies for all sets of contracts / products which are not onerous at inception, and are measured using GMM or VFA.

The company therefore should focus on assumption changes which could exhaust the CSM such that the contract become onerous subsequently:

- GMM products: these would be insurance risks (mortality, morbidity, longevity, lapses, expenses)
- VFA products: In addition to insurance risks, financial risks that the product is exposed to should also be considered

If the result of the assessment is such that the contract is onerous in subsequent measurements, it may not be reasonably concluded that there is “no significant possibility of becoming onerous”. The product should then be classified under “Others”.

Judgement is required when determining what is considered to be a significant possibility of contracts becoming onerous in the future. For example, effect of changes in assumptions on the possibility of contracts becoming onerous can be assessed:

- Based on confidence level interval
- Based on qualitative judgement of the possibility / effect of assumption change
- Based on level of profitability on initial recognition

For products with low profitability on initial recognition, small changes in assumptions could result in the contract becoming onerous. Products with high profitability with relatively low sensitivity to changes in assumptions have less risk of becoming onerous.

PAA

For contracts where PAA is applied, it is assumed that contracts are not onerous on initial recognition unless relevant facts and circumstances indicate that this is the case (paragraph 18).

For contracts where the company has elected to apply the PAA, the company needs to assess the likelihood of changes in relevant facts and circumstances to determine if the set of contracts could become onerous subsequently (paragraph 18). Significant judgement is required to determine what ‘facts and circumstances’ are relevant to the contracts and the entity, for example:

- Expected variability of claims cashflows;
- Changes in external conditions including economic or regulatory changes that could significantly impact expected cash flows;
- Changes to the organisation or processes that could increase costs of fulfilling the contracts;
- Aggressive underwriting or pricing;
- Unfavourable experience trends

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