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Chairman
PDC N° 19

Paris, 23 June 2020

Mr Jean-Paul Gauzes
EFRAG Board President
35 Square de Meeùs
B-1000 Bruxelles

IFRS 17—Annual cohorts

Dear Jean-Paul,

We refer to our letter dated 15 May 2020. In this letter, we informed you of our proposal for an exception to the annual cohort requirement as currently set out in IFRS 17 *Insurance Contracts*. This exception would apply to contracts with intergenerational sharing of risks between policyholders.

We shared our proposal with the International Accounting Standards Board (IASB). The Chairman of the IASB responded to our proposal in a letter dated 5 June 2020. We attach this reply in Appendix I to this letter.

The IASB staff (staff) reject our proposed exception to the annual cohort requirement because such an exception would include contracts for which the IASB concluded that not applying the aforementioned requirement would result in an ‘unacceptable loss of useful information’. This is because, in the staff view, the profitability of contracts for which an entity has discretion over the timing of allocation of the policyholders’ share of fair value returns on underlying items would be objectively determinable on a cohort-by-cohort basis.

We acknowledge that the staff rationale might be relevant in certain specific circumstances, for example when the underlying assets are segregated and ring-fenced at the level of an annual cohort or lower (e.g. contract’s level). In this situation, an entity could indeed determine profitability for each cohort.

However, our suggested exception captures contracts that have different terms. Our proposal targets contracts in which (i) underlying assets are all pooled together, irrespective of their date of purchase, and (ii) policyholders share the returns from that single common pool of underlying items whatever the contracts’ issuance year might be. Such contracts represent a very significant part of insurance portfolios in a number of European jurisdictions.

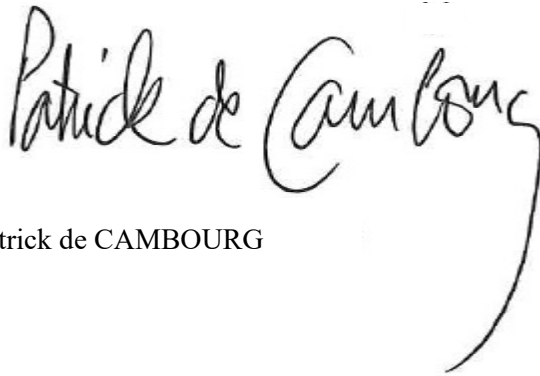
Specifically, the staff analysis overlooks the implications of the second criterion set out for our proposed exception. Applying this criterion, an entity would not apply the annual cohort requirement to contracts that *jointly* participate in a share in the returns of a clearly identified common pool of underlying assets. According to this criterion, policyholders' profit share would be determined collectively for the community of policyholders, without any individual contract having a right to the joint profit share until management exercises its discretion to allocate the returns. We note that the entity's profit share for those contracts is determined at a higher level of aggregation than the annual cohort. In those circumstances, allocating the entity's contractual profit share to annual cohorts would (i) be unnecessary and irrelevant to monitor profitability, and (ii) would require an arbitrary allocation *before* management exercises discretion as to the timing and amount of the allocation to individual policyholders. Accordingly, we think the annual cohort requirement does not provide useful information about those contracts.

As explained in Appendix II to this letter, the staff developed other arguments that rely on the same erroneous assumption.

We disagree with the staff rationale for rejecting our proposal because it assumes that the profitability of the underlying assets is objectively contractually allocable to each annual cohort, as if those assets were segregated and ring-fenced at the level of an annual cohort or lower (e.g. contract's level). Such an additional assumption is *not* applicable to the contracts scoped in our proposed exception, especially with regard to the second criterion. This assumption is contrary to the legal and contractual discretion of the insurer when individually allocating over a set period of time returns jointly benefiting to the policyholders as a whole.

Please do not hesitate to contact us to further discuss this letter.

Yours sincerely,

A handwritten signature in black ink that reads "Patrick de Cambourg". The signature is written in a cursive style with a long, sweeping underline that extends to the right and then curves back down.

Patrick de CAMBOURG

5 June 2020



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Patrick de CAMBOURG

Chairman

Autorité des Normes Comptables

Via email

Dear Patrick

Thank you for your letter of 25 May 2020 sharing with us the proposals you developed for EFRAG regarding the annual cohort requirement.

Attached is my response to the President of the EFRAG Board, who also wrote to me about your proposals, including an analysis by my staff of your proposals and of other proposals developed by other European constituents of EFRAG.

Thank you for taking the time to write to us. We look forward to continuing dialogue with you towards the successful implementation of IFRS 17.

Yours sincerely

A handwritten signature in black ink, appearing to read "Hans Hoogervorst". The signature is fluid and cursive, with a long horizontal stroke at the end.

Hans Hoogervorst

Chairman, International Accounting Standards Board

Attachments: Letter to Jean-Paul Gauzès, President of the EFRAG Board, dated 5 June 2020
Analysis of proposals for exceptions to the annual cohort requirement

This document has been prepared by the staff of the IFRS Foundation. The views within this document are those of the staff who prepared this document and are not the views or the opinions of the International Accounting Standards Board (Board) and do not represent the views of the Board or any individual member of the Board. Comments on the application of IFRS® Standards do not purport to set out acceptable or unacceptable application of IFRS Standards. Technical decisions are made in public and reported in IASB® Update.

Analysis of proposals for exceptions to the annual cohort requirement

1. In May 2020, the ANC, the ICAC and CFO Forum each shared with EFRAG and with the IASB their proposals for exceptions to the annual cohort requirement in IFRS 17.
2. This document sets out an analysis by the staff of the IFRS Foundation of the three sets of proposals.

ANC proposals

The proposal and rationale given

3. The scope of the ANC's exception from the annual cohort requirement is groups of contracts that:
 - a. include only contracts with cash flows that affect or are affected by cash flows to policyholders of other contracts as described in paragraphs B67-B71 of IFRS 17;
 - b. jointly participate in a share of returns on a clearly identified common pool of underlying items. Contracts jointly participate when the entity exercises discretion as to the timing and the allocation of the total policyholders' profit-share to individual policyholders; and
 - c. meet the definition in paragraph B101 of IFRS 17 of variable fee approach contracts.
4. Consistent with previous papers from the ANC, the rationale for proposing the exception is that annual cohorts do not provide useful information because profitability is not determinable on a cohort by cohort basis. In the ANC's view, profitability is not determinable on a cohort by cohort basis because the entity can choose how much of the return on underlying items to distribute to each policyholder (ie different policyholders can receive different rates of return even though they all share in the same return on underlying items).

Staff analysis

5. The scope of the ANC proposed exception can be enforced using existing requirements in IFRS 17 (the criteria in paragraphs B67 and B101 of IFRS 17), so it minimises the added complexity that an exception always entails.
6. However, the ANC's scope would include contracts for which the Board concluded an exemption from the annual cohort requirement would result in an unacceptable loss of useful information.
7. Specifically:
 - a. for a contract to be in the scope of the ANC exception, contracts have to share the effect of risks with other contracts, but the exception does not require all

risks to be shared nor does it specify the extent to which the risks have to be shared. Agenda Paper 2B of the February 2020 Board meeting (AP2B)¹ concluded that unless: (i) the effect of *any* financial guarantees on returns in underlying items is shared with other policyholders, and (ii) any other fixed cash flows that were not shared is ‘small’, the removal of the annual cohort requirement would lead to an unacceptable loss of useful information.² The ANC argues that, as a practical expedient, the requirement to meet the VFA scope is a sufficient restriction on the extent of unshared risks. However, as acknowledged by the ANC, the VFA scope could include contracts with financial guarantees the effect of which is borne solely by the entity or contracts that include more than ‘small’ amounts of other fixed cash flows that are not shared with other policyholders. Timely information about losses caused by those financial guarantees or other fixed cash flows would be lost—this is particularly important in the current low interest rate environment.

- b. for a contract to be in the scope of the ANC proposed exception, the entity must have discretion over the way that the total policyholders’ share of the fair value (FV) returns on underlying items is distributed to individual policyholders. However, it is *not* necessary for the entity to have discretion over the share of the FV returns that is distributed to the policyholders as a whole and the share that is retained by the entity. As explained in AP2B, it is the latter discretion that causes subjectivity in the determination of the contractual service margin (CSM) and potentially reduces the usefulness of the annual cohort information. Without that latter discretion, the determination of the CSM for annual cohorts, while complex, is objective. In these circumstances, AP2B concluded that there was no justification for the loss of information about trends in profitability that would result from an exception to the requirement for annual cohorts.
8. In terms of the rationale set out in the ANC proposals, there are two key arguments we disagree with:
- a. ANC argument 1: if an entity has **discretion** over the timing of an allocation of the policyholders’ share of FV returns on underlying items, profitability is not determinable on a cohort by cohort basis; and
 - b. ANC argument 2: if changes in the effect of a **financial guarantee** are shared with policyholders of other contracts in a portfolio, an annual cohort can only be onerous if whole portfolio is onerous.
9. In relation to discretion (paragraph 8.a of this paper), AP2B demonstrated:
- a. if the split between the entity and the policyholders as a whole is specified, it does not matter how the entity determines the subsidisation between policyholders, the entity’s share is still objectively determinable;

¹ The Board discussion of AP2B resulted in the Board agreeing with the staff recommendations in the paper based on the analysis set out in the paper.

² It is important to remember that even for contracts with these features, AP2B did *not* conclude that the cost of the annual cohort requirement exceeded the benefits of the resulting information. AP2B acknowledged only that features of such contracts increase the costs of applying the annual cohort requirement compared to other contracts and/or reduce the usefulness of the resulting information.

- b. IFRS 17 requires an entity to allocate its share of the FV returns in any period across the CSMs of the annual cohorts that exist in the period in which the FV returns occur. The entity's share in returns therefore depends on the contractual terms of each annual cohort and the economic conditions during the coverage period of each annual cohort. For example, a 20 per cent share in returns created by an annual cohort for which returns during the coverage period are 5 per cent is more profitable for an entity than is a 20 per cent share in returns created by an annual cohort for which returns during the coverage period are 1 per cent. Hence the annual cohort CSMs provide useful information about trends in profitability. Removing the annual cohort requirement would average higher or lower profits from each generation of contracts, resulting in a loss of information about changes in profitability over time. In particular, annual cohorts prevent the entity's share of FV gains or losses on underlying items being recognised *after* the annual cohort of contracts that existed when those FV gains or losses arose has ceased to exist. The fact that the entity expects to spread the *policyholders' share* of the FV returns to policyholders over a longer period, ie the duration of the entire portfolio, does not mean it should not recognise *its share* over the life of the annual cohort of contracts to which the FV returns relate.
 - c. if the split between the entity and the policyholders as a whole can be varied at the discretion of the entity, the determination of the CSM of annual cohorts becomes subjective. But the ANC scope includes contracts that do not include that discretion. Furthermore, even in those cases where the contracts do include such discretion, an entity has to make a judgement about the expected split in order to recognise new business, irrespective of the annual cohort requirement. Thereafter, it is possible to track the CSM for each annual cohort assuming that each CSM grows at the same rate of return. The Board concluded that it is possible to apply the annual cohorts even to contracts that include that discretion and that, although based on subjective judgement, the resulting information would be useful to users of financial statements.
10. In relation to the effect of a financial guarantee (paragraph 8.b of this paper), AP2B demonstrated that even if the changes in the effect of a financial guarantee are shared with other policyholders in a portfolio, the entity still retains its share of the change.. The share that the entity retains affects the CSM of the annual cohort in which the financial guarantee belongs, and could make that annual cohort onerous without the portfolio being onerous. Without annual cohorts, the effect of the financial guarantee borne by the entity would not be apparent—it could be obfuscated by profits from other contracts in the portfolio.

ICAC proposals

The proposal and rationale given

11. The scope of the ICAC's exception is contracts that are managed under cash flow matching techniques, potentially linked to Solvency II regulatory requirements. This scope is broad. In particular, it would include contracts that:
- a. are general model contracts;

- b. do not fall in the scope of paragraphs B67-B71 of IFRS 17 (the requirements relating to contracts that share risks across policyholders in different groups); and
 - c. include long-term fixed guarantees on interest rates payable to policyholders.
12. The contracts discussed are mostly immediate and deferred annuities and life endowments with guaranteed interest rates. Entities are required by regulation to invest in assets that match the cash flows, applying cash flow matching techniques. The ICAC proposals state that entities therefore essentially only bear default risk (which is said to be low because of the types of asset that the local regulator allows the entity to invest in) and reinvestment risk caused by deviations from the expected duration of the contracts (because of early or late deaths). The proposals do not discuss reinvestment risk that would arise if the entity could not find assets with a duration as long as the insurance contracts. The proposals also state that, by applying cash flow matching techniques to the assets and liabilities at a portfolio level, there is intergenerational sharing of risk, even though the contracts do not have the features described in paragraph B67 of IFRS 17 (ie the cash flows of one contract do not affect the cash flows of another contracts).
13. The rationale for the proposed exception is that insurance contracts issued more than one year apart are backed by a single portfolio of assets. Spanish regulation requires the assets and insurance contracts to be managed together using cash flow matching techniques. Managing the assets and insurance contracts at a portfolio level allows the entity to minimise the reinvestment risk caused by deviations from the expected duration of the contracts (because of early or late deaths).
14. The ICAC proposals state that annual cohorts would not provide relevant information and would lead to financial reporting not reflecting faithfully the economic nature of the contracts. The ICAC explains that a reduced number of contracts in a group would generate more variability in the adjustments to the CSM, resulting in a greater possibility of onerous contracts and 'artificial' variability in performance. The argument seems to rely on there being a greater chance of deviating from the expected longevity in a small group such as an annual cohort, than in a large group, such as a portfolio.

Staff analysis

15. The scope of the ICAC exception is broad and, in our view, extremely difficult to enforce. The ICAC proposals link the scope to specific regulatory requirements in Spain. But it is extremely unlikely, if not impossible, that 'cash flow matching techniques' could be defined in a way that could be applied consistently internationally. It is likely that almost all insurers could use that phrase to describe their asset/liability management activities.
16. Further, the scope of the ICAC exception is unrelated to the features that AP2B identified as increasing the costs of annual cohorts or reducing the usefulness of the resulting information. It seems there is nothing about the contracts in the ICAC proposed scope that makes the annual cohort requirement harder to apply or the resulting information less useful compared to any other type of insurance contracts. Agenda Paper 2A of the March 2019 Board meeting explained why determining the

level of aggregation using asset and liability management techniques or risk management techniques would lead to an unacceptable loss of useful information.

17. Hence, if the annual cohort requirement did not apply, users of financial statements would lose critical information about:
 - a. **trends in profitability** of contracts issued in different years; and
 - b. **losses** on onerous contracts.
18. In relation to the **trend in profitability** (paragraph 17.a of this paper), the ICAC proposals state that most Spanish insurers earn an expected constant financial margin in these contracts, and that the contracts are priced consistently to achieve a stable margin. But we cannot assume that will always be the case—amounts invested from premiums at different dates (and reinvested when assets are sold at different dates) will generate different returns reflecting the different economic conditions at those dates. Annual cohorts give transparency about the resulting different margins over time.
19. In relation to **losses** on onerous contracts (paragraph 17.b of this paper), most of the risk associated with the contracts described in the ICAC proposals is financial risk. Applying the general model in IFRS 17, changes in the effects of financial risk are recognised in profit or loss or OCI when the changes occur. This means that the guaranteed interest rates in the contracts might make contracts onerous on initial recognition (which would be captured in the information in paragraph 17.a of this paper), but changes in the effect of the guarantees will not make initially profitable groups of contracts onerous—any loss arising from the guarantee will be recognised as insurance finance income or expenses. Changes that could make the contracts onerous are limited to changes in underwriting risks. But this is true for all general model contracts, and we think information about such changes is critically useful—the annual cohort requirement is essential in capturing this information.

CFO Forum proposals

The proposal and rationale given

20. The proposals from the CFO Forum are for two exceptions from the annual cohort requirement:
 - a. an exception very similar to that proposed by the ANC; and
 - b. an exception very similar to that proposed by the ICAC.
21. The rationale given for the exceptions is also very similar to that given by the ANC and the ICAC.
22. **Differences with ANC**—The key difference between the CFO Forum proposals and the ANC proposals is that the contracts captured by the exception must have cash flows that *substantially* affect or are affected by cash flows to policyholders of other contracts—but the CFO Forum proposals includes no guidance on what ‘substantially’ in this context means. The CFO Forum proposals also differ from the ANC proposals in having no requirement for the entity to have discretion over how it distributes FV

returns across policyholders, although their explanation of why the exception is needed refers to such discretion.

23. **Differences with ICAC**—The key difference between the CFO Forum proposals and the ICAC proposals is that the CFO Forum proposals include some requirements on what ‘cash flow matching techniques’ involve. However, in our opinion, assessing whether those requirements are met would involve complex and subjective judgements that would be extremely difficult to audit.

Staff analysis

24. The CFO Forum has proposed two different exceptions. Their rationale for proposing the exceptions is that the annual cohort requirement for any contracts is not aligned to the fundamentals of insurance business, but the issue is specifically relevant to the types of contract covered by the two proposed exceptions. Our analysis of each proposed exception is the same as our analysis of the ANC and ICAC proposals. Both the differences described in paragraphs 22–23 of this paper in principle would limit the scope of each exception, but both would add subjectivity and complexity to their application.

Appendix II—Additional comments on the IASB staff analysis of the proposed exception

- 1 The reasoning detailed in the cover letter similarly applies to the other arguments expressed in the IASB letter.
- 2 **According to § 7b**, “*if an entity has discretion over the way that the total policyholders’ share of the fair value (FV) returns on underlying items is distributed to individual policyholders, the determination of the CSM for annual cohorts, while complex, is objective*”.
- 3 As mentioned above, such an allocation would take place before management exercises discretion as to the timing and amount of the allocation to individual policyholders and consequently could not “objectively” reflect the legal and economic features of such contracts.
- 4 **According to § 9a**, “*AP2B demonstrated that if the split between the entity and the policyholders as a whole is specified, it does not matter how the entity determines the subsidisation between policyholders, the entity’s share is still objectively determinable*”.
- 5 [Paper AP2B](#) of February 2020 does not provide such a demonstration. It refers back to [AP2A](#) of March 2019 in which the Board examined one example of annual cohort for contracts with intergenerational sharing of risks. This conclusion however relies on a simplified assumption within the context of a portfolio in its build-up phase whereby the insurance entity would invest all the premiums from newly written contracts at current market conditions. This led to considering that “*the entity’s share of the fair value gain is created by each group*” (AP2A March 2019) and that each annual cohort generates specific returns that “belong” to the cohort. This assumption may be relevant where, for instance, the underlying assets are ring-fenced at the level of an annual cohort or lower (e.g. contract’s level). Otherwise, this assumption generally does not reflect the economic reality considering, for instance, a mature portfolio where premiums from newly written contracts may be used instead to hold the entity’s existing financial instruments over a longer period. We therefore fundamentally disagree with the conclusion that paper AP2B of February 2020 demonstrates that an objective allocation to the annual cohort is practicable under all circumstances.
- 6 This assumption is **replicated in § 9b** stating that the “*entity’s share in returns therefore depends on the contractual terms of each annual cohort and the economic conditions during the coverage period of each annual cohort. For example, a 20 per cent share in returns created by an annual cohort for which returns during the coverage period are 5 per cent is more profitable for an entity than is a 20 per cent share in returns created by an annual cohort for which returns during the coverage period are 1 per cent. Hence the annual cohort CSMs provide useful information about trends in profitability*”.
- 7 This is inconsistent with the second criterion of the ANC proposed exception whereby policyholders share the returns from a single common pool of underlying items and the profit share is determined collectively for the policyholders as a whole. In a previous [letter dated 6 May 2019](#), ANC already opposed this assumption. Based on the contractual features in the proposed exception, the entity’s contractual profit share stems from a single pool of underlying items and the policyholders’ profit share is collective so that the underlying items belong to the community of policyholders without any group having individual rights on any subset of the overall portfolio. This is also illustrated by the fact that an insurer may decide to use the premiums received from the new business to indemnify the lapse of policyholders instead of selling assets. Considering that a change in the fair value of the assets acquired with the premium paid by a group solely belongs

to this group would be equivalent to considering that the underlying items are ring-fenced on a cohort by cohort basis.

- 8 The criteria of the proposed exception therefore secure that the split between the entity and the policyholder as a whole is not objectively determinable on a cohort-by-cohort basis.
- 9 **According to § 9c**, *“the ANC scope includes contracts that do not include the discretion of an entity over the split between the entity and the policyholders as a whole”*.
- 10 Criterion 2 of the proposed exception provides that the entity exercises discretion as to the amount of profit share allocated to individual policyholders. This indeed includes, without requiring it, the discretion over how an entity shares the returns from underlying items between itself and the policyholders as a whole. Such discretion is an additional reason for an exception. However, as mentioned above, the discretion as to the timing of the allocation of the joint contractual profit share to individual policyholders is already sufficient to justify the exception.
- 11 **According to § 10**, AP2B demonstrated that even if the changes in the effect of a financial guarantee are shared with other policyholders in a portfolio, the entity still retains its share of the change. The share that the entity retains affects the CSM of the annual cohort in which the financial guarantee belongs and could make that annual cohort onerous without the portfolio being onerous.
- 12 Paper AP2B disregards the fact that, within the context of the proposed exception, the policyholders’ contractual profit share is determined collectively for the community of policyholders as a whole. As highlighted previously, the entity’s share in the returns from the underlying items can only be determined at the level of the overall portfolio of contracts that share in the returns from the common pool of underlying items.
- 13 The entity therefore does not retain a profit-share out of a single annual cohort. It retains a profit share out of the overall returns from the pool of underlying items that includes:
 - The total expected returns from the pool of underlying items
 - Minus the guaranteed benefits
 - Minus the expected discretionary benefits. The discretion is usually constrained by a minimum contractual profit share. However, whenever management expects to pay additional amounts beyond the contractual minimum, the split between the entity and the policyholders as a whole can be varied at the discretion of the entity.