

CFO Forum - Exemption from Annual Cohorts Discussion Document

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1. Introduction

The European Insurance CFO Forum (“CFO Forum”) supports the development of a high-quality standard for insurance contracts accounting and has contributed significant effort in responding to Exposure Drafts, participating in EFRAG’s testing of IFRS 17 and proposing solutions to issues identified.

Our members believe the requirement in IFRS 17 to use annual cohorts to measure the contractual service margin is not aligned to the fundamentals of insurance business. Whilst this in principle relates to all insurance contracts, the issue is specifically relevant to contracts with risk sharing between generations and contracts that are cashflow-matched over different generations.

We believe that:

- The current Exposure Draft still **does not adequately reflect the true economic nature** of insurance contracts with risk sharing between generations and contracts that are cashflow-matched over different generations (together referred to as ‘mutualisation’) and the specific nature, performance and risks of these types of contract cannot be captured under an annual cohorts measure.
- The IASB staff, in a document for the February 2020 Board Meeting, established a list of four features of contracts “that increase the costs of applying the annual cohort requirement compared to other contracts and/or reduce the usefulness of the resulting information”. The CFO Forum’s view is that mutualised contracts exhibit these features, therefore **reducing the usefulness of the reporting information and increasing the costs of compliance with reporting under the annual cohorts measure**.
- **Our proposed solution more accurately represents** the intergenerational sharing nature of these contracts and is closely aligned to the current European regulatory requirements for territories where this business is actively sold.

Therefore, to assist with the finalisation of IFRS 17, the CFO Forum has proposed revised wording in this document to reflect the principle of these changes.

2. Proposed amendments to IFRS 17

To assist with the finalisation of IFRS 17, the CFO Forum has proposed the following revised wording to reflect the principle of the changes proposed by the CFO Forum. The proposed changes to the current IFRS 17 wording (existing wording, prior to revisions to be issued by the IASB by mid-2020, which are not yet available) are in italicised underlined text below.

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

[New] 22A An entity does not have to apply paragraph 22 to contracts that fulfill the conditions of paragraphs B67 (and B68), when:

- (a) the contracts share the return of the same specified pool of underlying items; and
- (b) their cash flows substantially affect or are affected by cash flows to policyholders of other contracts. In that case, the groups of contracts shall be established as to reflect the substantial effect of their respective cash flows. This substantial effect is on the cash flows that vary based on the return mentioned in (a), including the guarantees mentioned in B67(b) if any.

[New] 22B An entity does not have to apply paragraph 22 to contracts that are managed under cash flow matching techniques that include contracts issued more than one year apart. The cash flow matching techniques applied should be consistent with the objective of having a replicating portfolio as described in B46. For these insurance contracts, a portfolio of assets with similar cash-flow characteristics as the liabilities that this support has been assigned and maintained over the life of the obligations. Significant changes to the portfolio of assets are only made for the purpose of maintaining the replication of expected cash flows between assets and liabilities where the cash flows have materially changed. The portfolio of assets and liabilities should be identified, organised and managed separately from other portfolios of the insurer and the expected asset and liability cash flows are well-matched (i.e. the expected cash flow of the assigned portfolio of assets replicate each of the expected cash flows of the group of insurance contracts in the same currency, and any mismatch does not give rise to material financial and insurance risk). In this case, groups of contracts can be established reflecting how the insurance contracts are managed through the cash flow matching techniques.

[New]109A For insurance contracts which have been grouped together using paragraphs 22A and B, an entity shall disclose a description of such groups, an explanation how the cash flows are substantially shared, how groups have been determined, the effect of the new contracts added to the existing groups, and provide the information required by paragraph 109 separately from that for other contracts.

3. Basis for conclusion

3.1 Paragraph 22A

Contracts in scope of the Paragraph 22A exemption – references to existing criteria in IFRS 17

The IFRS 17 Standard as issued in May 2017 already recognises the existence of “contracts with cash flows that affect or are affected by cash flows to policyholders of other contracts”. The relevant paragraphs are B67 to B71.

- B67 presents the characteristics of such contracts:
“B67 Some insurance contracts affect the cash flows to policyholders of other contracts by requiring:
 - (a) the policyholder to share with policyholders of other contracts the returns on the same specified pool of underlying items; and
 - (b) either:
 - (i) the policyholder to bear a reduction in their share of the returns on the underlying items because of payments to policyholders of other contracts that share in that pool, including payments arising under guarantees made to policyholders of those other contracts; or
 - (ii) policyholders of other contracts to bear a reduction in their share of returns on the underlying items because of payments to the policyholder, including payments arising from guarantees made to the policyholder.”
- B68 states that the fulfilment cash flows of contracts belonging to such a group shall:
 - (a) include payments arising from the terms of existing contracts to policyholders of contracts in other groups, regardless of whether those payments are expected to be made to current or future policyholders; and
 - (b) exclude payments to policyholders in the group that, applying (a), have been included in the fulfilment cash flows of another group.”
- An illustration of the conditions set in B67 is given in B69 with a group benefitting from a guaranteed amount, which reduces the returns of the underlying items for the policyholders of another group.
- B70 indicates that in some cases, the interaction between the cash flows may have to be calculated at a higher level than the groups and should then be allocated to those groups on “a systematic and rational basis”.
- Lastly, B71 indicates that fulfilment cash flows may include payments expected to be made to current policyholders in other groups or future policyholders. In that case, an entity is not required to continue to allocate such fulfilment cash flows to specific groups but can instead recognize and measure a liability for such fulfilment cash flows arising from all groups.

There is a common belief that these paragraphs cover the case of contracts for which an intergenerational and substantial risk sharing exists, but fall short of providing a complete solution. In

fact, annual cohorts require arbitrary allocations for contracts with discretionary cash flows where management exercises discretion as to the timing and the allocation of the policyholders' profit share to individual policyholders. This is because the discretionary cash flows are fully shared across the different generations of policyholders so that profitability is not relevant on a cohort by cohort basis.

Contracts in scope of the Paragraph 22A exemption – references to AP2B §27 of the February 2020 Board meeting

The characteristics of the contracts that would be in scope of the new paragraph 22A are as follows:

- The contracts are participating contracts, which share the same pool of underlying items. This pool is either a segregated pool of assets or identified through regulatory or contractual terms.
- The regulatory or contractual formula is usually discretionary yet provides for a minimum right to participation.
- There is an intergenerational sharing of the risks and rewards corresponding to the participation, because the return is shared between the policyholders with the same participation formula, whatever their underwriting date.
- For such contracts, the cash flows that vary based on the underlying items' return are substantial for the policyholders.
- If some contracts benefit from a guaranteed amount, then the other policyholders sharing the return of the same pool of underlying items are affected by the benefits related to that guaranteed amount. The insurer will only contribute to the guaranteed amount in the last resort, if the return of the pool is not sufficient.

Currently, these contracts are managed together for both accounting and regulatory purposes. The concept of annual cohorts is not currently applied, because it is irrelevant for the measurement of the liability corresponding to the variable return. It is also irrelevant for assessing the profitability of these contracts, which will become onerous as a whole if the global asset return does not provide for both the costs of all policyholders, and the guaranteed amount of only some of them.

In the AP2B of the February 2020 Board meeting §27, the IASB staff established a list of four features of contracts "that increase the costs of applying the annual cohort requirement compared to other contracts and/or reduce the usefulness of the resulting information":

Feature	Cost of implementation and benefit of resulting information
1. Paragraphs B67 and B68 of IFRS 17 apply and the contract shares in the same pool of underlying items as other contracts in the group. In addition, the entity has discretion over how it shares the returns from underlying items between itself and the policyholders as a whole.	Cost is potentially relatively high and the benefits of the resulting information potentially reduced.
2. The contract meets the criteria in paragraph B101 of IFRS 17. This is the scope of the variable fee approach.	Cost is potentially relatively high.

Feature	Cost of implementation and benefit of resulting information
3. If there are financial guarantees over returns on underlying items in the contract: (a) their effect is shared with other policyholders across generations; and (b) the entity's remaining share is small.	The benefits of the resulting information are potentially reduced.
4. The contract includes only small amounts of 'fixed cash flows' the effect of changes in which is not shared with other policyholders.	The benefits of the resulting information are potentially reduced.

For the contracts described above, at least 3 of these features are met, and all 4 if the contracts are in scope of the Variable Fee Approach (i.e. if conditions of B101 are met):

- All these contracts share the same pool of underlying items and paragraphs B67 (and sometimes B68) will apply;
- Most of these contracts are in scope of the Variable Fee Approach (i.e. comply with B101);
- If there are financial guarantees over returns on underlying items in the contract, their effect is substantially shared with other policyholders across generations, and the remaining exposure for the insurer is relatively small;
- These contracts include only small amounts of "fixed cash flows" not shared with other policyholders.

Whilst most contracts eligible for 22A will be in scope of the Variable Fee Approach, it may also apply to General Measurement Model contracts which have cash flows that affect or are affected by cash flows to policyholders of other contracts as per paragraphs B67-B68.

An exception based on these features would fit these particular contracts with intergenerational risk sharing (mutualisation).

3.2 Paragraph 22B

A key characteristic of the particular contracts in scope of paragraph 22B is that these contracts and the related assets are managed on a cash-flow matching basis without a distinction between generations. Cash flows on the related assets are matched with the overall portfolio of contracts, and not on an issue year basis. As such, there is intergenerational sharing in the cash-flow matching and as such we have proposed the wording in Paragraph 22B.

The criteria should be based on the existence of cash flow matching techniques with the same objective as the one described in paragraph B46.

Cash flow matching techniques are applied to different generations of insurance contracts since the same issue year might contain different profiles of ages among policyholders (e.g. annuitants) in the case of a long term annuity portfolio which consequently lead to different longevity risk exposures.

These cash flow matching groups are defined and created for the cash flows that arise from a group of insurance contracts with similar insurance (e.g. longevity) and financial risks (e.g. guaranteed

interest rates embedded in the insurance portfolios). The main objective of the cash flow matching is to exactly match in amount and timing the liabilities arising from a group of insurance contracts.

It is worth noting that those contracts do not fulfill the characteristics described in paragraph B67-B71 and are accounted for under the general measurement model. Insurance companies do not have the discretion of modifying the interest rate granted to policyholders since it is contractually guaranteed upfront.

The application of the annual cohort requirement by policy year is not in line with the mutualisation effect embedded in the cash flow matching grouping. In the context of an asset liability management strategy, in case that the cash flow matching groups had to be broken down by annual cohorts, artificial volatility in the allocation of assets to liability is expected to arise.

4. Further arguments for exemption to annual cohorts

Do annual cohorts fail to reflect intergenerational sharing of risk?

Contracts in scope of the proposed exception have cash flows that affect or are affected by cash flows to policyholders of other contracts as outlined in IFRS 17.B67-B71 or have cash flows that are matched to asset cash flows over policy generations. Relying on existing provisions of IFRS 17, the cash flows are interdependent across groups, meaning that different generations of policies share risks of changes in cash flows.

Moreover, under the contracts in scope of 22A, individual policyholders jointly share in the profits of a common pool of underlying items. This implies that no single group/generation of policyholders within the portfolio is entitled to a separable profit share in a subset of the underlying items until the benefit is individually allocated to each policyholder.

In this regard, in the February 2020 Board meeting AP2B §21 (a), the IASB “*does not expect 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 [as] 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*”.

When the sharing of returns is determined for policyholders as a whole and an allocation on a cohort by cohort basis is not objectively determinable as cash flows are shared across (existing and new) generations of policyholders, the use of annual cohorts does not provide useful information about changes in the profitability of contracts over time because profitability is not measurable at that level. As a consequence, the allocation to annual cohorts cannot “appropriately” reflect the legal and economic features of such contracts.

Do annual cohorts result in arbitrary allocations?

The proposed scope exception would apply to contracts with intergenerational mutualisation. In absence of such exception, the requirement in IFRS 17.24 otherwise arbitrarily requires the entity to allocate to each group of contracts future cash flows expected to be paid to current and future policyholders. These allocations would be totally arbitrary in the sense that if identifying the subsidization effect of the current contracts to new business is determinable and it is a fundamental principle for contracts with intergenerational risk sharing mechanism, assigning those allocations to

different groups and track these allocations overtime introduce artificial element in the performance measurement and reporting. In a low interest rates scenario, the risk is to favor pro-cycling reporting effects linked to artificial and arbitrary allocations rather than reflecting the capability of managing risks and reporting meaningful profitability trends.

On the contrary for such contracts, the CSM roll forward is a powerful tool to understand how the expected profits emerge and change over time. This is achieved through the disclosure of the impact at inception of new contracts on the existing group, as well as details on the computation of the CSM effect of new business on the groups eligible to the exception to the annual cohorts and on the detailed features of such groups meeting the exception criteria . An additional disclosure is proposed to that effect.

Are annual cohorts too costly for contracts with intergenerational sharing of risks?

Intergenerational mutualisation is a key feature of life-saving business in many European jurisdictions hence the exception would apply to a large portion of Life business for many entities.

The CFO Forum believes that the scope of the proposed exception adequately captures the characteristics of contracts for which applying the annual cohort requirement would not provide relevant information to users of the financial statements. In case such a requirement persists, complex process and IT implementation would be required to perform, track and manage over time the allocations described above, all the more since this information does not currently exist. As the CSM is calculated retrospectively, outputs will need to be stored, referenced and updated in each subsequent reporting period. In order to achieve this, projected fulfilment cash flows will need to be segmented and stored at an annual cohort level. The changes to systems and processes that are required in order to achieve this functionality require significant effort and cost.

Cash flow matching techniques – An example

This section provides further information on the nature of Spanish long-term insurance products, which would meet the criteria for exemption from annual cohorts set out in paragraph 22B.

According to local regulation and since 1999, Spanish insurance undertakings are required to apply an Asset and Liability Management (ALM) framework to manage the insurance and financial risks arising from long term savings products. Over the last twenty years these cash flow matching techniques have proven to be robust in providing a risk management tool for those undertakings offering long term guarantees to its policyholders.

The main objective of the cash flow matching techniques is to ensure the matching of the future proceeds expected from the asset cash flows to mimic the movements of the probability weighted liability cash flows, aiming at ensuring the matching of both the timing and the quantity of liability cash flows. Calculations are required to be performed in monthly buckets until the depletion of future expected liabilities of an in-force portfolio. These adequacy checks are performed and monitored on a frequent basis. External auditors perform regular reviews on the adequacy of those tests which are also reviewed by the local regulator.

In terms of the assets used for ALM techniques, typically fixed asset cash flows are used and are managed and held to maturity (mostly debt instruments and other cash assets which are classified as Available for Sale). Additionally, in certain cases also derivatives are used in order to mimic the projection of the liability cash flows based on the expected duration of those contracts. Those derivatives are not used for speculative purposes as it is not permitted by the local regulator.

In terms of the approach used for defining the grouping of the cash flow matching portfolios, insurance undertakings create asset portfolios for those insurance liability portfolios which have homogeneous insurance and financial risks. Mutualization of risks among generations is demonstrated by the following facts:

1. Insurance risks: typically, a liability portfolio within the same cash flow matching group contains policyholders with different ages, thus with different exposure to longevity risks. Given its long-term nature, longevity risk is managed through the mutualization of risk exposures within the same group.
2. Financial risks: typically, the cash flow matching group contains different levels of guaranteed interest rates, within a range. The asset portfolio is created in order to provide coverage to those rates guaranteed to policyholders. Insurance undertakings shall manage assets to ensure that the proceeds from financial assets are sufficient to pay policyholders 'benefits at any projected period of time based on the contractual obligations.

The most common life insurance product subject to cash flow matching techniques relate to life-long annuities. Probability weighted liability cash flows are estimated until those are expected to be depleted (i.e. upon death of the policyholder) based on best-estimate assumptions. Surrender benefits are also considered in the projection of liability cash flows, including the corresponding market-value adjustment, where necessary, based on the contractual terms and conditions.

These cash flow matching techniques have been the fundamental pillar in order to obtain the regulatory approval to use the Matching Adjustment under the Solvency II framework. This mechanism permits insurance undertakings to adjust the risk-free rate term structure used for the valuation of liabilities aiming at ensuring the removal of volatility of Solvency II Own Funds. Additionally, cash flow matching techniques are fundamental in order to ensure the correct level of reserves to cover future life policyholder benefits.

Based on the above-mentioned facts, substantial intergenerational risk sharing is proved and, consequently, the adoption of the annual cohort requirements would lead to artificial volatility in the allocation of assets covering liabilities. Thus, a proposal is presented to provide an exemption to insurance companies as noted above in paragraph 22B of the proposed amendment.